ReedSmith

Supreme Court Appears to Hand Unanimous Victories to Investors, But Leaves Lots of Openings for Defendants

Author: Amy J. Greer, Partner, Philadelphia
Author: Michael J. Kaufman, Counsel, Chicago
Author: William M. Krogh, Associate, Philadelphia

Publication Date: June 07, 2011

Matrixx Initiatives, Inc. v. Siracusano **and** ***Erica P. John Fund v. Halliburton***

The Supreme Court issued two opinions this term that could dramatically alter the landscape of securities fraud litigation. In *Matrixx Initiatives, Inc., et al. v. Siracusano*, 563 U.S. ____ (2011), the Court unanimously held that a claim for securities fraud against a drug company may be stated if the company intentionally or with deliberate recklessness fails to disclose adverse drug reactions, regardless of whether those reactions are statistically significant. In another unanimous decision, *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. ____ (2011), the Court rejected the Fifth Circuit's stringent requirement that plaintiffs relying on a fraud-on-the-market theory need also prove loss causation at the class certification stage. While at first blush these decisions would appear to be clear victories for investor-plaintiffs, analysis reveals the more likely outcome of these new cases will be to make the initial pleading and class certification aspects of securities fraud litigation more critical than ever, encouraging the parties to engage experts and undertake extensive discovery even at those early stages of a lawsuit.

1. The *Matrixx* Case and the Materiality of Statistically Insignificant Adverse Drug Reactions

In *Matrixx*, the Supreme Court held that investors stated a claim for securities fraud under § 10(b) of the Securities and Exchange Act and Rule 10b-5 based on a pharmaceutical company's failure to disclose reports of adverse drug reactions, even if the number of those reactions does not rise to statistical significance. Plaintiffs filed a class action, alleging that Matrixx failed to disclose reports of a possible link between its Zicam Cold Remedy and a loss of the sense of smell (anosmia). Matrixx moved to dismiss the complaint, arguing that plaintiffs had failed to plead two essential elements of their securities fraud claim: (1) that Matrixx's misstatements and omissions regarding adverse drug reactions were "material"; and (2) that those misstatements and omissions were made with "scienter." In particular, Matrixx contended that the reports of adverse drug reactions were immaterial as a matter of law because they were not statistically significant, and that the failure to disclose those reports was without intent to deceive investors.

The Supreme Court, however, rejected these arguments. First, the Court concluded that plaintiffs had adequately alleged materiality. According to a long line of Supreme Court case law, a misrepresentation or omission is material 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." *Matrixx*, 563 U.S. at ____, citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Under that standard, materiality is a fact question to be resolved on a case-by-case basis by the jury. The Court therefore rejected Matrixx's effort to create a "bright line rule," which would have rendered statistically insignificant reports of adverse drug reactions immaterial as a matter of law. According to the Court, reasonable investors may consider reports of such reactions to be important in their decision to invest even if the number of those reports does not amount to statistical significance. Because adverse product reports can take many different forms, the Court reasoned, assessing their materiality must be "a fact-specific inquiry, requiring consideration of their source, content, and context." *Matrixx*, 563 U.S. at _____. The Court cautioned, however, that "something more than the mere existence of adverse event reports is needed to establish [materiality], but that something more is not limited to statistical significance and can come from the source, content, and context of the reports." *Id.*

In the case itself, Matrixx had allegedly received reports from medical experts and researchers that indicated a reliable causal link between Zicam and anosmia. The complaint alleged facts that suggested a significant risk to the commercial viability of Zicam, which was Matrixx's leading product. Matrixx had told the market that its revenues were going to rise as much as 80 percent on the strength of Zicam, when in fact it had information indicating a significant risk to its leading revenue-generating product. Furthermore, Matrixx went so far as to represent publicly that there was no evidence of a link between Zicam and anosmia, and that Zicam's safety was well-established. Yet, Matrixx had conducted no studies to disprove the anosmia link. Accordingly, the Court concluded that in this particular case, a jury could find that there was a substantial likelihood that the disclosure of even statistically insignificant reports of adverse reactions from Zicam would have significantly altered the total mix of information made available to a reasonable investor.

The Court also concluded that the plaintiffs had adequately alleged the necessary element of scienter - the mental state embracing an intent to deceive, manipulate or defraud. Matrixx, 563 U.S. at _____, citing *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 319 (2008). Under the Private Securities Litigation Reform Act of 1995, a complaint must allege facts that give rise to a "strong inference" of scienter, such that "a reasonable person would deem the inference of scienter as compelling as any opposing inferences one could draw from the facts alleged." 563 U.S. at _____, citing *Tellabs*, 551 U.S. at 324. The Court found that the complaint's allegations were sufficient to create a "cogent and compelling inference" that Matrixx's failure to disclose the adverse reports was intentional or at least done with deliberate recklessness. Matrixx insisted that it did not disclose the adverse reports because it believed that they were immaterial - that no investor would really care about such reports unless they were statistically significant. The Court, however, rejected Matrixx's attempt to suggest an alternative explanation for its nondisclosures, concluding that a reasonable person could also infer that Matrixx intentionally or recklessly failed to disclose the reports because it fully understood that their disclosure would have an adverse impact on the stock price.

