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Second Circuit Addresses Materiality Standard Under Federal Securities Law in *Landman Partners, Inc.* v. *The Blackstone Group, L.P.*

In an opinion issued on February 10, 2011, in *Landman Partners, Inc.* v. *The Blackstone Group, L.P.*, a panel of the United States Court of Appeals for the Second Circuit adopted a view of materiality that may potentially reduce the pleading burden of plaintiffs asserting claims under the federal securities laws. The ruling runs counter to a judicial trend that, since the Supreme Court's ruling in *Bell Atlantic Corp*. v. *Twombly*, 550 U.S. 544 (2007), has applied greater scrutiny to securities class action complaints. It did so by, among other things, minimizing the pleading obligations in claims under Sections 11 and 12(a)(2) of the Securities Act of 1933; focusing its analysis on the importance of the allegedly misleading statements to a corporate segment, rather than the public entity itself; and permitting a claim to be based on corporate and market developments that were publicly known but not specifically described in the registration statement at issue.

Background

Blackstone is an alternative asset manager and financial advisory firm. As of May 1, 2007, corporate private equity and real estate funds comprised approximately half of Blackstone's $88.4 billion assets under management. In June 2007, Blackstone offered stock in an initial public offering. The following April, investors in the IPO brought suit against Blackstone alleging that it made material omissions and misstatements in its registration statement and prospectus in connection with the IPO, in violation of Sections 11 and 12(a)(2) of the Securities Act.

Specifically, the plaintiffs alleged that Blackstone failed to disclose risks associated with its private equity funds' investments in FGIC Corp., a monoline insurer that had recently begun issuing credit default swaps insuring collaterized debt obligations and residential mortgage-backed securities backed by sub-prime mortgages, and in Freescale Semiconductor, Inc., a manufacturer of semiconductors which had lost an exclusive contract to manufacture chips for Motorola. The plaintiffs also alleged that Blackstone failed to disclose and made affirmative misstatements regarding the risks facing its real estate funds in light of the downturn in the subprime residential market (though Blackstone's real estate holdings were 85% commercial, not residential).

Section 11 prohibits material misstatements or omissions in a registration statement and Section 12(a)(2) prohibits material misstatements and omissions in a prospectus. A statement is deemed to be material if "a reasonable investor would have considered [it] significant in making an investment decision." *Ganino* v. *Citizens Utils. Co.*, 228 F.3d 154, 161-62 (2d Cir. 2000). Following the SEC's Staff Accounting Bulletin No. 99 ("SAB 99"), the Second Circuit has held that, as a starting place or preliminary assumption, 5% is an appropriate numerical threshold for materiality, but that courts must consider both quantitative and qualitative factors in assessing materiality. While the *Blackstone* decision considered claims under the Securities Act, the materiality standard is the same (though the pleading standard is higher) for claims under the securities fraud provisions of the Securities Exchange Act.

Blackstone moved to dismiss the complaint, arguing, among other things, that the alleged omissions and misstatements were not material. The district court granted Blackstone's motion to dismiss, finding that the alleged omissions and misstatements were not material as a matter of law. Applying SAB 99, the district court found that the investments in FGIC and Freescale each fell below the 5% threshold for materiality and that only one of the six tests of SAB 99 for qualitative materiality was satisfied.

The Second Circuit Opinion

The Second Circuit Court of Appeals reversed the district court's decision dismissing the complaint. The Second Circuit stressed that materiality is an "inherently fact-specific finding" and therefore, at the motion to dismiss stage, while the pleading burden under Sections 11 and 12(a)(2) is "relatively minimal" generally, the burden with respect to materiality "is even lower."

The Second Circuit acknowledged that Blackstone's investments in FGIC and Freescale "f[e]ll below the presumptive 5% threshold of materiality" at the corporate level, but stressed that the numerical threshold was simply a starting point for the assessment of materiality. In particular, the Court held that where, as in *Blackstone*, the issuer has multiple segments, if a misstatement is significant to "a particularly important segment of a registrant's business" it may be material even if it is "quantitatively small compared to a registrant's firm-wide financial results." In the case of Blackstone, the Court reasoned that investors would be particularly interested in details about the company's private equity investments because private equity is Blackstone's "flagship segment."

