ON LEMONS AND LEATHER: LIABILITY FOR MISREPRESENTATIONS OF FORWARD-LOOKING INFORMATION IN DANIER LEATHER

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I. INTRODUCTION

In a recent landmark case, Kerr v. Danier Leather, the Supreme Court of Canada considered the potential liability of a corporation that issued a prospectus containing a forecast of performance that was, at least arguably, misrepresentative of the company’s prospects at the time purchasers bought shares. The basic facts of the case are as follows. The shares of Danier Leather were sold in an IPO. The associated prospectus contained a forecast. Prior to the closing of the IPO, Danier’s internal analysis revealed that unseasonably warm weather had dampened sales thus raising a question of whether the forecast in the prospectus would be met. Danier did not disclose that sales had been lagging and closed the IPO without an update to the forecast in the prospectus. A strong promotion resulted in the forecast being substantially met in the end. The trial judge found Danier liable for making a misrepresentation in its prospectus, and the Ontario Court of Appeal reversed. While not accepting all of the Court of Appeal’s analysis, the Supreme Court upheld its finding and dismissed the appeal.

The case has been controversial, as perhaps exemplified by the fact that three courts that considered the legal questions underlying the relevant dispute took three very different approaches to their resolution. The case raises two contentious questions: is there an obligation on issuers to update previously disclosed forward-looking information (FLI) whenever circumstances change? And, does the

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business judgment rule apply to disclosure decisions? In this article, I evaluate how the *Danier* decision answered these questions.

In Section II, I review the statutory provisions that are relevant to liability for FI. Liability in *Danier* was alleged under the Ontario Securities Act (OSA). It is beyond the scope of this article to advocate reform of one kind or another to the statute itself. Rather, as will be seen, the statute invites debate over some important questions and my task will be to evaluate the court’s position in those debates from a policy perspective. In Section II, I review how the Supreme Court resolved the statutory controversies in *Danier*.

The courts in *Danier* themselves do a fine job of parsing the relevant statutory language. This article, in contrast, focuses more on the question of whether one interpretation or another would better advance the societal interests underlying potential liability for misrepresentations on FI. In Section III, I review the economic basis for liability for misrepresentations in corporate disclosures. There is, in principle, no tension between the objectives of issuers and those of investors over liability standards. Contracting parties, at the time of contracting, will seek to establish rules governing behaviour that maximize the joint gains of both parties. Issuers and investors are engaged in relations akin to contract: in primary transactions, investors hand over their cash in exchange for a bundle of rights to share in the performance of the corporation. Just as true contracting parties seek contractual terms that “maximize the size of the pie”, issuers and shareholders (and other parties in the transactions, such as lawyers and underwriters) would opt for liability rules that maximize the value of their relationship. Of course, in the context of claims for misrepresentations in disclosures, the focus of this article, shareholders would rely on statutory liability in the OSA, not the law of

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2. The basis for liability for FI is statutory given that common law actions for negligent misrepresentation, while conceivably available, are largely impractical in a modern corporate setting owing to the requirement of proven reliance on the statement in making an investment decision; as with other provincial securities acts, liability under the Ontario Securities Act, R.S.O. 1990, c. S.5 (OSA) does not have a reliance requirement.

3. The article does, however, take issue with non-statutory legal rules, particularly those found in National Instrument 51-102, which came into effect after *Danier*. I evaluate *Danier* on the basis of then-current law and leave discussion of NI 51-102 for the Conclusion.

4. Moreover, investors in the IPO can be seen as proxies for secondary purchasers, since IPO purchasers will want to maximize their returns in any future sales to secondary market purchasers, and the value of shares will depend in part on the existing liability regime.
contract, to seek damages. But the principle that parties collectively would want rules that maximize value applies when assessing the liability framework in the OSA.

As I will discuss, some degree of potential liability is generally valuable to issuers, since without it their disclosures may lack credibility, which in turn lowers their proceeds from sales of securities — without a credible signal of quality, such as that potentially provided by liability for misrepresentations, securities may be perceived as low-value ("lemons"). But the desirable degree of liability may be limited: it is unlikely, for example, that an issuer would want strict liability for making a forecast that turns out eventually not to be met for reasons beyond the issuer's control.

In Section III, I determine who should resolve this trade-off over liability. It makes sense to leave it to the parties themselves, given that issuers and investors are in quasi-contractual relations, and thus jointly have incentives to maximize value. More particularly, any deficiency in the information about a security will lower the security’s price — it is thus the issuer that bears the costs of asymmetric information. As a result, the law should allow the issuer itself to weigh the relevant considerations and customize the standards, perhaps through disclaimers, for evaluating its liability for misleading FLI.

In Section IV, I argue that the Danier decision leaves considerable scope for issuers to tailor liability for FLI to their particular circumstances. On the basis of the policy analysis in Section III, this is a welcome approach. In addition, I show that the decision in Danier is consistent with non-economic, or at least quasi-economic, concerns about investor protection that are manifest in the statute.5

In Section V I conclude that, in light of the legal and policy conclusions in Section IV, alternative interpretations of the OSA that would expand liability, such as approaches found in securities regulators' policy statements, and in a recent national instrument, are inappropriate. Danier makes sense.

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5. The basis for this conclusion is the wide discretion issuers have under the statute in deciding whether to disclose FLI at all. See, e.g., Jeremy Fraiberg and Robert Yalden, "Kerr v. Danier Leather Inc.: Disclosure, Deference and the Duty to Update Forward-Looking Information" (2006), 43 C.B.L.J. 106, who also note the importance of the optional nature of FLI.
II. FORWARD-LOOKING INFORMATION AND STATUTORY SECURITIES LAW

1. The Statutory Provisions

(a) Definition

The definition of FLI is found in s. 1 of the Ontario Securities Act (OSA). It states:

"Forward-looking information" 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; ("information prospective").

(b) Disclosure Obligations

The OSA imposes various important disclosure obligations on issuers, but there is no obligation to disclose FLI in the OSA. In particular, s. 56(1) provides that a prospectus must disclose "full, true and plain disclosure of all material facts" concerning the securities being distributed in association with the prospectus. The OSA s. 1(1) states that a "material fact", when used in relation to securities issued or proposed to be issued, means a fact that would reasonably be expected to have a significant effect on the market price or value of the securities. While inputs into a forecast could constitute material facts, the forecast itself cannot be a fact. At trial, the Ontario Superior Court of Justice held in Kerr v. Danier Leather that FLI implies some factual assertions, such as "the forecaster generally believes the forecast, the forecaster’s belief is reasonable and the forecaster is not aware of any undisclosed facts tending to seriously undermine the accuracy of the forecast". But it is clear that even the trial court in Danier, which generally took an expansive view of disclosure obligations, did not regard the content of the forecast itself to be a "material fact" that was subject to mandatory disclosure.

Another important disclosure obligation is the requirement in s. 75(1) to disclose material changes immediately upon their discovery. The OSA s. 1(1) states that a "material change" means "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price

7. Ibid., at para. 65.
8. Ibid., at para. 49.
or value of any of the securities of the issuer.” Material changes may affect forecasts, but a forecast itself obviously cannot be a material change and thus s. 75 does not establish an obligation to disclose FLI.

A related provision in the context of prospectuses is found in s. 57. Section 57 provides:

57(1) Subject to subsection (2), where a material adverse change occurs after a receipt is obtained for a preliminary prospectus filed in accordance with subsection 53 (1) and before the receipt for the prospectus is obtained or, where a material change occurs after the receipt for the prospectus is obtained but prior to the completion of the distribution under such prospectus, an amendment to such preliminary prospectus or prospectus, as the case may be, shall be filed as soon as practicable and in any event within ten days after the change occurs.

