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Supreme Court of Canada Weighs in on Disclosure Standard in Relation to Real Estate Developments in British Columbia

On May 11, 2011, the Supreme Court of Canada released its reasons for judgment in *Sharbern Holding Inc. v. Vancouver Airport Centre Ltd*, 2011 SCC 23.

While the case was decided under the now repealed *Real Estate Act*, R.S.B.C. 1996, c. 397, the findings are nonetheless of interest to real estate developers governed by the *Real Estate Development Marketing Act*, S.B.C. 2004, c. 41 ("REDMA"). Much of the Court's analysis should apply in the context real estate developments and disclosure statements governed by REDMA despite some content differences between the repealed and current statute. In addition, the decision has relevance to other statutory disclosure regimes based on the concept of materiality, such as securities law regimes.

The decision resonates with a common sense approach to materiality, which recognizes the need for investors to be informed but at the same time rejects the proposition that investors should be entitled to a remedy in relation to any non-disclosure they are able to seize upon, no matter how trivial or unimportant.

Background

Sharbern Holding Inc. ("Sharbern") was the representative plaintiff in a class action against a developer, Vancouver Airport Centre Ltd. ("VAC"). Sharbern represented investors who had purchased strata lots in a Hilton hotel from VAC (the "Hilton Owners"). VAC also developed and marketed strata lots in an adjacent Marriott hotel to other investors (the "Marriott Owners"). VAC entered into a separate Hotel Asset Management Agreement with each set of owners whereby it was given exclusive management of each of the hotels for 20 years, with an option to renew.

Sharbern alleged that VAC had failed to disclose details about differences in the financial arrangements given to the Hilton Owners versus those given to the Marriott Owners. The two primary differences were: 1) Marriott Owners were offered a guaranteed gross return of 12% of the unit purchase price; and 2) VAC's management fee for managing the Marriott was comprised of 5% of gross rental revenue and an added incentive based on the owners' net annual return on investment, whereas VAC's management fee for managing the Hilton was 3% of gross rental revenue (the "Compensation Differences").

Sharbern alleged that the Compensation Differences resulted in an undisclosed conflict of interest in that they created an incentive for VAC to favour the Marriott over the Hilton in its operation and management of the two hotels.

As the Hilton strata lots were a combination of an interest in real estate and an interest in a rental pool, VAC's disclosure obligations were governed by both the *Real Estate Act* and the *Securities Act*, R.S.B.C. 1996, c. 418. VAC issued a document that was a combination of both a *Securities Act* offering memorandum and a *Real Estate Act* disclosure statement.

Sharbern relied on the statutory cause of action contained in s. 75 of the *Real Estate Act,* the common law of negligent misrepresentation, and breach of fiduciary duty.

Under s. 75 of the *Real Estate Act*, a developer was liable to investors for any resulting loss they may have sustained if a "material false statement" was contained in a disclosure statement. Under this provision, investors were deemed to have relied on any such material false statement.

However, s. 75(2)(b)(viii) of the *Real Estate Act* contained a statutory defence that precluded a developer from being found liable under s. 75 if the developer had reasonable grounds to believe, and did believe up to the time of the sale, that the material false statement was true. To rely on the defence, VAC had to show that (i) it subjectively believed the representations it made were true; and (ii) it objectively had reasonable grounds for such a belief.

The trial judge, Madam Justice Wedge, concluded that the undisclosed Compensation Differences gave rise to at least a potential conflict of interest, particularly in view of the potential for common management of the two hotels. Although it is unclear from her reasons whether she was making a finding of misrepresentation both under s. 75 of the *Real Estate Act* and at common law, she found 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 and that both misrepresentations were "material". She held that the deemed reliance on misrepresentations codified in the *Real Estate Act* was irrebuttable. She also held that VAC was a fiduciary of the Hilton Owners in its capacity as manager of the hotel and that VAC breached its fiduciary duty by failing to disclose the actual or potential conflict of interest and by entering into a non-competition agreement with the Marriott Owners on behalf of the Hilton Owners without prior consent.

The Court of Appeal overturned Wedge J.'s findings with respect to misrepresentation, deemed reliance and breach of fiduciary duty. Sharbern sought and obtained leave to appeal to the Supreme Court of Canada.

The Supreme Court of Canada dismissed the appeal, and in doing so identified the following errors by the trial judge:

1. She treated the existence of a potential or actual conflict of interest as presumptively or inherently material rather than requiring proof of materiality;

2. She improperly reversed the onus of proof of materiality by requiring VAC to disprove materiality;

3. She failed to consider all of the evidence relevant to the determination of materiality;

4. She wrongly concluded that the presumption of deemed reliance on misrepresentations under the *Real Estate Act* was irrebuttable;

5. She failed to properly consider the defence under s. 75(2)(b)(viii) in the face of evidence led by VAC that it believed the representations it made were true and that it objectively had reasonable grounds for such a belief;

6. She erred in failing to consider and apply the elements of the common law tort of negligent misrepresentation;

7. She erred in finding that there was a breach of the fiduciary duty of disclosure since VAC had already disclosed, and the Hilton Owners had consented to, VAC's common management of the two hotels. VAC was only obliged to disclose the Compensation Differences if they constituted material facts of information beyond what had already been disclosed and Sharbern failed to adduce evidence to establish the materiality of the Compensation Differences; and

8. She erred in ruling that by entering into a non-competition agreement with the Marriott Owners, VAC breached a fiduciary duty owed to the Hilton Owners.

