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Securities Alert

Recent Federal Appellate Court Guidance on the Materiality Standard

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Introduction

The Supreme Court and the 2nd Circuit have recently addressed the concept of materiality in very fact-specific or industry-specific situations, and many companies have been left wondering how these decisions may affect their own disclosure obligations. While both cases soundly reject any bright-line tests for determining materiality, there are, nevertheless, several key lessons that companies can learn from these decisions to reduce their exposure to liability under the federal securities laws.

Matrixx Initiatives, Inc. v. Siracusano[1]

In *Matrixx Initiatives, Inc. v. Siracusano*, the Supreme Court held that securities class action plaintiffs had adequately pleaded materiality regarding a pharmaceutical company's nondisclosure of adverse event reports even though the reports were not statistically significant. In holding that the complaint adequately alleged that reports linking Matrixx's leading product, Zicam Cold Remedy, to a loss of smell could be material, the Court reiterated its long-standing test, articulated in *Basic, Inc. v. Levinson*, that the materiality inquiry is highly fact-specific and turns on whether there is a substantial likelihood that the disclosure of the omitted information would have significantly altered the total mix of information made available in the marketplace. The Court rejected the bright-line test advocated by Matrixx and adopted by several lower courts that adverse event reports regarding a pharmaceutical company's products are not material unless a sufficient number of such reports establish a statistically significant risk that the product is causing the events. Matrixx had argued that, unless the adverse event reports were statistically significant, they would not be scientifically reliable enough for any reasonable investor to use such information in making an investment decision. In rejecting this bright-line approach, the Court noted that medical researchers and, on occasion, even the FDA itself, act on evidence that is not statistically significant, and, therefore, reasonable investors may also act on information that is not statistically significant.

The Court did stress, however, that its decision did not mean that a company must always disclose the existence of adverse event reports, as these reports do not necessarily mean the drug is causing the adverse event. The Court stated that "[s]omething more is needed, but that something more is not limited to statistical significance and can come from the source, content, and context of the reports." The Court also emphasized that, even if adverse event reports are material, a company is still not required to disclose them unless the company makes a statement about the product that would be misleading without their disclosure as well. The Court found that both elements were satisfied in this case. First, the adverse event reports did create a plausible casual relationship between Zicam and loss of the sense of smell. Rather than just a few anecdotal reports from consumers, (i) Matrixx had received reports from three medical professionals and researchers about more than 10 patients who had lost their sense of smell after using Zicam, (ii) four product liability lawsuits against Matrixx had been commenced, (iii) Matrixx knew that two researchers had presented

[1] 563 U.S. ___, No. 09-1156, 2011 WL 977060 (Mar. 22, 2011).

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a report linking Zicam to loss of smell at a national medical conference, (iv) Matrixx was aware of previous studies showing a causal link between intranasal use of zinc and loss of smell and (v) Matrixx had conducted no studies of its own to disprove a link. Second, Matrixx had issued bullish revenue projections about its leading product and also publicly denounced reports linking Zicam to loss of smell as being "completely unfounded and misleading." In light of these statements, the Court had little trouble concluding that the omitted information would likely be viewed by a reasonable investor as having significantly altered the total mix of information made available in the marketplace.

Litwin v. Blackstone Group, L.P.[2]

In *Litwin v. Blackstone Group, L.P.*, the 2nd Circuit addressed the concept of materiality in the context of "trend disclosure" under Item 303 of Regulation S-K, which requires companies to disclose in their Management's Discussion and Analysis any known trends or uncertainties that they reasonably expect will have a material unfavorable impact on future operating results or financial condition. The alleged omissions and misstatements revolved around Blackstone's failure to disclose, in the prospectus for its initial public offering, adverse trends affecting its private equity and real estate investment segments. Finding the information immaterial as a matter of law, the district court had dismissed the plaintiffs' claims, relying heavily on the 2nd Circuit's and the SEC's acceptance of a 5 percent threshold as the appropriate starting place for immateriality. This rule of thumb, as formulated in SEC *Staff Accounting Bulletin 99*, advises that a numerical deviation of less than 5 percent may provide the basis for the preliminary assumption that the omission or misstatement is not material. A deviation of less than 5 percent may, nonetheless, be material based on an evaluation of various qualitative factors, including whether the information relates to a significant aspect of a company's operations or masks a change in earnings or other trends.

In *Litwin*, the 2nd Circuit, utilizing the fact-specific test from *Basic*, held that the plaintiffs had adequately alleged materiality with respect to omitted information concerning portfolio investments made by two of Blackstone's business segments, even though none of the investments constituted 5 percent or more of Blackstone's total assets under management. The court concluded that the omissions were significant to important aspects of Blackstone's business. The court stated "[e]ven 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."[3] Rejecting any formulaic approach or bright-line test, the court emphasized the importance of considering both quantitative and qualitative facts in assessing materiality.

Guidance for Public Companies

After *Matrixx* and *Litwin*, it is clearer than ever that companies should not rely on bright-line tests to determine whether information is material. Although appealing, bright-line tests, which may include industry or scientific standards, regulatory standards or numerical thresholds, should be avoided. Instead, companies should assess materiality in light of all the facts and circumstances and determine from the perspective of a reasonable investor whether disclosure would significantly alter the total mix of information available in the marketplace. In making this determination, companies should be sure to examine both quantitative and qualitative factors. To this end, we have identified two major areas of focus below.

Focus on what investors would want to know.

The Reasonable Investor. Companies assessing materiality should ask themselves whether it is information that a reasonable investor considering buying or selling their securities would want to know in light of the information already available in the market. Reasonable investors typically have one overriding concern: price. Consequently, as a starting point in their analysis, companies should consider whether the information, if disseminated, would cause the market price of their securities to change, or if the information has already been digested by the market.

