



## Outside Counsel Circuit Gives Guidance to Litigators On Securities Fraud Claims

## Expert Analysis

On Jan. 21, 2009, in *ECA and Local 134 IBEW Joint Pension Trust of Chicago v. JPMorgan Chase Co.*, \_\_\_F.3d\_\_\_, 2009 WL 129911, the U.S. Court of Appeals for the Second Circuit affirmed a district court decision dismissing securities fraud claims brought against JPMorgan that arose out of its dealings with Enron.

The circuit based its decision, in part, on its conclusion that an alleged \$2 billion misstatement was both quantitatively and qualitatively immaterial as a matter of law. In holding that the misstatement at issue was qualitatively immaterial, the circuit, for the first time, rigorously analyzed three specific considerations set forth in Securities and Exchange Commission Staff Accounting Bulletin No. 99, 64 Fed. Reg. at 45,152 (SAB 99), which the plaintiffs had argued applied.

Thus, *JPMorgan* is an important decision for securities litigators, including those involved in securities enforcement and criminal matters who confront allegations of misstatements that are demonstrably quantitatively immaterial, but are nevertheless alleged to be qualitatively material.<sup>1</sup>

In *JPMorgan*, the plaintiffs alleged that, to further its relationship with Enron, JPMorgan created a special-purpose vehicle named Mahonia, which bought gas from Enron using money borrowed from JPMorgan, which Mahonia repaid in gas. JPMorgan, in turn, allegedly resold the gas back to Enron.

The plaintiffs alleged that neither the physical commodity nor title to it were ever intended to be transferred. According to the plaintiffs, despite its mechanics, these pre-paid commodity transactions were nothing more than a loan from JPMorgan to Enron, which JPMorgan allegedly misclassified as “trading activities” (instead of loans) when it reported its own financial results. The plaintiffs further alleged that this misrepresentation, involving



By  
**Douglas I.  
Koff**



And  
**Jason  
Jurgens**

\$2 billion, was material.

Despite the seemingly large sum involved, the Second Circuit held that the particular alleged \$2 billion misrepresentation was not quantitatively material in the context of JPMorgan’s financial statements. Quoting the district court, the circuit held that “[c]hanging the accounting treatment of approximately 0.3% of JPM Chase’s total assets from trades to loans would not have been material to investors.”

The circuit then addressed (and rejected) the plaintiffs’ allegations that the \$2 billion misclassification of the Mahonia-trades was qualitatively material. Elaborating on *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000), the court explained that the quantitative materiality analysis should be supplemented by a qualitative materiality analysis because, in the context of a quantitatively immaterial misstatement, a reasonable shareholder might still consider the fact being misrepresented qualitatively important. To conduct this qualitative analysis, the circuit looked to SAB 99 for guidance.

SAB 99 “expresses the views of the [SEC] staff that exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate; misstatements are not immaterial simply because they fall beneath a numerical threshold.”

Like any other SEC Staff Accounting Bulletin, SAB 99 “represent[s] interpretations and policies followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws.”

The Second Circuit has been careful to note,

citing *Ganino*, that SAB 99 is merely “guidance,” and “does not carry with it the force of law.”

As the circuit further clarified in *JPMorgan*, although SAB No. 99 did not “change the standard of materiality,” the factors it sets forth should be treated as “persuasive authority” in “determining whether the misstatement significantly altered the ‘total mix’ of information available to investors.”

SAB 99 contains the following non-exhaustive list of “considerations that may well render material a quantitatively small misstatement of a financial statement item”:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet analysts’ consensus expectations for the enterprise;
- whether the misstatement changes a loss into income or vice versa;
- whether the misstatement concerns a segment or other portion of the registrant’s business that has been identified as playing a significant role in the registrant’s operations or profitability;
- whether the misstatement affects the registrant’s compliance with regulatory requirements;
- whether the misstatement affects the registrant’s compliance with loan covenants or other contractual requirements;
- whether the misstatement has the effect of increasing management’s compensation, for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation;
- whether the misstatement involves concealment of an unlawful transaction;
- historic “price volatility” in response to certain disclosures; and
- management expectations about the impact that a misrepresentation will have on price.

As the Second Circuit explained in *JPMorgan*, “[t]hese qualitative factors are intended to allow for a finding of materiality if the quantitative size of the misstatement is small, but the effect of the misstatement is large.”

DOUGLAS I. KOFF is a member of *Cadwalader, Wickersham & Taft*. JASON JURGENS is special counsel in the firm’s litigation department. JOSHUA M. BENNETT, a litigation associate, assisted in the preparation of this article.

## Factors as Applied

*JPMorgan* is only one of a handful of federal court of appeals' decisions to have expressly applied SAB 99 to test the merits of a securities fraud claim or charge, and it is the Second Circuit's first meaningful and substantive attempt to do so since *Ganino* first embraced SAB 99 in 2000.<sup>2</sup>

In *JPMorgan*, the court addressed three SAB 99 factors:

First, the plaintiffs alleged that the misstatement concealed an unlawful transaction. The court concluded that that factor did not apply since the transaction itself was not illegal. Implicit in this conclusion is the distinction between misaccounting for an otherwise legal transaction, on the one hand, and the deliberate misaccounting for a transaction that is inherently illegal independent of the alleged securities fraud (e.g., management stealing from the corporation), on the other.

