Kerr v. Danier Leather: an Analysis of the Difficulty to Enforce a Duty to Update Statements about the Future in the Context of Securities Regulation

by

DIEGO TRINDADE PEREIRA

A thesis submitted in conformity with the requirements
for the degree of Master of Laws

Faculty of Law

University of Toronto

© Copyright by DIEGO TRINDADE PEREIRA 2010

Kerr v. Danier Leather: an Analysis of the Difficulty to Enforce a Duty to Update Statements about the Future in the Context of Securities Regulation

Diego Trindade Pereira

Master of Laws

Faculty of Law

University of Toronto

2010

Abstract

Forecasts, predictions and opinions about the future should not be treated in the same way as hard information is treated under the Securities Act. Because this type of soft information cannot be verified in advance, the imposition of liability in respect of these statements about the future may hinder their production and have a result that is adverse to the interests of investors – who would prefer to hear management speak candidly about its thoughts on the company's future performance. This essay examines the way in which the Ontario Securities Act treats statements about the future, as well as the most important decision in this area up to the present: Kerr v. Danier Leather. It will also discuss whether there should be a duty to update predictions when the circumstances that formed the basis of these forecasts have changed significantly.

Table of Contents

1. Introduction 1

2. The importance of disclosure 2

2.1. Informational efficiency and Ackerlof's problem 2

3. The arguments for a market *without* mandatory disclosure rules 4

3.1. The market creates an environment favouring voluntary disclosure 4

3.2. Distinguishing good and bad companies 6

4. Arguments in favour of mandatory disclosure rules 8

4.1. Initial reasons 8

4.2. Additional reasons 9

4.2.1. Insider Trading 10

4.2.2. Management self-entrenchment and leverage buy-outs 12

4.2.3. Public good perspective in securities research and sensitive corporate information 13

5. Mandatory disclosure in the Province of Ontario 15

5.1. Materiality 15

5.2. Material Facts v. Material Changes 17

5.3. Continuous disclosure and forward looking information 19

5.4. Updating forward looking information 21

6. The Danier Leather Case 22

6.1. The plaintiff's arguments 23

6.2. The defendant's arguments 23

6.3. The courts' analysis 24

6.3.1. The Trial Court 24

6.3.2. The Court of Appeal 25

6.3.3. The Supreme Court 26

7. Commentary about Danier Leather in the scholarship 27

8. The common law perspective on statements about the future and the duty to update 36

9. National Policy 51-201: blurring the lines between material facts and material changes 40

9.1. National Policy 51-201 and a duty to update forecasts 42

9.2. Potential problems with a material information standard 42

10. Conclusion 44

11. Bibliography 47

11.1. Articles 47

11.2. Books 49

11.3. Cases 49

1. Introduction

The first time I read the decision *in Kerr v. Danier Leather*[1] was during my securities regulation class. I remember strongly disagreeing with the result that the Supreme Court had reached. I felt sympathy for the shareholders having lost their case against the corporation and its directors. It did not seem right that management would not be liable for having failed to update its earnings forecast after having learned about the first signs that the company would not be able to accomplish the goal set in its prospectus. At that time I thought that management ought to have been liable due to its negligence in disclosing the early signs of a drop in sales, as the company's initial public offering was still going on and the transaction had not yet closed. I also became curious as to why the Ontario Securities Act (OSA) only required the disclosure of material changes, after the receipt for the prospectus was issued. It seemed to me that all material information should have been disclosed to investors at the appropriate time, regardless of being a material fact or a material change.

Opinions change. After studying the regulation of information and the policies founding the OSA, I started to agree with the reasoning adopted by the Supreme Court. This paper will focus on the basis for this shift on my understanding of the policy choices that were in play in Danier Leather. I will start by looking at the reasons for which mandatory disclosure exists, the regulatory scheme in Ontario, and the decision in Danier Leather. Later I will discuss the differences in respect of the treatment of forward-looking

[1] [2007] 3 S.C.R. 331, 2007 SCC 44 (S.C.C.)

statements (FLIs) and other types of information the disclosure of which is required by the OSA.

2. The importance of disclosure

2.1. Informational efficiency and Ackerlof's problem

Ready access to information is a key feature of capital markets.[2] Policies and regulations exist to ensure that there is a steady flow of information available to investors. The value of a security is measured by the expectation of future income that the security will produce for the investor.[3] To make this evaluation, the investor needs to know all relevant information pertaining to the company's business. A decision to invest is a judgement about the future performance of the company issuing the stock. For this reason, investors need to know the risks to which the company is exposed before making an investment decision.[4] Because most people are risk adverse, a company with a higher risk profile will have to pay higher dividends to convince investors to purchase the company's stock. Access to information is intrinsically related to stock pricing.[5]

A properly functioning market is one that has informational efficiency.[6] This means that in an efficient market new information will be directly and quickly absorbed into the price of a security. Allocative efficiency goes hand in hand with informational efficiency. Assuming that investors are rational beings seeking their self-interest, in an efficient

---

[2] Mark R. Gillen, *Securities Regulation in Canada*, 3rd. ed. (Toronto, Ont.: Thomson Carswell, 2007) at 58-59 [Gillen].
[3] *Ibid.* at 53-54.
[4] David Johnston & Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4th. Ed. (Markham, Ont.: LexisNexis Butterworths, 2006) at 5-6 [Jonhston].
[5] Gillen, *supra* note 2 at 58-59.
[6] *Ibid.*

market funds must flow to companies with the best projects – because these companies are the ones that would issue better paying securities taking into account the relation between risk and dividend.[7] Therefore, there must be enough information in the market to enable investors to distinguish between well managed and badly managed companies.

One of the major rifts in securities scholarship relates to the way in which informational efficiency can be achieved. Confidence in the market and protection of investors' savings depend on the accuracy and availability of information. The market is gradually destroyed if investors cannot distinguish good from bad companies and are being exploited in their investment decisions.[8] Information asymmetry is different from imperfect information.[9] There is information asymmetry when one party "A" has better information which is not available to party "B", and party "A" is likely to take advantage of party "B"'s ignorance in their dealings. By contrast, imperfect information means that both parties are partly ignorant about the real value of some good or service.[10] This scenario does not lead to exploitation, but the first one could. Due to the risk of exploitation, Ackerlof observes that if the buyer is aware of this informational deficit, the buyer will require a discount on the product to reflect its lack of knowledge about the product's quality or refuse to enter the deal.[11] The pernicious consequence of this defence mechanism is that sellers with better products, in this case securities, would not be willing to sell their products at a discount and would leave the market.[12] This process

[7] Johnston, *supra* note 4 at 7.
[8] George Ackerlof, "The market for lemons: qualitative uncertainty and the market mechanism", (1970) 84 Q. J. Econ. 488.
[9] Edward Iacobucci, "On lemons and leather: liability for misrepresentations of forward-looking information in Danier Leather", (2009) 48 Can. Bus. L. J. 3 at 16 [Iacobucci].
[10] *Ibid.* at 16.
[11] Ackerlof, *supra* note 8 at 489-90.
[12] *Ibid.*

repeats itself to the point in which only products of the worst quality are being sold in the market. Ackerlof refers to it as the "lemons problem" in a reference to the automobile market in the United States.[13] Uncertainty as to the quality of a product helps bad products drive good products out of the market in the absence of means to distinguish between good and bad products. This conclusion fully applies to securities markets.

The division in securities scholarship concerns the need for and the level of government intervention in the regulation of capital markets to fix the information asymmetry problem that Ackelorf described in his article. It remains unclear which side is going to win the debate or whether the debate is "winnable". Empirical evidence is still inconclusive and some question if regulated and unregulated capital markets can be compared at all.[14] Reaching a definitive answer respecting this discussion is beyond the scope of this paper. The next few pages summarise the arguments against and in favour of mandatory disclosure as a point of departure for the analysis of the disclosure rules contained in the Ontario Securities Act.[15]

3. The arguments for a market ***without*** mandatory disclosure rules

3.1. The market creates an environment favouring voluntary disclosure

Some scholars defend the idea that no regulation is needed and the market itself provides companies with incentives to give investors an optimal level of information about

---

[13] *Ibid.*
[14] Frank H. Easterbrook & David R. Fischel "Mandatory disclosure and the protection of investors" (1984) 70 Va. L. Rev. 669 at 729-731 [Easterbrook].
[15] R.S.O. 1990, c. S-5 [OSA].

company stock.[16][17][18] Secrecy is not in the interest of managers of good companies. Competition for investment will lead managers of good companies into voluntarily disclosing all relevant information about the company including bad news.[19][20] The theory consists on the following: releasing both bad and good news enhances the credibility of management's disclosures and its ability to signal to investors that the company is well managed. If one corporation chooses to make disclosures, the others must follow suit. If a corporation keeps its silence while the competitor made its disclosures, these theorists say that the market will assume that the worst has happened to the corporation – due to the asymmetry of information and the risk of exploitation that Ackerlof described in his article. In other words, managers are forced into a natural system of continuous disclosure in order to keep attracting investors.[21]

There is evidence that disclosure pays off.[22] It decreases the company's cost of raising capital. Managers have incentives to make the affairs of the company public when the "marginal revenue" of giving out company information surpasses its "marginal cost".[23] Marginal revenue consists of the reduced cost of capital in attracting prospective new investors. Marginal costs involve all expenses relating to the certification mechanism that

[16] George J. Stigler "Public regulation of the securities market" (1963-1964) 19 Bus. Law. 721 at 730. [Stigler].
[17] George J. Benston, "Required disclosure and the stock market: an evaluation of the Securities and Exchange Act of 1934" (1973) 63 Am. Econ. Rev. 132 at 153 [Benston, "Required disclosure"]
[18] Roberta Romano, "Empowering investors: a market approach to securities regulation" (1998) 107 Yale L. J. 2359 at 2361-62 and 2373 [Romano].
[19] Easterbrook, *supra* note 14 at 674.
[20] Romano, *supra* note 18 at 2374.
[21] Easterbrook, *supra* note 14 at 675.
[22] Romano, *supra* note 18 at 2374.
[23] Benston, "Required disclosure", *supra* note 17 at 134.

allows good companies to distinguish themselves from bad companies[24]– a mechanism which is described below.