Overarching Principles Enunciated by the Court

The Supreme Court of Canada acknowledged that in the context of securities being offered for sale to the general public, the content of a statutory duty of disclosure may vary from statute to statute. However, the Court identified a common theme and articulated a limitation on the duty of disclosure based on business common sense. The common theme is that issuers must disclose to potential investors information affecting their investment decision. The common sense limitation is that issuers are not subject to an indeterminate obligation, such that an unhappy investor may seize on any trivial or unimportant fact that was not disclosed to render an issuer liable for the investor's losses.

In considering the case law on disclosure in a securities law context, the Court noted that it was not in the interests of investors to be buried "in an avalanche of trivial information" that will impair decision making (at paragraph 43). Rather, Rothstein J. said, the materiality standard calls for the disclosure of information that a reasonable investor would consider important in making an investment decision. He went on to say (at paragraph 65) that "the statutory requirement does not impose on issuers an obligation to disclose all facts that would permit an investor to sort out what was material and what was not. This approach would not only result in excessive disclosure, regardless of materiality, it would overwhelm investors with information and impair, rather than enhance, their ability to make decisions."

As I will discuss in more detail in what follows, I am of the view that these overarching principles and approach apply to non-disclosure claims rooted in REDMA, notwithstanding the differences between the former *Real Estate Act* and that statute.

Specific Findings as to Common Law Test for Materiality

The Supreme Court of Canada, critical of the trial judge's approach to assessing materiality and her treatment of the evidence and onus of proof, articulated a methodology for determining materiality of a non-disclosure or misrepresentation.

Key statements by the Court include the following:

- There must be a substantial likelihood that an omitted fact would be considered important (rather than *might* be considered important) for it to be material;
- Materiality is a contextual matter, determined in light of the total mix of information made available to an investor;
- Materiality involves the application of a legal standard to particular facts and is therefore necessarily a fact-specific inquiry to be determined on a case-by-case basis;
- The burden of proof is on the party alleging materiality, who must provide evidence in support of that contention (except in those cases where common sense inferences are sufficient);
- Materiality is to be determined objectively, from the perspective of a reasonable investor;
- Evidence of the behaviour of other potential investors and actual investors is relevant. For example, in this case there was evidence of the conduct of fully informed investors in the Hilton, either prior to making their investment decision or subsequent to their investment, when they had learned of the guarantee given to Marriott Owners, which the trial judge failed to take into account.

To What Extent Do These Overarching Principles and Findings on the Common Law Test for Materiality Apply to Disclosure Statements Under REDMA?

A reader of the judgment should exercise caution when considering its application to claims brought under REDMA for the simple reason that whereas the *Real Estate Act* did not define "material false statement" (justifying an examination of the common law test for materiality), REDMA defines the term "material fact" in significant detail. The term "material fact" is then incorporated into the definition of "misrepresentation" and that term is used in s. 22 of REDMA, which sets out the equivalent statutory cause of action to the former s. 75 cause of action.

Specifically, the definitions of "material fact" and "misrepresentation" in REDMA read as follows:

> **"material fact"** means, in relation to a development unit or development property, any of the following:
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> (a) fact, or a proposal to do something, that affects, or could reasonably be expected to affect, the value, price, or use of the development unit or development property;
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> (b) the identity of the developer;
>
> (c) the appointment, in respect of the developer, of a receiver, liquidator or trustee in bankruptcy, or other similar person acting under the authority of a court;
>
> (d) any other prescribed matter;
>
> **"misrepresentation"** means
>
> (a) a false or misleading statement of a material fact, or
>
> (b) an omission to state a material fact;

These definitions are not only incorporated into s. 22 of REDMA (the equivalent of former s. 75 of the *Real Estate Act* which the Supreme Court of Canada was considering), they are also incorporated into sections 14 through 16, which set out the disclosure obligations of developers. In addition to giving rise to a potential statutory cause of action for misrepresentation under s. 22, failure to comply with these provisions may result in an agreement to purchase or lease a development unit being unenforceable under s. 23 of REDMA.

Despite this important difference between the two statutory regimes, there are many similarities between the old *Real Estate Act* regime and the REDMA regime. Both provide a statutory remedy for misrepresentation and a provision whereby non-compliance with the disclosure regime may render the agreement to purchase unenforceable. Under s. 22 of REDMA, the purchaser is deemed to have relied on the misrepresentation in the same way they would have been under s. 75 of the *Real Estate Act.* Section 22 contains a defence similar to that found in old s. 75(2)(viii), although that defence is now only available to "individuals".

Subsection 22(5) of REDMA expressly provides that the presumption of reliance on the misrepresentation is rebuttable by proof that the purchaser had knowledge of the misrepresentation at the time they received the disclosure statement.