Section 57 specifically contemplates the disclosure obligations of an issuer who faces changed circumstances after it has issued a prospectus but before the distribution of securities has taken place, and sets out a disclosure obligation only where there has been a material adverse change, which does not include a forecast.

Thus, while much of the OSA is designed to establish a mandatory disclosure regime, issuers need not disclose FLI.

(c) Liability for Misrepresentations in FLI Disclosures

When FLI is disclosed there is potential liability under the OSA for any misrepresentation associated with the FLI. With respect to a prospectus associated with primary market sales (i.e., sales from issuer to buyer), potential liability is found in the OSA, s. 130(1), which provides:

130(1) Where a prospectus, together with any amendment to the prospectus, contains a misrepresentation, a purchaser who purchases a security offered by the prospectus during the period of distribution or during distribution to the public has, without regard to whether the purchaser relied on the misrepresentation, a right of action for damages . . .

Section 1(1) of the OSA defines a misrepresentation to be:

(a) an untrue statement of material fact, or
(b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

Aside from some technical defences (such as a document being issued without an individual’s knowledge), there are two kinds of defences available to an issuer that is claimed to have included a

9. Analogous provisions for an offering memorandum (which relates to exempt market transactions such as a private placement) and a takeover circular are found in ss. 130.1 and 131 respectively.
misrepresentation in its FLI disclosure. First, there are general due diligence defences against misrepresentation claims. Second, there are FLI-specific defences, including reliance on disclaimers.

General due diligence defences to misrepresentations limit liability to cases where the principals involved in making the representation fail to take reasonable care. The defences for primary market misrepresentations are not available to the issuer or selling security holder, but are to other individuals or entities, such as underwriters or experts, involved in the preparation of the document. For misrepresentations in a prospectus, for example, s. 130 of the OSA provides in part:

\[130(4)\] No person or company, other than the issuer or selling security holder, is liable under subsection (1) with respect to any part of the prospectus or the amendment to the prospectus purporting to be made on his, her or its own authority as an expert or purporting to be a copy of or an extract from his, her or its own report, opinion or statement as an expert unless he, she or it,

(a) failed to conduct such reasonable investigation as to provide reasonable grounds for a belief that there had been no misrepresentation; or
(b) believed there had been a misrepresentation.

The due diligence defences that arise with respect to continuous disclosure are broader. For all parties except experts, like auditors, there is no liability for misrepresentations in “non-core” documents (generally documents that are not required as a matter of securities laws to be disclosed) unless the misrepresentation was knowingly or recklessly made:

\[138.4(1)\] In an action under section 138.3 in relation to a misrepresentation in a document that is not a core document, or a misrepresentation in a public oral statement, a person or company is not liable, subject to subsection (2), unless the plaintiff proves that the person or company,

(a) knew, at the time that the document was released or public oral statement was made, that the document or public oral statement contained the misrepresentation;
(b) at or before the time that the document was released or public oral statement was made, deliberately avoided acquiring knowledge that the document or public oral statement contained the misrepresentation; or
(c) was, through action or failure to act, guilty of gross misconduct in connection with the release of the document or the making of the public oral statement that contained the misrepresentation.

Aside from this robust defence to claims in non-core documents, there is a general due diligence defence for any other kind of misrepresentation allegation. Section 138.4(6) provides:
138.4(6) A person or company is not liable in an action under section 138.3 in relation to,
(a) a misrepresentation if that person or company proves that,
   (i) before the release of the document or the making of the public oral statement containing the misrepresentation, the person or company conducted or caused to be conducted a reasonable investigation, and
   (ii) at the time of the release of the document or the making of the public oral statement, the person or company had no reasonable grounds to believe that the document or public oral statement contained the misrepresentation . . .

Turning to FLI-specific defences, in essence, a defendant cannot be liable for misrepresentations in FLI if the statements in question contain, proximate to the FLI, cautionary language about the speculative nature of FLI, and the FLI was reasonable. The provision concerning disclaimers for FLI in a prospectus is representative. Section 132.1(1) of the OSA provides:

132.1(1) A person or company is not liable in an action under section 130, 130.1 or 131 for a misrepresentation in forward-looking information if the person or company proves all of the following things:
1. The document containing the forward-looking information contained, proximate to that information,
   i. reasonable cautionary language identifying the forward-looking information as such, and identifying material factors that could cause actual results to differ materially from a conclusion, forecast or projection in the forward-looking information, and
   ii. a statement of the material factors or assumptions that were applied in drawing a conclusion or making a forecast or projection set out in the forward-looking information.
2. The person or company had a reasonable basis for drawing the conclusions or making the forecasts and projections set out in the forward-looking information.

(2) Subsection (1) does not relieve a person or company of liability respecting forward-looking information in a financial statement or forward-looking information in a document released in connection with an initial public offering.

One question that this section begs is whether the conditions of s. 132.1(1) are necessary for disclaimers to offer a defence, or whether they are simply sufficient. It appears that they are sufficient and not necessary. Under the statute, if an issuer expressly disclaimed reasonableness in its FLI, nothing in s. 132.1(1) requires liability given an absence of reasonableness. And nothing from the Supreme Court’s decision in Danier implies otherwise. Indeed, the court held that the issuer in that case should be held to a standard of reasonableness based on the issuer’s express representations to that effect.10
2. Danier Leather

As set out above, the two key questions arising in the Danier Leather case are: whether there is a duty to update previously issued FLI when circumstances change, and whether the business judgment rule applies in evaluating misrepresentations in the disclosure context. In this section, I examine these questions in more detail and describe how the Supreme Court answered them in the Danier case.

(a) The Duty to Update

It was argued in Danier Leather that s. 130 on misrepresentations in a prospectus could support liability for a failure to update a forecast that since its disclosure had become unreasonable. The argument is as follows. Under s. 1(1), a misrepresentation includes an omission to state a material fact that is necessary to make a statement not misleading in the circumstances. If a forecast, while reasonable when made, has become unreasonable because of changed circumstances, then there are material facts that must be disclosed in order to make the forecast not misleading in the circumstances.

While this interpretation of s. 130 is coherent, a counterargument arises because of ongoing disclosure obligations that the OSA establishes in s. 57. Section 57 specifically contemplates the disclosure obligations of an issuer who faces changed circumstances after it has issued a prospectus but before the distribution of securities has taken place, and sets out a disclosure obligation only where there has been a material adverse change. A "material change," as discussed in setting out s. 75 above, concerns a change in the "business, operations or capital" of the issuer.

It is clear that an expansive understanding of s. 130 that would ground liability for failing to update FLI is not logically inconsistent with s. 57.11 On this expansive understanding, Section 130 would require an update to FLI if the FLI has become materially misleading, which is not mutually exclusive with the s. 57 requirement to update FLI only on the basis of a "material change". That is, an issuer can

10. As I discuss below, in the absence of specific disclaimers, from a policy perspective, the appropriate default rule is that the issuer implicitly warrants that its representations are reasonable. As I also discuss below in the Conclusion, National Instrument 51-102 would require FLI to be reasonable. This is unnecessarily restrictive under the analysis of this article.

comply with both the expansive reading of s. 130 and s. 57. But it is equally apparent that s. 57 and this expansive reading of s. 130 do not sit well together. If the reason that a forecast has become potentially misleading is because of a material change, then s. 57 establishes liability on its own; s. 130 is unnecessary to ground liability. On the other hand, if a forecast has become misleading because of any other circumstance, then the provision in which the legislature specifically contemplated updating a prospectus does not require further disclosure; using s. 130 to ground liability would reach a result that the specific provision does not contemplate. Put another way, if s. 130 requires updates whenever FLI in a prospectus becomes misleading, s. 57 is irrelevant.

The Supreme Court adopted the second interpretation, concluding that the only obligation to update FLI is found in s. 57. The issue in Danier Leather arose because Danier included a projection about quarterly earnings in its preliminary prospectus. The trial court found that the projection was reasonable at the time it was made, but that it had ceased to be reasonable by the time distributions were completed under the prospectus (even though the projection was eventually substantially met in fact because of unexpectedly successful promotions).

