Duty to Disclose to Shareholders: *Matrixx Initiatives v. Siracusano*

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Summary

On January 10, 2011, the U.S. Supreme Court heard oral arguments in the case *Matrixx Initiatives v. Siracusano*. The question presented was whether a plaintiff can state a claim under Section 10(b) of the Securities Exchange Act and Securities and Exchange Commission (SEC) Rule 10b-5 based upon a pharmaceutical company's nondisclosure of adverse event reports, despite the lack of an allegation that the reports are statistically significant. On March 22, 2011, the Court unanimously held that the plaintiffs in this case had stated a claim under Section 10(b) and rule 10b-5.

The case was first brought in U.S. District Court for the District of Arizona. The district court found that there were not statistically significant data as to the accuracy of reports that the company's cold medication caused cases of the loss of smell and granted the defendants' motion to dismiss.

The shareholders appealed the district court's decision to the U.S. Court of Appeals for the Ninth Circuit. That court, analyzing issues of required materiality and scienter under the Private Securities Litigation Reform Act (PSLRA), held that the shareholders had sufficiently complied with the requirements and reversed the district court's decision. The U.S. Supreme Court agreed with the Ninth Circuit Court of Appeals and affirmed its decision.

On January 10, 2011, the U.S. Supreme Court heard oral arguments in the case *Matrixx Initiatives v. Siracusano*.[1] The question presented was whether a plaintiff can state a claim under Section 10(b) of the Securities Exchange Act[2] and Securities and Exchange Commission (SEC) Rule 10b-5[3] based upon a pharmaceutical company's nondisclosure of adverse event reports, despite the lack of an allegation that the reports are statistically significant. On March 22, 2011, the Court unanimously held that the plaintiffs in this case had stated a claim under Section 10(b) and rule 10b-5.

The case was first brought in U.S. District Court for the District of Arizona as *Siracusano v. Matrixx Initiatives, Inc.*[4] Plaintiff shareholders brought a class action securities fraud suit under the Private Securities Litigation Reform Act (PSLRA)[5] against a pharmaceutical company and its officers based upon the allegation that the company had knowledge that a cold remedy (Zicam) which it produced could cause permanent and total loss of smell (anosmia) and that the company did not adequately disclose this information to the public. Although the company had warned investors that there was a potential for lawsuits, it materially misled investors, according to the plaintiffs, by not disclosing that lawsuits had already been filed. The defendants moved to dismiss, and the Federal District Court of Arizona granted the defendants' motion.

The district court found that there were not statistically significant data as to the accuracy of reports that the company's cold medication caused the cases of anosmia. The court found that the shareholders were not able to allege scienter[6] with the requisite particularity under the PSLRA.[7] "[T]he complaint fails to allege any motive or state of mind with relation to the alleged omissions."[8] The court did not allow an amended complaint, stating:

> Absent allegations Defendants *knew* there was a definitive and statistically significant link between Zicam and anosmia *during the Class Period* [emphases in original] that

[1] No. 09-1156.

[2] 15 U.S.C. §78j(b). Section 10(b) is the general antifraud provision of the Securities Exchange Act of 1934 and states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> ...
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission [Securities and Exchange Commission] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[3] 17 C.F.R. §240.10b-5.

[4] No. CIV-04-1012-PHX-MHM, 2005 U.S. Dist. LEXIS 41102 (D. Ariz. Dec. 15, 2005).

[5] 15 U.S.C. §78u-4.

[6] "Scienter" is defined as a "Latin term for a person's guilty knowledge; i.e., knowing that a person's activities are wrong." MODERN DICTIONARY FOR THE LEGAL PROFESSION (3d ed. 2001).

[7] In order to plead scienter, the PSLRA requires the complaint "to state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(2). The plaintiff "must allege that ... the defendant had an intention 'to deceive, manipulate, or defraud.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

[8] No. CIV-04-1012-PHX-MHM, 2005 U.S. Dist. LEXIS 41102, at *27 (D.Ariz. Dec. 15, 2005).

> was "sufficiently serious and frequent to affect future earnings," any amendment would be futile.[9]

Plaintiffs appealed the case to the U.S. Court of Appeals for the Ninth Circuit,[10] which reversed the lower court's decision.

The Ninth Circuit first looked at the issue of whether the shareholders had sufficiently pleaded materiality. A company subject to the disclosure requirements of the federal securities laws must not omit from its reports any material information. The reporting of all material information is for the purpose of providing the investing public with the information that it needs to make an informed investment decision.

"An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important...."[11] In the instant case, the Ninth Circuit disagreed with the lower court's using a statistical significance standard to conclude that the shareholders failed to allege materiality and to comply with the pleading requirement under the PSLRA. The circuit court based this disagreement upon the Supreme Court's rejection in *Basic, Inc. v. Levinson*[12] of a strict rule for the determination of materiality.

