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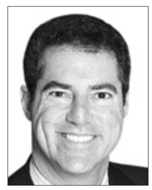
SECOND CIRCUIT REVIEW

Expert Analysis

Court Addresses Materiality Standard Under Federal Securities Law



By **Martin Flumenbaum**

And **Brad S. Karp**

This month, we discuss *Landmen Partners Inc. v. The Blackstone Group, L.P.*,[1] in which the U.S. Court of Appeals for the Second Circuit adopted a view of materiality that potentially reduces the pleading burden on plaintiffs bringing claims under the Securities Act of 1933. The opinion, written by Senior Circuit Judge Chester A. Straub and joined by Judges José A. Cabranes and Roger J. Miner, focused on the significance of misleading statements to certain segments of an issuer's business, rather than to the whole of the issuer's business. The court also permitted the claims to proceed based on corporate and market developments that were publicly known but not specifically described in the registration statement and prospectus at issue.

Background and History

Blackstone is a large financial advisory firm and alternative asset manager with approximately $88.4 billion in assets under management as of May 1, 2007. In June 2007, Blackstone offered stock in an IPO and raised more than $4.5 billion. The following April, investors in the IPO sued 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.

At the time of the IPO, Blackstone's business was divided into four segments: (1) corporate private equity; (2) real estate, which included Blackstone's management of general real estate funds and internationally focused real estate funds; (3) marketable alternative asset management, which comprised management of hedge funds, mezzanine funds, senior debt vehicles, proprietary hedge funds, and publicly traded closed-end mutual funds; and (4) a financial advisory segment, which offered a variety of advisory services.[2] The corporate private equity and real estate segments together constituted more than half of Blackstone's business and, according to the complaint, Blackstone held out the private equity segment as an important source of value for the entire Blackstone brand.

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Plaintiffs alleged that, at the time of the IPO, two of Blackstone's corporate private equity portfolio companies and its real estate fund investments faced serious risks, which Blackstone failed properly to disclose. According to plaintiffs, Blackstone knew of, and reasonably expected, these problems to subject it to a clawback of performance fees and reduced performance fees, thereby materially affecting its future revenues.

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In particular, plaintiffs pointed to FGIC Corp., a monoline insurer in the business of insuring municipal bonds, in which Blackstone, along with a consortium of investors, purchased an 88 percent interest in 2003. After Blackstone's investment, but before the IPO, FGIC began participating in riskier ventures, including issuing credit default swaps insuring collateralized debt obligations and residential mortgage-backed securities backed by subprime mortgages. By the time of the IPO, FGIC was exposed to billions of dollars in subprime mortgages and credit default swaps.[3] FGIC's shift toward a less conservative business strategy was public information, but plaintiffs alleged that Blackstone should have disclosed how these changes and related market trends "might have been reasonably expected to materially affect Blackstone's" bottom line.[4]

Plaintiffs also pointed to Blackstone's investment in Freescale Semiconductor Inc., a manufacturer of semiconductors, alleging that Blackstone should have disclosed information about Freescale's loss of an important contract. In March 2007, just before Blackstone's IPO, Freescale lost an exclusive contract to manufacture chipsets for its largest customer, Motorola, negatively impacting Freescale's revenue.[5]

Although the loss of the exclusive contract was publicly known at the time of the IPO, plaintiffs again alleged that Blackstone should have disclosed how it expected the loss of the contract to affect Blackstone's future revenue. In that vein, plaintiffs argued that Freescale was significant to Blackstone, given that it invested $3.1 billion in Freescale, representing 3.5 percent of Blackstone's assets under management and 9.4 percent of the corporate private equity segment's assets under management.

Plaintiffs further 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 sub-prime residential market. Plaintiffs alleged that Blackstone failed to disclose information about the downturn and the downturn's likely impact on Blackstone's performance fee revenue, which plaintiffs claimed was foreseeable at the time of the IPO.

Plaintiffs additionally alleged that Blackstone made an affirmative material misstatement in its registration statement by conveying a misleadingly optimistic view of the real estate market, including that "[t]he real estate industry is…experiencing historically high levels of growth and liquidity driven by the strength of the U.S. economy."[6] Plaintiffs claimed that these omissions and misstatements were material because Blackstone's real estate segment constituted 22.6 percent of its total assets under management. Although 85 percent of its real estate holdings were commercial, Blackstone's real estate holdings included at least one "modest-sized residential real estate investment."[7]

Section 11 of the Securities Act 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 investment decisions."[8] Following the SEC's Staff Accounting Bulletin No. 99 (SAB 99), the Second Circuit has held that a "five percent numerical threshold is a good starting place for assessing the materiality of the alleged misstatement."[9] In other words, an alleged misrepresentation relating to assets that constitute less than five percent of a defendant's total assets could be considered immaterial. But the Second Circuit has stated that courts also must consider qualitative factors.

Such factors may include, for example, whether the alleged omissions led to an increase in management compensation, concealed unlawful transactions or conduct, related to a significant aspect of the defendant firm's operations, hid a failure to meet analyst expectations, led to a significant market reaction, changed a loss into income or vice versa, or affected the defendant company's compliance with loan covenants or other contractual requirements.[10]

Blackstone moved to dismiss the complaint, arguing, among other things, that the alleged omissions and misstatements were not material. The district court agreed and granted Blackstone's motion to dismiss. Applying SAB 99, the district court found that the investments in FGIC and Freescale each fell below the 5 percent threshold for materiality (the FGIC investment amounted to about 0.4 percent of Blackstone's assets under management at the time; Freescale amounted to about 3.6 percent) and that only one of the SAB 99 tests for qualitative materiality was satisfied—namely, that the alleged omissions had the effect of increasing Blackstone's management's compensation.

