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Federal Courts Address the Materiality Standard – Now What?

By Steve Jacobs

Since the beginning of 2011, the Federal courts have decided two cases that, together with a decision from 2010, change the playing field for disclosure standards in periodic reports and registration statements by public companies. The 2011 cases deal with materiality judgments while the 2010 decision reminds issuers of the rules of the road for making forward-looking statements.

In March 2011, the Supreme Court decided *Matrixx Initiatives, Inc. v. Siracusano*, holding that securities class-action plaintiffs had adequately pleaded materiality regarding nondisclosure of adverse events even though the events were statistically insignificant. The Court affirmed the materiality standard stated in *Basic v. Levinson* – whether a reasonable investor would have viewed the undisclosed information as having significantly altered the total mix of information made available. The Court rejected a "bright-line" statistical significance test to determine whether certain undisclosed information – in this case, some reports showing a link between Matrixx's Zicam remedy and loss of smell – would be material to a reasonable investor.

Shortly before the Supreme Court decision, the Second Circuit, in *Litwin v. Blackstone Group, L.P.,* found that the issuer, Blackstone Group, had violated Item 303 of Regulation S-K. Regulation S-K governs the disclosure requirements of registration statements and periodic reports filed by public companies. Item 303 requires, among other things, the disclosure of "any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in … liquidity increasing or decreasing in any material way" and "any known trends or uncertainties that have had or that the [company] reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations."

In *Blackstone*, investors in Blackstone's IPO alleged that it made material omissions in its registration statement and prospectus. The plaintiffs claimed that Blackstone failed to disclose certain risks relating to two of its funds. Blackstone argued that the investments in question each fell below the 5% materiality threshold and that only one of the six tests for qualitative materiality in SAB 99 was satisfied. The Court cited, among other things, the SEC's 1989 MD&A interpretive release regarding Item 303 that the Regulation requires disclosure "where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the [company's] financial condition or

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results of operations.” The Court went out of its way to reject a formulaic approach. Instead, the Court stated that both quantitative and qualitative factors need to be considered in a holistic approach. From a quantitative standpoint, the Court stated that a 5% threshold was a good starting place for making materiality decisions. However, this quantitative test was not enough according to the Court. The Court stated that SAB 99’s qualitative analysis, consisting of the following factors, was also necessary:

- Did the omissions conceal unlawful transactions or conduct;
- Did the omissions relate to a significant aspect of the company’s business;
- Was there a significant market reaction to the public disclosure of the omissions;
- Did the omissions hide a failure to meet analysts expectations;
- Did the omissions change a loss into income or vice versa; and
- Did the omissions affect the company’s compliance with loan covenants or other contractual requirements.

The 2010 case was also decided by the Second Circuit. In *Slayton v. American Express*, the Court stated that cautionary statements must not be “boilerplate” or “vague” and must be tailored to the specific projections intended to be protected. The Court stated AMEX’s forward-looking statement in its Form 10-Q filing in May 2001 regarding future losses in the high-yield bond market did not satisfy the first prong of the ’34 Act’s safe harbor because the statement was too vague to be “meaningful.” The 10-Q stated that “potential deterioration in the high-yield sector, which could result in further losses ... could cause results to differ materially” from AMEX’s predictions. In particular, the Court criticized the fact that AMEX’s cautionary statements remained unchanged in the face of a changing business environment.

In light of these cases, public companies should consider the following:

1. <u>Materiality: It Depends</u>. Materiality is a fact-specific inquiry. In other words, it depends on the circumstances. If a number or event is small in dollar amount (i.e., small from a quantitative perspective), a disgruntled investor may still argue its importance from a qualitative perspective (e.g., important to the brand or an important market segment or product). Remember, the test is whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a “reasonable investor” as having “significantly altered” the “total mix” of information made available. If it can be shown that the alleged misrepresentation or omission is so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of its importance given the total mix of what was disclosed, the company has a better chance of getting a claim dismissed at an early pre-trial stage.

2. <u>Disclosure Committees</u>. As part of the SEC’s rulemaking regarding CEO/CFO certifications under Sections 302/906 of Sarbanes-Oxley, the SEC recommended – but did not mandate – that companies form disclosure committees. The SEC requires reporting companies to maintain controls and procedures “designed to ensure that information required to be disclosed by [an] issuer in the reports that it files or submits under the [Exchange] Act is recorded, processed, summarized and reported within

the time periods specified in the Commission's rules and forms." The purpose of disclosure controls and procedures is to make certain that the information required to be disclosed is "accumulated and communicated to the issuer's management … to allow timely decisions regarding required disclosure." In most cases, it is a company's disclosure committee that has been charged with carrying out this requirement. The disclosure committee must be designed so that information "bubbles up" to the persons charged with making materiality decisions. Disclosure committee members need to be trained so that they make materiality judgments on both a quantitative and a qualitative basis.

3. Routinely Review Cautionary Statements. If we have learned anything since 2008, it's that the economic world changes quickly. What was important to a company's business last year, last quarter or even last week, may not continue to be so in the future. Cautionary language must be meaningful – substantive, company-specific warnings based on a realistic description of the risks applicable to the particular circumstances, not merely a boilerplate litany of generally applicable risk factors. Relying on the same disclaimers year in and year out leaves a company open to the risk that a plaintiff will say they are "mere boilerplate," and thus deprive the company of a very important tool in avoiding expensive litigation. The "Cautionary Statements" need to be reviewed every time they are included in a filing for accuracy, relevance and degree of importance. Similarly, risk factors also need to be reviewed for substance and as to the order in which they appear. A risk factor at the top of the list because it was the most important – lack of capital, for example – may not be nearly as important in the quarter following a large equity raise. As another example, if a company were successful in diversifying its product line, the risk that is inherent in being overly reliant on a single product would decrease.

If you have any questions about this e-Alert, please contact **Steve Jacobs** at 210.978.7727 or **sjacobs@jw.com**.