The Supreme Court decided that s. 57 exhausts the mandatory duties to update FLI in the OSA. The court stated:

> Imposition of civil liability under s. 130(1) for an omission to do what the legislature as a matter of policy has declined to require in s. 57(1) would simply be to substitute’s the court’s view of policy for that adopted by the legislature. The distinction between ‘material change’ and ‘material fact’ is deliberate and policy-based. 12

The court concluded that it would be incorrect to state that prospective purchasers would be misled by the failure to update potentially out-of-date FLI, stating that, “Prospective purchasers were entitled to assume that no material changes (as defined in the [OSA]) had occurred to the material facts disclosed in the prospectus between the filing date and the closing date, but that is the extent of the assurance given by the Act to prospective investors.” 13 Thus, where material changes occur that affect previously disclosed FLI (or do not affect the FLI, for that matter), s. 57 requires their disclosure, but the issuer need not make disclosures about other changes in material facts, whether or not they affect FLI.

Applying this finding to the Danier facts, the issuer was not liable

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12. Danier, supra, footnote 1, at para. 38.
13. Ibid., at para. 37.
for a failure to update the forecast. A change in the weather, the trial court through Supreme Court all agreed, was a material fact, not a change in the "business, operations or capital" of the issuer.

(b) The Business Judgment Rule

The other key question was the standard that applies in reviewing whether directors took reasonable care in preparing FLI that is claimed to contain a misrepresentation. This standard could be relevant under the statute to a finding of whether there was a misrepresentation in the first place, or whether the defendant could successfully invoke the due diligence defences. In Danier, the question was how the court should evaluate the decision of the directors not to update the FLI that had allegedly become misleading. Given that the Supreme Court held that there was no obligation to update absent a material change, and that no court found the original forecast to have been unreasonable, their comments on the question are obiter dicta. But, especially given the controversy engendered by the Court of Appeal's adoption of the business judgment rule, the Supreme Court's views on the matter are of considerable practical importance.

In describing the risk of liability for FLI in primary or secondary market disclosures and the potential role of the business judgment rule, it is as a preliminary matter important to clarify that potential liability for a misrepresentation in a prospectus is not strict. That is, that a forecast ultimately turns out to be inaccurate is not in itself a basis for liability — even the trial court in Danier, which took an expansive view of potential liability for FLI, held that FLI that turns out to be in error was insufficient to ground liability.

Whether there is necessarily liability based on the reasonableness of FLI on the date that the forecast was made is not answered in Danier. The trial court in Danier concluded that there was, as a matter of law, an implied representation of the reasonableness of a forecast both at the time the forecast was made and at the date of the sale of the security. No expert for the plaintiff or the defendant concluded that the forecast in this case was unreasonable at the time it was made, and neither did the trial judge. However, given changed circumstances (poor sales owing to warm weather), the trial judge found that the forecast was unreasonable at the date of the sale of

15. As discussed in the Conclusion, National Instrument 51-102 makes reasonableness mandatory; the discussion of Danier in this article relates to the law as it existed at that time.
securities and that the defendants were liable under s. 130 as a consequence. As noted, both the Court of Appeal and Supreme Court held that the only date that mattered for evaluating liability under s. 130 was the date the FLI was issued, not the date of sale. The Court of Appeal held that there were no implied or actual representations of objective reasonableness on the date the forecast was issued; rather, there were actual representations only that the forecast represented management’s best judgment.

The Supreme Court does not fully resolve the question of whether, as a default matter, there is an implied representation of reasonableness in the FLI. The Supreme Court held that the issuer in Danier, as a matter of fact, did represent that its FLI was objectively reasonable at the date that it was made. Given reliance at most on an implied representation of objective reasonableness, the courts do not disagree that an explicit representation of reasonableness, or perhaps even a different standard for that matter (such as subjective belief that the forecast was reasonable), could set the basis for evaluating the FLI.

I return to the role of issuer choice in standard-setting below, but now consider the kind of review that prevails when “objective reasonableness” is the standard. Again, the standard could conceivably apply either in determining whether there has been a misrepresentation, the approach of the Court of Appeal in Danier, or in applying the due diligence defences outlined in the OSA. There is controversy over the appropriate approach. In particular, there is disagreement over the amount of judicial deference to accord the issuer’s management team itself when reviewing the reasonableness of its disclosures. The key question here is whether the business judgment rule should apply in evaluating the FLI.

The business judgment rule developed in Canada in cases where courts were called on to evaluate the business merits of a decision by corporate management, either directors or officers, in carrying out their duties for the purposes of a suit for breach of the duty of care: see, e.g., Peoples Department Stores Inc. (Trustee of) v. Wise. The rule essentially holds that businesspeople will not be held liable for decisions that the court concludes are incorrect, but rather must only make decisions within a range of reasonableness. The most frequently cited statement of the rule is from Maple Leaf Foods Inc. v. Schneider Corp.:

16. As I set out below, in my view the default rule should be that there is an implied representation of reasonableness in FLI, but that this can be waived with disclaimers.
The court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within range of reasonableness, the court ought not to substitute its own opinion for that of the board even though subsequent events may have cast doubt on the board’s determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board’s decision.18

The rationale for the rule can be summarized by the following sentence from Peoples:

Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.19

The question at play in Danier Leather was whether the logic of the business judgment rule applies to a disclosure decision concerning FLI of an issuer. The Supreme Court, in contrast with the Court of Appeal, found that it does not. The comments of the Supreme Court, as noted above, were obiter dicta. The trial judge found that the FLI was reasonable at the date that it was issued. Given the Supreme Court’s conclusion that the forecast need only be evaluated as of the date the forecast was issued, this was sufficient to find against the plaintiffs. But the Supreme Court for the sake of argument considered the reasonableness of the representations as of the date the securities were sold.

The trial judge found the forecast to be unreasonable as of the sale date. The Supreme Court rejected this finding, holding that it had no factual basis given that at trial there was uncontradicted expert testimony that the forecast remained reasonable at the date of sale. In addition, the Supreme Court clarified the correct approach to evaluating reasonableness.20 The Supreme Court stated that, “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.”21 The Supreme Court concluded that reflexively deferring to the judgment of the issuer on a

20. Again, while the Supreme Court considers reasonableness as of the sale date for the sake of argument, the relevant standard of review of reasonableness would only apply as of the date of the FLI being issued given the Supreme Court’s findings on s. 130.
21. Danier, supra, footnote 1, at para. 54.
III. POLICY ANALYSIS

Daniel Leather reached two important conclusions on the law concerning FLI: there is no duty to update existing FLI except as found in the continuous disclosure regime, and the business judgment rule does not apply to disclosure decisions. I now begin the task of evaluating the court’s approach. This section first reviews the economics of asymmetric information and traces its implications for the optimal approach to liability for FLI. In particular, optimal law would give significant deference to issuers over the standard of liability that they face. The section forms the basis for an analysis of the holdings in Daniel in Section IV that concludes that the Supreme Court’s approach in Daniel is not only consistent with the statute, but also has a strong economic basis.