3.2. Distinguishing good and bad companies

The certification mechanism consists of a number of voluntary measures that cannot be easily copied by bad companies.[25][26] External auditors, underwriters and stock option plans are part of this certification process. Other certification mechanisms include having a high dividend payout policy and having a highly leveraged company. [27]

Good companies engage external auditors to inspect the company's books for accuracy. Auditors' reports are trustworthy because their business depends on their reputation for generating accurate statements about the financial health of companies that they inspect.[28] Underwriters perform due diligence on the company's accounts as their money and reputation are at stake while purchasing the company's securities for resale.[29] Stock option plans for senior management align the interest of managers with the interests of shareholders. Managers holding portfolios that are not diversified and that contain a significant number of company stocks are good evidence that the company has good projects. [30] These managers stand to lose large sums of money if the company does not perform well. Companies that pay high dividends will have to go back to capital markets periodically to seek further financing for new projects. Their return to the markets

---

[24] Easterbrook, *supra* note 14 at 677.
[25] *Ibid.* at 675.
[26] George J. Benston, "Required periodic disclosure under the securities acts and the proposed securities code", (1973-1974) 33 U. Miami L. Rev. 1471 at 1475 [Benston, "Required periodic disclosure"].
[27] Easterbrook, *supra* note 14 at 676.
[28] *Ibid.* at 675.
[29] *Ibid.*
[30] *Ibid.* at 676.

submits these companies to the scrutiny of new underwriters, new auditors and new investors.[31] A highly leveraged company has heightened risks of going bankrupt. Bankruptcy imposes high costs on management's reputation, careers and portfolios. [32] By issuing debt, these companies are also under the oversight of financial institutions, which have the expertise to monitor the debtor company's business to make sure that they will be paid back their loans.

Listing in a stock exchange is another certification measure. Rules of stock exchanges and competition among exchanges create an investor friendly atmosphere. Exchanges want to increase the volume of trading and to achieve that end they create rules designed to provide investors with accurate information about the companies listed in the exchange. [33][34]

For these reasons, according to scholars that support voluntary disclosure, public regulation of disclosure serves no apparent social purpose and its continued existence can only be attributed to the success of special interest groups' lobbyists.[35] Lawyers, accountants and other professionals involved in navigating complex securities legislation have an interest in keeping the regulatory scheme because it is a good source of revenue.[36] Large companies are also happy with the *status quo* because the costs of compliance make it difficult for smaller players to have access to capital markets. Fewer participants mean less competition for the same pool of capital.

---

[31] *Ibid.*
[32] *Ibid.*
[33] *Ibid.* at 689-90.
[34] Romano, *supra* note 18 at 2399.
[35] Easterbrook, *supra* note 14 at 672.
[36] *Ibid.* at 671.

4. Arguments in favour of mandatory disclosure rules

4.1. Initial reasons

In the wake of the 1930's depression, the US government used the following reasons to justify the introduction of securities laws requiring mandatory disclosure: compulsory disclosure would increase public confidence in the markets, protect investors and increase the availability and accuracy of information.[37][38]

Increasing public confidence and protecting unsophisticated investors are two sides of the same coin. Mandatory disclosure would ensure that everybody is trading with the same information. It was designed to prevent better-informed traders from taking advantage of small investors who would not have the resources to research information and to keep current with market developments. Feeling protected, small investors would be more confident in putting their resources in the stock market.[39]

However, critics of mandatory disclosure point out that there is no empirical evidence showing that levels of fraud have diminished with the introduction of mandatory disclosure laws in the United States.[40][41] Before the enactment of the securities act, a great number of small investors had put their savings in the stock market. In addition, the concern about investors being taken advantage of by professional traders ignored the fact that the market will quickly reflect newly disclosed information through the pricing

---

[37] *Ibid.* at 692-94
[38] Benston, "Required disclosure", *supra* note 17 at 137.
[39] Easterbrook, *supra* note 14 at 692.
[40] *Ibid.* at 693.
[41] Benston, "Required disclosure", *supra* note 17 at 135-36 and 151.

mechanism.[42] Uninformed investors benefit from the pricing mechanism because it quickly ensures that uninformed investors are trading on fair terms. And despite regulatory efforts, small investors will always come last as public information is more likely to reach first those who trade stocks for a living.[43][44]

It has also been pointed out that investors could protect themselves against risk, even if the information about the stocks is inaccurate, by having a diversified portfolio. Even though high-quality disclosure would provide investors with enhanced protection against unsystemic risk, this protection is *not crucial* because investors could protect themselves by holding a truly diversified portfolio of securities.[45]

The last objective of securities laws was to increase the availability and accuracy of information. This objective assumed that more information is always good. This is not necessarily true. Investors have to spend more time looking for relevant information if companies are forced to disclose too much.[46] Companies may play the system to disclose a lot of irrelevant information while keeping good information undisclosed.[47]

4.2. Additional reasons

It has been conceded that the initial reasons that justified the introduction of mandatory disclosure in the aftermath of the depression in the US may no longer survive the

[42] Easterbrook, *supra* note 14 at 694.
[43] *Ibid.*
[44] Benston, "Required disclosure", *supra* note 17 at 137.
[45] Merritt B. Fox, "Required disclosure and corporate governance" 62 Law and Contemp. Probs. 113 at 116 [Fox, "Required disclosure"]
[46] Easterbrook, *supra* note 14 at 709.
[47] *Ibid.*

scrutiny of modern law and economics scholarship.[48] However, proponents of government intervention in securities markets justify the existence of disclosure regulations on two new grounds.

The first ground relates to failures of the market in providing incentives for managers to disclose information when the interests of managers are not perfectly aligned with those of the company's shareholders.[49][50][51][52] Proponents of mandatory disclosure argue that the voluntary certification mechanisms described above do not prevent managers from acting in a self-interested way at the expense of the company or its shareholders. If disclosure is voluntary, managers may under disclose information to protect their jobs, to stifle competition when taking the company private, to make a profit on insider trading or to hide their bad performance.

The second ground relates to the public goods nature of securities research and the impact that securities analysts have had in the efficiency of capital markets.[53]

4.2.1. Insider Trading

Managers engaging in insider trading can profit of their privileged information regardless of the company's performance. They can bet against the stock by shorting the company. Those against mandatory disclosure say that shareholders may contract penalties with

---

[48] Fox, "Required disclosure", *supra* note 45 at 115.
[49] Joel Seligman, "The historical need for a mandatory disclosure system"(1983-1984) 9 J. Corp. L. 1 [Seligman].
[50] John Coffee Jr., "Market failure and the economic case for a mandatory disclosure system" (1984) 70 Va. L. Rev. 717 [Coffee Jr.].
[51] Merritt B. Fox, "Retaining mandatory securities disclosure: why issuer choice is not investor empowerment" (1999) 85 Va. L. Rev. 1335 [Fox, "Retaining mandatory"]
[52] Fox, "Required disclosure", *supra* note 45.
[53] Coffee Jr., *supra* note 50 at 722.

managers to avoid this type of behaviour. The problem is that insider trading is hard to detect and punish, especially if it would be up to private parties (the shareholders) to keep an eye on management.[54] In corporations with widely dispersed ownership, it is harder for people to get organized to oversee and sue managers. The stakes of each individual shareholder in such corporation are too small to justify the enormous effort that such oversight would require. In addition, without a duty to speak and provide the market with information, it would be impossible for public authorities to prosecute insider trading. The definition of insider trading implies a duty to speak as insider trading means trading with undisclosed information.

Securities legislation and securities policy-making presuppose that widespread insider trading is not good for the economy.[55] The reasoning behind the prohibition against insider trading is that this practice raises the cost of capital for all companies listed in the stock exchange.[56] Where insider trading is common practice, investors expect to be cheated of the real price of their stocks. For this reason, securities would be traded at a discount to reflect the investors' lack of confidence in the fairness of the system. These statements, however, have been subject to intense debate in securities scholarship about whether they are actually true. It is not within the scope of this essay to delve into that discussion. The point here is that, assuming that insider trading is harmful, mandatory disclosure assists in detecting and fighting it.

