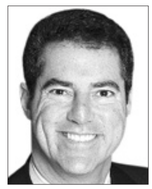
New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 246—NO. 38
WEDNESDAY, AUGUST 24, 2011

SECOND CIRCUIT REVIEW

Expert Analysis

Second Circuit Clarifies Materiality Requirement in Securities Fraud Cases

By Martin Flumenbaum

And Brad S. Karp

This month, we discuss *Hutchison v. Deutsche Bank Securities Inc.*,[1] in which the U.S. Court of Appeals for the Second Circuit clarified when misstatements and omissions in a company's registration statement will be considered "material" for purposes of prosecuting a securities fraud claim under §§11, 12(a)(2) and 15 of the Securities Act of 1933.[2] *Hutchison* reconciles two recent, and seemingly inconsistent, Second Circuit decisions addressing the materiality requirement. The Second Circuit's decision, written by Chief Judge Dennis Jacobs and joined by Circuit Judge Debra Ann Livingston and District Judge Jed S. Rakoff (sitting by designation), reaffirms that materiality is a fact-based inquiry and that matters that may be immaterial to a company's overall business nevertheless may be material for purposes of the federal securities laws in certain circumstances. In reaching its decision, the Second Circuit affirmed a district court ruling dismissing a securities class action pursuant to Federal Rule of Civil Procedure 12(b)(6) for failing to allege adequately that certain misstatements or omissions in a company's IPO registration statement were "material" to investors.

Background

The Securities Act contains a number of provisions that impose liability for misrepresentations in a registration statement in connection with a securities offering. Section 11 of the Securities Act provides securities purchasers a private right of action against the issuer or seller of those securities for making misstatements or omissions of material fact in a registration statement filed with the SEC.[3] Section 12(a)(2) imposes liability on the issuer or seller of securities if the securities were sold using a prospectus that contained a material misstatement or omission.[4]

MARTIN FLUMENBAUM *and* BRAD S. KARP *are partners at Paul, Weiss, Rifkind Wharton & Garrison LLP. They specialize in complex commercial litigation and white collar criminal defense.* PAULA VIOLA, *a litigation associate at the firm, assisted in the preparation of this column. Mr. Karp, on behalf of SIFMA, submitted an amicus brief to the U.S. Supreme Court in support of Blackstone's petition for a writ of certiorari in 'Litwin v. Blackstone.'*

Section 15 creates liability for individuals or entities that "control any person liable" under sections 11 or 12.[5] Courts have held that if a plaintiff can establish (i) a material misrepresentation, (ii) a material omission in contravention of an affirmative legal disclosure obligation, or (iii) a material omission of information that is necessary to prevent existing disclosures from being misleading, then an issuer's or seller's liability under §11 typically will follow, unless certain defenses have been established.[6]

> 'Hutchison' reaffirms that matters that may be immaterial to a company's overall business nevertheless may be material for purposes of the federal securities laws.

A fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to act, meaning there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information available.[7] Although courts agree that the determination as to whether a fact is "material" is an inherently fact-specific inquiry, the Second Circuit has not been clear in articulating how to determine when a fact is sufficiently important that it would have affected the reasonable investor's investment decision.

Procedural History

Defendants-appellees are a commercial real estate finance company named CBRE Realty Finance Inc. CBRE's business is to acquire, finance and manage commercial real estate loans. CBRE's investment portfolio consists of various loan instruments, including real estate loans, real estate-related mezzanine loans, commercial mortgage-backed securities and joint venture investments. In 2006, CBRE made an initial public offering (IPO) of common stock, raising approximately $144 million. In connection with its IPO, CBRE filed an SEC Form S-11/A Registration Statement in which it stated that none of its loans "exhibit[ed] characteristics" of a probable risk that CBRE would be unable to collect on its outstanding loans.