1. The Basic Problem

Before analyzing policy questions relating to liability for disclosure in any depth, it is helpful initially to describe the relevant economic problem that confronts a seller and buyer of a security: asymmetric information. The seller knows more about the value of the security than the buyer. As Akerlof famously showed, markets in which the seller knows more about the value of the product than the buyer can suffer serious infirmities; indeed, asymmetric information can effectively destroy markets.23 The reason for this is as follows. Assume that the seller knows precisely the value of a product but the buyer only knows the average value of a product. Akerlof uses the example of a used car: the buyer may know the average value of a particular make of car from a particular year, but the seller will have value-relevant information about how she drove and maintained the car that the buyer does not. Consider the decision of the informed seller to sell the car. Suppose that cars of this make and year range in value between $100 and $1,900, and that the average is $1,000. It is seemingly reasonable to predict that the buyer would be willing to pay the average price for the used car of $1,000. But this turns out to be problematic. The better-informed seller who has driven and

maintained the car in a neglectful way such that her car is worth only $100 would be very pleased to sell her low-value car for the average price. In contrast, the informed careful owner whose car is worth $1,900 would be reluctant to sell. As a consequence, one possible outcome is that all owners whose cars are worth more than the average drop out of the market: better to keep the car than get paid a below-value price for the car.

But consider now the average price for the remaining cars. Assuming uniform distribution across car values (that is, each value is equally common in the population of used cars of the make and year in question), once all cars valued over $1,000 drop out, the average remaining car has a value of $550. A similar decision confronts the now-above average sellers: those contemplating sales of now-above average cars (i.e., worth more than $550) will be reluctant to sell at a price below value and will themselves drop out of the market. The average of remaining cars then drops to $325. More sellers drop out, and so on. In the end, this process of “adverse selection” results in the market for used cars unravelling. The only sellers willing to sell have the lowest quality cars for which they will receive a fair price: $100. Other sellers with better cars avoid selling at a discount.

Notice that the key premise on which the unravelling result rests is that information is not simply imperfect, but rather asymmetric. To illustrate, suppose that both buyer and seller are not certain precisely what the value of the car is: it could be worth $800 or it could be worth $1,200 with equal probability. These circumstances allow the possibility of trade: a price of $1,000 means that each party is treated fairly in expected terms, even though one side or the other may lose ex post. It is only when one side, the seller in the above example, knows something that the buyer does not that the market unravels. As Akerlof put it, asymmetric information can result in only “lemons” being sold.

Asymmetric information can destroy markets by lumping high quality sellers together with low. It is clear that security markets are vulnerable to this weakness. Those offering to sell securities to the public are generally better informed than buyers. An entrepreneur selling her shares to the public, for example, may be involved in the day-to-day operations of the business that gives her access to information that outsiders do not have. When she offers to sell her shares, outsiders may be concerned that the seller seeks to take advantage of their ignorance of the true value of shares, and will discount their willingness to pay as a consequence, just as the used car buyer assumes the worst in the above example. 24
As a result of asymmetric information and adverse selection, sellers and buyers jointly have incentives to reduce the degree of asymmetric information between them. There is some incentive for buyers in the used car example to gain expertise in evaluating quality. Buyers who are able to discern the quality of a used car are able to outbid other potential buyers because they need not fear that the seller is only selling to take advantage of an information problem; they can verify for themselves what the value of the car is. To the extent that there is a surplus from transferring the car to a higher valued user, there can be a return to buyer expertise. This example analogizes in a straightforward way to securities markets: informed buyers are more willing to pay the “true value” of the security than uninformed buyers.

Sellers also have an incentive to adopt measures that reduce asymmetric information and make credible the prospect that the car they are attempting to sell is of higher quality. There are a host of possibilities, including third-party certification, developing a reputation for fair dealing, and various signals of quality sent by the seller, such as advertising or warranties that commit to make the buyer whole for any deficiency in the car’s performance. These sell-side mechanisms that are most relevant to the present article, given its focus on optimal liability for seller’s disclosures about FLI. In particular, as I explain in the next subsection, disclosure can usefully be described as a kind of signal.

2. Legal Liability and Signalling

Signalling theory, as developed by Spence and others, applies where an actor with private information takes certain actions that credibly convey that information to otherwise uninformed parties. The signalling activity conveys information credibly because the cost of the activity is correlated with the kind of information that the informed party is attempting to convey: it would be a losing proposition for someone to send false information because of the cost of doing so. For example, suppose that more education is costly for a

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24. See, e.g., Stuart Myers and Nicholas Majluf, “Corporate financing and investment decisions when firms have information that investors do not have” (1984), 13 J. of Fin. Econ. 187.
student to obtain because of the costs of effort, but also suppose that the effort costs of education are greater the less intellectually capable is the student. More intellectually capable students can signal their ability to potential employers by pursuing more education. Employers can rely on education as a signal of quality since students with less talent would find it too costly in terms of effort to mimic the talented by obtaining similar degrees of education. Education can thus signal intellectual ability. Of course, if education were not costly, or if it were equally costly for all students, then education would not operate as a signal: low ability students would find it equally attractive as high ability students to pursue education. It is only where the cost of the signal, the cost of educational effort, correlates with the trait that is being signalled, intellectual ability, that signalling can arise.

Signalling equilibria do not always permit actors with different characteristics to differentiate themselves; that is, a so-called “separating equilibrium” does not always emerge. Instead, “pooling equilibria” can arise in which types fail to distinguish themselves. Where signalling costs are high regardless of type, for example, pooling equilibria can emerge. Suppose in the educational illustration set out above that the labour market returns from signalling high quality by obtaining an education are insufficient to compensate talented students for the additional effort costs of more education. High ability students could signal quality by pursuing more education, but if the costs of doing so exceed the benefits, they will not invest in the signal. Signalling may not always resolve asymmetric information problems.

Securities laws on corporate disclosures can be thought of as facilitating signalling. To focus on the role of law, for the moment assume that the only penalties for false disclosures by corporate actors are legal; temporarily set to one side factors such as reputational costs. Suppose that there are two kinds of firm, “good” firms that have valuable investment opportunities and “bad” firms that do not. Insiders at the good firms know they are good, insiders at bad firms know they are bad, but investors cannot distinguish the two through external investigations of the companies.

Legal penalties for false disclosures can support a signalling equilibrium in which good firms distinguish themselves from bad firms. If there were no legal penalty for false disclosure, both good and bad firms would have an incentive to disclose that they have promising investment opportunities. There is zero cost for both bad

28. Ibid.
and good firms to send a positive signal, which renders the signal meaningless. Outside investors would not be able to distinguish the firms and a lemons problem could arise in which good firms avoid selling securities because of the “lemons discount” they would face. But if there were significant penalties for false disclosures, disclosures could become valuable signals. Specifically, if the legal penalty for false disclosure is more costly to a bad firm than is the benefit of being thought of as a good firm, then the bad firm will not make false disclosures. On the other hand, the good firm can make true disclosures of its situation and, in a world of perfect legal enforcement, can do so without risk of legal liability. The cost of the signal (disclosing good investment opportunities) is lower for firms that are in fact good than for bad firms, which permits a separating signalling equilibrium to emerge.

From a social perspective legal liability is a particularly useful signalling mechanism. For one, the cost of signalling (the level of liability) is not exogenously given, like the psychic cost of educational effort, but rather can be adjusted better to permit signalling to emerge. If the expected penalties for false disclosure are too small, for example, then signalling cannot emerge: bad firms will make false disclosures in order to mimic good firms. Adjusting the penalties higher will avoid this problem, better assuring the emergence of separating equilibria in practice.

Another attractive property of liability for false disclosures is that the costs associated with liability are privately burdensome but are not wasteful from a social perspective. In the educational setting, the high ability student incurs real costs of effort in order to signal her ability. This makes sense privately for the student—the costs of effort are less than the benefits—but consumes real resources: her time and effort. In addition, all good students incur the costs in order to send the signal. In contrast, the signalling equilibrium involving liability for false corporate disclosures does not consume social resources in the same way. In equilibrium, the good firms make true disclosures at a small cost, while bad firms do not make disclosures at all (and hence reveal themselves to be bad firms) unless required to do so, in which case they too will disclose truthfully in order to avoid legal penalties. Even in a disequilibrium case where a bad firm does falsely disclose, the penalty associated with the false signal does not waste resources. The false discloser pays a penalty to someone else (the state, or perhaps deceived investors) who benefits from the penalty—that there is simply a transfer of wealth, not a dissipation of real resources. In sum, the legal feature that creates the disclosure signal, liability, should not
arise in equilibrium, and even if it does, it is not socially wasteful. Liability for disclosure may facilitate a socially useful signal.