---

[54] *Ibid.* at 739.
[55] Gillen, *supra* note 2 at 361-63.
[56] This is controversial. There is an unresolved debate about whether insider trading is actually detrimental to the economy. This debate is outside of the scope of this paper. For a summary of the arguments in favour and against the prohibition of insider trading see Gillen, *supra* note 2 at 402-21.

4.2.2. Management self-entrenchment and leveraged buy-outs

Self-induced disclosure proponents say that even in secondary markets, managers have an interest in keeping full and honest continuous disclosure.[57] The reason is that managers tend to return to capital markets for additional funding after a successful IPO. With good continuous disclosure, managers help entice investors' interests in buying the company stock in the secondary market. This would drive or keep the price of the stock up and assist management in obtaining a good price should it decide to make additional public offers.

The "repeat player" theory does not take into account that managers may keep certain corporation information hidden in order to prevent hostile take-overs.[58] Public information, especially negative information, may turn the corporation into a target for a take-over bid. The result of most take-over bids is the substitution of high-level management of the target corporation. For fear of losing their jobs, managers may provide sub-optimal levels of information in order insulate themselves from the risk of a take-over bid.[59] This entrenchment strategy prevents shareholders from receiving attractive offers to transfer the ownership of the corporation. Mandatory disclosure enhances corporate performance by making it easier to get rid of bad management.

Keeping part of the information on the corporation undisclosed might also help managers curb the appearance of competing bidders in the context of a leveraged buy-out. It is obvious that in this context, external bidders do not have management's support and

---

[57] Easterbrook, *supra* note 14 at 684.
[58] Fox, "Required disclosure", *supra* note 45 at 120.
[59] Coffee Jr., *supra* note 50 at 747

would have to rely on already issued information to price and make a bid. Without the assurance that the information available is current and accurate, it would be much less likely that any one would make a bid for a corporation without the support of management. Without competition, it would be easier for managers to execute an LBO at a lower cost.[60]

4.2.3. Public good perspective in securities research and sensitive corporate information

Economic theory states that if people can free ride on the efforts of others, the goods or services that are the product of those efforts will be underprovided.[61] This is the so-called public goods problem. It happens even if free riders would be willing to pay for the good or service had they not been able to free ride on it. Information is a sort of "public good" because the first user, the person who actually pays for it, does not use up all of the information.[62] In other words, the information does not get fully consumed by the person who paid for it. Because other people can take advantage of the information without having to bear the costs of producing the information, there is an incentive not to pay for the information. If one can get it for nothing, no one would want to pay for it. As a result, the information tends to be underprovided.[63]

This is a problem that affects securities research. It is difficult for people paying for the advice of securities analysts to prevent that advice from leaking to free riders. Nevertheless, securities analysis is a thriving industry and has become essential for the

---

[60] *Ibid.* at 741.
[61] *Ibid.* at 722.
[62] *Ibid.* at 726-27.
[63] *Ibid.* at 727.

efficient functioning of capital markets.[64] Securities analysts help increase the accuracy with which information impacts the price of stocks. They compare hard data across the board based on companies' standardized filings and make recommendations on what to purchase and what to sell. In this research, they also look into relevant external factors including demographics, macroeconomic conditions and even political circumstances.

The introduction of mandatory disclosure in the United States after the great depression is perhaps the main reason for which the securities analysis industry exists as mandated disclosure created a big subsidy for securities analysts.[65] In fact, before the introduction of mandatory disclosure there were no securities analysts, as their role is understood today. This profession was only made possible by the emergence of a mandatory disclosure system. This system created an easily accessible database that greatly diminished the costs of securities research by transferring the burden of gathering information onto the issuers of securities. With lower research costs, securities analysts can cover a wider range of firms and help further increase market efficiency.[66]

Mandatory disclosure also reduces waste. It facilitates comparison of performance among companies in the same industry and prevents the duplication of efforts that would happen if each shareholder were required to research company information by himself.[67][68]

Finally, because some information may give competitors of the corporation an edge in the corporation's trade, one can safely assume that managers would not disclose all

---

[64] *Ibid.* at 729.
[65] *Ibid.* at 728.
[66] *Ibid.* at 731-32.
[67] *Ibid.* at 734.
[68] Easterbrook, *supra* note 14 at 687.

material information for fear of losing competitive advantage. If there were no mandatory disclosure, such information would not be voluntarily given.[69]

5. Mandatory disclosure in the Province of Ontario

The discussion above served to illustrate the importance of disclosure. The debate on how to achieve good disclosure, whether or not through regulation, is still unresolved in securities scholarship, but there is a consensus that disclosure is essential for the good functioning of capital markets. Despite this debate, Ontario has followed the lead of the United States and has long enacted rules requiring disclosure of corporate information. This part of the essay describes Ontario's mandatory disclosure regime before entering into a discussion on the disclosure of soft information, and in particular on the mandatory disclosure of statements about the future.

5.1. Materiality

Securities laws do not require all information relating to a corporation to be disclosed to the public. Only information that is material or relevant must be disclosed.[70][71] The test of materiality is met when the information is likely to have an impact on the price of the corporation's share.[72] If it does, the information is material.

This principle is the same in the United States and in Ontario. Both securities acts require disclosure of all material information when corporations are issuing securities to the public for the first time. Securities regulations specify the type of information that must

[69] *Ibid.* at 686.
[70] Johnston, *supra* note 4 at 148.
[71] Steven E. Bochner & Samir Bukhari, "The duty to update and disclose reform: the impact of regulation FD and current disclosure initiatives" (2001-2002) 7 Stan. J. Bus. & Fin. 225 at 227.
[72] *Supra* note 4 at 148 [Bochner].

be filed with the securities commission at this point. In Ontario, an offering document must contain all material facts pertaining to the corporation's business.[73] Note the emphasis on the word "facts". Facts refer to hard data. In other words, events that have already taken place and are certain or capable of being verified.[74] A prospectus offering is a document that looks into the past of the corporation. It contains past balance sheets and other past financial information about the company's business.

After the corporation has made its initial public offering, laws both in the US and in Ontario require continuous filing of updates of certain material information. However, the US and Ontario securities laws diverge on the way in which the updates are required.[75] US legislators have preferred to establish a schedule of events – including control transactions – that triggers the duty to file a report update (form 8k).[76] This approach provides certainty as to what must be disclosed, but it may be under inclusive in certain circumstances. Information that is material may not be made public if it does not fall within one of the categories required by the act. Due to this concern about under inclusiveness, Ontario legislators preferred to adopt a loose and broad general rule open to management's interpretation in respect of continuous and timely disclosure. [77]

---

[73] OSA, s. 56(1).

[74] Bruce A Hiler, "The SEC and the court's approach to disclosure of earnings projections, asset appraisals, and other soft information: old problems, changing views" (1986-1987) 46 Md. L. Rev. 1114 at 1115 [Hiler].

[75] Jeremy D. Fraiberg & Robert Yalden, "Kerr v. Danier Leather Inc.: disclosure, deference and the duty to update forward looking information" (2006) 43 Can. Bus. L. J. 106 at 110-11 [Fraiberg].

[76] *Ibid.*

[77] *Ibid.*

5.2. Material Facts v. Material Changes

In Ontario, after a corporation has disclosed all material facts pertaining to its business in its prospectus, the corporation must continue to provide information to investors on certain designated occasions by filling out and delivering interim financial statements, annual information forms, MD & As and so on. In addition, the corporation must make timely disclosure of any material changes that take place in its business in between the filing of these continuous disclosure forms.

Material changes are defined as "a change [or a decision to implement a change] in the business, operations or capital of the issuer [i.e. company] that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer."[78]

The distinction between material facts and material changes denotes an important policy choice. Material fact is a larger concept than material changes. The Ontario legislature preferred to limit the obligation of making timely disclosure to certain core circumstances. A change to a material fact that does not affect business, operations and capital of the company need not be disclosed. In other words, changes that are external to the company's business are not object of mandatory disclosure. In choosing this approach, the legislature tried to lessen the burden of compliance with disclosure rules imposed on management. It would be prejudicial to the interests of public to require the corporation to issue press releases with respect to facts that are external to the corporation, as it would wash down the importance of press releases. As it was

[78] OSA, s. 1(1) "material change".

previously observed, too much information is not always good. The increased and more frequent press reports would raise the costs of securities research as the analysts and the public would have to sift through a number of relatively irrelevant reports to locate the really important information. By way of example, it would be a change to a material fact if the Federal Government decided to de-regulate the telecom market and let foreign companies compete in Canada, but it would not be a material change as the de-regulation does not affect the business, the operation or the capital of current Canadian telecom operators. Therefore, there would be no need for filing a material change report on part of the telecom operator.

