

Supreme Court Will Examine Materiality in Securities Fraud Class Action Against Pharmaceutical Company

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On June 14, 2010, the United States Supreme Court granted *certiorari* in the matter of *Matrixx Initiatives, Inc., et al. v. Siracusano, et al.*, No. 09-1156, agreeing to address plaintiffs' pleading burden for claims brought under Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act"). *Matrixx* is the latest among a string of securities cases taken by the Court assessing the scope and pleading standard for fraud claims. For the first time, *Matrixx* provides the Court with the opportunity to address the pleading requirement for alleging materiality of a misstatement or omission.

In the context of securities claims, information is material if a reasonable investor would have viewed the misrepresented information, or disclosure of omitted information, as having significantly altered the "total mix" of information available to the investor. The key consideration for the Court will be the specificity with which plaintiffs must allege facts supporting the materiality of a misstatement or omission. The Court could follow the Second Circuit's lead, establishing a more exacting pleading requirement, or it could adopt the more permissive Rule 8 notice pleading standard applied by the Ninth Circuit. Where the Court draws the line on this question will ultimately be the most significant issue resolved in *Matrixx*.

Although it presents an issue of first impression for the Court, it remains unclear whether *Matrixx* will have a substantial impact on future securities fraud class actions. The plaintiffs brought the putative class action back in April 2004 against Matrixx Initiatives, Inc., the manufacturer of Zicam Cold Remedy. Since 2004, the Court has decided three major securities cases involving Section 10(b) claims, including *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), *Tellabs Inc. v. Makor Issues & Rights*, 551 U.S. 308 (2007), and *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008). In particular, the Court's decision in *Dura*, which requires plaintiffs to plead "loss causation," may resolve any dispute about the materiality of the omissions allegedly made by Matrixx. Thus, any pronouncement by the Court may be of little consequence to pending and future securities class actions.

Disclosure of Adverse-Event Reports

It is alleged that from 1999 to 2004, Matrixx received a dozen reports of Zicam users experiencing a loss of the sense of smell, a condition called anosmia. Matrixx allegedly never publicly disclosed these "adverse-event reports." The plaintiffs alleged that Matrixx's failure to disclose the adverse-event reports constituted a material omission in connection with a purchase or sale of Matrixx's securities.

As a result, the plaintiffs alleged that Matrixx and three of its executives violated Section 10(b) and SEC Rule 10b-5.

In March 2006, the District Court of Arizona granted defendants' motion to dismiss the plaintiffs' claims. See *Siracusano v. Matrixx Initiatives, Inc.*, No. CV 04 0886 PHX MHM, 2005 WL 3970117 (D. Ariz. Dec. 15, 2005). The district court held that the adverse-event reports alleged in the complaint were not statistically significant evidence that Zicam caused the adverse events. Following precedent in the Second and Third Circuits (and now the First Circuit), the district court determined that allegations failing to establish statistically significant evidence are not sufficient to allege a *material* omission. Plaintiffs appealed to the Ninth Circuit.

The Ninth Circuit Rejects the Statistical Significance Requirement

A unanimous panel of the Ninth Circuit reversed the district court's decision. See *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167 (9th Cir. 2009). Writing for the panel, Judge Tashima began the court's analysis by noting that questions of materiality are ordinarily "within the province of the trier of fact" and rarely should be resolved at the pleading stage. He further stated that "[t]he Supreme Court has rejected the adoption of a bright-line rule to determine materiality because 'the determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw . . . and the significance of those inferences to him.'"

With this judicial policy providing background, Judge Tashima proceeded to list the allegations of various undisclosed adverse-event reports as support for the materiality of Matrixx's omission. In assessing the sufficiency of those allegations, the Ninth Circuit applied the notice pleading standard under Rule 8. Quoting the Rule 8 standard as announced in *Bell Atlantic Corporation v. Twombly*, 550 U.S. 544 (2007), Judge Tashima concluded that plaintiffs' allegations of adverse event reports were enough "to nudge[] [the shareholders'] claims across the line from conceivable to plausible." Thus, the Ninth Circuit rejected the "statistical significance" standard in favor of a fact-specific inquiry to determine "whether the complaint state[d] a claim that [was] plausible on its face."