3. The Trade-Off

As noted above, insufficient legal penalties for false disclosures undermine a signalling equilibrium: if the costs of misrepresentations are low enough, even bad firms will claim to have good investment opportunities. To best ensure that bad firms do not mimic good firms, legal liability should be extremely burdensome. High penalties deter misrepresentations.

There is a problem, however, with very high penalties for misleading disclosure, particularly with respect to \( \text{FLI} \). Suppose, for example, that liability for false \( \text{FLI} \) were strict: if the issuer were to offer a projection about the future that turned out to be false, the corporation would be liable to pay a very large financial penalty. In the shadow of such a threat, the issuer considering what to disclose would be extremely cautious: uncertainty about the future is unavoidable. Even if the issuer predicts sales growth of 10\%, for example, it may prefer to disclose projected growth of "no less than 2\%" in order to minimize its expected costs of liability. The result of uncertainty about future events combined with strict liability is the persistence of asymmetric information: good firms would be too cautious about revealing their prospects, and it will be more difficult for investors to distinguish good firms from bad.

Even if liability is not strict, another risk that issuers must consider is that of judicial error. If there is potential liability for disclosing allegedly misleading \( \text{FLI} \), there will always be a risk that courts do not evaluate the issuer's conduct appropriately and find liability where there should not be liability. There are two kinds of concern. First, courts will typically evaluate the issuer's conduct \textit{ex post}, after it has turned out that the \( \text{FLI} \) was not true in fact. Disclosure that turns out to be wrong may nevertheless have been appropriate at the time that it was made, but hindsight bias may influence courts. Second, as noted in discussing the business judgment rule, courts may not be particularly expert in evaluating how much care issuers should take. Courts may not appreciate the costs and benefits of investing in precaution, such as hiring consultants to assist in confirming the corporation's predictions. Courts may hold issuers liable where they in fact took the correct amount of care in making their disclosures.

\[29.\text{ Danier being an interesting exception in that the impugned forecast turned out eventually not to be misleading.}\]
from the collective perspective of issuers and investors. Issuers may limit these risks by advancing only very conservative FLI, which fails to address fully the asymmetric information problem.

The implication of these considerations is that neither stricter, more punitive penalties for false disclosures on FLI, nor more relaxed, less severe penalties are obviously optimal. The more significant the penalties, the greater the risk of excessive caution and less informative disclosures; the less significant the penalties, the greater the risk that even bad firms will be willing to incur liabilities in order to mimic good firms by making false disclosures. Either because of overly cautious, underinformative disclosures by good firms in the shadow of overly severe liability rules, or because of dishonest disclosures by bad firms in the shadow of overly lax rules, sub-optimal liability rules fail to address the asymmetric information problem. Separating signalling equilibria may not emerge.

There is an additional complication in analyzing the effects of liability on the production of credible information. I earlier set aside reputational concerns in focusing on the role of the law in establishing potential liability and thus signalling. Accounting for reputation renders the costs and benefits of legal liability even more complex. Reputational costs from false disclosure are very likely to arise in public markets. If investors perceive that the issuer is prone to making less-than-truthful representations, they will more readily dismiss the firm’s future representations. This in turn will make the issuer more vulnerable to a lemons problem in attempting to sell securities in the future: outside investors may worry that the issuer is selling securities to take advantage of asymmetric information and thus will discount what they are willing to pay. The reputational impact of misleading disclosures is a higher cost of capital for the firm, which in turn lowers the value of the firm. Empirical studies confirm that public firms do indeed bear a reputational burden from misrepresentations.\(^\text{30}\)

In a perfect world, reputational and legal sanctions would coordinate so as to achieve optimal penalties.\(^\text{31}\) If there are severe reputational penalties, there is a danger that additional legal penalties would create excessive caution on the part of the issuer, perhaps manifest through milquetoast disclosures that mitigate the risk of liability but fail to inform. Conversely, if reputational sanctions for a particular firm are unlikely to be effective, such as


where a firm has a very short time horizon, legal liability should be more severe in order to deter misleading representations. Given variance in reputational costs from misleading disclosures across firms and across time, optimal coordination of reputational and legal sanctions is difficult.

4. The Case for Relying on the Issuer to Resolve the Liability Trade-Off

How should policy address the competing concerns of excessive severity and laxity in establishing liability for misrepresentations in FLI? I conclude that the optimal course of action, from a policy perspective, is to allow the issuer to establish its own liability regime for its disclosures by giving significant weight to disclaimers associated with FLI.

(a) The Issuer Bears the Costs of Asymmetric Information

If there is uncertainty about the value of a corporation’s securities, and a belief that insiders at the corporation have better knowledge about value than outside investors, it is the corporation that bears losses when selling securities, not outside investors. Consider the used car example set out above. If a used car seller cannot credibly convey information about the value of the car, sellers of above average cars will be reluctant to sell, and eventually only low-quality lemons will be sold. Buyers in the scenario do not overpay as the result of asymmetric information: the cars that are sold are lemons, buyers anticipate them to be lemons and pay a corresponding price. If a seller of an above average car were compelled to sell, it would have to sell at a “lemons discount”, which results in a transfer of wealth from seller to buyer.

Now consider securities markets. Buyers have an enormously wide range of prospective investments: they can invest in shares, corporate bonds, government bonds, bank deposits, real estate, gold, baseball cards, etc. Competition in capital markets is extremely intense. If a corporation attempts to sell securities in such a market, nobody is compelled to buy. If the corporation suffers from a problem of asymmetric information, buyers will be concerned that the firm is selling shares to exploit this advantage, perhaps selling when the market has excessive confidence in the investment opportunities the firm enjoys. Rational buyers will therefore look to other investments that do not suffer from asymmetric information. If a cash-strapped corporation must sell securities, it will only be able to do so at a discount that compensates investors for the prospect of opportunistic
exploitation of hidden information. (Such a theoretical result is confirmed in practice: equity values tend to fall on the announcement of a sale of shares.\textsuperscript{32} It is not buyers, then, who suffer from asymmetric information — they can protect themselves simply by not buying. It is sellers, who either do not sell or sell only at a discount, that bear the costs of asymmetric information.

(b) Issuer Incentives to Establish Liability Rules

This article recommends that issuers be able to establish their own liability rules for FLI disclosure through legal deference to disclaimers. The point of entering into contractual relations is to establish the threat of legal liability both for oneself and one’s contractual counter-party. It is commonplace for sellers voluntarily to increase their risk of liability in a contractual transaction in order to increase the value of that transaction. Suppose, for example, that a car seller wants to signal its quality to buyers. It voluntarily increases its liability in the contract by offering a warranty that obliges it to make significant repairs in the first three year’s of the car’s operation. This is costly, but beneficial to the car seller by helping resolve the asymmetric information problem and thus avoid a lemons discount. Buyers have better assurance that a car is not a lemon, and thus are willing to pay more for the car. The seller on net benefits from offering the warranty: it is worth more to the buyer (and hence seller as reflected in the car’s price) than it costs the seller. More liability is better for the seller.

It is straightforward to apply this logic to sales of securities.\textsuperscript{33} Suppose that liability for disclosures were purely voluntary. Sellers would no more choose to avoid categorically the prospect of liability for securities disclosures than they would liability for car repairs. If outsiders have greater confidence in the veracity of a disclosure, confidence that exists because the threat of liability, then the corporation can sell its securities for a higher price, just as car sellers can sell cars with warranties at a higher price. Securities sellers, just like car sellers, would have incentives to incur potential liability that better ensures the quality of what they are selling.

