

Practising Law Institute: Securities Litigation & Enforcement Institute 2011

HIGH COURT AGAIN REJECTS BRIGHT LINE RULE FOR PLEADING MATERIALITY

by David H. Kistenbroker, Carl E. Volz and Aharon S. Kaye
Katten Muchin Rosenman LLP. ©2011 David Kistenbroker. All rights reserved.

I. Introduction

In *Matrixx Initiatives, Inc. v. Siracusano*,¹ the Supreme Court recently reaffirmed its long-standing holding in *Basic v. Levinson*² that there is no “bright-line rule” for determining whether information withheld from a company’s public filings is material as a matter of law.³ Unwilling to allow materiality to be reduced to a test of “statistical significance,” the Court held instead that assessing materiality involves a “fact-specific inquiry . . . that requires consideration of the source, content, and context of the [allegedly omitted information].”⁴ Thus, the Court held, while statistical significance is relevant to the inquiry, “it is not dispositive in every case.”⁵

II. Background

Matrixx Initiatives, Inc. (“Matrixx”) is a publicly held pharmaceutical company that sells cold remedy products through its wholly-owned subsidiary Zicam, LLC. At issue in *Matrixx* were reports made to Matrixx by a handful of doctors that alleged their patients had experienced complete loss of smell, or anosmia, after using Zicam Cold Remedy gel or nose spray (“Zicam”), a product which represented 70% of Matrixx’s sales.⁶ Despite knowledge of these complaints, Matrixx told investors that Zicam was “poised for growth in the upcoming cough and cold season,” that “the company had ‘very strong momentum,’” and it expected revenues to “be in excess of 50%, and that earnings . . . [would] be in the 25 to 30 cent range.”⁷ During the class period, Matrixx further increased these projections, “predicting an increase in revenues of 80 percent and earnings . . . in the 33-to-38-cent range.”⁸ Matrixx went on to issue a press release suggesting studies had discredited Zicam-anosmia claims, although it had conducted no such studies.⁹ When news of the doctors’ reports aired on Good Morning America in February 2004, however, Matrixx stock dropped nearly 26%.¹⁰

Plaintiffs filed a class action suit on behalf of individuals who purchased Matrixx securities between October 22, 2003 and February 6, 2004. Plaintiffs claimed that Matrixx failed to disclose the reports of a possible link between Zicam and loss of smell, rendering the statements relating to revenues and product safety made by Matrixx during the class period materially misleading in violation of §10(b) of the Securities Exchange Act and SEC Rule 10b-5.¹¹ Defendants moved to dismiss the complaint, arguing that plaintiffs had failed to allege that the reports of Zicam-induced-anosmia represented a “statistically

Mr. Kistenbroker is Managing Partner of the Chicago office of Katten Muchin Rosenman LLP, Chairman of the Firm’s National Litigation Department, Co-Chair of the Securities Litigation Practice Group and Co-Chair of the Corporate Governance Practice Group. Mr. Volz is a member of the Firm’s Securities Litigation Practice Group and a partner of the Firm whose practice is focused exclusively on the defense of securities litigation and corporate governance cases. Mr. Kaye is an associate in the Firm’s litigation department.

The authors thank J. Matthew Haws, a 2012 J.D. candidate at University of Illinois College of Law, for his valuable assistance with the preparation of this article.

significant” link between Zicam and anosmia.¹² Relying on decisions from the Second and Third Circuit, the district court agreed, finding the adverse event reports immaterial as a matter of law.¹³ Since Plaintiffs had not alleged that defendants were aware of a statistically significant link between Zicam and anosmia, the court reasoned, they had not plead facts sufficient to support a strong inference that defendants had acted with requisite scienter.¹⁴

