

## CLASS ACTION UPDATE

JULY 2004

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### Trial Decision in *Danier Leather* Class Action awards damages for “misleading” Forecasts in a Prospectus

On May 7, Justice Sidney Lederman released his reasons in the highly anticipated **Kerr v. Danier Leather, Irving Wortsman, Jeffrey Wortsman and Bryan Tatoff** (2004), Unreported O.J. No. 1916 (Ontario S.C.J.) shareholder class action.

#### Facts

In an action against Danier and two of its inside directors, shareholders were awarded damages based on the civil action for misrepresentation in section 130 of the Ontario *Securities Act*. The alleged misrepresentation related to financial forecasts in the prospectus for an initial public offering of Danier Leather shares. Prior to the closing of the IPO on May 20, 1998, preliminary prospectuses had included forecasts for the last quarter of the year ending June 30, 1998. As of May 20, 1998, actual results were much lower than monthly targets upon which the forecast had been based. A few days after IPO closed, Danier disclosed revised, less optimistic forecasts. The share price declined as a result. Eventually the actual unaudited results were published which showed a better performance than suggested by the revised forecasts. In fact, the initial forecast was not far off actual results.

According to the Act, civil liability for “misrepresentation” can arise when a prospectus (1) contains an untrue statement of material fact, (2) omits to state a material fact, that is required to be stated, or (3) omits to state a material fact that is necessary to make a statement not misleading in the light of the circumstances in which it was made. Liability was determined under the third condition.

#### Forecast Was a Misrepresentation

##### ■ Untrue Statement of Material Fact

The defendants argued that forecasts are not “facts” because their inclusion is optional. Lederman J. found that, required or not, if a forecast is included it must comply with the

standards of the Act. Relying on principles from common law misrepresentation cases, Lederman J. held that a forecast is deemed to contain the following implied statements:

- That the forecast presents management’s best judgment;
- That management believes the forecast and this belief is reasonable, as the forecast was prepared with reasonable care and skill; and
- That management is unaware of any facts that would seriously undermine the forecast.

The court held that the forecast was “material”, because of a number of factors, including:

(i) the confidential information memorandum issued by the underwriters presented the forecast prominently and included a price range for shares based on forecasts earnings, and (ii) an underwriting team member’s assertion that a credible forecast would yield a better price.

In determining the point in time the truthfulness of the statement is to be assessed, the court held that notwithstanding the absence of explicit language in the Act, the Final Prospectus is the operative document and must be accurate. A forecast which is no longer reliable should not appear in a final prospectus regardless of whether it is stated to be “as of” a particular, earlier date. Silence will essentially amount to an assertion that the statement remains true.

### ■ **Obligation to State Material Facts Necessary to Make a Statement Not Misleading**

The plaintiffs succeeded, however, in proving that Danier failed to state material facts necessary to make a statement not misleading in light of the circumstances in which it was made. They argued that omission of the actual intra-quarter results rendered the forecasts misleading.

After reviewing National Policies 40 and 48, and U.S. case law, the court concluded that certain facts may be material because of the statement to which they relate, even if they are not material on a stand-alone basis. If a forecast is a statement of material fact then intra-quarter results that seriously put its accuracy in question would be material as well.

Also, intra-quarter results would render the forecast an untrue statement of material fact, either because it is no longer management’s subjective belief, or management’s belief is no longer objectively reasonable.

The court considered a financial analysis prepared on May 18 (as of May 16) that compared actual revenue for the quarter against the forecast. The analysis, which was not disclosed to Danier’s professional advisors, showed actual revenue significantly below that on which the forecast was based, but concluded that the forecast could still be met. The two defendant directors who reviewed the analysis provided reasons for their belief that the forecast could still be achieved, including sales promotions planned for the end of the quarter.

Lederman J. considered whether management had a subjective and reasonable belief in the forecast, and while he accepted that the directors believed that they would meet the forecast, he found their belief objectively unreasonable.

Notwithstanding that the forecast was substantially achieved in the end, the court held that the truth of factual assertions at the time of purchase is what matters.

### **Cautionary Language No Protection**

The defendants argued that the standard cautionary language and risk factor disclosure in the prospectus negated the materiality of the forecast. While the court recognized the U.S. “bespeaks-caution doctrine,” it found that these disclaimers did not qualify the factual statement that the forecast represents management’s best judgment. As part of an IPO prospectus, the forecast provided the only publicly-available information on potential value of the shares and was therefore at high risk of misleading readers.

The court also noted that Danier could have addressed the misrepresentation before closing by (1) issuing a revised forecast, (2) disclosing actual intra-Q4 results together with an expression of continued confidence in the forecast, and (3) delaying the closing of the IPO.