At first blush, the Supreme Court's rulings regarding materiality and scienter in Matrixx seem to increase the exposure of companies to securities fraud liability. After all, the Court, in rejecting a bright-line test for materiality, indicates that the issue of materiality is a fact question that cannot be resolved at the pleading stage or even at the summary judgment stage. Defendants therefore will be hard-pressed to discard securities fraud claims before trial by arguing that their alleged misstatements or omissions are immaterial. Moreover, in ruling that plaintiffs had sufficiently alleged that Matrixx acted with scienter, the Court seems to have enabled plaintiffs to allege the requisite state of mind simply by providing facts from which a reasonable person could infer that the defendant acted with either scienter or some innocent state of mind, as long as the innocent explanation is not the more cogent of the two.

Nonetheless, a careful reading of the Court's opinion also yields strategies by which defendants may still successfully dismiss claims for failure to allege materiality or scienter. In its materiality holding, the Court stresses that a company need not disclose "trivial" information, only "reliable" evidence of a causal link between a drug (or product) and adverse effects. *Matrixx*, 563 U.S. at _____. While the evidence need not rise to the level of statistically significant results from clinical trials, only "reliable" evidence suggesting "causation" must be disclosed. Indeed, although an absence of statistical significance is not dispositive, it is still relevant to the reliability (or lack thereof) of the evidence that the product was the cause of the adverse effects. The Court does not establish any clear definition of reliability, but does declare that the materiality of any adverse reports requires a case-by-case analysis of their "source, content, and context." As such, defendants may still seek to dismiss claims by showing that undisclosed adverse reports were unreliable and therefore immaterial. For example, defendants may argue any of the following: (1) that the reports were trivial; (2) that the reports do not indicate causation - a causal link between the product and any adverse consequences; (3) that the reports were unreliable because their source was unqualified or biased; (4) that the reports were unreliable because their content was unsupported, incoherent, uneven, or not probative of causation; or (5) that the reports were unreliable when placed in their proper context. In addition, the Court still encourages defendants to demonstrate that reports of adverse effects lacked statistical significance.

In order to show that adverse reports lacked reliability, defendants will undoubtedly enlist the services of experts. A statistician may be used to demonstrate the lack of statistical significance; industry experts may be called on to opine regarding the source, content, and context of the adverse reports; and still other experts may be asked to offer an opinion regarding the causal link between the drug or product at issue and any adverse reactions. Such experts have long been engaged to offer testimony on the issue of the materiality of the adverse reports at trial. By suggesting that unreliable evidence of a causal link between a product and adverse reactions may lack sufficient materiality, however, the Supreme Court in Matrixx encourages the parties to engage these experts, even at the pleading stage of a securities fraud action.

Similarly, the Court's scienter ruling could well invite defendants to attempt to attack a securities fraud complaint at the pleading stage by presenting alternative, "honest" motives for their conduct and arguing that such motives are more plausible than an intent to deceive. Matrixx argued that its failure to disclose adverse reports was motivated not by an intent to deceive investors, but by its belief that such reports were so meaningless that investors would not care about them. The Court rejected Matrixx's scienter argument for the same reason that it rejected its materiality argument: the adverse reports were not immaterial as a matter of law, and therefore a reasonable person could find that Matrixx's nondisclosures were done with an intent to deceive. Yet, the Court also suggests that if Matrixx could show that it did not disclose the reports because it honestly believed that they were unreliable, or because it wanted more time to make sure of their reliability before it disclosed them, then Matrixx would prevail. 563 U.S. at _____, n. 15 (declaring that the motive offered by *amici* that Matrixx may have delayed disclosure to review all the evidence "may be the most cogent inference in some cases"). The Court also made clear that the inference of Matrixx's scienter was compelling because it had issued a press release indicating that studies had confirmed the lack of a link between Zicam and anosmia, while at the same time admitting that it had performed no such studies. That admission, coupled with the Court's view that the adverse reports were not immaterial, was sufficient to allege the element of scienter.

Yet, in most securities fraud cases, such admissions do not exist. Rather, plaintiffs allege only circumstantial evidence of an intent to deceive, which is then typically countered by evidence of other, innocent explanations for defendants' conduct. The Supreme Court in *Matrixx* allows federal courts to continue to weigh the circumstantial evidence of scienter against evidence of opposing states of mind. If a federal judge determines that the inference that the defendant harbored an innocent state of mind (e.g., that the defendant honestly believed that undisclosed adverse reports were trivial) is more likely than that the defendant intended to deceive investors, the judge can still dismiss the complaint. Moreover, defendants may now assert that they failed to disclose adverse reports because they honestly believed that their source, content, or context rendered them unreliable. Accordingly, although the Supreme Court in *Matrixx* rejected an effort to discard a securities fraud class action at the pleading stage, its opinion will undoubtedly create a new layer of intense litigation at that stage in the months and years ahead.