On appeal, the Ninth Circuit reversed, rejecting the “statistical significance standard” as contrary to the holding of the Supreme Courts in *Basic*.¹⁵ Warning against the adoption of a “bright-line rule,” the Ninth Circuit emphasized that “courts should engage in a ‘fact-specific inquiry’ in assessing materiality.”¹⁶ The Ninth Circuit also found that plaintiffs had properly plead scienter, holding Matrixx’s failure to disclose the adverse event reports and its involvement in a related lawsuit during the class period was “an extreme departure from the standards of ordinary care.”¹⁷

III. The “Statistical Significance Standard”

On petition for a writ of certiorari, the parties in *Matrixx* argued over the importance of the Ninth Circuit’s ruling. Matrixx suggested to the Supreme Court that the Ninth Circuit had created a circuit split by rejecting a “statistical significance standard” in conflict with First, Second, and Third Circuit precedent.¹⁸ Matrixx cited the Second Circuit’s decision of *In re Carter-Wallace, Inc. Securities Litigation*,¹⁹ for the proposition that §10(b) claims do not exist on the basis of adverse event reports that are not statistically significant because such reports do not indicate that the product caused the adverse reaction, negating both materiality and scienter.²⁰ Similarly, Matrixx pointed to *N.J. Carpenters Pension & Annuity Funds v. Biogen IDEC Inc.*,²¹ where the First Circuit found scienter lacking because the plaintiff had relied on statistically insignificant adverse event reports.²² Further, Matrixx explained that the Third Circuit had concluded, in *Oran v. Stafford*,²³ that “drug companies need not disclose isolated reports of illnesses suffered by users of their drugs until those reports provide statistically significant evidence that the ill effects may be caused by . . . use of the drugs.”²⁴

Plaintiffs argued that Matrixx’s claim of a circuit split was illusory.²⁵ They pointed out that both *Carter-Wallace* and *Biogen* were decided on a lack of scienter, and that in both cases materiality had already been assumed or conceded.²⁶ They argued that in spite of *Biogen*, the Second Circuit has continued to reject any “bright-line” materiality standard or numerical benchmark.²⁷ Also, Plaintiffs argued that the Third Circuit in *Oran* relied primarily on the fact that corrective disclosures had little effect on the stock price to find a lack of materiality.²⁸ Plaintiffs went on to suggest that the Ninth Circuit’s opinion was wholly in line with a string of other circuit cases.²⁹

IV. The Matrixx Decision

The Supreme Court did not address whether the Ninth Circuit’s opinion created a split among the circuit courts, but its opinion sends a clear message to any circuit court inclined to undermine *Basic* or limit the fact-finder’s prerogative to decide materiality. Despite what it called valid concerns that companies that regularly receive adverse event reports will simply dump them on the investing public in a prophylactic attempt to quash securities fraud claims or that such disclosures could “spawn confusion” and “deter consumers from purchasing drugs that are needed to improve their health,”³⁰ the Court remained committed to the more nuanced “total mix” analysis.³¹

Writing for a unanimous Supreme Court, Justice Sotomayor agreed with the Ninth Circuit’s assessment and flatly rejected the “statistical significance standard” as inapplicable in light of *Basic* because a “categorical rule would ‘artificially exclud[e]’ information that ‘would otherwise be considered significant to the trading decision of a reasonable investor.’”³² Noting that at times medical experts and the FDA rely on data that lacks statistical significance to infer a causal link between a drug and an injury, the Court found that it was not unreasonable for investors to do the same.³³

The Court also applied *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*³⁴ to hold the allegations sufficient to plead scienter.³⁵ Specifically, the Court found that the allegations created a “cogent and compelling” inference that Matrixx chose not to disclose the adverse event reports to prevent a negative market reaction.³⁶ The inference that Matrixx had acted recklessly, if not intentionally, was at least as compelling, if not more compelling, than the non-culpable inference that Matrixx thought the adverse event reports were too few in number to suggest any link between Zicam and anosmia.³⁷ In making this determination, the Court relied heavily on the alleged efforts by Matrixx to prevent disclosure and its inaccurate suggestion that other studies showed no link between Zicam and anosmia.³⁸

