

## Securities E-News



**JULY 2011**

### **The Supreme Court of Canada Considers Materiality Standard**

On May 11, 2011, the Supreme Court of Canada released a unanimous decision in *Sharbern Holding v. Vancouver Airport Centre*. This case provides securities law practitioners and public company officials with important guidance in determining materiality in the context of disclosure documents.

The facts of the case are relatively straightforward. Vancouver Airport Centre Ltd. (VAC) was incorporated for the purpose of developing and marketing two hotels on the same property, namely a Marriott hotel and a Hilton hotel. The two hotels were essentially identical and were joined by a shopping concourse. Strata lots in each hotel were marketed and developed at different times, resulting in differences in the financial arrangements offered to the purchasers of each hotel. VAC offered purchasers in the Marriott hotel a guaranteed gross return of 12%; VAC was entitled to a monthly management fee equal to a percentage of the gross rental revenue as well as an incentive management fee. VAC did not offer purchasers in the Hilton hotel a gross return guarantee; however, VAC's monthly management fee for the Hilton was lower than for the Marriott, Hilton owners were given increased revenue streams and were relieved of certain expenses. The Hilton disclosure statement prepared to solicit potential investors did not disclose the differences in financial arrangements between the Hilton owners and Marriott owners. The Hilton owners incurred losses.

The appeal arises from a class action lawsuit in which the appellant Sharbern Holding Inc. (Sharbern) purchased strata lots in the Hilton hotel and claimed that VAC was liable for failing to disclose details about differences in the financial arrangements given to the Hilton owners, and those given to the Marriott owners. Before the court, Sharbern alleged that the differences resulted in an undisclosed conflict of interest in that they created an incentive for VAC to favour the Marriott over the Hilton in VAC's operation and management of the two hotels.

The trial judge decided in favor of Sharbern on the basis that the undisclosed differences in financial arrangements gave rise to at least a potential conflict of interest, particularly in view of the potential for common management of the two hotels. She concluded that VAC negligently misrepresented both the absence of an actual or potential conflict of interest and the nature of the agreements between VAC and the Marriott owners.

The Court of Appeal found that the details of the financial arrangements between the two hotels were not material and reversed the trial court judgment.

Two main questions were raised on appeal before the Supreme Court of Canada. The first was whether VAC was liable for making material false statements in the offering memorandum and disclosure statement that it used to sell the Hilton strata lots. The second question dealt with whether VAC was liable for breach of fiduciary duty when it acted as manager of the Hilton under the hotel asset management agreement. The Supreme Court concluded that Sharbern's claims failed on both grounds and dismissed the appeal.

Although the statutory provision considered in the case was a requirement under the British Columbia *Real Estate Act* which imposed liability for a "material false statement," Justice Rothstein's discussion of the concept of materiality is still highly relevant to securities law practitioners and public company officials. In his reasons for the judgment, Justice Rothstein summarized the important aspects for determining materiality in disclosure documents. The judgment contains five important considerations which should guide anyone required to determine the materiality of a particular fact, statement or omission:

- i. **Materiality is a Question of Mixed Law and Fact.** Materiality is a question of mixed law and fact, determined objectively, from the perspective of a reasonable investor. This statement was made by Justice Rothstein in light of an argument put forward at trial by Sharbern's counsel to the effect that there was no need for a plaintiff to tender industry or expert evidence as to what would influence a reasonable investor because the question of materiality of conflicts of interest in a prospectus is uniquely for the court, involving a question of construction. To support this assertion, Sharbern's counsel referred to the statement made by Justice Binnie in *Kerr v. Danier Leather Inc.* [2007] 3 S.C.R. 331 where in the context of explaining that the business judgment rule should not be used to qualify or undermine the duty of disclosure, Justice Binnie declared that disclosure was a matter of legal obligation. In his reasons, Justice Rothstein contrasted the statement made by Justice Binnie in *Kerr* by saying that the business judgment rule is applied by courts when they are asked to resolve disputes involving business decisions made by managers whereas, in the opinion of Justice Rothstein, judges are not less expert than business managers when it comes to the application of a legal standard to a given set of facts, noting that managers' assessment of risk has nothing to do with meeting their disclosure obligations. Justice Rothstein added: "While VAC made its own assessment of what information it was required to include in the Hilton disclosure statement, it is the court that determines whether the disclosure made meets VAC's legal obligations."
- ii. **Substantial Likelihood and the Probability vs Possibility Standard.** An omitted fact is material if there is a substantial likelihood that it would have been considered important by a reasonable investor in making his or her decision, rather than if the fact merely might have been considered important. In other words, an omitted fact is material if there is a **substantial likelihood** that its disclosure **would** have been viewed by the reasonable investor as having significantly altered the total mix of information made available.
- iii. **The Standard of Proof for Materiality.** The proof required is not that the material fact would have changed the decision, but that there was a substantial likelihood it would have assumed actual significance in a reasonable investor's investment-decision deliberations.
- iv. **Materiality to be Determined in Light of the Total Mix of Information.** Materiality involves the application of a legal standard to particular facts. It is a fact-specific inquiry, to be determined on a case-by-case basis in light of all of the relevant considerations and from the surrounding circumstances forming the total mix of information made available to the investors.
- v. **Burden of Proof Rests on the Party Alleging Materiality.** The materiality of a fact, statement or omission must be proven through evidence by the party alleging materiality, except in those cases where common sense inferences are sufficient. A court must first look at the disclosed information and the omitted information. A court may also consider contextual evidence which helps to explain, interpret or place the omitted information in a broader factual setting, provided it is viewed in the context of the disclosed information. As well, evidence of concurrent or subsequent conduct or events that would shed light on potential or actual behaviour of persons in the same or similar situations is relevant to the materiality assessment. However, the predominant focus must be on a contextual consideration of what information was disclosed, and what facts or information were omitted from the disclosure documents provided by the issuer.

In conclusion, this five-part test will serve as a road map to determine whether a particular fact, statement or omission is material and could trigger a disclosure obligation. *Sharbern Holding v. Vancouver Airport Centre*,

together with the Canadian Securities Administrators' National Policy 51-201 - Disclosure Standards and the United States Securities and Exchange Commission Staff Accounting Bulletin No. 99, constitute the reference toolkit to be used by anyone who has to determine the materiality of a specific fact, statement or omission in the context of drafting reporting issuers' continuous disclosure or offering documents.

### Need Assistance?

Heenan Blaikie's securities law practice has significant experience with representing reporting issuers and their reporting obligation be it under stock exchange rules or securities law. If you have any questions on the subject addressed in this Securities E-News or would like assistance in assessing its likely impact on your company's disclosure obligations, please feel free to contact us.

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