## Due Diligence Defence Denied

The director defendants sought personal protection in the due diligence defence in s. 130(5) noting that they had conducted a reasonable investigation providing reasonable grounds for their belief that forecasts would be met, and that they themselves believed there had been no misrepresentation. In the judge's view, the "circumstances of the particular case" suggested a more stringent standard of reasonableness for inside directors. He concluded that their failure to adequately analyze the results for intra-Q4 and what was causing them was not what should be expected of a prudent person. Moreover, failure to consult with professional advisors on the impact of actual results on the forecast and the potential impact on share price did not reflect a standard of conduct expected of senior management.

## Damages Awarded at Highest Level

The judge held that damages should generally equal the difference between the price paid and the post-misrepresentation trading price, and his goal was to determine the real value of the shares at the time of purchase free of the misrepresentation (with any necessary adjustment if the defendant proved that the depreciation was due to some other factor). The plaintiffs were entitled to recover damages even if they had not sold and crystallized their loss. The purchase price of Danier shares was \$11.25. The closing price on June 4 – the date of the disclosure - was \$10.25, suggesting damages of \$1.00/share. However, the post-misrepresentation price was adjusted to eliminate the effects of price stabilization activities and any abnormal price movements to eliminate the effects of panic selling. Surprisingly, the plaintiff's expert convinced the court that the market did not fully absorb the effect of the forecast revision and the market price was no longer affected by price stabilization activities until June 10 at which point the closing price was \$8.90. This meant damages of \$2.35/share.

## Conclusion

This case will no doubt impact the way that issuers and directors analyze the effect of new information on prior public predictions such as forecasts. Based on this decision, even when forecasts are stated as of a particular date, failure to disclose new information or their underlying assumptions can give rise to liability. This will undoubtedly result in changes in securities law and underwriting practices. The case is under appeal.

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## Ontario Superior Court of Justice Declines to Certify Class Action in First Major Tobacco Litigation in Canada

### Facts

In 1995, four proposed representative plaintiffs, led by David Caputo, commenced class action proceedings against Imperial Tobacco Limited, Rothmans, Benson & Hedges Inc. and RJR-MacDonald Inc. (hereinafter the "Defendants") seeking damages for personal injuries allegedly caused by their use of the Defendants' cigarette products.

In addition to the claims asserted on behalf of the proposed class, each proposed representative plaintiff personally claimed compensatory damages in the amount of \$1 million, as well as aggravated, punitive and exemplary damages. Furthermore, the Plaintiffs sought to have the Court issue a mandatory order requiring the Defendants to create and fund a treatment center for those proposed class members addicted to nicotine.

### Arguments of the Parties

In support of their motion for certification, the Plaintiffs argued among other things that:

- the Defendants designed, manufactured and sold an inherently defective and dangerous product in the form of cigarettes;
- the Defendants promoted and marketed these products with the knowledge that they were addictive; and
- the Defendants had full knowledge of the harmful nature of their products, which was not only undisclosed, but rather was deliberately suppressed by them.

The Defendants argued, *inter alia*, that the proposed class proceeding lacked the core element of commonality necessary for certification and that a class proceeding would not be the preferable procedure because of the vast number of individual issues that must be decided in respect of each of the millions of putative class members, leaving the proceeding unmanageable and complex.

Lastly, the Defendants argued that proposed class members who began smoking after 1972 are in a different position than those who commenced before that time because of the existence of express warnings regarding the health risks inherent in smoking.

## Judgment

Justice Winkler refused to certify the proceeding for a number of reasons, namely that (i) the class definition was defective, (ii) there was a lack of common issues, and (iii) that a class proceeding would not be the preferable procedure.

In respect of the proposed class, Justice Winkler found that the description of the class was defective, as it contained arbitrary exclusions of “some people who shared the same interest in the resolution of the common issue”. He noted that the action “vastly overreaches” and, as a consequence, is void of an essential element of commonality.

In holding that a class proceeding would be unmanageable, Justice Winkler found that the claims of the potential class members arise from multiple factual situations spanning at least fifty years, during which time prevailing circumstances changed dramatically. As a result, an individual inquiry of each class member would be necessary both in respect of liability and damages. Justice Winkler noted that:

*“If the defendants were to only contest a portion of the individual claims, and each dispute could be concluded in one day, simple mathematics indicate that such a process would require the equivalent of 1,000 years of litigation, if it were to be conducted sequentially.”*

Ultimately, Justice Winkler held that the action, as framed, was far too broad to withstand scrutiny. However, he was careful to note that his reasons do not preclude other potential class actions against tobacco companies, merely that the defects in this action were fatal to certification.

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