V. Implications of Matrixx

Arguably, the *Matrixx* decision adds little by way of new doctrine to §10(b) and Rule 10b-5 claims. *Matrixx* follows *Basic*’s guidance that “[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”³⁹ Indeed, the Court in *Basic* was faced with very similar circumstances. There, the question before the Court was whether misstatements regarding preliminary merger discussions were material.⁴⁰ Arguing that the consummation of the merger agreement was inherently speculative, the defendant in *Basic* asked the Court to apply the Third Circuit’s “agreement-in-principle” test.⁴¹ Because no “agreement-in-principle” had been reached in the merger at issue, the misstatements would have been rendered immaterial as a matter of law under such a test.⁴² However, the Supreme Court refused to accept such a test, instead insisting that the materiality of speculative information requires a court to balance the probability that an event might occur against its expected magnitude to the company,⁴³ an inquiry that cannot be reduced to any particular test.

Whether faced with adverse event reports or preliminary merger negotiations, information becomes more important to investors as rumors or allegations become more pronounced or settled. As the *Matrixx* Court observed, drawing the line of materiality at “statistical significance” negates legitimate claims that information related to even a *less than likely link between a product and an injury* has a material impact on a company. The *Matrixx* case was a perfect vehicle to point this out because Zicam, representing the largest portion of Matrixx sales, is a homeopathic treatment for the common cold, while anosmia is a devastating injury.⁴⁵ As the Court explained:

Consumers likely would have viewed the risk associated with Zicam (possible loss of smell) as substantially outweighing the benefit of using the product (alleviating cold symptoms), particularly in light of the existence of many alternative products on the market. Importantly, Zicam Cold Remedy allegedly accounted for 70 percent of Matrixx’s sales. Viewing the allegations of the complaint as a whole, the complaint alleges facts suggesting a significant risk to the commercial viability of Matrixx’s leading product.⁴⁶

Thus, as the Court implied, consumers, and therefore investors, are more likely to care about statistically insignificant reports than they might if they were dependent on Zicam to stay alive.⁴⁷ However, the Court did not say that statistical significance was irrelevant to the materiality of adverse event reports.⁴⁸ Rather, it left open the possibility that statistical insignificance might be dispositive in *some* cases, which might leave cases in place, like *Oran v. Stafford*,⁴⁹ which relied heavily on the notion of statistical insignificance to find materiality inadequately plead.⁵⁰ While the Supreme Court found the adverse event reports in *Matrixx* gave rise to a “plausible causal relationship” between Zicam and anosmia despite their lack of statistical significance,⁵¹ subsequent courts might find particular adverse event reports immaterial as a matter of law because they do not give rise to such a relationship at least *in part* because of their statistical insignificance.⁵²

Moreover, although it did not add any new doctrine to *Basic*'s materiality element, the *Matrixx* Court further explained that "[e]ven with respect to information that a reasonable investor might consider material, companies can control what they have to disclose under [§10(b) of the Securities Exchange Act and Rule 10b-5] by controlling what they say to the market."⁵³ This point was recently addressed in the decision of *In Re Sanofi-Aventis Securities Litigation*.⁵⁴ In *Sanofi-Aventis*, the Southern District of New York denied dismissal of a securities fraud complaint which alleged that Sanofi-Aventis SA, a French pharmaceutical company, "misled investors regarding the commercial viability of rimonabant," an obesity drug. Plaintiffs alleged that "Sanofi publicly touted rimonabant and released only good news about rimonabant," simultaneously "withholding bad news" concerning a potential link between rimonabant and suicidal tendencies.⁵⁵ Relying on *Matrixx*, the District Court held that the defendants were "not entitled to dismissal of the [complaint] on the basis that they lacked a duty to disclose the suicidality information."⁵⁶ Although a company may have no affirmative obligation to make any disclosures, the District Court found that because Sanofi was "regularly commenting about a pending [FDA] application" for rimonabant, the company had "an unwaivable duty to be both accurate and complete when it spoke to investors" regarding the product.⁵⁷