Turning to liability for disclosures of FLI specifically, as a preliminary matter, note that in important ways the trade-offs that confront the choice of liability rules for FLI are similar in kind to the trade-offs that arise in respect of ordinary, retrospective disclosures.

\textsuperscript{32} See, \textit{e.g.}, Myers and Majluf, \textit{supra}, footnote 24.

as well. But resolving the trade-offs may be different in the two contexts given the additional uncertainty surrounding FLI. A strict liability rule, for example, may not undermine frank disclosure with respect to *ex post* descriptions of past events, but could with respect to uncertain future events. Consider a patent for a piece of technology. Severe liability for misrepresentations would not deter a company from announcing that it has already obtained a patent — such a representation can easily be verified. But severe liability might deter a firm that genuinely and reasonably believes that it is likely to obtain a patent for the technology in the future from announcing its belief. If, for some unanticipated reason, the technology is not obtained, it would expose the corporation to allegations that it had made a misrepresentation. Since the trade-offs may have different weights in the different contexts, it is appropriate for the law on disclosing FLI to differ from the law on disclosing other kinds of information; accepting the below conclusion that issuers should be able to tailor liability for FLI does not imply that one must accept a similar conclusion with respect to other disclosures. It may, for example, be appropriate to insist that retrospective disclosures be reasonable, while allowing disclaimers of reasonableness on FLI, given that the issuer has greater control over the *ex post* accuracy of backward-looking information than that of FLI.

The analysis above noted a number of trade-offs that confront the question of optimal liability for liability in FLI. As a general matter, lax liability risks undermining the signalling value of disclosure, while strict liability also may jeopardize signalling as good firms exercise caution and fail fully to disclose how successful they are likely to be. There are also the penalties that reputation imposes on a corporation for misleading disclosures; legal liability must account for these costs or risk over- or underdeterrence of misrepresentations.

Each firm in question faces different costs and benefits along these dimensions. A mandatory, OSA-created "one-size-fits-all" approach to the question of liability for FLI would undoubtedly miss the mark for individual firms. Instead, it would make sense from an economic perspective to allow the issuer itself to determine liability standards that ought to attach to statements about FLI: issuers have better information about their own circumstances, and have incentives to adopt a regime that limits their costs from asymmetric information. Issuer choice could arise through the operation of disclaimers. Liability standards set out in a statute could, for example, be strict in the absence of clear statements that the issuer is disclaiming liability on such a basis. Depending on the costs (in terms of liability risk) and
benefits (in terms of higher securities prices because of avoidance of the lemons discount) of liability, whenever disclosing FLI the issuer might opt for strict liability and not include disclaimers, might opt for a due diligence defence, or might even disclaim liability altogether. The last scenario is plausible if reputational sanctions for a given firm are sufficient to render its disclosures credible.

The advantage of this approach is that the issuer, who ultimately bears the costs of an inappropriate liability regime, is best placed to weigh the costs and benefits of these alternative liability regimes. Buyers of the issuer's securities either from the seller directly in primary transaction, or from another shareholder in a secondary transaction, are in the position of evaluating the disclosures in part on the basis of the liability regime adopted by the issuer. If the issuer disclaims liability in a setting where the buyer concludes that such liability is necessary to lend credibility to the issuer's disclosures, then the buyer need not buy the security, or may buy it only at a price that discounts the claims of the seller. There will be market punishment for an inadequate liability regime that avoids the inevitable bluntness and errors (either excessive strictness or laxity) associated with general regulations.

With this policy analysis in place, I turn now to a discussion of the Danier decision.

IV. EVALUATING DANIER LEATHER

In this section I evaluate the conclusions of the Supreme Court in Danier on the two key interpretive questions. I conclude that the court's answers are consistent with the economic analysis of issuer choice in Section III. I also conclude that the Danier result is consistent with investor protection concerns that are manifest in the OSA but not central to the economic analysis of Section III. In order to focus on the analysis in the Danier case itself, in this section I continue to focus on the law as found in the statute; I leave to the Conclusion discussion of the rules in National Instrument 51-102, which was adopted after the events in Danier.

1. Danier Leather and Issuer Choice

(a) Duty to Update

Danier Leather held that issuers do not have an obligation to update FLI in a prospectus when that information becomes out of date unless there has been a material change. The court based its
conclusion on the statute: s. 57 sets out specific requirements for updating a prospectus and only refers to a material change; the s. 130 misrepresentation provision should not be interpreted to render s. 57 irrelevant. While the court’s interpretation of the statute is coherent, in addition, there is a compelling economic justification for the court’s result. The court’s preference for issuer discretion on this question is consistent with the economic analysis of issuer discretion generally.

The issue of whether there should be liability for failing to update FLI is not susceptible of easy answers. On the one hand, the absence of a duty to update may undermine the informational content of the initial FLI disclosure. After a prospectus has been issued, outsiders may read FLI that remains valid in fact but discount it because of the possibility that recent events have altered the landscape. If FLI is less reliable, then issuers are less capable of mitigating problems of asymmetric information, and they bear the costs in the form of higher discounts for their securities. On the other hand, information that may be relevant to a firm’s outlook is potentially enormously broad and obviously very fluid. A very strong obligation to update FLI whenever new information affects its accuracy would create significant costs from exposure to potential liability; there is a risk that investors could claim *ex post* that some particular factor that affects previously-issued FLI had changed and the issuer failed to update. A very strict rule thus also risks failing to mitigate asymmetric information, since parties may be very cautious in issuing FLI, if they issue it at all, in light of the potential liability it may attract in the future for failing to update.

There is a trade-off when contemplating the optimal approach to the duty to update: too weak an obligation risks undermining the credibility of FLI; too strong an obligation risks excessive caution on the part of issuers contemplating how to frame FLI in a prospectus. Either extreme invites problems because of asymmetric information. As noted in Section III, the issuer is best placed to resolve such a trade-off, since it ultimately bears the costs of asymmetric information. Fortunately, the Supreme Court’s decision leaves as much discretion as the statute allows to the issuer.\(^{34}\) Clearly, s. 57 requires updates involving material changes, just as s. 75 does in the context of continuous disclosure. There is no interpretive discretion on this matter. But by not interpreting s. 130 to require updates whenever material facts have affected FLI, the court preserves room for an issuer

\(^{34}\) Again, given the focus on evaluating the decision in *Danier* itself, recommending changes to the statute are beyond the scope of the article.
to commit to update only to the extent that the OSA requires updates in s. 57.

Moreover, it is essential to appreciate that limiting mandatory statutory duties to update to material changes does not foreclose the possibility of corporations privately adopting stricter duties to update. An issuer, if it is concerned that the s. 57 duties to update will not provide sufficient assurance to investors that its FLI remains accurate, may commit to updating even in the absence of material changes simply by saying so in the prospectus. An issuer could accompany the FLI with a statement assuring investors that if information arises that materially (or otherwise; this too is up to the issuer) affects the FLI, it will update the FLI accordingly. The issuer's commitment to update could concern the period between prospectus approval and the closing of the particular stock offering in question, but could also extend beyond the offering period if the issuer wishes. This statement provides a legally binding commitment in that the issuer would be liable for a misrepresentation if it did not update according to its statement.

The possibility of issuers voluntarily increasing the duties to update should not be dismissed as fanciful. If the mandatory baseline is too lax, issuers bear the costs of lemons discounts and hence have an incentive to increase their exposure to liability. In Danier itself, the issuer stated in its prospectus that the "financial reports issued by the Company to its shareholders during the forecast period will contain either a statement that there are no significant changes to be made to the Forecast or a revised forecast accompanied by explanations of significant changes". Such a statement extended Danier's potential liability beyond that under s. 57. To be sure, National Policy 48 on disclosure of future-oriented financial information purported to require issuers to update FLI whenever there is a material fact or change, which calls into question how voluntary the statement was. But, as I discuss further in the Conclusion, the policy was not law and Danier was not required to follow it; indeed, Danier departed from the policy in that it only committed to update the forecast in any new financial reports and not in all cases where there was a new material fact or change.