Compliance with timely disclosure rules requires good judgement on part of management. It is hard to tell when the obligation to disclose has crystallized. For instance, the decision to enter into a merger or to acquire a significant asset is a relevant change to the company's business and must be disclosed because it is an internal event that is likely to have an impact on the share price of the corporation. The difficulty that timely disclosure rules present is to determine at which point during the negotiations the information must be made public. If the news are released at a very early stage during the negotiations, they may entice competitors to disrupt the deal. At the same time, disclosure must be made as soon as possible in order to avoid any claims that managers, employees or other insiders were trading with privileged information. Recognizing the difficulty to which management is exposed; the OSA has provisions permitting

management to make confidential disclosure to securities authorities for a limited period, after which the information must be made widely public. [79]

5.3. Continuous disclosure and forward looking information

The benefits of disclosure have been described in relation to Ackerlof's problem. Continuous disclosure is part of a system that allows investors to make enlightened decisions about where to apply their savings. However, the benefits of disclosure become less clear when continuous disclosure rules apply to forward-looking information.

Forward-looking information is a defined term in the OSA. It means "disclosure regarding possible events, conditions or results of operations that is based on assumptions about future economic conditions and courses of action and includes future oriented financial information, with respect to prospective results of operations, financial position or cash flows that is presented either as a forecast or a projection."[80]

Traditionally, securities authorities have discouraged the publication of any information that could not be verified before hand.[81] Projections and forecasts, otherwise known as soft data, were not allowed to be included in the filings with the securities commission.[82] The reason was simple. Projections and forecasts relate to the future and are inherently uncertain. It would be difficult for the authorities to ensure the accuracy of these statements before they were rendered public.[83] There was a concern about investors being misled by placing too much emphasis on forecasts when making investment

[79] OSA s. 75(3) and (4).
[80] OSA s. 1(1) "forward-looking information".
[81] Romano, *supra* note 18 at 2379.
[82] Neil Campbell, "Compulsory disclosure of soft information" (1993) 22 Can. Bus. L. J. 321 at 323 [Campbell].
[83] *Supra* note 74 at 1118-19.

choices.[84] In the view of regulators, investors and their hired analysts could create their own projections of a company's business based on the past data published in the company's required filings. Another important issue was the liability for wrong forecasts. Even outside of the statutory context, the common law had grappled with imposing liability for predictions. For example, the torts of deceit and misrepresentation have had their application limited to enforcing misrepresented "facts" – past or present events – as compared to misrepresented predictions.[85]

This position of securities regulators was heavily criticized. [86] Arguably, the most important information that investors seek is the future earning capacity of their investments.[87] Management is in the best position to make an educated guess about the company's future as management knows everything about the operations and issues surrounding the company's business.

For this reason, regulators came under pressure to give the mandatory disclosure system some flexibility and allow the publication of that type of information. The legislator recognized the importance of such information and the difficulty of imposing liability for wrong forecasts. In 2002, when the government introduced statutory liability for secondary market disclosure in part XXIII.1 of the OSA, it also created a "safe harbour" provision in subsection 138.4(9). As long as the FLI contains cautionary language about the speculative nature of the information and has a reasonable basis for the conclusions or projections that it sets out, management will not be liable if the forecast is later proven

[84] *Ibid.* at 1116.
[85] Anthony M. Dugdale ed., *Clerk & Lindsell on Torts*, 18th ed. (London, UK: Sweet & Maxwell, 2000) at 797-98.
[86] Hiler, *supra* note 74 at 1123.
[87] *Ibid.*

wrong. Safe harbours, however, do not protect forward looking statements contained in a prospectus offering and this is, perhaps, one of the reasons for which FLIs are optional in offering documents.[88]

5.4. Updating forward looking information

The fact that safe-habours do not apply to FLIs contained in a prospectus raises an interesting question with respect to the possibility of liability for failing to update these forward-looking statements. The Supreme Court has recently decided a case concerning this issue. In *Kerr v. Danier Leather*,[89] management failed to disclose a drop in sales that could have resulted in the forecast included in its prospectus not being met.[90] Danier Leather was controversial. All three levels of court decided the case on different grounds. Danier Leather also drew a lot of academic criticism with scholars advocating for and against liability for failing to update FLIs.[91] [92] In Danier Leather, the Supreme Court held that there is no duty to update a forecast if the changes that made the forecast inaccurate were not "material changes".

---

[88] In 2004, the government confirmed the rule that FLIs do not give rise to liability if followed by cautionary language by adding s. 132.1 in part XXIII, which deals with civil liability in general – and not only in respect of the secondary market. However, s. 132.1(2) withdraws forecasts from safe harbour protection if the forecast was issued in connection to an initial public offering.

[89] Danier Leather, *supra* note 1.

[90] It should be noted that section 132.1 of the OSA was introduced in 2004. It did not exist at the time in which the facts of Danier Leather took place. It would not have made a difference in Danier Leather's case because, as previously noted, section 132.1(2) expressly excludes forecasts relating to initial public offerings from the protection afforded by the safe harbour.

[91] For a duty/liability in respect to failing to update an FLI: Anita Anand & Mary Condon, "Weather, Leather and the obligation to disclose: Kerr v. Danier Leather Inc." (2006) 44 Osgoode L. J. 727 [Anand]; Harry Underwood & Rene Sorrel, "Danier Leather Inc. and the duty to update a prospectus" (2006) 43 Can. Bus. L. J. 134 [Sorrel]; Stephane Rousseau, "Kerr v. Danier Leather Inc.: la qualité de la divulgation et le bon fonctionnement du marché de l'appel public à l'épargne mis en péril?" (2006) 40 R.J.T. 681 [Rousseau].

[92] Against a general duty/liability to/for not updating an FLI: Iacobucci, *supra* note 9; against liability, except in some specific circumstances such as IPOs and take-over bids: Fraiberg, *supra* note 75.

6. The Danier Leather Case

In 1998, management of Danier, a leather garment manufacturer and retailer, decided to take the company public. Even though the OSA did not require it, Danier included forward-looking information (FLI) in its prospectus. Management outlined what its expectations were with respect to the company's returns at the end of the fiscal year. The statements were clearly speculative in nature. They were an opinion about how well the company would perform based on the company's current economic situation.

Danier's problems started here. The final prospectus included an FLI forecasting 4.5 million dollars in net earnings at the end of the fourth quarter.[93] The commission issued receipt for the final prospectus on May 6th, 1998. On May 16th, four days before the closing of the offering, the intra-quarterly results came out. They showed a sharp decrease in sales due to unseasonable warm weather. Management decided not to disclose this information and continued selling shares of the corporation. On May 20th, day of the closing, Management remained confident that it would be able to achieve the results forecast in the prospectus. [94] However, on June 4th, it became clear to management that the first forecast was unrealistic. Sales were still lagging behind expectations. On the same day, management issued a press release with a revised net earnings forecast. It predicted net earnings of 3.735 million dollars. The revised net income was lower by 17%. Danier shares were trading at $11.65 two days before the press release. Three days after the revised forecast was made public, its shares were trading at a low of $8.25.

[93] Danier's fiscal year ended on June 27.

[94] Danier's IPO sold 6,040,000 million subordinate voting shares at $11.25 per share for total gross proceeds of $67,950,000.

Unhappy investors launched a class action on the grounds of statutory misrepresentation. In any case, despite the warm weather, Danier was almost able to meet the net earnings prediction set in the prospectus forecast. It achieved 4.416 million as a result of giving a 50% discount on the price of its garments.

6.1. The plaintiff's arguments

The plaintiffs alleged that Danier's management was liable for statutory misrepresentation because it failed to rectify the prospectus after becoming aware, on May 16th, that the forecast was misleading in view of the new circumstances. Since the forecast was included in a prospectus connected to an IPO, it would be subject to civil liability under section 130 of the OSA.

Section 130 creates a statutory regime for prospectus misrepresentation. Section 1 defines misrepresentation as an "untrue statement of material fact", or an omission to state a material fact that is required to make a statement not misleading in light of the circumstances in which it was made.[95]

6.2. The defendant's arguments

Among other defences, including the application of the business judgment rule – which is not the object of this paper – the defendants alleged that they have complied with the

[95] Section 130 was introduced in the OSA because the usual common law remedies for misrepresentation: fraud, deceit and the tort of negligent misrepresentation did not provide an adequate remedy in the context of securities litigation. Under the common law, the plaintiff has to prove reliance on the misrepresentation. This requirement presented an almost insurmountable obstacle to a successful action against the issuer and its management. It also prevented the filing of class actions for misrepresentation. Stocks are usually traded over electronic and anonymous means through brokers and other agents. It is difficult for the shareholder to prove that he had read the negligent statement and ordered the trading of his stock in reliance to that statement. Section 130 removed the plaintiff's burden of proving reliance. Proof of misrepresentation is enough to make the issuer liable.

disclosure requirements of the OSA. The OSA does not mandate disclosure of material facts or changes to material facts that are not material changes after receipt of the final prospectus. Only material changes have to be disclosed. Compliance with sections 1, 56,[96] 57 and 75[97] could not imply violation of section 130 of the OSA.[98]

6.3. The courts' analysis

6.3.1. The Trial Court

The trial court rejected the defendants' reading of the OSA and adopted a purposive interpretation. It took former National Policy 48 as a point of reference to the spirit of the OSA and analyzed whether the forecast qualified as misrepresentation. National Policy 48 advocated a larger obligation to disclose that included the publication of changes to any material information.