VI. Practical Guidance

The *Matrixx* Court's balancing inquiry also provides some practical guidance for firms to decide whether information is material and must be publicly disclosed. While keeping in mind that statistical significance is still relevant, a company should consider the substance and source of potentially negative information and its significance to the company as a whole. Information relating to a small portion of the company's revenue and earnings may very well be immaterial.⁵⁸

-
1. 131 S. Ct. 1309 (2011).
 2. 485 U.S. 224 (1988).
 3. *Matrixx*, 131 S. Ct. at 1318-1323.
 4. *Id.* at 1321 (quoting *Basic*, 485 U.S. at 236).
 5. *Id.*
 6. *Id.* at 1314-15, 1323.
 7. *Id.* at 1315.
 8. *Id.*
 9. *Id.* at 1324.
 10. *Id.* at 1316.
 11. *Id.* "Section 10(b) of the Securities Exchange Act makes it unlawful ... to 'use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.' 15 U.S.C. § 78j(b). SEC Rule 10b-5 implements [§ 10(b)] by making it unlawful to, among other things, 'make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.'" *Id.* at 1317.
 12. *Siracusano v. Matrixx Initiatives, Inc.*, No. CV-04-0886-PHX-MHM, 2005 WL 3970117 at **5-6 (D.Ariz. Dec. 15, 2005). In finding "adverse information related to the safety of a product is not material unless such reports provide reliable statistically significant information that a drug is unsafe," the district court cited to *In re Carter-Wallace, Inc.*, 220 F.3d 36, 42 (2d Cir. 1998) and *Oran v. Stafford*, 226 F.3d 275, 284 (3d Cir. 2000).
 13. *Id.* at *23-24.
 14. *Id.* at *8.
 15. *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d 1167, 1178 (9th Cir. 2009).
 16. *Id.* (quoting *Basic*, 485 U.S. at 236).
 17. *Id.* at 1183 (quoting *Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 976 (9th Cir. 1999)).

