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Second Circuit Addresses Materiality at the Pleadings Stage in Two Recent Decisions

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In two recent decisions issued less than one week apart, *Hutchison v. Deutsche Bank Securities Inc.*, 2011 WL 3084969 (2d Cir. July 26, 2011), and *SEC v. Gabelli*, 2011 WL 3250556 (2d Cir. Aug. 1, 2011), the United States Court of Appeals for the Second Circuit addressed motions to dismiss securities law claims based upon the immateriality of the defendants' alleged misstatements or omissions. Generally, the question of whether a misstatement or omission is "material" — *i.e.*, significant enough that a "a reasonable shareholder would consider it important in deciding how to act" — is a fact-intensive inquiry not suitable for resolution on a motion to dismiss. The Second Circuit's decisions confirm that although this holds true in most cases, in a proper case the immateriality of an alleged misstatement or omission can be decided at the pleadings stage.

In *Hutchison*, plaintiffs alleged that defendant CBRE Realty Finance, Inc. ("CBRE"), a commercial real estate finance company, had made misstatements and omissions when it made its initial public offering ("IPO"). Plaintiffs alleged that, in its IPO, CBRE had failed to disclose that it had made investments in two troubled mezzanine loans totaling approximately $52 million. Not long after its IPO, CBRE announced that loans were troubled, and shortly thereafter CBRE was forced to foreclose and write down the value on each loan.

Plaintiffs filed suit shortly thereafter under Sections 11, 12 and 15 of the Securities Act of 1933., 15 U.S.C. §§ 77k, 77*l*, 77*o*. CBRE moved to dismiss the complaint pursuant to Federal Rule of Civil Procedure 12(b)(6), arguing that plaintiffs' complaint failed to "plausibly allege that the prospectus contained a material misstatement or omission." The United States District Court for the District of Connecticut agreed, and

granted CBRE's motion to dismiss on the ground that plaintiffs had "not plausibly allege[d] that the omissions concerning the Triton loans were material because" the loans were fully collateralized.

On appeal, the Second Circuit affirmed on different grounds. The Court considered plaintiffs' argument that CBRE's alleged misstatement of $51.5 million was material because the misstatement constituted "25% of CBRE's mezzanine loans which were 60% of CBRE's total capital, 27% of all of CBRE's loan, and 21% of CBRE's entire investment portfolio." CBRE had countered that, even if it had made misstatement, misstatement relating to $52 million was not material in light of CBRE's $1.1 billion investment portfolio.

Despite the fact that losses related to the Triton loans amounted to less than 1% of CBRE's overall loan portfolio, the Second Circuit held that, on a motion to dismiss, the question of whether the alleged misstatement or omission was material turned on whether the segment affected by the alleged misstatement or omission had "independent significance for investors." If the segment affected had such "independent significance" then "even a matter material to less than all of the company's business may be material for purposes of the securities law."

Because CBRE's mezzanine loans were not "of a distinct interest to investors," however, the misstatement went to nothing more than "another component of CBRE's book of business." As such, the materiality of CBRE's alleged misstatement had to be measured against CBRE's "entire investment portfolio." Because CBRE maintained a $1.1 billion investment portfolio, CBRE's alleged misstatement of $52 million was not "material."

Gabelli stands in as a much more typical example of the general rule on materiality at the motion to dismiss stage. In *Gabelli*, the Securities and Exchange Commission ("SEC") alleged that defendants, officers of GGGF, permitted one of GGGF's clients, Headstart, to engage in "market timing" — a practice of "buying and selling mutual fund shares in a manner designed to exploit short term pricing inefficiencies" — while banning all of its other investors from engaging in this practice. The SEC further alleged that Headstart was given this permission in exchange for investing in a hedge fund that one of the officer's managed. During the three years Headstart engaged in market timing Headstart earned profits while other investors suffered losses.

Defendants moved to dismiss the SEC's claim on the ground that defendants' alleged misstatements regarding market timing were not "material." The United States District Court for the Southern District of New York agreed and granted defendants' motion to dismiss.

On appeal, the Second Circuit reversed, holding that the question of whether defendants' misstatements were material could not be resolved on a motion to dismiss. The Court's holding was based upon its finding that Headstart had earned profits "while other GGGF investors, who were not only themselves precluded from such trading but also unaware of its being undertaken by Headstart, suffered annual losses of at least 24.1%." The Court further held that "the notion that a reasonable investor would regard as immaterial the failure to disclose the secret arrangement . . . border[ed] on the frivolous."

In short, although *Gabelli* confirms how difficult it can be to prevail on a motion to dismiss predicated upon the immateriality of the alleged misstatements or omissions, *Hutchison* provides one example of where, in a proper case, immateriality can be demonstrated as a matter of law to support dismissal.

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