In the end, Danier was not liable for having made this statement because, as the Supreme Court observed, no financial statements were issued during the relevant time period. But the possibility of self-inflicted disclosure obligations and potential liability is implicit in the court's analysis of Danier's compliance with its statement. It is

also implicit in the court's emphasis on the fact that “the prospectus did not promise that the forecast would be updated if and as soon as conditions changed. Potential investors should therefore have recognized that the forecast was just a snapshot of the company's prospects...” \(^{36}\) The court expresses a clear preference for issuer choice over liability.

In summary, had the Supreme Court found that s. 130 establishes a mandatory duty to update whenever conditions materially change, there would have been little room for discretion on the part of issuers in setting their own liability regime over updates to FII. In contrast, by finding that the mandatory duties to update are confined to s. 57, the court helpfully creates room for issuers to tailor the obligation to update to their particular circumstances. Issuers could commit to update during the period before the stock offering closes, or could commit to update even beyond this period. Given that the trade-offs involved in deciding whether there should be a duty to update to FII will not be the same across firms across time, the court's decision is welcome from an economic perspective.

(b) Application of the Business Judgment Rule

The Ontario Court of Appeal in Danier held that the business judgment rule applies to evaluations of the reasonableness of representations. In obiter dicta, the Supreme Court did not accept this conclusion, concluding that there ought not to be judicial deference to disclosure decisions as there would be to ordinary business decisions. In evaluating the Supreme Court's decision, I focus on the interaction of the business judgment rule and the economic analysis in Section III. On this framework, which recommends issuer choice over its liability regime, the Supreme Court takes the preferable position, though with some qualifications.

In determining whether the business judgment rule should apply, it is helpful to return to the basic aim of disclosure: to reduce asymmetric information and thus reduce the lemons discount an issuer would face in selling securities to the public. The threat of liability lends credibility to disclosures. Under the business judgment rule, there would be considerable deference to the source of the disclosures, management themselves, in determining whether the disclosures contain a misrepresentation. This would risk undermining the credibility of the disclosure: it would be much easier for management to defend an allegation of a misrepresentation

\(^{36}\) Ibid., at para. 51.
if courts defer to management’s views on whether it was a misrepresentation than if courts rely on more objective standards of review.

The Supreme Court was not entirely persuasive in analyzing the business judgment rule in 

Danier. The court stated that the traditional justifications of the business judgment rule are the relative lack of expertise of the courts in evaluating business decisions, and the need to encourage risk-taking by management by shielding them from liability. The court stated that these justifications “do not apply to disclosure decisions”. This is at best an overstatement. The facts of 

Danier themselves are instructive. Determining whether the warm weather was sufficiently destructive to Danier’s bottom line that the quarterly projection was not going to be met clearly required an exercise of business acumen. Based on their experience, management felt that they would be able to make their projections; it turned out they were correct. In contrast, the trial judge concluded that management were unreasonable in continuing to believe that projections could be met on the date of sale, even in the face of uncontradicted expert testimony to the contrary (that the Supreme Court accepted), and even though the projections were eventually met. This is a disagreement about business questions that would require expertise to decide.

Moreover, encouraging risk-taking is relevant. If liability were strict, management would be extremely cautious in making disclosures of FLI so as to minimize the expected costs of future lawsuits, just as they would be cautious in making other business decisions to minimize the costs of future lawsuits if the business judgment rule did not exist. Strict liability could lead to cautious, underinformative disclosure and less information in the marketplace as a result.

It is not, then, that disclosure of FLI raises questions of expertise and risk-taking that are different in kind from other business decisions shielded by the business judgment rule. The difference between disclosure and other business decisions, in my view, is that the incentives not to deceive investors and not to make bad business decisions are different. Faulty disclosure potentially results in a

37. Ibid., at para. 58.
38. Ibid. A Delaware case makes a similar claim. In In re Anderson, Clayton Shareholders’ Litigation, 519 A.2d 669 at p. 667 (Del. Ch.), the Court of Chancery stated, “[D]ecisions dealing with the quality of, and the circumstances surrounding, disclosures are not inherently of the kind which courts are ill suited to treat on their merits. Thus, one of the underlying reasons for the great deference the business judgment rule carries with it, is not present in a setting of this kind.”
transfer of wealth from new outside investors to current investors if the outsiders overpay for securities in reliance on misleading information. Managers acting on behalf of current investors, or, as in Danier, managers who are themselves current investors, may be willing to sacrifice longer run gains from honesty, such as preserving a reputation, in order to realize the short run gains from false disclosures. If incentives to mislead are strong, the whole purpose of disclosure, to reduce asymmetric information, is undermined: investors will put little credence in disclosures. This contrasts with most business contexts where poorly made decisions typically destroy wealth without presenting an opportunity for significant short-run gains to investors or management. As a consequence, the threat of liability may be an important source of discipline in the context of disclosures, while it would not be in respect of other business decisions. For the threat of liability to be meaningful, the business judgment rule should not presumptively apply.

Having said that, the implications of the conclusion that expertise and risk-taking are relevant give rise to an important qualification to my analysis of the business judgment rule as it relates to FLI. I have concluded that concerns about credibility would lead many issuers voluntarily not to rely on the business judgment rule. But this is not to say that issuers should not have discretion. Again, issuers are best placed to resolve the trade-off between weaker liability and problems of asymmetric information on the one hand, and stronger liability and problems of judicial error and excessive caution on the other. If issuers make clear statements that their FLI disclosures are based on their own, subjective view of likely events, and that objective analysis could lead to different conclusions, then in my view the business judgment rule should effectively apply. Given that issuers would generally prefer the credibility of a stricter objective standard, the business judgment rule ought not to apply as a default rule. But it ought to apply if the issuer expressly invokes it in disclaimers.

This qualification to the business judgment rule's inapplicability is consistent with the Supreme Court's approach in Danier Leather. Prior to discussing the business judgment rule, the court evaluated the standard, objective or subjective, by which FLI disclosures should be judged. The court reviewed a number of statements by Danier about the compatibility of its disclosures with an objective standard of reasonableness, including that there was a "reasonable basis" for the

39. For an analogous argument on the difference between directors' liability for duty of care and duty of loyalty violations, see Easterbrook and Fischel, supra, footnote 33.
forecasts. Had the issuer not made such statements, but rather had it stressed the subjectivity of its forecast, it would be consistent with the court’s approach to conclude that the business judgment rule would apply. Again, the court’s approach leaves room for issuer choice.

2. Issuer Choice and Investor Protection under the OSA

The Danier decision leaves scope for issuers to customize their liability for FLI both with respect to the duty to update and the application of the business judgment rule, which is appropriate in that they bear the costs and benefits of the liability regime, and have better information about the costs and benefits in their particular circumstances. The basis for a counterargument to customized liability, and correlative reliance on investors to account for the customized liability regime in making investment decisions, is scepticism about the sophistication of investors. The concern might be that investors, unlike the informed, rational actors in abstract economic theories, may not be capable of recognizing the limitations of FLI in a customized liability regime. Given that a central purpose of the OSA is investor protection, the argument may be that the Danier outcome is inconsistent with the spirit of the Act.