18. Petition for Writ of Certiorari at 6-9, *Matrixx Initiatives Inc. v. Siracusano*, 131 S.Ct. 1309 (Mar. 23, 2010) (No. 09-1156), 2010 WL 1063936, at **7-10.
19. 150 F.3d 153 (2d Cir. 1998).
20. Petition for Writ of Certiorari, *supra* note 20, at **7-8. *Matrixx* also cited *Avon Pension Fund v. GlaxoSmithKline PLC*, 343 F.App'x 671, 672-73 (2d Cir. 2009) (complaint insufficient where "it plead[] no facts indicating that the test results were even statistically significant") and *Masters v. GlaxoSmithKline*, 271 F.App'x 46, 50 (2d Cir. 2008) (reports of harmful effects of drugs need not be disclosed unless reports "show statistically significant evidence of an adverse effect.").
21. 537 F.3d 35 (1st Cir. 2008).
22. *Id.* at 48.
23. 226 F.3d 275, 284 (3d Cir. 2000).
24. *Id.*
25. Brief in Opposition to the Petition for Writ of Certiorari at 13-15, *Matrixx Initiatives Inc. v. Siracusano*, 131 S.Ct. 1309 (May 13, 2010) (No. 09-1156), 2010 WL 1973595, at **13-16.
26. *Id.* at 13-14.
27. *Id.* at 14 (citing *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) ("courts exclusive reliance on a single numerical or percentage benchmark to determine materiality was error").
28. *Id.* at 15.
29. *Id.* at 16 (citing *Martinez v. Schlumberger, Ltd.*, 338 F.3d 407, 428 (5th Cir. 2003) ("*Basic* suggests that we are not to rely on a bright-line test to determine whether a company's alleged misrepresentations are material."); *Kurz v. Philadelphia Elec. Co.*, 994 F.2d 136, 139 (3d Cir. 1993) (*Basic* rejects bright-line rule even though it "would be easier to administer"); *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1234 (7th Cir. 1988) (same).
30. Petition for Writ of Certiorari, *supra* note 20, at **12-13.
31. *Matrixx*, 131 S.Ct. at 1322.
32. *Id.* at 1319 (quoting *Basic*, 485 U.S. at 236).
33. *Id.* at 1319, 1321.
34. 551 U.S. 308 (2007).
35. *Matrixx*, at 1324-25.
36. *Id.* (quoting and applying *Tellabs*, 551 U.S. at 324).
37. *Id.*
38. *Id.*
39. *Basic*, 485 U.S. at 236.
40. *Id.* at 228-29.
41. *Id.* at 232-33.
42. *Id.*
43. *See id.* at 238.
44. *See Matrixx*, 131 S.Ct. at 1321-22.
45. *Id.*
46. *Id.* at 1323.
47. *Id.*
48. *Id.* at 1321.
49. 226 F.3d at 284.
50. *See* cases cited *supra* note 20; *but see In re Sanofi-Aventis Sec. Litig.*, No. 07cv10279, 2011 WL 1196052, at *7 n. 9 (S.D.N.Y. Mar. 30, 2011) (recognizing that *Matrixx* overruled *Carter-Wallace*).
51. *Matrixx*, 131 S.Ct at 1323.
52. Since *Matrixx* was decided, the federal circuit courts have not cited the case as new law on the subject of materiality. Instead, *Matrixx* has been cited primarily as a post-*Tellabs scienter* case, see *Frank v. Dana*, No. 09-4233, 2011 WL 2020717, at *5 (6th Cir. May 25, 2011), a post-*Iqbal* pleadings case; see *Argueta v. U.S. Immigration & Customs Enforcement*, No. 10-1479, 2011 U.S. App. LEXIS 11983, at *40 (3d Cir. June 14, 2011), or for the proposition that an omission might render statements materially misleading, see *Baker v. Cook*, No. 2:10-cv-00290-TC, 2011 U.S. Dist. LEXIS 56106, at **8-9 (May 23,

2011); *Minneapolis Firefighters' Relief Ass'n v. MEMC Elec. Materials, Inc.*, 641 F.3d 1023, 2011 U.S. App. LEXIS 12238, at *9 (8th Cir. June 17, 2011). The Ninth Circuit, in *United States v. Sayre*, 2011 U.S. App. LEXIS 10687, at *2 n.1 (9th Cir. May 23, 2011), took note that *Matrixx* endorsed the "total mix" articulation of the materiality standard but did not rule out other "reasonable investor" articulations of materiality.

53. *Matrixx*, 131 S.Ct. at 1321-22. See also *Basic Inc.*, 485 U.S. at 239 n.17 ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5"); *MEMC Elec. Materials, Inc.*, 2011 U.S. App. LEXIS 12238 at **12-13 ("Mere allegations that statements in one report should have been made in earlier reports do not make out a claim for securities fraud . . . To do so could encourage companies to disclose as little as possible."); *In re: K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 898 (8th Cir. 2002) ("Materiality alone is not sufficient to place a company under a duty of disclosure."); *Gallagher v. Abbott Labs.*, 269 F.3d 806, 808 (7th Cir.2001) (Publicly-traded companies are not required to disclose all information as soon as it comes into their possession simply because the information is material to stock prices.).

54. 2011 WL1196052, at *6.

55. *Id.*

56. *Id.* at *7 n. 9.

