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Materiality of Misrepresentations in U.S. Securities Litigation

The U.S. Supreme Court Reaffirms Law on Pleading Materiality in Securities Fraud Actions, Declines to Endorse Bright-Line Standard

SUMMARY

The U.S. Supreme Court has recently curtailed the scope of securities fraud actions and tightened pleading requirements, making it more difficult for plaintiffs to allege securities fraud and ultimately making such claims more prone to an early dismissal. As such, in electing to review the “materiality” issue in *Matrixx Initiatives, Inc., et al. v. Siracusano, et al.*, No. 09-1156, some observers thought that the high court might tighten further the pleading requirements in securities litigation.

Last week, the Supreme Court issued its decision in *Matrixx*, holding that plaintiffs had adequately pleaded material misrepresentations by defendants for failing to disclose “adverse event reports” relating to Matrixx’s popular nasal spray, while declining to adopt a bright-line standard for determining the materiality of such reports in actions against pharmaceutical companies. In applying existing law to the allegations and circumstances present in the case, the Court’s decision is narrow and does not alter the class action landscape.

BACKGROUND

Under the Supreme Court’s 1988 decision in *Basic Inc. v. Levinson*, “misleading statements or omissions” are actionable as securities fraud only if there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”¹ In formulating this materiality standard, the Court declined to adopt a bright-line rule that preliminary merger negotiations are material only once the parties to the negotiations reach an agreement in principle, on the view that such an approach “must necessarily be either overinclusive or underinclusive.”²

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Notwithstanding *Basic*'s bias against bright-line materiality standards, numerous courts have since held that drug companies have no duty to disclose reports of adverse events associated with a product if the reports do not disclose a "statistically significant" number of adverse events. These courts have reasoned that reasonable investors would not consider such reports relevant unless they were statistically significant.

The *Matrixx* case arose in this context. The price of Matrixx stock declined in February 2004 in the wake of reports that more than a dozen people lost their sense of smell (a condition known as "anosmia") after using the company's popular Zicam Cold Remedy. Shortly thereafter, a pension fund and individual investor brought a securities class action on behalf of Matrixx investors against the company and three of its executives. Plaintiffs alleged that defendants defrauded investors under Section 10(b) of the Securities Exchange Act of 1934 by failing to disclose adverse event reports relating to Zicam.

The district court dismissed the action for failure to allege materiality and scienter. The court agreed with defendants that the adverse event reports did not show a "statistically significant correlation between the use of Zicam and anosmia" and therefore were not a "material omission."³ The Ninth Circuit reversed, however, holding that "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."⁴ The Ninth Circuit further held that plaintiffs adequately pleaded scienter because the complaint, on a "holistic review," supported a "compelling inference" that defendants withheld information about Zicam "intentionally or with deliberate recklessness."⁵

THE SUPREME COURT'S DECISION

On March 22, 2011, Justice Sotomayor delivered a unanimous decision, affirming the Ninth Circuit. The opinion is narrowly tailored to the case's facts and does not revise or depart from the materiality standard established in *Basic*. Nor does it change the Court's recent pronouncements regarding scienter.

As in *Basic*, the Court found that the proposed bright-line test would "'artificially exclud[e]' information that 'would otherwise be considered significant to the trading decision of a reasonable investor.'"⁶ The Court took notice of medical research and drug safety standards and concluded that defendants' "premise that statistical significance is the only reliable indication of causation . . . is flawed."⁷ As Justice Sotomayor observed, "[g]iven that medical professionals and regulators act on the basis of evidence of causation that is not statistically significant, it stands to reason that in certain cases reasonable investors would as well."⁸

At the same time, the Court emphasized that "the mere existence of reports of adverse events . . . will not satisfy [*Basic*'s] standard," and that the anti-fraud provisions of the federal securities laws, in any event, "do not create an affirmative duty to disclose any and all material information."⁹ As a result, the Court considered "the source, content, and context of the reports" and ultimately concluded that the allegations

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in the case “suffice to ‘raise a reasonable expectation that discovery will reveal evidence’ satisfying the materiality requirement, . . . and to ‘allo[w] the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.’”¹⁰ Here, in the Opinion’s “fact-specific” analysis of plaintiffs’ allegations regarding what defendants knew and told the market, the Court acknowledged that under a different set of allegations, the decision not to dismiss the case could have gone the other way.

Having rejected the proposed bright-line test and found, assuming the complaint’s allegations to be true, that “Matrixx received information that plausibly indicated a causal relationship between Zicam and anosmia,” the Court held that “[t]he 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.”¹¹

The Court’s decision expressly leaves open whether “deliberate recklessness” is sufficient to establish scienter, noting that defendants did not appeal this aspect of the Ninth Circuit’s holding. Congress left this issue open in the Private Securities Litigation Reform Act of 1995, and the Supreme Court has yet to decide whether scienter under Section 10(b) requires proof of deliberate intent, such as knowledge that nondisclosure of certain information would likely mislead investors.

IMPLICATIONS

The Supreme Court’s unanimous decision in *Matrixx* does not change existing law. The cost of securities litigation increases substantially when cases move past the pleading stage, and pharmaceutical companies would have obtained a significant advantage at that stage had the Supreme Court adopted a bright-line (im)materiality standard with regard to undisclosed adverse event reports.

Looking back, it is not clear why the Court decided to review this case, particularly when all it did was reaffirm the Ninth Circuit’s decision. In any event, defendants in securities cases should find comfort in the Court’s statement that adverse event reports are not *per se* material and the extent of the Court’s analysis prior to determining that the reports relating to Zicam were adequately *alleged* to be material, based on a “fact-specific” inquiry and the “total mix” of information. The Court’s decision thus reaffirms that securities plaintiffs must adequately allege materiality in the complaint and encourages defendants to oppose such allegations if they are conclusory or contradicted by facts or studies that courts are able to consider on a motion to dismiss.

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ENDNOTES

- 1 485 U.S. 224, 231-232 (1988) (citation omitted).
- 2 *Id.* at 236.
- 3 *Siracusano v. Matrixx Initiatives, Inc.*, Nos. CV 04 0886, CV 04 1012, 2005 WL 3970117, at *7 (D. Ariz. Dec. 15, 2005).
- 4 *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167, 1179 (9th Cir. 2009).
- 5 *Id.* at 1182-83.
- 6 *Matrixx Initiatives, Inc. v. Siracusano*, --- S. Ct. ---, 2011 WL 977060, at *8 (U.S. March 22, 2011) (citing *Basic*, 485 U.S. at 236).
- 7 *Id.*, at *9.
- 8 *Id.*, at *10.
- 9 *Id.*, at *11.
- 10 *Id.*, at *10, *12 (citations omitted).
- 11 *Id.*, at *12, *14.

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