The Supreme Court Should Place an Exacting Pleading Standard on Materiality

The Ninth Circuit's rejection of the "statistical significance" standard provides the Supreme Court with an opportunity to resolve a clear Circuit split and supply clarity in securities actions based on material omissions.¹

The Circuit split reveals a judicial divide between competing legal policies. On the one hand, the First, Second, and Third Circuits' requirement of alleging statistically significant evidence is in accord with recent legislative and judicial steps to curtail the scope of securities class actions. On the other hand, the Ninth Circuit's decision recognizes the long-held view that materiality is a fact-based inquiry normally left in the hands of the trier of fact. The Ninth Circuit therefore assessed the materiality element under the more lenient Rule 8 pleading standard.

While the Supreme Court will inevitably balance these competing judicial policy preferences, it must also recognize the vital role materiality plays in the context of omissions claims. Unlike actions based on misstatements, plaintiffs alleging omissions claims need not plead the element of reliance. Nevertheless, because plaintiffs must allege that the omitted information is *material*, plaintiffs must show that the undisclosed information would have significantly altered the total mix of information

available to investors. In the context of omissions, it is therefore logically presumed that reasonable investors would rely on the *material* information if it had been disclosed. This makes the materiality element more important when coupled with an alleged omission. As such, it is imperative that the Court place a non-illusory pleading standard for material omissions claims.

Materiality and Loss Causation – Does *Dura* Control?

Materiality is undoubtedly a key element in a securities fraud claim, but does it have any remaining significance at the pleading stage? In *Dura*, the Court held that plaintiffs are required to plead facts showing that their economic loss was a result of the fraud (*i.e.*, loss causation). In other words, the fraudulent conduct (either a misstatement or omission) must impact that the value of the security that plaintiffs purchase or sell. Normally this entails plaintiffs pleading that the company's stock price dropped shortly and sharply after the fraud was revealed to the public.

In *Matrixx*, for example, the Ninth Circuit notes that Matrixx's stock price declined immediately after the adverse-event reports were disclosed to the public. Assuming that Matrixx's stock traded on an efficient market, this fact shows that investors not only would, but did believe that Matrixx's alleged collective omissions were material to their decision of whether to purchase or sell the company's stock. See *In re Merck & Co., Inc. Sec. Litig.*, 432 F.3d 261, 269 (3d Cir. 2005) (materiality of omissions may be measured *post hoc* by looking to movement, in the period immediately following full disclosure, of the price of the company's stock).² But neither the Ninth Circuit nor the district court cited *Dura* or offered Matrixx's stock drop as evidence of materiality.

The absence of *Dura* from the courts' analysis is not altogether unsurprising. *Dura* was decided before the Matrixx defendants filed their motion to dismiss with the district court and neither party cited *Dura* in their appellate papers. It is unclear whether *Dura* will remain off the Supreme Court's radar as well, but is certainly shouldn't. Loss causation plays an intricate role in the materiality inquiry for securities class actions, and should be mindfully considered by the Court.

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- ¹ Along with claims brought under Section 10(b) of the Exchange Act, plaintiffs may bring material omissions claims under Sections 11 and 12 of the Securities Act of 1933. Any general pronouncements by the Court in *Matrixx* will inevitably have some impact on pleading requirements for Section 11 and 12 claims.
- ² If *Matrixx*'s stock price had not moved after the adverse-event reports were revealed to the public, it would be safe to assume that reasonable investors did not find the adverse-event reports material to their decision of whether to purchase or sell the company's stock. Nevertheless, in a pre-*Dura* decision, the Ninth Circuit has held that the failure of a company's stock price to immediately move following a corrective disclosure is not conclusive that the omission was immaterial. See *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 934 (9th Cir. 2003).