In addition, Blackstone argued that its alleged omissions were not material because the relevant information – Freescale's loss of its contract with Motorola and the downturn in the subprime residential market – was publicly available and thus was already part of the total mix of information available to investors. The Second Circuit rejected this argument. The Court acknowledged that, as a general matter, the total mix of information may include information already in the public domain and facts known or reasonably available to potential investors. However, the Court concluded that "case law does not support the sweeping proposition that an issuer of securities is never required to disclose publicly available information" and held that, even if the underlying events were public, their potential impact on Blackstone may not have been publicly known.

Finally, with respect to the alleged omissions and misstatements related to Blackstone's real estate investments, the Court found that the plaintiffs' allegations about the "general deterioration of the real estate market" were sufficient to state a claim. Because Blackstone's real estate segment played a "significant role" in Blackstone's business and it was possible that the residential market downturn would come to affect the commercial markets in which Blackstone owned substantial assets, the Court reasoned that "[a] reasonable Blackstone investor may well have wanted to know of any potentially adverse trends" concerning Blackstone's real estate investments. Thus, the Court found, the alleged misstatements and omissions were qualitatively material.

Discussion

The Second Circuit's decision in *Blackstone* is significant for a number of reasons. First, its emphasis on the limited nature of the burden of pleading materiality – a frequent and often successful basis of motions to dismiss claims under the Securities Act of 1933 – is difficult to reconcile with the Supreme Court's approach articulated in *Twombly* and *Ashcroft* v. *Iqbal*, 129 S. Ct. 1937 (2009), and applied by the courts since those decisions.

Second, by focusing its materiality analysis on an individual business segment rather than the publicly-reporting entity itself, the decision will likely promote efforts by plaintiffs to circumvent the traditionally-accepted 5% materiality threshold by seeking to reduce the denominator. The court did so by treating as material misstatements or omissions regarding "significant" or "important" aspects of an issuer's business even if they fall below the 5% numerical threshold. Companies that segment their business into smaller units – something that may provide both greater operational control and greater transparency for investors – may therefore be placing themselves in a worse position in litigation.

Third, conducting the materiality analysis at the business segment level encourages companies, in the words of the district court, to "obfuscate[] truly material information in a flood of unnecessary detail, a result that the securities laws forbid." The Second Circuit responded that a company is only required to disclose facts that are material – but this response provides little guidance, because the question before the court was when is information material.

This decision may make it more difficult for defendants to obtain early dismissal of Securities Act claims based on a failure adequately to plead materiality. It is also likely to encourage plaintiffs, in asserting such claims with respect to matters that would until now have been considered immaterial to an issuer overall, to focus instead on the smallest business segment they can identify to which the allegedly misleading or omitted information has any possible relevance.

However, while the *Blackstone* decision goes against a recent trend of generally pro-defense decisions in securities cases, defendants still maintain several available defenses at the motion to dismiss stage. In cases brought under Sections 11 and 12(a)(2) of the Securities Act, defendants may focus their motions on whether the complaint has adequately alleged a misstatement, or attempt to demonstrate the absence of loss causation on the face of the complaint. In cases brought under Section 10(b) of the Securities Exchange Act, defendants may focus on a lack of facts sufficient to raise a strong inference of scienter, or rely on the stricter pleading standards under that statute to assert the arguments that the Second Circuit rejected in *Blackstone*. These defenses are unaffected by the *Blackstone* decision. Moreover, defendants can still, of course, argue that the complaint has not sufficiently alleged materiality, but must now anticipate and address arguments focusing on qualitative factors and on the business segment-level in preparing motions to dismiss.

Finally, because the *Blackstone* decision goes against the recent trend of generally pro-defense decisions in securities cases, it may be limited to its facts, a case in which the issuer represented that one of its segments was particularly important for the enterprise as a whole and where an offer became effective at a unique time in the market. Issuers preparing for public offerings may want to take this decision into account in crafting their disclosures, particularly any disclosures related to key business segments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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