Brownstein Victory Demonstrates Value of Vigorously Challenging Materiality Allegations in Securities Fraud Trials

The materiality of misrepresentations and omissions in securities fraud litigation is a complex but critical issue. For several reasons, defendants sometimes give this element of a securities claim less attention than it deserves.

Defendants may avoid vigorously challenging materiality for at least three reasons. First, there may be a tendency to accept the legally deficient but superficially appealing argument that "all information is important and thus material to investors." Second, particularly if the possible event to which the alleged misrepresentation or omission pertained has occurred since the purchase or sale of the security, hindsight analysis too easily leads one to conclude that "since the event happened, information about it must have been important or material." Third, often the materiality of a particular misrepresentation or omission to a reasonable investor is viewed in isolation, rather than as part of a more nuanced analysis of the "total mix" of all information that was available. Viewing information in isolation almost always increases its apparent importance. Despite these tendencies, plaintiffs' attorneys and government prosecutors must not be given a free pass on this important element of a securities claim.[1]

A recent trial victory by Brownstein trial attorneys[2] illustrates the importance of vigorously challenging materiality. Brownstein attorneys successfully defended a national brokerage and investment banking firm against Colorado securities fraud claims asserted by purchasers of millions of dollars of municipal bonds. Brownstein's client was the underwriter of the bonds, which were purchased by the plaintiffs, four privately owned banks. The plaintiffs alleged various material misrepresentations and omissions in connection with the sale of the bonds. The Court concluded that the bonds' underwriter satisfied the standard of care for a municipal underwriter of securities. Additionally, the Court concluded that the most hotly contested alleged misrepresentation was not material. In so doing, the Court accepted the Brownstein trial team's argument that an alleged misrepresentation of $3.3 million as to available financing was not material based on the case's facts and circumstances.

The case concerned the plaintiffs' purchase of over $4 million in municipal bonds issued to assist with the financing of infrastructure for a real estate development project in the greater Denver metropolitan area. To help finance construction of the development's horizontal infrastructure, the developers utilized a $12.5 million line of credit from a bank. When the bonds were offered to the plaintiffs, the offering memorandum allegedly overstated by $3.3 million the amount of money that remained available on the credit line to the developers. This alleged misstatement was at the core of the plaintiffs' case.

At trial, rather than concede materiality, the Brownstein trial team argued that the amount was not material based on the particular facts and circumstances. Focusing on the requirements articulated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449–50 (1976) and its progeny that "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 made available," the trial team successfully argued that the $3.3 million in additional financing would have made no difference to a reasonable investor. For example, the team emphasized the following arguments, which should be helpful in defending a wide variety of securities fraud actions:

- Materiality requires delicate assessments of inferences a reasonable shareholder would make;

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- Materiality is based on the case's individual circumstances;
- Materiality is not based on hindsight;
- Materiality is not about what an investor may want or find interesting; and
- Materiality concerns a reasonable investor, not the case's particular investor.

The trial team emphasized two points that the court accepted: (1) materiality is based on the "total mix" of available information, which is broader than the offering memoranda; and (2) because the plaintiff banks were sophisticated investors and the bonds could be offered only to such investors, a reasonable investor in this case must be seen from the perspective of a sophisticated investor. These two points provided valuable context that helped show that the alleged $3.3 million difference was not material.

First, as to the "total mix" argument, the trial team presented evidence that the alleged $3.3 million misstatement must be viewed in light of all of the information available to the banks, not just the information in the offering memoranda. Adopting this perspective, the court found that the "total mix" included the developers' financial information, the fact that financing for vertical construction could not be obtained until the infrastructure was completed and approved, the fact that only $2.5 million was needed to complete the infrastructure and the loan had over $5 million left to borrow, and a letter from the lending bank expressing satisfaction with the developers as customers. This additional information helped show that the alleged $3.3 million misstatement, although seemingly large if viewed in isolation, was immaterial as to the developers' ability to complete the infrastructure.

Second, the Court accepted Brownstein's argument that because the banks were sophisticated investors and the bonds could be offered only to such investors, the court must analyze a reasonable investor under the materiality standard from the perspective of a sophisticated investor. Applying this standard, the court found that a reasonable investor with the knowledge and sophistication of the banks would have focused on the issue of whether there were sufficient funds available to complete the horizontal infrastructure so that vertical construction could commence, rather than fixating in the abstract on how much money had been spent and remained on the loan. The Court concluded that the alleged $3.3 million difference in available funding to complete the horizontal infrastructure was not material.

The materiality standard is the same for cases under federal, Colorado, and many state securities laws. Thus, materiality arguments similar to these may be helpful in defending numerous securities fraud actions. As this recent victory demonstrates, it is critical—and can be dispositive—to present a nuanced materiality defense in a securities fraud trial.

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[1]The importance of defending cases by challenging materiality is acutely important when the weapons available to defense attorneys are limited, such as for claims that do not require the plaintiff or government to prove reliance or scienter. *See, e.g.*, C.R.S. § 11-51-604(4).

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