With respect to plaintiffs' allegations about Blackstone's real estate investments, the district court held, among other things, that Blackstone's investments were commercial and that the complaint failed to "identify a single real estate investment or allege a single fact capable of linking the problems in the subprime residential mortgage market… to Blackstone's real estate investments."[11] The district court also held that Blackstone was under no obligation to disclose publicly available information about macroeconomic conditions because such matters already are part of the total mix of information available to investors.[12]

Plaintiffs appealed from the district court's judgment dismissing the complaint.

The Second Circuit Decision

The Second Circuit vacated the district court's decision, emphasizing its resistance to a "formulaic approach to assessing the materiality of an alleged misrepresentation,"[13] and holding that materiality is an "inherently fact-specific" analysis.[14] The pleading burden under Sections 11 and 12(a)(2) is generally "relatively minimal," but the burden with respect to materiality "is even lower."[15] The court explained that, in order for the complaint to fail to allege materiality, the alleged omissions and misstatements would need to have been "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance."[16]

The court acknowledged that Blackstone's investments in FGIC and Freescale "f[e]ll below the presumptive 5 percent threshold of materiality" at the corporate level, but stressed that the numerical threshold was simply a starting point for the assessment of materiality. The court held that where, as with Blackstone, the issuer has multiple segments, if a misstatement or omission 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."[17]

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."[18] The court rejected Blackstone's argument that the alleged omissions did not relate to a significant aspect of Blackstone's operations, citing allegations of Blackstone's own statements that the corporate private equity segment's "long-term leadership in private equity has imbued the Blackstone brand with value that enhances all of [its] different businesses."[19]

The court also pointed out that, within the corporate private equity segment, Freescale was alleged to be nearly three times larger than the next largest investment, and accounted for 9.4 percent of the assets in that segment. Accordingly, the court refused to hold "that the alleged loss of Freescale's exclusive contract with its largest customer and the concomitant potential negative impact on one of the largest investments in Blackstone's Corporate Private Equity segment was immaterial."[20]

In addition, the Second Circuit rejected Blackstone's argument 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 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.

'Landmen Partners' will likely increase efforts by plaintiffs to devise arguments focused on qualitative factors and business segment-level significance. However, because the decision runs contrary to the recent judicial trend of applying greater scrutiny to class action complaints, its reach may be limited to its facts.

However, the court concluded that the "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. The court explained that the key information that plaintiffs asserted should have been disclosed is the extent to which the pertinent information (e.g., FGIC's risk-taking, Freescale's loss of its exclusive contract with Motorola, the downward trend in the real estate market) was expected to impact Blackstone.

The court also noted that the district court failed to account for an additional relevant qualitative factor set forth in SAB 99—that the omissions masked a change in earnings or other trends. Blackstone allegedly failed to disclose information related to FGIC and Freescale that plaintiffs claimed was likely to have a negative effect on Blackstone's revenue and, thus, on its earnings. These qualitative factors, along with the fact that the alleged omissions and misrepresentations were significant at the corporate segment level, led the court to conclude that plaintiffs had adequately alleged materiality with respect to Blackstone's investments in FGIC and Freescale.[21]

Finally, with respect to the alleged omissions and misstatements related to Blackstone's real estate investments, the court found that plaintiffs' allegations about the "general deterioration of the real estate market" were sufficient to state a claim. The court held that it was unnecessary for plaintiffs to identify specific real estate investments or assets held by Blackstone that might have been at risk as a result of market conditions. In fact, those details were precisely what plaintiffs alleged that Blackstone should have provided.

Moreover, because Blackstone's real estate segment played a "significant role" in Blackstone's business and it was possible that the residential market downturn would affect the commercial markets in which Blackstone owned substantial assets, the court concluded 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 held that the alleged misstatements and omissions regarding Blackstone's real estate holdings were material.

Conclusion

Landmen Partners will likely increase efforts by plaintiffs to devise arguments focused on qualitative factors and business segment-level significance. However, because the decision runs contrary to the recent judicial trend of applying greater scrutiny to class action complaints,[22] its reach may be limited to its facts—a case where the issuer represented that one of its segments was particularly important for the enterprise as a whole and an offer became effective at a time of market crisis. Issuers preparing for public offerings nevertheless should take this decision into account in crafting their disclosures, particularly disclosures related to key business segments.

1. *Landmen Partners Inc. v. Blackstone Group, L.P.*, No. 09-4426-cv, 2011 WL 447050 (2d Cir. Feb. 10, 2011).
2. Id. at 1.
3. Id. at 2.
4. Id. at 9.
5. Id. at 3.
6. Id. at 4.
7. Id. at 3.
8. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000).
9. *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JPMorgan Chase Co.*, 553 F.3d 187, 204 (2d Cir. 2009).
10. *Landmen Partners Inc. v. Blackstone Group, L.P.*, 659 F.Supp.2d 532, 541-43 (SDNY 2009); *JPMorgan Chase Co.*, 553 F.3d at 204-05.
11. *Landmen Partners*, 659 F.Supp.2d at 544.
12. Id. at 545 (internal quotations omitted).
13. *Landmen Partners*, 2011 WL 447050, at 8 (quoting *Ganino*, 228 F.3d at 162).
14. Id. (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988)).
15. Id. at 8.
16. Id. at 7 (quoting *Ganino*, 228 F.3d at 162).
17. Id. at 11
18. Id. at 10.
19. Id.
20. Id. at 11.
21. The court also rejected Blackstone's argument that, given its structure, a loss in one portfolio company might be offset by a gain in another portfolio company. See id. at 10. The court explained that Blackstone is not permitted, in assessing materiality, to aggregate negative and positive effects on its performance fees in order to avoid disclosure of a particular material negative event. Id.
22. See, e.g., *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007).