

Statutory disclosure obligations trump business judgment

Matthew Fleming,
Fraser Milner Casgrain LLP

The Supreme Court has ruled that statutory disclosure obligations are not to be subordinated to the exercise of business judgment.

In the June 2006 issue of *Legal Alert*, I noted that the Ontario Court of Appeal's decision in *Kerr v. Danier Leather* ("Danier") reaffirmed and strengthened the "business judgment rule" — that is, the principle that the courts will typically refrain from questioning the business decisions of officers and directors, provided those decisions fall within a range of reasonable options.

SCC departure

However, in that same article, I noted that the Court of Appeal may not have had the final word on the issue since its decision was being appealed to the Supreme Court of Canada. In its recent decision, the Supreme Court articulated a marked-

ly different view of the application of the business judgment rule to the statutory disclosure obligations of reporting issuers.

In short, the Supreme Court ruled that such statutory obligations are legal requirements independent of the business judgment of officers and directors.

Background

The litigation in *Danier* arose out of an alleged misrepresentation in the prospectus issued by the company in connection with the initial public offering of its shares. The prospectus contained a forecast of the company's projected fourth quarter revenues that was accompanied by standard cautionary language indicating that those revenues might not be achieved.

Prior to the closing of the IPO, the CFO of the company prepared an analysis of the company's sales from the first half of the fourth quarter for the CEO. That analysis indicated that the company's actual revenues were significantly behind projected revenues. Neither the CEO nor the CFO advised the company's legal advisors

or underwriters of the intra-quarter results.

Share price

A few weeks after the IPO closed, the company issued a press release revising its projected fourth quarter revenues downward. Following the closing of the IPO, the company's share price was trading at a value in excess of the IPO price of \$11.25; however, approximately one week after the announcement revising the fourth quarter forecast downward, the company's share price had dropped to \$8.90.

Interestingly, Danier eventually managed to substantially achieve the original forecast in the prospectus. However, these events culminated in a class action for prospectus misrepresentation under s. 130 of the Ontario *Securities Act* (the "Act") (R.S.O. 1990, c. S.5, as amended).

Trial Decision

At trial, the company and its CEO and CFO were found liable for misrepresentation under s. 130 of the Act. Focusing mainly on the interpretation of the relevant provisions of the

See Directors' and Officers' Liability, page 87

Directors' and Officers' Liability *continued from page 86*

Act respecting the company's disclosure obligations, the trial judge found that the CEO and CFO's belief that the company was capable of achieving the forecast in the prospectus, notwithstanding the initially poor sales revenues, was unreasonable in the circumstances.

Accordingly, the trial judge found that the failure to correct the prospectus prior to the closing of the IPO constituted a misrepresentation for which the company, the CEO and the CFO were liable.

Court of Appeal

The Court of Appeal unanimously overturned the trial decision finding, among other things, that the Act did not require the company to disclose material facts (such as the poor intra-quarter actual results) during the period of distribution. The company was only obligated to disclose material changes to the company's "business, operations or capital."

The Court of Appeal also disagreed with the trial judge's determination that the forecast in the prospectus contained an implied representation of objective reasonableness, noting that there was nothing in the prospectus that suggested the forecast was put forward as being objectively reasonable.

Finally, the Court of Appeal concluded that the fourth quarter forecast represented a "quintessential example of the exercise of business judgment" and that the trial judge had wrongly substituted his view as to whether the forecast was reasonable for that of management.

Business judgment rule

The business judgment rule represents an acknowledgement by the courts that judges are ill-suited to second-guess business decisions by corporate officers and directors, particularly where judges are likely to examine those decisions with the benefit of hindsight.

Thus, the rule recognizes that executives and directors may have to make real-time business decisions or take business risks based on their experience and expertise and that it would be unfair to penalize those individuals if, after the passage of time, it becomes apparent that a "better" decision might have been made.

Reasonableness standard

However, the business judgment rule is not absolute. The courts have established that business decisions will only be immunized from second-guessing by judges where those decisions fall within a range of reasonable alternatives open to the officers or directors at the time the decision was made.

Therefore, while officers and directors are not held to a standard of perfection, a decision that fell outside the spectrum of reasonable options would not be shielded from judicial scrutiny or criticism by the business judgment rule.

Supreme Court of Canada

In its decision, the Supreme Court upheld the Court of Appeal's conclusion that the company, the CEO and the CFO were not liable for misrepresentation under the Act. However, the Supreme Court disagreed that the business judgment rule applied in the circumstances of this case:

...while forecasting is a matter of business judgment, disclosure is a matter of legal obligation. The Business Judgment rule is a concept well-developed in the context of *business* decisions but should not be used to qualify or undermine the duty of disclosure. . . . The disclosure requirements under the Act are not to be subordinated to the exercise of business judgment.

Significance

Officers and directors of reporting issuers are not infrequently faced with the question of whether certain information must be publicly disseminated pursuant to the disclosure requirements under the Act. Although such a decision may be said to include an element of "judgment" on the part of the officers or directors (likely rendered with the benefit of legal advice), that judgment is not subject to protection under the business judgment rule. A positive statutory obligation exists under the Act to make disclosure.

Application of business judgment rule

Corporate executives and corporate counsel should be alive to the prospect that the Supreme Court's decision is likely *not* limited to the disclosure obligations of reporting issuers under the Act. The Supreme Court has drawn a distinction between legal obligations imposed by statute and corporate decisions taken in the course of managing a company's business affairs.

While this distinction is now clear in the context of disclosure requirements under securities laws, it is less clear for other statutory duties, such as the statutory duties of loyalty and care imposed by business corporations statutes.

Ultimately, the Supreme Court's decision in *Danier* means that officers and directors must be careful not to confuse decisions where clear legal obligations exist with business decisions. Only the latter are likely to be afforded deference by the courts under the business judgment rule.

REFERENCES: *Kerr v. Danier Leather*, 2007 SCC 44, (2005), 77 O.R. (3d) 321 (C.A.); *Securities Act*, R.S.O. 1990, c. S.5, as amended.