One might argue, I suppose, that because the term "material fact" is exhaustively defined in REDMA, what the Supreme Court had to say about common law materiality in *Sharbern* is not relevant to the new regime. This argument, I submit, would be misguided. Instead, I suggest that the recent decisions of the Court of Appeal and Supreme Court of British Columbia in which purchasers have successfully resisted enforcement of agreements to purchase under s. 23 of REDMA now have to be read in the context of the *Sharbern* decision and as qualified thereby to the extent they are inconsistent with the overarching principles articulated by the Supreme Court of Canada.

The REDMA definition of "material fact" (in particular, the definition in paragraph (a)) gives us categories of information that may be material but does not eliminate the need for an inquiry into whether a particular undisclosed or misrepresented fact is, under the definition, material. I submit that the onus remains squarely on the purchaser to lead evidence of materiality, *i.e.*, on how the undisclosed or misrepresented fact affects or reasonably could be expected to affect the value, price or use of the development unit or development property.

I suggest that going forward, judges will be cautious about drawing what Mr. Justice Rothstein described as a "common sense inference" as to the affect of the undisclosed or misrepresented fact on value, price or use of the development unit in the absence of positive evidence on that issue. In some of the pre-existing cases, the drawing of such an inference seems to have been virtually automatic: see for example, *Chameleon Talent Inc. v. Sandcastle Holdings Ltd*., 2010 BCCA 300 and *Ulansky v. Waterscape Homes Limited Partnership*, 2011 BCSC 83.

I also suggest that in light of this decision, it should be open to developers in future cases to lead evidence tending to establish that the undisclosed or misrepresented fact could not reasonably be expected to affect value, price or use of the development unit from the perspective of a reasonable investor, including evidence of how other fully informed investors behaved.

The Supreme Court of Canada has made clear that although these types of statutory regimes are consumer legislation and oust the rule of *caveat emptor,* such enactments have been framed to provide a balance between too much and too little disclosure. One can hope that this common sense limitation might limit the practice of purchasers experiencing buyer's remorse "firing a bucket of grapeshot over the deck" of the vendor/developer (to use the description of Melnick J. in *Watson v. Havaday Developments Inc*., 2011 BCSC 505 at paragraph 21).

Picayune details that might notionally be said to go to the value, price or use of a unit but which would not affect the investment decision of a reasonable investor should not serve as a cynical out for purchasers in a falling market.

Ruling on Common Law Action for Negligent Misrepresentation

The Supreme Court of Canada ruling confirms the availability of a common law action for negligent misrepresentation as an alternative to the statutory cause of action found in s. 75 (now s. 22 of REDMA).

The Court's ruling also clarifies that where a purchaser is pursuing a common law action for negligent misrepresentation, they must prove the elements of that cause of action, including a breach of the standard of care and reasonable reliance by the investor on the alleged misrepresentation.

Hotel Management Agreements Giving Rise to Fiduciary Duties

Separate and apart from the rulings on the statutory and common law actions for misrepresentation and the common law test of materiality is the Court's ruling on whether VAC owed fiduciary duties to the Hilton Owners that it had breached. This aspect of the decision is of interest to developers who choose to take on a management role in relation to rental strata properties once they have marketed them to owners who have purchased the lots in order to obtain an income stream.

After agreeing with the trial judge that fiduciary duties will not necessarily exist in all agency relationships, the Court confirmed that because VAC was given discretion as a manager, had the ability to unilaterally affect the Hilton Owners' legal or practical interests and because the Hilton Owners were particularly vulnerable in that regard, VAC owed fiduciary obligations to them.

However, the Supreme Court of Canada rejected the trial judge's finding that VAC had breached its fiduciary duty of disclosure in all the circumstances.

In particular, the Court held that the fiduciary relationship was circumscribed by the contractual bargain and the knowledge of the Hilton Owners that VAC would be simultaneously balancing fiduciary obligations owed to them and to owners of a competitor property. VAC had already disclosed, and the Hilton Owners had consented to, VAC's common management of the Hilton and Marriott hotels.

VAC was only obliged to disclose the Compensation Differences if they constituted material facts or information beyond what had already been disclosed. Sharbern failed to prove materiality in this context.

The trial judge also held that it was a breach of fiduciary duty for VAC to commit the Hilton Owners to a non-competition agreement with the Marriott Owners in the absence of the former's consent. The Supreme Court of Canada disagreed. Mr. Justice Rothstein noted that: 1) the Disclosure Statement provided that VAC had the right to enter into such agreements; and 2) such

agreements would be part of the ordinary day-to-day course of business not feasibly requiring consent of all the owners. He went on to find that the trial judge failed to consider the totality of the evidence on the overall practice of cooperation between the hotels.

Developers who take on a management role after these types of units are sold should be aware of fact that they will owe fiduciary duties, including a duty of disclosure and a duty to avoid conflicts of interest. However, the Supreme Court's approach underscores the fact that even in the context of a fiduciary relationship, both the duty to disclose and the duty to avoid conflicts of interest are contextual and may be circumscribed by the contract between the parties.

For more information, please contact Lisa A. Peters, Senior Research and Opinions Partner at lpeters@lawsonlundell.com or 604.631.9207.