Business Segments. After the *Litwin* decision, companies, such as Blackstone, that operate through multiple segments should understand that this may require them to make additional disclosures. Such companies must consider whether

[2] No. 09-4426 U.S. Court of Appeals for the Second Circuit (2d Cir. Feb. 10, 2011).
[3] *Litwin*, No. 09-4426 at 25.

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incoming information may be material to a particular segment, paying close attention to quantitative and qualitative factors. While the *Litwin* court does say "not every portfolio company or real estate asset . . . will be deemed material,"[4] events affecting large (quantitative) or "flagship" (quantitative or qualitative) segments should be considered carefully. "Flagship" segments may include those that "play a significant role in the company's history, operations, and value."[5] Even relatively smaller segments that play a significant role in a company's business may generate material information. Blackstone's real estate segment accounted for just 22.6 percent of the company's total assets under management, compared to the company's private equity segment that comprised 37.4 percent of total assets under management. The 2nd Circuit refused to find immaterial Blackstone's failure to discuss the collapse of the residential real estate market and the possible effect of such collapse on Blackstone's commercial real estate investments, even though Blackstone's residential holdings accounted for, at most, just 15 percent of Blackstone's real estate segment and 3.45 percent of total assets under management. *Litwin* also explicitly ruled out using good news concerning one aspect of a company's business to counterbalance bad news from another.[6]

Key Products. Companies that rely heavily upon a small quantity of products, or even a single product, should also take note. While the *Matrixx* opinion did state that "the mere existence of reports of adverse events" will not suffice to create materiality, this does not appear to be particularly helpful for companies with a very small number of products. The finding of materiality in *Matrixx* hinged upon the existence of the reports in light of other statements that *Matrixx* had made, such as predictions of revenue increases and assurances of the safety of its product. It seems likely that a comparable company, almost entirely reliant on a single product, would be especially prone to making similar statements. Thus, such companies should be extremely cautious when they receive reports that, if true, would threaten the viability of a crucial product.

Focus on what the company can control.

Robust Internal Reporting and Disclosure Controls. Today's instantaneous communications systems have made business cheaper and more efficient, but increased demands by investors and analysts for up-to-the-minute information have made accurate disclosure much more challenging. Companies, even extremely large companies, are expected to have appropriate internal reporting and disclosure controls to ensure that all of their public disclosure is accurate. This can be difficult enough to achieve for standard disclosure on Forms 10-K and 10-Q. However, directors and officers should also be sure that company personnel involved in earnings releases, investor calls, Web site postings and similar disclosures are timely informed of potentially material events on an ongoing basis.

Carefully Worded Public Statements. One of the major lessons to learn from Matrixx is that, in many cases, companies set the bar for materiality by their previous public statements. Companies do not have an affirmative duty to disclose any and all material information. Other than disclosure that is specifically required by statute or regulation, companies need only disclose when necessary "to make . . . statements made, in the light of the circumstances under which they were made, not misleading."[7] Matrixx's unqualified statements regarding the safety of its product set the bar so high that virtually any adverse reports would likely have made the statements misleading under the analysis applied by the Supreme Court.

There are concrete steps that companies can take to avoid similar issues. First, companies may want to reevaluate the frequency and regularity of their public statements. As discussed above, all public disclosure should be preceded by an assessment of whether all related material information is already public. This may become extremely burdensome if the company desires to speak with investors often or at irregular intervals. Second, companies should remember that making affirmative statements to the market can create an obligation for a company to disclose additional information that otherwise would not need to be disclosed. Although the mere existence of adverse reports is not material, and companies need not list every developing issue, they should be careful not to deny their existence. Unduly optimistic or categorical statements should also be avoided.

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[4] *Litwin*, No. 09-4426 at 29.
[5] *Id.* at 24.
[6] *Id.* at 23.
[7] *Matrixx*, No. 09-1156 at 16 (quoting 17 C.F.R. § 240.10b-5(b).

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Expanded and Updated Safe Harbor Disclaimers. Future statements are particularly susceptible to being made untrue in hindsight by risks that were only developing at the time the statements were made. Although courts should evaluate statements according to their veracity at the time they were made, it can be difficult for courts not to look back and second-guess good intentions. Thus, when public disclosure is made, companies should ensure that the cautionary language they use to avail themselves of the safe harbor for forward-looking statements is meaningful. In another recent 2nd Circuit case, *Slayton v. American Express*,[8] the court emphasized that the cautionary statements must not be "boilerplate" or "vague" and must be tailored to the specific future projections they are intended to qualify.[9] The 2nd Circuit was particularly critical of the repetition of the same risk factors in multiple SEC filings while the problems the company was facing changed. Similarly, the 3rd and 5th Circuits have required "extensive and specific" cautionary statements and "'substantive' company-specific warnings," respectively.[10]

Companies should carefully review and frequently refresh their disclaimers to include information about important segments and products that has been reported through internal control systems. It is, of course, impossible to predict the future and identify the particular factor that will cause a projection to fail to come true. Nevertheless, after *Slayton*, companies will want to be able to point to specific cautionary language that is related to the product or segment affected and that demonstrates that investors were given at least some warning about that particular risk. Without such a warning, the company may be left without the protection of the safe harbor.

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[8] 604 F.3d 758 (2d Cir. 2010)
[9] *Id.* at 772.
[10] *Inst. Investors Group v. Avaya*, 564 F.3d 242, 256 (3d Cir. 2009); *Southland Secs. v. INSpire Ins. Solutions*, 365 F.3d 353, 371-72 (5th Cir. 2004).

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