57. *Id.*

58. See e.g., *Romine v. Acxiom Corp.*, 296 F.3d 701, 706-07 (8th Cir. 2002) (affirming that a 2% overstatement of earnings was immaterial as a matter of law); *Parnes v. Gateway 2000, Inc.*, 122 F. 3d 539, 547 (8th Cir. 1997) ("alleged overstatement of assets by \$6.8 million was immaterial as a matter of law" because a reasonable investor "would not have been put off by an asset column that was 2% smaller."); *Garber v. Legg Mason, Inc.*, 537 F. Supp. 2d 597, 613 (S.D.N.Y. 2008) (omission from prospectus of \$12 million in fees (0.4% of annual revenue) "simply too small to be material as a matter of law"); *In re PETsMART, Inc. Sec. Litig.*, 61 F. Supp. 2d 982, 994 (D. Ariz. 1999) (revenue shortfalls of 10% or less may be immaterial as a matter of law). Cf. *In re Wachovia Sec. Litig.*, 753 F. Supp. 2d 326 (S.D.N.Y. 2011), where the plaintiffs alleged Wachovia made misstatements relating to its charge-off policy, Wachovia argued that these misstatements were immaterial per se because the charge-offs represented only a .02% impact on Wachovia's \$460B loan portfolio, but the Southern District of New York – citing *Matrixx* – declined to rely on material falsity in these circumstances to dismiss when the parties had not briefed the issue of qualitative impact. The District Court in *In re Wachovia* still dismissed plaintiffs' § 10(b) claims, holding that plaintiffs' allegations were insufficient to show a strong inference of scienter by concluding that "bad judgment and poor management are not fraud, even when they lead to the demise of a once venerable financial institution." *Id.* at 367.



David H. Kistenbroker

Managing Partner

Chicago

p / 312.902.5452

f / 312.902.1061

david.kistenbroker@kattenlaw.com

David H. Kistenbroker is Managing Partner of the Chicago office, National Chair of the Litigation and Dispute Resolution Practice, and Co-Chair of the Securities Litigation and Corporate Governance Practices. He also is a member of the firm's Executive Committee and Board of Directors.

Mr. Kistenbroker's practice is focused on the representation of publicly traded companies and their directors and officers in securities class actions, SEC investigations and corporate governance disputes. He has been selected by his peers as one of Illinois' leading trial lawyers and was featured in *The National Law Journal* for having one of the top ten defense verdicts in the nation. He was recognized in *Benchmark: America's Leading Litigation Firms and Attorneys* (2008–2011) published by *Legal Media Group*, has been listed in *Chambers USA: America's Leading Lawyers for Business* (2008–2011) in the area of General Commercial Litigation, and was named to the 2010 and 2011 Directorship 100 lists of the most influential people in corporate governance and the boardroom. Mr. Kistenbroker is the co-chair of the Practising Law Institute Securities Litigation & Enforcement Institute for 2011. A frequent lecturer on securities litigation, directors and officers insurance matters and corporate governance, Mr. Kistenbroker currently is serving as co-chair of the Practising Law Institute Securities Litigation & Enforcement Institute for 2011. He also is a member of the Board of Directors of the University of Chicago Laboratory Schools.

Mr. Kistenbroker earned his Juris Doctor in 1980 from Marquette University School of Law, his M.A. in political science in 1977 from Marquette University and his B.S. in 1975, *magna cum laude*, from the University of Wisconsin-Whitewater. He is admitted to the bars of the U.S. Supreme Court, the U.S. Courts of Appeals for the Second, Sixth, Seventh, Eighth and Ninth Circuits, and the U.S. District Courts for the Northern District of Illinois and the Eastern District of Wisconsin. He also is a member of the Trial Bar for the U.S. District Court for the Northern District of Illinois.

Katten

www.kattenlaw.com

Katten Muchin Rosenman LLP

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND WASHINGTON, DC

© 2011 Katten Muchin Rosenman LLP. All rights reserved.

*Katten Muchin Rosenman LLP is an Illinois limited liability partnership including professional corporations that has elected to be governed by the Illinois Uniform Partnership Act (1997).
London affiliate: Katten Muchin Rosenman UK LLP.*

11/18/11