The trial court held that a forecast can be a "fact" and can be "material".[99] It is "fact" with respect to the way in which the predictions were made, not with respect to the actual results – which may vary and not give rise to any liability.[100] In the trial court's opinion, even though a forecast is a statement about the future, it contains implied assertions of

---

[96] Section 56 of the OSA requires that a prospectus provide full, true and plain disclosure of all material facts relating to the securities to be issued in the distribution.

[97] The obligations of timely disclosure are set out in section 75 of the OSA. Reporting issuers must make public any "material change" in the affairs of the issuer within 10 days after the change takes place. Section 57 also requires disclosure of any material adverse changes that occurred after the filing of a preliminary prospectus, but before the issuance of the receipt for the final prospectus.

[98] The safe harbour provision [OSA s. 138.4 (9)] did not exist at the time in which Danier made its initial public offering. In fact, there was no statutory liability scheme with respect to secondary market disclosure at that time. In any event, even if it existed, section 138.4(10) clearly excludes from the safe harbour any FLI filed with prospectus during an initial public offering.

[99] *Kerr v. Danier Leather*, 2001 CanLII 28392 (ON S.C.)

[100] At paragraph 77, the judge wrote: "A forecast is not an untrue statement of material fact if the results were not achieved; rather, a forecast is an untrue statement of material fact if any of the factual ssertions implied in the forecast are untrue."

fact upon which the forecast is based. Investors relying on the forecast may reasonably assume that the forecast is management's best judgment about the company's future; that the forecast was made with reasonable diligence and care; and that management is not aware of any facts that could undermine the accuracy of the forecast. A forecast is also material because it may have an effect on the price or value of the securities being traded.

Being a fact and material, failure to update a forecast clearly falls within the scope of section 130 of the OSA. As of May 20th, management was aware of facts that could undermine the accuracy of the forecast. Under these circumstances, the forecast was untrue and under the OSA, misrepresentations include omissions to state material facts that would be necessary to make a statement not misleading. "Silence amounts to an assertion that the statement continues to be true".[101] For this reason, the court found the defendants liable.

6.3.2. The Court of Appeal

The Court of Appeal disagreed with the trial judge's conclusions and dismissed the plaintiffs' action. For the Court of Appeal, the trial judge created an obligation that did not exist in the Act: the duty to update material facts after the issuance of the receipt for the final prospectus.[102]

After reviewing sections 56, 57 and 75 of the OSA, the Court of Appeal concluded that representations with respect to material facts need only be accurate as of the date in which the final receipt is issued. Any post-receipt variation of material facts, that are not

---

[101] *Ibid.* at para. 94.
[102] *Kerr v. Danier Leather*, 2006 CanLII 32595 (ON C.A.)

material changes, need not be disclosed.[103] Part XV constitutes a complete code of prospectus disclosure apart from section 130. Section 130 belongs to the remedies part of the OSA and does not impose additional disclosure obligations. The language employed in section 57 only requires disclosure of material adverse changes. Material changes are narrowly defined in the OSA, as it was pointed above. Both the trial judge and the Court of Appeal agreed that warm weather is not a material change. It is a change to a material fact.

Danier's final receipt was issued on May 6th. As of that date, the assertions of fact implied in the forecast were still true. Management was not aware of any facts that would have changed the forecast. When the fact did arise, on May 16th, Management was not under the duty to disclose the variation. In the absence of this duty, the defendants could not be liable for misrepresentation, even if the forecast was not accurate at the date of closing, May 20th.[104]

The Court of Appeal further stated that the forecast did not carry an implied representation of objective reasonableness. It held that this is a matter of fact, not of law, and that the trial judge ruled on the representation as if it was a matter of law.

6.3.3. The Supreme Court

The Supreme Court agreed with the reasons given at the Court of Appeal with respect to Part XV of the OSA being a complete code of disclosure for distribution under a

[103] *Ibid.* at paras. 79-80.

[104] The Court of Appeal also discussed the application of the business judgment rule to the disclosure provisions of the OSA. It was a novel approach that was not well received in the legal community. The Supreme Court dismissed it and stated that disclosure is a matter of legal duty and not of business convenience. Because the Supreme Court foreclosed the application of the business judgment rule in the context of disclosure, this approach will not be discussed in this paper.

prospectus. [105] It held that compliance with sections 56 and 57 of the OSA shielded the defendants from liability under section 130. The distinction between material facts and material changes was a matter of legislative choice with which the Supreme Court would not interfere.

The appellants further argued that the lower courts erred in failing to find that the poor intra-quarterly results constituted a material change. The Supreme Court rejected that argument by making a distinction between “operations” and “results of operations”. The poor intra quarterly results were due to warm weather, a factor that is external to the corporation.

The Supreme Court reversed the Court of Appeal decision with respect to the implied representation of reasonableness. The forecast contained many statements with respect to its reasonableness. An auditor report confirmed these statements. Therefore, investors were entitled to believe that the forecast was based on assumptions that other people in the industry would consider reasonable.

7. Commentary about Danier Leather in the scholarship

Anita Anand and Mary Condon disagreed with the position taken by the Court of Appeal, which was later in part upheld by the Supreme Court after their article was published.[106] First, they argued that the events that triggered management's revision of its forecast were indeed a material change rather than a change to a material fact.[107] In their opinion, “results of operations” should have been read into the term “operations” in connection to

---

[105] Danier Leather, *supra* note 1 at paras 4-5.
[106] Anand, *supra* note 91.
[107] *Ibid.* at 729 and 730-33.

the statutory definition of "material changes". What should matter is the impact or the result of the change in the company's business, independently of where the change came from. In addition, they argued that the protection afforded to investors by the OSA is fundamentally undermined if investors are not provided with material information regardless of whether the information is a "fact" or a "change".[108]

Their basic argument is that the Court of Appeal's interpretation of OSA is unprincipled. Depending on the cause of the event, it will be a material fact or a material change, irrespective of the importance of the event from the perspective of shareholders. This approach would bring uncertainty and inconsistency on the enforcement of disclosure rules. In their view, "had the cause of Danier's poor sales results been a strike, the event would have been disclosable". [109] This would go against the logic that underlies the OSA which "is to give investors relevant information to make good investment decisions" and for this reason the results matter more than what caused them. Based on this policy objective, the court should have read "results of operations" into "operations" as part of the definition of material changes. [110] Disclosure requirements should be interpreted taking into account the utility of the information to the investor. In fact, the information disclosed in a prospectus should not become stale or inaccurate before investors actually purchased the securities, that is, before investors rely on the information. [111] For Anand and Condon, this is consistent with common law duties imposed on representors, as information is required to be accurate as of the day of reliance. [112]

[108] *Ibid.* at 729.
[109] *Ibid.* at 731.
[110] *Ibid.* at 733.
[111] *Ibid.* at 734.
[112] *Ibid.*

Another argument that militates in favour of a duty to fully update a prospectus, including material facts, until the day of closing is that such duty would be enforced for a very brief period. [113] Usually, during initial public offerings, the transaction is closed within two weeks of the issuance of the receipt for the final prospectus. Anand and Condon believe that creating a duty to update any material fact for these two weeks would not impose an undue burden on issuers, who could easily monitor any changes to the prospectus during this period – when investors are still making up their minds about purchasing the company's securities.

In support of this expanded duty, Anita and Condon cite National Policy 51-201 that somewhat blurs the distinction between material fact and material change and required timely disclosure of all material information. Both argue that unsophisticated investors will tend to not be aware of the technical distinctions between material facts and changes in a situation just as the one found in Danier Leather.[114]

Yalberg and Fraiberg[115] also ask whether there should be a duty to update a forecast under securities laws. In their view, forecasts should not have to be updated, with the exception of few time-limited circumstances in which the update would be appropriate. For Yalberg and Fraiberg, creating a general duty to update forecasts would have deleterious effects from the investors' perspective. [116] If this type of information is optional, a duty to update this information followed by some kind of liability would lead to a disclosure chill. Nobody would run the risk of releasing forward-looking information

[113] *Ibid.*
[114] *Ibid* at 735.
[115] Fraiberg, *supra* note 75.
[116] *Ibid.* at 121-22.

for fear of liability.[117] They also criticize the fact that a "material information" standard of disclosure would increase the costs of continuous monitoring and rectifying the FLI.[118] Yalberg and Fraiberg observe that the legislation has already established the appropriate level of liability concerning FLIs with the introduction of "safe harbour" provisions in the OSA.[119] Compliance with safe harbour provisions ensure that the investors will have an accurate forecast at the time of its publication that also includes a detailed explanation of the facts that may lead to the forecast not turning into reality. Finally, they cite fear of loss of reputation as a strong incentive for issuers to voluntarily update FLIs, even if they are shielded from liability by way of a safe harbour.[120]

At the same time, however, Yalberg and Fraiberg advocate for a time-limited duty to update forecasts during distribution periods.[121] This is similar to the opinion defended by Anand and Condon. This duty would ignore the boundaries established by the material fact/material change dichotomy and would apply to changes to any material information. Yalberg and Fraiberg argue that it is reasonable to require that issuers update these forecasts for a short time span due to the heightened level of reliance that investors place on these statements during the distribution period.[122] This is the "sales pitch" argument. The vendor is trying to sell you a product and creating expectations about its future performance. Therefore, during the time at which the sale is occurring the vendor should make sure to convey all information concerning the product, including any change of expectations, to allow the purchaser to make an enlightened decision.

