MAY 21, 2019

Good Laws Gone Bad: Continued Confusion over the Materiality Standard in Civil Misrepresentation Actions

The following article was originally published in our *2019 Canadian Capital Markets Report*.

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Civil liability for secondary market disclosure was conceived by securities regulators with the best of intentions. But, left to the courts to develop without supervision by its makers, it has of late become an unruly child.

Two recent Ontario court decisions – *Wong v Pretium Resources*, 2017 ONSC 3361 (*Wong*), and *Paniccia v MDC Partners Inc.*, 2018 ONSC 3470 (*Paniccia*) – have compounded the confusion over the appropriate standard for assessing materiality for the purpose of granting leave to proceed under the secondary market liability provisions of the Ontario *Securities Act* (OSA). Issuers should be aware of this uncertainty in the case law and should test their disclosure decisions against both the "market impact test" found in the text of the OSA and the lower threshold of the "reasonable investor test."

Wong: To Disclose or Not to Disclose? Consider the "Reasonable Investor"

In *Wong*, the Ontario Superior Court of Justice granted the plaintiff leave to proceed with an action under section 138.3 of the OSA for secondary market misrepresentation against Canadian mining company Pretium Resources Inc. (Pretium).

The allegations in *Wong* related to Pretium's decision not to disclose concerns raised by an external consultant regarding unfavourable mineral sampling results at Pretium's flagship Brucejack Project. Pretium believed that the concerns raised by its consultant were unfounded and that the mineral sampling results were inaccurate. It therefore decided not to disclose the consultant's concerns to the market when they were raised. The plaintiff argued that Pretium's failure to disclose the external consultant's concerns in its press releases, material change reports and MD&A's issued during the relevant period were a misrepresentation by omission.

Despite Pretium's genuine belief that the concerns raised by its external consultant were unfounded, and that Pretium's belief was ultimately proven correct, the Court found there was a reasonable possibility that the plaintiff would succeed at trial and accordingly granted the plaintiff leave to proceed with the action.[1]

The Court found that the consultant's concerns regarding the mineral sampling results were material facts requiring disclosure by Pretium at the time they were raised by the consultant. In assessing the alleged materiality of the consultant's concerns, the Court applied the "reasonable investor test" and found that a reasonable investor would have considered the consultant's concerns to be important when deciding whether to invest in Pretium, regardless of the company's own views. Critically, in applying the reasonable investor test, the Court made a determination of materiality without appropriate regard to the relevant test for materiality set out in the OSA – namely, whether the information would reasonably be expected to have a significant effect on the market price or value of the company's securities (i.e., the "market impact test").

By failing to consider the impact (if any) that Pretium's failure to disclose had on the market price or value of Pretium's securities, the Court moved away from the objective market impact test set out in the OSA and applied a lower threshold for assessing the materiality of the information in question.

Paniccia: Following in *Wong*'s Footsteps

In *Paniccia*, the Ontario Superior Court of Justice followed *Wong* and applied the reasonable investor test, as opposed to the market impact test mandated by the OSA, while assessing the materiality of alleged misrepresentations in another application for leave to proceed with an action under the secondary market liability provisions of the OSA.

The plaintiff in *Paniccia* alleged that there were numerous misrepresentations in the continuous disclosure of the defendant MDC Partners Inc. (MDC), including that

- MDC did not disclose that the U.S. Securities and Exchange Commission (SEC) had served a subpoena on MDC;
- MDC did not disclose that it had formed a special committee to conduct an internal investigation regarding its internal controls over financial reporting; and
- MDC failed to accurately disclose its CEO's compensation.

In dismissing the plaintiff's motion for leave to proceed, the Court found that there was a "fundamental flaw" in the plaintiff's case – namely, that none of the alleged misrepresentations were material.

In assessing materiality, the Court evaluated whether each piece of information not addressed in MDC's public disclosure constituted a material fact, which is a prerequisite to qualifying as a misrepresentation for purposes of the civil liability provisions of the OSA. The Court canvassed the law surrounding materiality and the definition of material fact under the OSA and, in doing so, correctly recognized that the definition of material fact encompasses "any fact that reasonably would be expected to have a significant effect on the market price or value of the securities of an issuer" (the market impact test). However, the Court also cited the decision in *Wong* in support of the proposition that a fact may be considered material "if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to invest and at what price" (the reasonable investor test).

Although the Court recognized that the appropriate standard for determining materiality under the OSA is the market impact test, it arguably departed from that standard in applying the reasonable investor test to conclude that the alleged misrepresentations were not material. Fortunately for MDC, the application of the lower threshold for materiality under the reasonable investor test, as opposed to the market impact test set out in the OSA, did not have an effect on the outcome of the case.

Key Considerations

The fundamental issue raised by *Wong* and *Paniccia* is that the reasonable investor test sets a lower threshold for materiality than does the market impact test. That is to say, a reasonable investor may consider certain information important when making an investment decision when that same information would not be reasonably expected to have a significant effect on the market price or value of a company's securities. This critical distinction between the two tests has been confirmed by the Ontario Divisional Court in *Cornish v Ontario Securities Commission*, 2013 ONSC 1310.

Perhaps the solution is for Canadian securities regulators to intervene in secondary market civil liability cases to help guide this unruly child back onto its intended path. Until that happens, issuers should bear *Wong* and *Paniccia* in mind and ensure that their disclosure meets both the statutory market impact test and the judicially imposed, lower threshold of the reasonable investor test.

Further, Canadian issuers should be aware of the following:

- When assessing materiality, courts will not defer to the business judgment of executives in making an assessment as to whether public disclosure is required.
- Materiality is not assessed with the benefit of hindsight. As demonstrated in *Wong*, the fact that an issuer is later proven to be correct may not be considered a relevant factor in assessing the materiality of the information at the relevant time.
- The primary goal of the OSA is investor protection and the application of the law on materiality will be viewed through this lens.

[1] In determining whether to grant a plaintiff leave to proceed with an action for misrepresentation under section 138.8(1) of the OSA, a court considers the merits of the plaintiff's case and must assess whether "there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff."

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