Landmen Partners, Inc. v. The Blackstone Group, L.P.: The Second Circuit Discusses the Meaning of "Materiality" Required for Disclosure Under Item 303(a) of Regulation S-K

On February 10, 2011, the United States Court of Appeals for the Second Circuit held in *Landmen Partners, Inc. v. The Blackstone Group, L.P.*, that the District Court erred in dismissing for failure to state a claim, plaintiffs' class action brought pursuant to Sections 11 and 12(a)(2) of the Securities Act of 1933. The main issue on appeal was whether the plaintiffs had adequately alleged that Blackstone, as issuer, failed to disclose material information − as required by Item 303(a) of Regulation S-K − related to its investments in two portfolio companies and real estate. The Court's analysis focused on the legal standard for determining materiality under Item 303(a).

I. Background and Procedural History

The lead plaintiffs in *Landmen* represented a class of investors who purchased common units in the Blackstone Group ("Blackstone"), an asset management company, during its initial public offering ("IPO") in June of 2007.[1] In September of 2008, plaintiffs filed a lawsuit in the Southern District of New York under Sections 11 and 12(a)(2) of the Securities Act of 1933, based on alleged omissions in Blackstone's Registration Statement and Prospectus issued in connection with its IPO.[2] The plaintiffs claimed that "at the time of the IPO, and unbeknownst to non-insider purchasers . . . two of Blackstone's portfolio companies as well as its real estate fund investments were experiencing problems."[3] According to the plaintiffs, Blackstone was aware of the problems and reasonably expected the problems to materially affect future revenues.[4]

The District Court dismissed the case pursuant to Rule 12(b)(6) of Civil Procedure, after finding that the alleged omissions were immaterial as a matter of law.

II. The Second Circuit's Decision

On appeal, taking the allegations of the complaint as true for purposes of the motion to dismiss, the Second Circuit held that plaintiffs had adequately pled materiality under Item 303(a) and vacated the dismissal. In the opinion, the Second Circuit noted that the pleading standard for Section 11 and 12(a)(2) claims is basic notice pleading under Rule 8 of the Federal Rules of Civil Procedure because fraud is not an element of either

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1 *Landmen Partners, Inc. v. The Blackstone Group, L.P.*, No. 09-4426, slip op. at 1 (2d Cir. Feb. 10, 2011) (hereinafter "Slip Opinion").

2 "Section 11 of the Securities Act imposes liability on issuers and other signatories of a registration statement that, upon becoming effective, 'contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading.'" Slip Opinion at 16 (citing 15 U.S.C. § 77k(a)). Section 12 imposes liability under similar circumstances on issuers or sellers of securities by means of a prospectus. *Id.* at § 771(a)(2).

3 Slip Opinion at 5-6.

4 *Id.* at 6. In their complaint, plaintiffs contended that Item 303(a) of Regulation S-K provided the basis for Blackstone's disclosure obligation. Under Item 303(a), registrants are required to "[d]escribe any known trends or uncertainties . . . that the registrant reasonably expects will have a material . . . unfavorable impact on . . . revenues or income from continuing operations." 17 C.F.R. § 229.303(a)(3)(ii).

claim.[5] The heightened pleading standard of Rule 9(b) only applies when such claims are premised on fraud. Since fraud was not alleged in the case, only basic notice was needed.

The Court began its analysis by defining materiality as information that a "reasonable investor would have considered significant in making investment decisions."[6] Furthermore, information is material if a reasonable investor would have viewed the subsequent disclosure as having "significantly altered the total mix of information made available."[7] Blackstone argued that information on its investment in one of the companies at issue in the case was public knowledge at the time of the IPO, and therefore could not be considered material.[8] The Court declined to follow the proposition based on caselaw to the contrary. The Court also emphasized that the key information that plaintiffs claimed should have been disclosed under Item 303(a) was the "manner in which those then-known trends, events, or uncertainties might reasonably be expected to materially impact Blackstone's future revenues" ─ not the mere fact of Blackstone's investment.[9]

The Court addressed the factors used to determine materiality and noted that the Second Circuit has consistently rejected a formulaic approach; rather, certain quantitative and qualitative factors must be considered in an integrative manner. In regards to the quantitative factor, the Second Circuit and the SEC has allowed the use of a less than 5% threshold as an appropriate "starting place" or "preliminary assumption" of immateriality.[10] When conducting a qualitative analysis, the following factors should be considered: (1) whether the omissions concealed unlawful transactions or conduct; (2) whether the omissions relate to a significant aspect of the company's business; (3) if there was a significant market reaction to the public disclosure of the omissions; (4) whether the omissions hide a failure to meet analysts' expectations; (5) if the omissions changed a loss into income or vice versa; and (6) whether the omissions affected the company's compliance with loan covenants or other contractual requirements.[11]

While the Court acknowledged that Blackstone's investments in the two portfolio companies each fell below the presumptive 5% threshold of materiality, the Court held that the District Court had incorrectly evaluated some of the qualitative factors.[12] For instance, the Court found that the District Court put too much emphasis on the fact that a loss in one portfolio company could be offset by a gain in another. On this point, the Court concluded that "Blackstone is not permitted, in assessing materiality, to aggregate negative and positive effects on its performance fees in order to avoid disclosure of a particular material negative event."[13]

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5 Slip Opinion at 15-16. There is an exception where claims under Sections 11 and 12(a)(2) are combined with fraud claims and themselves sound in fraud. That exception was not presented in *Landmen*.

6 *Id.* at 18.

7 *Id.* at 18-19.

8 *Id.* at 21.

9 *Id.* at 22.

10 *Id.* at 11-12. The threshold is based on the percentage of which an investment represents the company's total assets under management. For example, the District Court noted that "Blackstone's $331 million investment in [one of the portfolio companies at issue] represented a mere 0.4% of Blackstone's total assets under management," and was therefore presumptively immaterial. *Id.*

11 *Id.* at 13.

12 *Id.* at 22.

13 *Id.* at 23.

The Court also disagreed with the District Court's finding that the alleged omissions did not relate to significant aspects of Blackstone's business. For example, although one of the portfolio companies at issue accounted for only 3.5% of Blackstone's total assets under management, it represented 9.4% of the Corporate Private Equity segment's assets and was nearly three times larger than the next investment in that segment.[14] Corporate Private Equity ─ the largest of Blackstone's four segments ─ constituted approximately 37% of the company's total assets under management.[15] The Court wrote: "Even 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."[16]

III. Significance of the Decision

The Second Circuit's decision is significant for two primary reasons. First, companies can use the opinion for guidance on the types of information that might be considered material for purposes of disclosure under Item 303(a). Second, the decision could encourage more private litigants to allege violations of Item 303(a).

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Nicole Falls at 212.701.3115 or nfalls@cahill.com.

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14 *Id.* at 8, 25.

15 *Id.* at 4.

16 *Id.* at 25.

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