---

[117] *Ibid.* at 119.
[118] *Ibid.*
[119] *Ibid.* at 120.
[120] *Ibid.* at 121.
[121] *Ibid.* at 121-22.
[122] *Ibid.* at 122.

Outside of the distribution period, Yalberg and Fraiberg believe that the dichotomy should still exist.[123] The adoption of the distinction between material fact and material changes was based on solid policy reasons. First, it would not be sensible to impose on issuers the burden of interpreting and disclosing the effects of all political, economic or social affairs on the business of the company. This is the "too much information" argument, as mentioned before.[124] Second, if all material facts must be disclosed at all times, information that is part of corporate strategy would have to be disclosed at an early stage and would probably prejudice negotiations of important transactions, as competitors would try to interfere with the transaction before the deal becomes a firm agreement.[125]

Yalberg and Fraiberg also observe that due to the intrinsic fluidity of the intra-quarterly results, or earnings forecasts, it is better not to conceive them as part of material changes.[126] It is better to have the cause of the change of earnings results be a material change than the results themselves. The cause of poor results, if it affects the business, operations or capital of the company should be disclosed, but not a change in the results themselves. If the cause affects business, capital or operations it may have a lasting effect that must be disclosed. Variations in earning results, however, may not be permanent and may change as Danier Leather clearly exemplifies. Having to disclose these variations every time they happen may open the door to litigation against management for what, in

[123] *Ibid.* at 121-22.
[124] *Ibid.* at 110.
[125] *Ibid.*
[126] *Ibid.* at 116.

the end, may not constitute a poor result.[127] It is equivalent to imposing liability for failing to predict the future.

Stephane Rousseau believes that the objectives of securities regulation will be best served if investors have the assurance that the information contained in a prospectus, including an FLI, has not become stale as of the date in which the transaction is closed.[128] However, he concedes that the board of directors of the issuer should not become the insurer of investors against vicissitudes of the market. For this reason, Rousseau argues that liability for forward-looking information be followed by a director's defence of reasonable diligence.[129]

Rousseau believes that differences between secondary and primary markets justify a blurring of the line distinguishing material facts from material changes.[130] On this point, he seems to share the opinion of Yalberg, Fraiberg, Anand and Condon. He argues that in primary markets there is more informational asymmetry than in secondary markets and if investors do not have absolute confidence that they are being given accurate and up-to-date information, the costs of raising capital will go up as a result. [131] Investors will demand a discount on the shares they purchase because they are not sure about the value of what they are acquiring. The heightened information asymmetry is largely due to the absence of external sources of information other than the issuer in primary markets.[132] Companies going public have not been followed by the financial press, by securities

[127] *Ibid.*
[128] Rousseau, *supra* note 91 at 682.
[129] *Ibid.* at 683.
[130] *Ibid.* at 692.
[131] *Ibid.* at 692-94
[132] *Ibid.* at 693.

analysts or have been submitted to the scrutiny of institutional investors. [133] Also, in the primary market management employs sales efforts to promote the company's securities, including road shows with underwriters.[134] This raises the opportunity for abuse and for "generous claims" about the future performance of the stock. In addition, from an economic perspective, it would be better to avoid the principle of "buyer beware" because it would be essentially a waste of resources. The issuer, who is the party with better access to information, should provide it to the shareholders to avoid duplication of efforts, even if the issuer has to incur the cost of a second due diligence on the day of closing.[135]

Setting aside Underwood and Sorell's [136] discussion of the application of the business judgement rule in the context of mandatory disclosure, as the Supreme Court clearly shut the door on that possibility, their article revolves around the consistency of common law misrepresentation rules and the objective of the OSA, namely, the protection of investors.

Underwood and Sorrell criticise the Court of Appeal decision by noting that a duty to correct a statement that has been rendered misleading to the knowledge of the representor is consistent with the wide objectives of the OSA and could have been read into the Act.[137] Silence with respect to changed circumstances would be equivalent to an affirmative assertion that nothing has changed.[138] And if at the time of reliance the statement is no longer true, that statement is a misrepresentation and liability should

[133] *Ibid.* at 693.
[134] *Ibid.* at 694.
[135] *Ibid.* at 695.
[136] Sorrel, *supra* note 91.
[137] *Ibid.* at 144.
[138] *Ibid.*

follow.[139] The fact that the statement was about the future does not eliminate the assumption that it was made with reasonable care and skill and that the same care and skill should be used to correct that statement if the circumstances upon which it was based no longer exist. In Underwood and Sorrell's opinion, s. 57(1) of the OSA does not prevent the application of a "common law" duty to correct an existing statement.[140] There is a difference, in their view, between a duty to disclose a new fact and a duty to fix a past statement. New facts need not be disclosed if they are not material changes. However, an already disclosed statement should not remain uncorrected if the statement has become stale. The duties are different and should not have been confused. "In the absence of a forecast contained in the prospectus, (...) there may be no duty to disclose the fact that the weather conditions are affecting the sales",[141] even if they are material. However, the same reasoning cannot apply once a forecast has been released and the sales results make the prediction unlikely to come true.

Iacobucci focuses on the level of liability that should be ascribed to the issuer for failing to update a forecast.[142] He observes that issuers and shareholders have common interests in respect to liability standards. Taking a contractual view of the relationship between issuers and shareholders, he asserts that both parties would enter into private arrangements to maximize the value of their relationship, and through these arrangements they would reach an appropriate level of liability. [143] Using the signalling theory, Iacobucci argues that issuers want to be subject to liability as means of proving the

---

[139] *Ibid.*
[140] *Ibid.* at 145.
[141] *Ibid.*
[142] Iacobucci, *supra* note 9.
[143] *Ibid.* at 4-5.

quality of their securities to prospective investors. [144] The higher the level of liability to which issuers expose themselves, the more confidence they signal to investors about the quality of the securities being offered. This would reflect on the price discount on the securities that investors would demand, if management were not voluntarily guaranteeing the value of the securities by making binding representations. In his opinion, courts should give deference to legal disclaimers by the issuer, who would be in a better position to evaluate the level of risk that it would be prepared to assume.[145]

Iacobucci also notes that while a certain degree of liability is desirable, too much liability for misleading disclosure may hinder the objectives of mandatory disclosure: good firms would be too cautious in their statements for fear of large financial penalties. [146] Wrongful enforcement is just as bad as too much liability. Hindsight bias, especially in relation to forward-looking statements, would be a real threat to those who dare to forecast the performance of their companies, which would in turn lead again to conservative forecasts.[147] Lower levels of liability would also be counterproductive. It would enable bad firms to easily mimic signals of good firms, because bad firms would prefer to take the risk of being caught than to forgo the opportunity of getting "easy" capital by passing off as a good company.[148]

For Iacobucci, policy makers have to take into account, when striking the balance with respect to liability for an FLI, certain facts: first, it is the issuer who bears the costs of asymmetrical information as investors will demand a discount to purchase the issuer's

---

[144] *Ibid.* at 18-19.
[145] *Ibid.* at 23.
[146] *Ibid.* at 20-21.
[147] *Ibid.*
[148] *Ibid.*

securities;[149] second, the issuer has incentives to voluntary increase its liability by way of contract;[150] third, given the additional uncertainty that surrounds FLIs, a high standard of liability may have more adverse impacts on the accuracy of the FLI than it would have with respect to the disclosure of past events. Past events are certain and can be easily verified. FLIs are inherently uncertain. Consequently, FLIs would result in being too conservative as means of avoiding liability – as no one can predict the future.[151] In this regard, Iacobucci is against an one-size-fits-all mandatory regime for FLIs as issuers are in a better position to judge the likelihood of achieving the forecasts stated in their FLIs.[152] In the end, Iacobucci praises the Danier Leather decision because by restricting the obligation to update to material changes, the Supreme Court created room for issuers to tailor the level of liability to which they want to be exposed when issuing an FLI in respect of material facts.[153]

8. The common law perspective on statements about the future and the duty to update

There are significant differences between the common law and the rules of the OSA in connection to a number of issues. The OSA requires the compulsory disclosure of business information on specific dates and on a continuous basis. The common law does not impose a similar obligation. By way of the torts of deceit and negligent misrepresentation, the common law is interested in protecting reasonable and justified

[149] *Ibid.* at 22.
[150] *Ibid.* at 23.
[151] *Ibid.* at 24.
[152] *Ibid.*
[153] *Ibid.* at 28.

reliance.[154][155] The statutory cause of action for misrepresentation under the OSA does not require actual reliance. Wronged plaintiffs may sue for statutory misrepresentation irrespective of actually having relied on the misrepresentation at the time they invested in the company. The OSA is primarily concerned with the availability of good information and the protection investor's confidence in the general market.