Second, the plaintiffs alleged that *JPMorgan's* misstatements related to a significant aspect of its operations. With respect to this factor, the court held that it "also favors" *JPMorgan* because *JPMorgan's* Enron-related business represented less than 0.1 percent of *JPMorgan's* revenues during the relevant years.

Third, the plaintiffs cited the "market reaction" to public disclosures of *JPMorgan's* role in Enron's collapse. In rejecting that argument, the court expressly limited the "usefulness" of SAB 99's "market reaction" factor to instances where management expects that a known misstatement may result in a significant positive or negative market reaction.

## Implications for Practitioners

The Second Circuit's materiality analysis in *JPMorgan* has several important implications for securities practitioners.

First, the size of the dollar amount involved in a misstatement is not dispositive of the issue of materiality. To be sure, many courts have recognized this in the past. See, for example, *Glassman v. Computervision Corp.*, 90 F.3d 617, 633 (1st Cir. 1996); *Parnes v. Gateway 2000 Inc.*, 122 F.3d 539, 546-47 (8th Cir. 1997); *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 715 (3d Cir. 1996); *In re Duke Energy Corp. Secs. Litig.*, 282 F. Supp. 2d 158, 161-62 (S.D.N.Y. 2003), *aff'd*, 113 Fed. Appx. 427 (2d Cir. 2004). However, as securities fraud practitioners confront misrepresentations involving larger and larger sums, having a precedent involving a ten-figure misrepresentation, like *JPMorgan*, could prove pivotal.

Second, after *JPMorgan*, even when a misrepresentation is clearly quantitatively immaterial, a rigorous, fact-specific analysis of potentially applicable SAB 99 factors is required. The myriad of potential factual scenarios, together with the many undefined concepts built into SAB 99 promise to make qualitative materiality a subject for future litigation. Moreover, given the fact-specific nature of the SAB 99 analysis, we believe there

may be situations when the applicability of one qualitative factor may not be sufficient to prove materiality. Thus, before conceding materiality, practitioners confronting a single applicable SAB 99 factor should consider the strength of that factor's application, and whether it pales in comparison to the quantitative immateriality of the misstatement at issue.

Third, the qualitative materiality analysis should be informed by quantitative considerations. After *JPMorgan*, determining what constitutes a "significant aspect of operations" requires a quantitative assessment. Presumably the Second Circuit would view other SAB 99 factors through a similar quantitative prism.

Fourth, securities fraud defendants seeking to demonstrate immateriality as a matter of law should be heartened by the circuit's discussion about factors "favor[ing]" defendant *JPMorgan*. That analysis confirms that SAB 99 factors can also weigh against a finding of materiality.

In some cases, there inevitably will be a "SAB 99 split" (i.e., some SAB 99 factors favor the defendant, while others favor the plaintiff). Courts, therefore, will have to delicately balance whether and under what circumstances certain

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SAB 99 factors (or collections of factors) should be afforded more weight than others.

Courts also will have to consider the interplay between various SAB 99 factors. For example, the factor regarding "imprecise estimates" may have significant implications on the applicability of other SAB 99 factors, such as whether or not a particular alleged misstatement actually masked a change in earnings or trend.

Fifth, defendants should be aware of *JPMorgan's* reasoning that a misrepresentation may be qualitatively material if management expects that a known misstatement may result in a significant positive or negative market reaction. On its face, this rationale appears to blur the distinction between scienter and materiality, as the entire premise of the "market reaction" SAB 99 factor, after *JPMorgan*, is management's knowledge of the misstatement. Commentators previously had raised concerns about SAB 99 for precisely this reason. See, for example, Clarissa Hodges, "The Qualitative Considerations of Materiality: The Emerging Relationship Between Materiality and Scienter," *Bowne Digest for Corp. & Sec. Law* (July-August 2002).

## Conclusion

Based on our review of the *JPMorgan* briefs and a transcript of the oral argument, it does not appear the parties addressed this issue.

Historically, courts have been hostile to theories that seek to blur the distinction between scienter and materiality, and typically emphasize that only the materiality of the alleged untrue statement of fact is relevant—not the materiality of the act or transaction that caused the untruth to be published.<sup>3</sup>

In any event, it remains to be seen how practitioners and courts will construe *JPMorgan's* rationale regarding the "market reaction" SAB 99 factor.

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1. The decision also contains an important discussion regarding the scienter pleading requirements under the PSLRA that are beyond the scope of this article.

2. We are aware of only two other federal court of appeals' decisions to have expressly applied SAB 99 in addressing qualitative materiality theories. See *United States v. Nacchio*, 519 F.3d 1140 (10th Cir. 2008), citing *Ganino*, 228 F.3d at 162-64 and SAB 99; *Romine v. Acxiom Corp.*, 296 F.3d 701, 706-07, 710-11 (8th Cir. 2002).

3. See *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 659-600 (4th Cir. 2004); *United States v. Reyes*, 491 F. Supp. 2d 906, 912 n. 6 (N.D. Cal. 2007); *In re Duke Energy Sec. Litig.*, 282 F. Supp. 2d at 161-62; cf. *Stoneridge Investment Partners, LLC v. ScientificAtlanta Inc.*, 552 U.S. \_\_\_ (2008) (Slip. Op. at 9) (rejecting proposition that "in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect"); but see *Gebhardt v. ConAgra Foods Inc.*, 335 F.3d 824 (8th Cir. 2003).