Setting to the side possible misgivings about regulation designed for unsophisticated investors in an era of a robust market for financial intermediaries like mutual funds, there are three arguments in favour of the issuer-choice approach in Danier Leather notwithstanding a general statutory emphasis on investor protection. First, it is worth noting that the risk of investors being misled by the failure to disclose new information that may be relevant to interpreting past disclosures is not limited to FLI, yet there clearly is no duty to disclose in other settings absent material changes. For example, investors often rely on past, retrospective financial statements to infer prospects for the future. Suppose that a firm in a mature industry issues an annual report that truthfully reveals consistent 5% annual revenue growth over the previous four years. Suppose, however, that a month after the last statement was issued it becomes clear that, for reasons that do not amount to a material change, revenue will shrink in the current fiscal year. Investors may have rationally relied on the retrospective statements in order to infer prospects for the future, and such inferences may be incorrect given the new information about shrinking revenues. But absent a material change, there is no legal requirement that the corporation disclose these shrinking revenues.
The limited duty to update FLI in *Danier Leather* is consistent with the limited duty to make disclosures generally.

Second, more generally, there is an essential difference in the statute between investor protection with respect to FLI and other kinds of disclosure. The statute sets out a robust scheme of mandatory disclosure generally. A prospectus, for example, must disclose all material facts under s. 56 of the OSA. But disclosing FLI itself is not mandatory. This is crucial to appreciate in both recognizing the compatibility of the statute with issuer discretion over liability for FLI, and in addressing whatever concerns about investor protection exist under a regime of issuer choice. If the issuer is under no compulsion to disclose FLI in the first place, it is suitable to allow the issuer discretion over how it presents the FLI when it does disclose the information.

The implications of the absence of a requirement to disclose FLI in the OSA are far-reaching. The logic of the omission allows support for the Supreme Court’s reliance on issuer choice in the context of FLI even if one believes in the importance of mandatory disclosure in other contexts. The statute reflects the idea, expressed above, that the trade-offs concerning FLI disclosure are different from those concerning retrospective information: there is a comprehensive regime requiring disclosure of various data on backward-looking information, but complete discretion to disclose FLI. It is consistent with issuer discretion to disclose FLI at all to confer on issuers discretion over liability standards when FLI is disclosed.

Finally, the role for disclaimers contemplated in *Danier* and in my analysis is also consistent with the statute. For the issuer choice regime to operate successfully there must be confidence in the role of disclaimers and other representations by the issuer. This confidence is manifest in the OSA. The statute explicitly relies on disclaimers, as noted above, in s. 132.1(1): an issuer is not liable for misrepresentations concerning FLI if it includes appropriate cautionary disclaimers and the FLI is reasonable. The legislature’s acceptance of the role of cautionary language in s. 132.1(1) provides support for reliance on issuer choice found in the *Danier* decision. If

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40. See also, Fraiberg and Yalden, *supra*, footnote 5.
41. Itself a matter of some debate: see, e.g., Easterbrook and Fischel, *supra*, footnote 33.
42. Given the wide range in reliability of FLI, such a statutory distinction almost certainly makes sense.
43. Some might argue that s. 132.1 is an exclusive defence to misrepresentations for FLI and it includes a reasonableness requirement, which would render it inconsistent with the issuer choice regime set out in this article. In my view, the
there were no confidence that investors would take disclaimers seriously, it would be wrong to create safe harbours based on such disclaimers. Reliance on disclaimers is consistent with the statute.

V. CONCLUSION

I have concluded that the decision in Danier Leather is both consistent with the statute, and economically grounded. Conspicuous by its absence in the discussion thus far is attention to securities regulators’ policy statements. These sometimes advance an expansive view of an issuer’s obligations with respect to FLI. For example, National Policy 48, now repealed, purported to require issuers to update FLI whenever there is new information, material change or not, that has a material effect on the FLI. The Court of Appeal in Danier explicitly disavowed deference to National Policy 48, noting that it did not have the force of law as a result of Ainsley Financial Corp. v. Ontario (Securities Commission). 44

Even though it was not a source of law under Ainsley, it might be suggested that National Policy 48 should have had persuasive force for courts in interpreting the OSA in Danier. Without commenting generally on the appropriate role for policy statements, the legal and policy analysis in this paper suggests that courts were correct to place little weight on NP 48 on FLI. The Supreme Court in Danier interprets the statute in a manner that defers to the issuer’s own representations about future liability. This attitude was manifest in the court’s analysis of specific questions in that case, the duty to update and the business judgment rule. The court’s posture, which has a strong economic basis, implies a departure from the more regulatory approach of National Policy 48.

At the end of 2007, securities regulators updated the law, not just the policy, surrounding the disclosure of FLI by amending National Instrument 51-102; unlike policy statements, national instruments are adopted by provinces as rules and thus have the force of law. The instrument departs from the Danier decision in important respects. On the question of the duty to update, the instrument does not require

better interpretation of s. 132.1 is that it sets out a safe harbour (and one that emphasizes disclaimers), but that it is not the exclusive defence to a misrepresentation. As noted above, in determining its standard of review, the Supreme Court’s decision in Danier emphasized the content of the actual disclosures of Danier, concluding that they implied reasonableness as a matter of fact. It is thus consistent with the letter and spirit of the Supreme Court’s reasons in Danier to adopt a standard of review that is consistent with issuers’ disclaimers, including those that effectively adopt the business judgment rule.

a timely update of previously issued FLI; issuers do not have an ongoing duty immediately to update FLI except if there has been a material change. Thus, the instrument would not change the decision on the duty to update in Danier itself. However, the instrument does establish a duty on the issuer to describe in the management discussion and analysis portion of periodic disclosures any events that may reasonably be expected to cause actual events to differ from previously issued, material FLI. While not creating a timely duty to update, the instrument does require periodic updates. Requiring updates, even if only periodic, exposes the issuer to liability for failing to update the virtually infinite number of variables that could affect previously-issued FLI. Increased liability risk associated with mandatory updates could chill the disclosure of FLI. This could result in less, not more, information in the marketplace. Of course, some issuers would voluntarily commit to periodic updates, as Danier itself did. Given that there are trade-offs in determining the appropriate approach to the duty to update, and that the issuer has information and incentives to make the appropriate trade-off the issuer is best placed to determine the scope of its own duty to update. National Instrument 51-102 is a step backward in this respect; the issuer-generated duty to update established in Danier is preferable.

There is another departure in NI 51-102 from Danier. While in Danier the Supreme Court asked whether the issuer represented in fact that its FLI disclosures were reasonable, NI 51-102 requires that the disclosure be reasonable. It is likely, then, that when evaluating possible misrepresentations found in FLI, courts would take it as a starting point that disclosures must be reasonable on an objective basis, as opposed to, for example, simply reflecting the subjective belief of management given the issuance of disclaimers that establish such a basis for evaluation. Such an approach goes too far under this article’s analysis. While a default presumption of reasonableness is appropriate, allowing issuers to establish a different standard in its disclaimers is also desirable. The Supreme Court’s take on the OSA in Danier created room for such issuer choice. On this analysis, National Instrument 51-102 is an unwelcome development. Rather than having the choice of relying on, for example, market punishments for subjectively believed views that turn out to be wrong ex post, issuers of FLI are compelled to accept the risk of legal liability for FLI that a court determines ex post to be unreasonable. The statute itself, as interpreted by the court in Danier, takes a better approach.

In conclusion, the fundamental strength of the Danier approach is to place authority for resolving trade-offs of the costs and benefits of
legal liability for FLI in the hands of the issuer. Such an approach encourages the issuance of FLI, and predictably leads to more information in the marketplace, than mandatory, stricter standards such as those found in National Instrument 51-102. Given that FLI under the statute need not be disclosed at all, and when it is the statute recognizes a role for disclaimers, it is not only desirable from a policy point of view, but is consistent with the statute to create space for issuers to tailor liability for FLI: the option to disclose recognizes that legal liability for FLI is not like that for other kinds of information; and the statutory reliance on disclaimers evinces confidence in the sophistication of investors to protect themselves on the basis of issuers’ qualifications to the reliability of FLI. Danier provided the right approach.