While the objectives of the statute and the common law may be different, they both converge on their treatment of statements about the future and for this reason an analogy can be drawn between statute and common law on this point.

The reason for this convergence in treatment is that both the statute and the common law are subject to the same constraint: it is impossible to verify the accuracy of forecasts at the time in which they were made. This fact imposes a limit on the common law and the statute's ability to hold someone liable for these types of statements. Under the statute, this impossibility prevents the law from imposing a high level of liability for wrong forecasts. If that were the case, the forecasts would be too conservative or would not be issued at all as a way to avoid liability. Under the common law, a forecast cannot ground an action for misrepresentation or deceit because a statement about the future is neither true nor false.[156] [157] However, under the common law, even though a forecast is not

---

[154] Allen M. Linden, *Canadian Tort Law*, 7th. ed. (Markham, Ont.: Butterworths, 2001) at 431-432 [Linden]

[155] The modern Canadian law of negligent misrepresentation was set out by J. Iacobucci in *Queen v. Cognos*, [1993] 1 S.C.R. 87 [Cognos]. In addition to reasonable and justified reliance, the plaintiff must show that he or she had a "special relationship" with the person making the statement. This is a test of proximity designed to avoid the problem of pure economic loss. To be successful, the plantiff's action must also demonstrate that misleading, made negligently and that the he or she detrimentally relied on the statement.

[156] In *Cognos,* the defendant argued several authorities in support of the conclusion that statements about the future are not actionable under the tort of negligence. Justice Iacobucci acknowledged these precedents, and implicitly approved these authorities as he continued the reasons for his judgment without criticizing

actionable for failing to become reality, the person who made the forecast could still be liable if she did not employ reasonable care and skill in the preparation of the forecast or if she did not honestly believe in it when it was made.[158] The safe harbour provision of the OSA has roughly similar requirements as the common law on this point, but with an additional obligation: that there be a disclaimer about the factors that may vary the actual results in relation to the results anticipated by the forecast.

The fact that forecasts are not actionable for being wrong and that tort law imposes liability only for the ***way*** in which these forecasts were made has an important consequence in connection to a possible duty to update forecasts.

Underwood and Sorrell are correct in stating that silence with respect to changed circumstances may be equivalent to a representation that nothing has changed.[159] And where such implied representation exists, a duty to update a previous representation may arise when circumstances have actually changed.[160] However, Underwood and Sorrell failed to notice an important nuance here. This principle has been applied in respect of representations made in the course of negotiations leading to a contract, usually a contract of services or sale, where a representation about the present may be deemed a

---

them. He did not specifically decide on this point because the relevant representations in *Cognos* were about an existing fact.

[157] *Williams v. School District No. 63 (Saanich)*, 1986 CarswellBC 699; 37 C.C.L.T. 203, 11 C.C.E.L. 233 (B.C.S.C.) at paras. 32-33; *Datile Financial Corp. v. Royal Trust Corp. of Canada*, (1991), 5 O.R. (3d) 358 (Gen. Div.) at paras. 54-56; *Foster Advertising Ltd. v. Keenberg* (1987), 38 C.C.L.T. 309 (Man. C.A.) at paras. 2-17 and para. 51; and *Andronyk v. Williams* (1985), 35 C.C.L.T. 38 (Man. C.A.) at paras. 53-59 – these are the decisions that J. Iacobucci mentioned in *Cognos*..

[158] G.H.L. Fridman, *The law of torts in Canada* 2nd. ed. (Toronto, Ont.: Carswell, 2002) at 613 [Fridman]: "if an opinion as to future events is given, however, the representor is obliged to exercise reasonable care in checking the facts on which the opinion is based."

[159] Sorrel, *supra* note 91 at 144.

[160] Linden, *supra* note 154 at 429: "Obligations to inform may likewise arise upon the happening of future contingencies. Thus, where a statement is true at the time it is made, but later becomes untrue in circumstances

continuing representation.[161] In Danier, there was a representation about the future followed by implied representations of fact respecting the way in which the forecast was made. In addition, the forecast was accompanied by nugatory language that made it clear that the forecast was just a snapshot of the company's prospect at the time in which it was issued. The Supreme Court gave full effect to these disclaimers.[162]

But even if such nugatory language did not exist, it is argued that under the common law the implied representations underlying the forecast could not be interpreted as continuing representations as Underwood and Sorrell postulated.[163] The jurisprudence with respect to "continuing representations" applies to *express representations* about a current state of affairs.[164] It has not been possible to find any case law interpreting "implied representations that accompany predictions or forecasts" as "continuing representations" – in other words, as implied representations against facts that arose *after* the statement about the future was made.[165]

In refusing to impose a general duty to update forecasts, the Supreme Court of Canada interpreted the OSA in a way that is consistent with the common law tort of misrepresentation. The common law and the OSA may have different objectives and methods, but in respect to statements about the future, they face the same problem and have employed similar solutions.

[161] See Cognos, *supra* note 155; see also *With v O'Flanagan* [1936] Ch. 575 [With].
[162] Cognos, *supra* note 155 at paras. 49-51, in especial para. 51.
[163] Sorrel, *supra* note 91 at 144.
[164] Cognos, *supra* note 155; With, *supra* note 161.
[165] *Esso Petroleum Co. v. Marden*, [1976] Q.B. 801 [Marden] has been referred to in Sorrel's article (p. 138). However, Marden is different from Danier in that Esso's forecast was unreasonable as of the date in which it was represented to Marden. In Danier, the forecast was reasonable on the date in which it was issued – only subsequent events made the forecast unreliable.

9. National Policy 51-201: blurring the lines between material facts and material changes

In *Pezim v. British Columbia (Superintendent of Brokers)*,[166] Iacobucci J. wrote that while national policies cannot be elevated to the statute of law, considerable deference should be given to securities administrators with respect to what a material change meant.[167] The case was heard on appeal from a decision of the Court of Appeal of British Columbia that established a clear-cut line between the definitions of material fact and material changes. The Supreme Court decision was against the statements contained in National Policy 40, which clearly indicated the desire of securities regulators to shift to a "material information" standard – one that would include not only material facts, but also material changes.[168] The Supreme Court recognized that securities authorities could not override the law by issuing policies; however, it also conceded that due to the specialized expertise of the securities commissions the courts should respect the interpretation employed by regulators with respect to what material changes are.

With the introduction of National Policy 51-201, there is evidence that the regulators kept an expansive view of the definition of material changes. This policy came about at the time in which Danier was finding its way to the Supreme Court. While the material fact, material change duality was acknowledged in view of the decision in *Pezim*, the

---

[166] [1994] 2 S.C.R. 557 (S.C.C.) [Pezim]
[167] *Ibid.* at 596.
[168] National Policy 40, para. B.

new policy suggests that issuers should shy away from a bright line standard or test to determine the materiality of information in connection with its timely disclosure.[169]

The new national policy encourages companies to monitor the market reaction to information that is publicly disclosed. This monitoring would assist management in determining the standard of disclosure of new information. The standards of materiality would vary depending on the particular circumstances of the company including its size, nature of operations, volatility of the market and other factors. The policy stressed out the importance of not taking an overly technical approach to disclosure and suggested that companies err in the side of disclosure when in doubt.

In section 4.4, National Policy 51-201 advises companies to disclose the impact of economic, social and political events even if they are external to the company's business, operations or capital structure. If an event, albeit external, has had a direct effect on the business and affairs of the company that is both material and uncharacteristic of the effect generally experienced by other companies in the same line of business, the company should disclose the impact. This is clear evidence of a liberal approach in respect to the division between material facts and material changes.

In addition, the same policy also states that securities authorities will administratively enforce the "material information" standard set out by TSX rules. Material information includes both material facts and material changes relating to the business and affairs of the company.

---

[169] National Policy 51-201, s. 4.2.

It is interesting to note the reference to administrative procedure. Because policy cannot override law, breach of TSX standards could only give rise to an administrative penalty. Arguably, it could not found an action for misrepresentation under the statute, under the authority of *Pezim.*

9.1. National Policy 51-201 and a duty to update forecasts

By enforcing a material information standard, as prescribed by stock exchange rules, National Policy 51-201 indicates that securities authorities could potentially punish administratively a company that failed to update a forecast, if the information to be updated could materially affect the price of the company's stock once the update is made public.

Since a material information standard comprises of both material facts and material changes, on the facts of Danier, the company and its management could have received administrative sanctions for not having informed the market of the risks that warm weather represented to achieving the results anticipated in the forecast. Under the material information standard, the drop in sales as a result of warm weather would have to be disclosed despite management's honest belief, on May 20th, that it could still achieve the expected results until the end of the term.

9.2. Potential problems with a material information standard

Despite the opinions and the National Policy favouring the adoption of a "material information" standard for timely disclosure, there are good reasons that favour the continued existence of material fact/material change dichotomy.

