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Southern District of New York Ruling Highlights that Materiality Is a Meaningful Pleading Obstacle in '33 Act Cases

Claims brought under the Securities Act of 1933 (the "Act") are typically challenging for defendants to dismiss. Some defendants may have affirmative defenses, but most of the Act's provisions impose strict liability for alleged misstatements—meaning that a plaintiff need not plead scienter—and claims brought under the Act are subject to the relatively low pleading standard imposed by Federal Rule of Civil Procedure 8. Further, although plaintiffs suing under the Act must allege facts sufficient to show that the purported misstatements were material, courts are generally reluctant to dismiss for failure to plead this element because materiality is an inherently fact-bound inquiry.

Notwithstanding these principles, on September 29, 2015, the United States District Court for the Southern District of New York (Oetken, J.) dismissed a putative class action brought under the Act on the ground that the complaint's materiality allegations failed as a matter of law. The opinion provides valuable insights on how to defeat other Act claims on similar grounds.[1]

Relevant Background

Plaintiff, an investor in building products company Ply Gem Holdings, Inc. ("the Company"), sued the Company and certain of its officers, directors, and underwriters, alleging that material information was omitted from or misstated in the registration statement issued before the Company's initial public offering in May 2013. Charging violations of Sections 11, 12(a)(2) and 15 of the Act, the complaint alleged that the Company's registration statement misstated or omitted information about a series of agreements it had with a large customer. According to the complaint, the Company was required to disclose this information under Items 303 and 503(c) of SEC Regulation S-K.[2] Defendants challenged the complaint as legally deficient, including because the pleading failed to adequately allege that any of the purported misstatements were material.

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[1] Paul, Weiss represented defendants Ply Gem Holdings, Inc. and its officers and directors in this case. The team included litigation partners Daniel Kramer and Alexandra Walsh, and associates Christopher Terranova and Ekta Dharia.

[2] Item 303 of Regulation S-K provides that issuers must disclose, in its management's discussion and analysis in regulatory filings, any known trend, demand, commitment, event or uncertainty that is reasonably likely to result in material changes in liquidity, the mix and relative costs of capital resources, and net sales, revenues or income in management's discussion. Item 503(c) requires, where appropriate, a discussion in a prospectus of the most significant factors that make an offering speculative or risky.

The District Court's Decision Granting Defendants' Motion

Situating a Cost within a Company's Finances. The Court acknowledged that "materiality is an inherently fact-specific finding" and that dismissals based on lack of materiality are proper only where the alleged misstatements or omissions are "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." (Op. at 8 (quotation marks omitted).) However, the Court held that for a plaintiff to satisfy its burden to plead materiality, a complaint must contain enough facts to "meaningfully situat[e]" the cost associated with the alleged misstatement "in the context of the Company's finances." (*Id.* at 10.) Here, the complaint alleged that Ply Gem's registration statement failed to disclose that the agreement with its large customer required the Company to purchase so many windows that the Company needed "approximately five to six tractor trailer loads of windows per day, seven days per week" to carry the windows. (*Id.* at 9.) In their motion, Defendants pointed out that without additional factual context—such as the value of the windows purchased and the costs of transportation and disposal—the complaint offered no basis upon which to assess whether the costs imposed by the buyback agreement were material. (*Id.*) The Court agreed, holding that assessing materiality based on Plaintiff's allegations was "like trying to guess the number of jellybeans in a jar after being told only that the jar is 'big.'" (*Id.*)

The Court followed similar logic in rejecting other parts of the complaint. Plaintiff alleged, for example, that at a particular plant the Company "was forced to buy window panes . . . at a steep premium" and "produced a large volume of defective windows." The Court held that again the complaint failed to situate these issues within the Company's finances, concluding that "[a]llegations of 'steep' costs and 'large' volumes offer little basis upon which to assess the materiality of the alleged omission." (*Id.* at 13.) Likewise, the Court held that the complaint's assertion that "some of" the Company's increase in low-margin sales was due to its new supply was insufficient to plausibly allege that the purported omission was likely to be material.

Quantitative Guidepost for Materiality. The Court also recognized that SEC Staff Accounting Bulletin ("SAB") No. 99 provides relevant guidance in assessing materiality allegations. SAB No. 99, as the Court noted, provides that "[t]he use of a percentage as a numerical threshold, such as 5%, may provide the basis for a preliminary assumption that [the] particular item [at issue] is unlikely to be material." (*Id.* at 8.) The Court concluded that, in this case, the issues purportedly omitted from or misstated in the registration statement "f[ell] short of materiality" when "measured against the 5% threshold." Further, Plaintiff failed to cite "any qualitative factors that it believes support a finding of materiality." (*Id.* at 10-12.) Those failures figured heavily in the Court's analysis.

Relevant Metric for Materiality. The Court also held that, even if Plaintiff had adequately alleged the costs of the alleged misstatements or omissions, such costs "should be compared to like items on the corporate financial statement." (*Id.* at 11, 14.) For example, Defendants argued that the buyback costs should be compared to quarterly net sales of $169 million, explaining that a buyback cost is a sales

reduction and is treated by the Company as a component of net sales. In contrast, Plaintiff argued that buyback costs should be compared to quarterly "operating earnings (income)" of $662,000. The Court rejected Plaintiff's argument because "[d]oing so would mean that any cost exceeding $33,100 (which is 5% of $662,000) would presumptively be subject to disclosure under SAB No. 99," which could risk "bury[ing] the shareholders in an avalanche of trivial information," contrary to "[t]he purpose of the Securities Act." (*Id.* at 11 (quotation marks omitted).) Instead, the Court relied on Defendants' proposed metric of net sales, and held that the buyback cost was "well below the SAB No. 99 threshold." (*Id.*) Similarly, the Court rejected Plaintiff's argument that gross profit margin was the appropriate metric with which to assess costs allegedly incurred in ramping up a particular plant because "Plaintiff provides no indication why these costs should be considered in terms of gross profit margin." (*Id.* at 13-14.)

Item 503 Claims. Having found that the alleged misstatements and omissions were not reasonably likely to be material under Item 303, the Court concluded that "for the same reason that its Item 303 claims fall short of materiality," Plaintiff's Item 503 claims failed to plead that the alleged misstatements and omissions were among "the most significant factors" rendering the IPO speculative or risky. (*Id.* at 15.)

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The Court's decision demonstrates that, although materiality is a fact-specific inquiry and claims under the Act are subject to a relatively low pleading standard, complaints under the Act can be successfully attacked. Motions that highlight the absence of the particular information necessary to situate the costs associated with alleged misstatements within the company's finances are likely to get more traction, as are motions that are able to invoke SAB 99's 5% threshold. Judge Oetken's decision should prove useful authority in explaining why pleadings deficient in these respects fail as a matter of law.

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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