At the time of the IPO, two mezzanine loans, worth $19.7 million and $31.8 million respectively, were outstanding to a developer, Triton Real Estate Partners, LLC.[8] Within five months of the IPO, CBRE issued a press release indicating that the two mezzanine loans had become delinquent. CBRE reported more bad news in the following months, including that CBRE had foreclosed on both mezzanine loans and consequently incurred a $7.8 million charge, that CBRE was no longer pursuing equity real estate investments through joint ventures, and that CBRE had lost $1.7 million trying to protect its mezzanine loan position.

Plaintiffs-appellants, Sheet Metal Workers Local No. 33, purchased securities from CBRE in the IPO. Within days of CBRE's first press release, CBRE's common stock price dropped, causing Sheet Metal Workers to lose a substantial portion of its investment. Sheet Metal Workers instituted a class action against CBRE under §§11, 12(a)(2) and 15 of the Securities Act, alleging that CBRE had made materially inaccurate statements by failing to disclose the two outstanding mezzanine loans in its IPO Registration Statement.

Plaintiffs alleged that CBRE knew that the two mezzanine loans were in trouble at the time of the IPO because the developer, Triton, was experiencing financial difficulty. Plaintiffs argued that these troubled loans constituted a significant portion of CBRE's overall investment portfolio and that, therefore, CBRE had a duty to disclose this material information in its IPO Registration Statement.

The district court granted defendants' motion to dismiss plaintiffs' Second Amended Complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. Specifically, the district court held that plaintiffs had not plausibly alleged that the omissions concerning the Triton loans were material because those loans were fully collateralized by the underlying real estate and therefore "CBRE was not at risk" of a material loss on loans at the time that the Registration Statement and prospectus issued.[9] Plaintiffs appealed to the Second Circuit, maintaining that the omissions were material.

Second Circuit Decision

The Second Circuit affirmed the district court's dismissal of the class complaint, albeit for different reasons. The Second Circuit held that the adequacy of collateral is one factor for determining whether an omission concerning the loan is material, but it is not the only factor. A district court must consider other quantitative measures, including the importance of the omission to a reasonable investor based on the value of the troubled investment in relation to the company's overall investment portfolio.

In determining how important an omission may have been to a reasonable investor in light of the overall context, the Second Circuit has provided two seemingly divergent approaches in a pair of recent decisions, *ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase*[10] and (2) *Litwin v. Blackstone Grp*,[11] both of which analyzed the circumstances under which statements in a registration statement are "material" for purposes of a §11 claim.

In *JP Morgan*, the court conducted a quantitative materiality analysis that compared the value of the troubled investment to the value of defendant's entire investment portfolio. In that case, plaintiffs alleged that JP Morgan made material misstatements concerning $2 billion in prepay transactions that JP Morgan made to a special purpose entity that, in turn, made loans to Enron Corporation. The court conceded that "$2 billion in prepay transactions may sound staggering," but held that this number was not material to investors because JP Morgan was merely "reclassifying" the $2 billion for accounting purposes. The court explained that "reclassifying $2 billion out of one category of trading assets (derivative receivables) totaling $76 billion into another category (loan assets) totaling $212 billion does not alter JPMC's total assets of $715 billion."[12] Moreover, "changing the accounting treatment of approximately 0.3% of JPM's total assets…would not have been material to investors" since the underlying assets in either classification carry some default risk.[13]

By contrast, in *Blackstone*, the court conceded that the troubled investment was less than 5 percent of the company's entire portfolio, but determined that the investment was material nevertheless because of the impact of the troubled loan on an important segment of Blackstone's business. In *Blackstone*, plaintiffs alleged that the company failed to disclose in its IPO registration statement the risk of its $331 million investment in two companies, which at the time of Blackstone's $4.5 billion IPO, faced massive losses.

The court held that these omissions were material despite the fact that Blackstone's investment in these two companies constituted less than 5 percent of Blackstone's overall portfolio because these investments constituted a significant portion (9.4 percent) of the assets of Blackstone's Corporate Private Equity group—the "flagship" segment of Blackstone's business, which played a critical role in the overall enterprise and was important to investors. Thus, the court concluded that "even where a misstatement or omission may be quantitatively small compared to a registrant's firm-wide financial results…its significance to a particularly important segment of a registrant's business tends to show its materiality."[14]

The Second Circuit in *Hutchison* set out to reconcile these two decisions and described the unifying principle that, in its view, harmonizes *Blackstone* and *JP Morgan*, as follows: "if a particular product or product-line, or division or segment of a company's business, has independent significance for investors, then even a matter material to less than all of the company's business may be material for purposes of the securities laws."[15] But in the event a particular segment does not have independent significance for investors, then materiality will be assessed by comparing the value of the troubled asset to the company's overall asset base.