> The Supreme Court has rejected the adoption of a bright-line rule to determine materiality because "'[t]he determination [of materiality] requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him.'" [citations omitted] Instead, courts should engage in a "fact-specific inquiry" in assessing materiality.[13]

Continuing with the issue of materiality, the appellate court pointed out that the district court should have left to the trier of fact whether the allegations of nondisclosure were significant.

> In relying on the statistical significance standard to determine materiality, the district court made a decision that should have been left to the trier of fact. Instead, we agree with the approach of the court in *In re Pfizer Inc. Securities Litigation*, [citation omitted] where the United States District Court for the Southern District of New York rejected the defendant pharmaceutical company's argument that the plaintiffs failed to plead materiality, which was based on the contention that three studies revealing adverse effects of the company's drug were not statistically significant. The court reasoned that it "cannot determine as a matter of law whether such links were statistically insignificant because statistical significance is a question of fact." [citation omitted][14]

The Ninth Circuit then listed various allegations which it concluded were sufficient to meet the pleading standard under the PSLRA, which states that:

> [T]he complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or

[9] *Id.*

[10] *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167 (9th Cir. 2009).

[11] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[12] 485 U.S. 224 (1988).

[13] 585 F.3d 1167, 1178.

[14] 585 F.3d 1167, 1179.

> omission is made on information or belief, the complaint shall state with particularity all facts on which that belief is formed.[15]

Based upon these findings, the appellate court held that the shareholders had complied with the pleading requirement of particularity for allegations of materiality under the PSLRA and reversed the district court's finding to the contrary.

The Ninth Circuit then looked at the issue of scienter. As mentioned above, under the PSLRA the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[16] The courts have found that a successful allegation of scienter must show that the defendant had an intention "to deceive, manipulate, or defraud."[17] A fairly recent Supreme Court case held that a complaint involving scienter can survive "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[18]

After reviewing all of the allegations in the complaint which linked anosmia with the Zicam cold remedy, the Ninth Circuit found that the inference of scienter was "cogent and at least as compelling" as any explanation that the cold remedy did not cause the anosmia. When the pharmaceutical company withheld possibly damaging information about Zicam, according to the court, it did not disclose all of the material information required of it.

> Withholding reports of adverse effects of and lawsuits concerning the product responsible for the company's remarkable sales increase is "an extreme departure from the standards of ordinary care" and "presents a danger of misleading buyers or sellers." [citation omitted] We therefore conclude that the inference that Appellees withheld the information intentionally or with deliberate recklessness is at least as compelling as the inference that Appellees withheld the information innocently.[19]

The Ninth Circuit held that the shareholders had sufficiently pleaded materiality and had shown sufficient inference of scienter to comply with the PSLRA. It reversed the district court decision and remanded the case for further proceedings.

The Supreme Court allowed plaintiffs' claim to go forward by finding that the plaintiffs had adequately pleaded both materiality and scienter.

In finding that plaintiffs had adequately pleaded materiality, the Supreme Court relied upon *Basic, Inc. v. Levinson*[20] in much the same manner as the Ninth Circuit Court of Appeals and rejected the adoption of a "bright-line rule" for determining materiality. In the instant case, because Matrixx had provided to the public only favorable information about its Zicam cold remedy and had not provided to the public research reports linking Zicam to a loss of smell in some users, Matrixx had not disclosed all of the material information that a reasonable investor would wish to have in making an informed investment decision.

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[15] 15 U.S.C. §78u-4(b)(1).

[16] 15 U.S.C. §78u-4(b)(2).

[17] *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

[18] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007).

[19] 585 F.3d 1167, 1183.

[20] 485 U.S. 224 (1988).

> [T]he mere existence of reports of adverse events—which says nothing in and of itself about whether the drug is causing the adverse events—will not satisfy this standard. Something more is needed, but that something more is not limited to statistical significance and can come from "the source, content, and context of the reports." [citation omitted] This contextual inquiry may reveal in some cases that reasonable investors would have viewed reports of adverse events as material....[21]

The Court went on to state that not all material information has to be disclosed. Instead, disclosure is required when necessary "to make ... statements made, in the light of the circumstances under which they were made, not misleading."[22]

In finding that plaintiffs had adequately pleaded scienter, the Supreme Court, as did the Ninth Circuit Court of Appeals, referred to the "cogent and compelling" standard as set out in *Tellabs, Inc. v. Makor Issues & Rights, Ltd*.[23]

> The inference that Matrixx acted recklessly (or intentionally, for that matter) is at least as compelling, if not more compelling, than the inference that it simply thought the reports did not indicate anything meaningful about adverse reactions....
>
> These allegations, "taken collectively," give rise to a "cogent and compelling" inference that Matrixx elected not to disclose the reports of adverse events not because it believed they were meaningless but because it understood their likely effect on the market.[24]

For these reasons the Supreme Court affirmed the judgment of the Ninth Circuit Court of Appeals.

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[21] Slip op., at 16.

[22] 17 C.F.R. §240.10b-5(b).

[23] 551 U.S. 308 (2007).

[24] Slip op. at 21-22.