A more rigorous disclosure standard would lead to an increased fear of liability that could result in over disclosure. As previously said, too much information augments the costs of securities research and washes down the importance of the company's press releases. Companies could also play the market by including a lot of meaningless information to hide more important news in the midst of voluminous press releases.

In respect to FLIs, a material information standard would further discourage the issuance of forecasts. Because this type of information is optional, managers would prefer to either release conservative forecasts or not issue these documents at all.

The duty to keep monitoring the industry and current events would increase the costs of being a public company. It would diverge managements time from running business into making sure that the company is compliant with the law.

Some authors have indicated that a "material information standard" would be necessary to protect the savings of unsophisticated investors in the context of an IPO. These investors would not be aware of the nuances between material facts and material changes and could be misled. This argument loses is not compelling. Most investors during an IPO are institutional and have teams of lawyers, accountants and market analysts to help them make decisions to invest. Underwriters and issuers in road shows target investors that have the means to buy large blocks of shares and not the individual retail investor who buys a limited number of stocks.

Bearing in mind the problems that enforcement of a material information standard would bring, the division between "material fact" and "material change" does not sound unprincipled as some have pointed out. It is clear that the distinction does leave out

certain categories of information that could arguably be important from the perspective of investors. But this is a conscious trade-off that the legislators chose when they enacted the OSA. They could have chosen a material information standard, but chose not to in view of the burden that such a standard would impose on issuers and the impact that it would have in diminishing the importance of press releases and on the costs of gathering relevant information.

10. Conclusion

Disclosure plays a pivotal role in capital markets. It allows investors to separate wheat from chaff. Despite the important doctrinal debate whether mandatory disclosure is needed, there is a consensus with respect to the need for disclosure of company information in general.

Once securities authorities have allowed the disclosure of soft information, that is, information that is not verifiable before hand, the rules with respect to liability created some novel difficulties for the enforcement of securities laws. The disclosure of hard data is not as risky, from a litigation perspective, as the disclosure of soft information. Management has the means to ensure that hard data is correct, by employing competent accountants and other professionals to verify the information before it is released to the market. But with soft information the situation is different. Because it is just an opinion about events to come, it may turn out to be wrong even if grounded on solid past data. This makes it hard for a company to manage its litigation risk. The introduction of safe harbours with respect to disclosures contained in documents other than a prospectus

connected to an IPO is an attempt of the OSA to encourage companies to make these disclosures in a candid way, without fear of liability.

Because of the high level of reliance that shareholders place in prospectus connected to an initial public offer, and because there is very little information in the market with respect to the company that is going public, the OSA did not extend the benefit of the safe harbour to this type of prospectus. However, at the same time, it made FLIs optional in these circumstances. Any inaccuracy in these FLIs could lead to an action for misrepresentation.

The OSA also limited the duty to update previously issued statements to circumstances where a material change took place. There is no need to update a statement that is not object of a material change. This is a balance that the OSA has struck in view of need for information and the burden that it would impose on the company issuing the information.

Advocates of a time-limited duty to update forecasts during distribution periods forget that FLIs are an optional part of a prospectus. If liability is imposed, two situations may happen: there will be no more FLIs included in a prospectus or FLIs will be too conservative to serve any useful purpose for the investor.

In addition, hindsight bias can interfere in the analysis of whether the forecast was properly updated, if such a duty to update in enshrined in the law.

After acknowledging the differences between the common law and OSA, it is interesting to notice that not even the common law imposes a duty to update forecasts. Statements about the future are beyond the scope of the law of misrepresentation and deceit.

Liability can only arise for the way in which the statements were made, but not for the statements themselves. Under very limited circumstances, the common law may impose a duty to update a statement, but this duty only exists in relation to past or present representations that are deemed continuous representations. This is not the case of the implied representations that underlie a forecast.

In essence, Danier Leather is a good decision. It respected the limits and policy choices that the Ontario legislator has made with respect to prospectus liability. FLIs are different from hard data and should be treated differently as well. Safe harbours exist to account for this differentiated treatment in any context other than an IPO. The exclusion of safe harbours from initial public offerings is evidence that the legislator understands that FLIs are used as sales instruments in these contexts. The limited duty to update an FLI only when material changes occur is a compromise that the legislator created in view of the heightened reliance that shareholders place in initial public offerings on the company's prospectus information.

11. Bibliography

11.1. Articles

Anita Anand & Mary Condon, "Weather, Leather, and the obligation to disclose: Kerr v. Danier Leather Inc." (2006) 44 Osgoode Hall L. J. 727

Bruce A. Hiler, "The SEC and the court's approach to disclosure of earnings projections, asset appraisals, and other soft information: old problems, changing views" (1986-1987) 46 Md. L. Rev. 1114

Edward Iacobucci, "On lemons and leather: liability for misrepresentations of forward-looking information in Danier Leather", (2009) 48 Can. Bus. L. J. 3

Frank H. Easterbrook & David R. Fischel, "Mandatory disclosure and the protection of investors" (1984) 70 Va. L. Rev. 669.

George J. Stigler, "Public regulation of the securities market" (1963-1964) 19 Bus. Law. 721

George J. Benston, "Required disclosure and the stock market: an evaluation of the Securities and Exchange Act of 1934", (1973) 63 Am. Econ. Rev. 132

George J. Benston, "Required periodic disclosure under the securities acts and the proposed federal securities code", (1973-1974) 33 U. Miami L. Rev. 1471

Harry Underwood and Rene Sorrel, "Danier Leather Inc. and the duty to update a prospectus", (2006) 43 Can. Bus. L. J. 134

Jeremy D. Fraiberg & Robert Yalden, "Kerr v. Danier Leather Inc.: disclosure, deference and the duty to update forward-looking information" (2006) 43 Can. Bus. L. J. 106

Joel Seligman, "The historical need for a mandatory disclosure system" (1983-1984) 9 J. Corp. L. 1

John Coffee Jr., "Market failure and the economic case for a mandatory disclosure system" (1984) 70 Va. L. Rev. 717

Kevin G. Demarais, "Dredging the safe harbor for forward-looking statements – an analysis of the private securities litigation reform act's safe harbour for forward looking statements" (1998-1999) 32 Suffolk U. L. Rev 265

Merritt B. Fox, "Retaining mandatory securities disclosure: why issuer choice is not investor empowerment" (1999) 85 Va. L. Rev. 1335.

Merritt B. Fox. "Required disclosure and corporate governance" 62 Law and Contemp. Probs. 113

Neil Campbell, "Compulsory disclosure of soft information" (1993) 22 Can. Bus. L. J. 321.

Roberta Romano, "Empowering investors: a market approach to securities regulation, (1998) 107 Yale L. J. 2359

Jeremy D. Fraiberg and Robert Yalden, "Kerr v. Danier Leather Inc.: disclosure, deference and the duty to update forward-looking information", (2006) 43 Can. Bus. L. J. 106

Stephane Rousseau, “Kerr v. Danier Leather Inc.: la qualite de la divulgation et le bon fonctionnement du marche de l'appel public a l'epargne mis en peril?”, (2006) 40 R.J.T. 681

Steven E. Bochner and Samir Bukhari, “The duty to update and disclosure reform: the impact of regulation FD and current disclosure initiatives” (2001-2002) 7 Stan. J. Bus. & Fin. 225

11.2. Books

Allen M. Linden, *Canadian Tort Law*, 7th. ed. (Markham, Ont.: Butterworths, 2001).

Anthony M. Dugdale ed., *Clerk & Lindsell on Torts* 18th ed. (London, UK: Sweet & Maxwell, 2000)

David Jonhnston & Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 4th. ed. (Markham, Ont.,: LexisNexis Butterworths, 2006)

George Henri Louis Fridman, *The law of torts in Canada* vol. 2 (Toronto, Ont.: Carswell, 1990)

Mark R. Gillen, *Securities Regulation in Canada*, 3rd. ed. (Toronto, Ont.: Thomson Carswell, 2007)

S.M. Waddams, *The law of contracts*, 5th. ed. (Toronto, Ont.: Canada Law Book, 2005)

11.3. Cases

Andronyk v. Williams (1985), 35 C.C.L.T. 38 (Man. C.A.)

Datile Financial Corp. v. Royal Trust Corp. of Canada, (1991), 5 O.R. (3d) 358 (Gen. Div.)

Esso Petroleum Co. v. Marden, [1976] Q.B. 801

Foster Advertising Ltd. v. Keenberg, (1987), 38 C.C.L.T. 309 (Man. C.A.)

Pezim v. British Columbia (Superintendant of Brokers), [1994] 2 S.C.R. 557 (S.C.C.)

Queen v. Cognos, [1993] 1 S.C.R. 87

Kerr v. Danier Leather, 2001 CanLII 28392 (ON S.C.)

Kerr v. Danier Leather, 2006 CanLII 32595 (ON C.A.)

Kerr v. Danier Leather, [2007] 3 S.C.R. 331, 2007 SCC 44 (S.C.C.)

Williams v. School District No. 63 (Saanich), 1986 CarswellBC 699; 37 C.C.L.T. 203, 11 C.C.E.L. 233 (B.C.S.C.).

With v O'Flanagan [1936] Ch. 575.