> The 'Hutchison' case clarifies that, to meet the materiality threshold, plaintiffs must establish either that misstatements or omissions (i) negatively impacted the value of a 'flagship' segment of the issuer's business that is of particular importance to investors, or (ii) negatively impacted the overall value of the issuer's business enterprise.

Plaintiffs argued that CBRE's failure to disclose the Triton Loans was material because the value of those loans—$51.5 million—constituted 25 percent of CBRE's mezzanine loans, which comprised 60 percent of CBRE's total capital, 27 percent of all of CBRE's loans, and 21 percent of CBRE's entire investment portfolio. Plaintiffs further argued that mezzanine loans were an important segment of CBRE's business.

The Second Circuit rejected these arguments on the basis that plaintiffs had failed adequately to demonstrate that the mezzanine loans constituted a component of CBRE's business that is of distinct interest to investors other than as another component of CBRE's business. The court continued: "For a company that makes real estate loans, mezzanine loans…are not the subject of investors' fixation." Therefore, any alleged impairment of the Triton loans must be analyzed in relation to CBRE's entire investment portfolio of $1.1 billion consistent with the quantitative approach followed by the court in *JP Morgan*. Judged in this light, the Second Circuit concluded that the Triton loans were not material, since they comprised less than 5 percent of CBRE's overall investments.

Additionally, the court held that plaintiffs had failed to show that the Triton loans were troubled at the time of the IPO. In particular, while CBRE incurred a $7.8 million charge on the write-down of one of the loans, plaintiffs failed to allege that this figure was known to CBRE at the time of the IPO. Moreover, the court found that there was no evidence that the drop in stock price following CBRE's Aug. 6, 2007, press release was a result of CBRE's losses on the mezzanine loans, since that press release was "loaded" with bad news about the company, any portion of which could have caused CBRE's stock price to drop. Furthermore, CBRE had already reported the foreclosures on the mezzanine loans in May 2007, so that item in the August 2007 press release did not contain information that was new to the market.

Conclusion

Hutchison represents an important clarification of the Second Circuit's approach to determining whether misstatements or omissions are "material" for purposes of a section 11, 12, or 15 claim under the Securities Act. In particular, the case clarifies that, to meet the materiality threshold, plaintiffs must establish either that misstatements or omissions (i) negatively impacted the value of a "flagship" segment of the issuer's business that is of particular importance to investors, or (ii) negatively impacted the overall value of the issuer's business enterprise. Such requirements likely will pose a meaningful hurdle for plaintiffs seeking to advance a securities fraud class action claim against issuers and/or underwriters.

1. Docket No. 10-1535-cv, 2011 WL 3084969 (2d Cir. July 26, 2011).
2. 15 U.S.C.A. §§77k(a), 77l(a)(2), 77o(a).
3. 15 U.S.C.A. §77k(a).
4. 15 U.S.C.A. §77l(a)(2).
5. 15 U.S.C.A. §77o(a).
6. *Hutchison*, 2011 WL 3084969 at *8-9.
7. Id. at 5.
8. A "mezzanine loan" is a subordinated loan that is secured by a second mortgage on the underlying property or by a pledge of the ownership interests in the property.
9. *Hutchison v. CBRE Realty Fin. Inc.*, 638 F.Supp.2d 265, 275 (D. Conn. 2009).
10. 553 F.3d 187 (2d Cir. 2009).
11. 634 F.3d 706 (2d Cir. 2011).
12. 553 F.3d at 204.
13. Id.
14. 634 F.3d at 720.
15. 2011 WL 3084969 at *8.