2. The *Halliburton* Case and Evidence of Loss Causation at the Class Certification Stage

In *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. ____ (2011), the Supreme Court held that plaintiffs relying on a "fraud-on-the-market" theory of reliance need not provide evidence that a defendant's failure to disclose was the cause of a decline in stock price in order to obtain class certification. At the same time, however, the Court left open the door to defendants' offering evidence of a lack of price impact to rebut plaintiffs' claims of reliance at the class certification stage. The *Halliburton* plaintiffs alleged that the company and its officers attempted to inflate Halliburton's stock price by minimizing its potential asbestos liability and by overstating its revenue from its engineering business. Halliburton made subsequent corrective disclosures that the plaintiffs alleged caused the stock price to decline and resulted in their economic loss. The plaintiffs asked the court to certify a class consisting of all persons who purchased Halliburton stock between the initial misstatements and the later corrections. The trial court denied the motion, finding that all of the requirements for class certification under Federal Rule of Civil Procedure 23 had been established, except that the common issues in the case did not "predominate" over the individual issues. In particular, the court concluded that proof of the class members' reliance on the fraud, which is a required element to establish securities fraud, would create individual issues that would predominate over the common questions in the case. In cases where individualized proof of actual reliance is required, that issue usually eclipses the common questions, thus precluding class certification.

In many securities fraud cases, however, plaintiffs do not need to provide individualized proof of actual reliance. Rather, the Supreme Court made clear in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) that plaintiffs are entitled to a rebuttable presumption of reliance where they show that the so-called fraud-on-the-market doctrine applies. Under that doctrine, the plaintiffs' reliance is presumed when the misstatements become public, because those misstatements are reflected in the market price of the security, and plaintiffs have relied on the integrity of that market price in making their investments. To trigger the presumption, class plaintiffs must show that the alleged misstatements were made publicly, that the company's stock was traded in an efficient market, and that the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed. The plaintiffs in *Halliburton* established the elements necessary to invoke the fraud on the market presumption of reliance, as defined by the Supreme Court in *Basic*.

The district court, however, refused to certify the class because the plaintiffs had failed to prove the element of loss causation by a preponderance of the evidence. Loss causation as defined by the Supreme Court is established by evidence that the plaintiffs not only purchased securities at a market price inflated by the fraud, but also that they suffered economic loss when the disclosure of the fraud caused a decline in that market price. The United States Court of Appeals for the Fifth Circuit affirmed the district court, concluding that a class plaintiff may not take advantage of the fraud-on-the-market presumption of reliance unless it also proves loss causation. *The Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010). Specifically, the Fifth Circuit held that plaintiffs must prove by a preponderance of the evidence at the class certification stage "that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in losses." *Id.* at 331-32. The Court made clear that plaintiffs must prove that the decline in stock price was caused by the defendant's correction of its prior misstatement rather than by some other intervening event or contemporaneous disclosure. The Fifth Circuit characterized its additional requirement as a "rigorous" one that "requires both expert testimony and analytical research or an event study that demonstrates a linkage between the culpable disclosure and the stock-price movement." *Id.* (Emphasis in original)

The Supreme Court, however, vacated the decision of the Fifth Circuit. In its opinion, the Supreme Court rejected any requirement that plaintiffs prove the element of loss causation in order for a class to be certified. The Court also reaffirmed its precedent in *Basic*, precluding federal courts from resolving the underlying merits of a case at the class certification stage.

Nonetheless, the Court did expressly leave open the question of whether evidence of a lack of "price impact" can be used at the class certification stage to rebut the presumption of reliance on a misrepresentation. *Halliburton*, 563 U.S. at ____ & note (2011). Under this approach, a defendant would offer evidence that a misrepresentation and its eventual correction were not the cause of a stock price's movement. If the price is not impacted by the fraud, the argument would run, then the investor could not have relied on the misrepresentation merely by purchasing stock at that price. Thus, the fraud-on-the-market theory would fail, and the plaintiffs could not rely on its presumption of reliance. Without that presumption, class certification would be unlikely because of the predominance of individual reliance issues.

The approach left open in Halliburton is precisely that adopted by the Second Circuit in *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 484-86 (2d Cir. 2008). In that case, the court held that the presumption of reliance in fraud-on-the-market cases can be rebutted at the class certification stage by evidence that undercuts the efficiency of the market, or that "severs the link" between the alleged misrepresentation and the transaction price, including evidence that the misrepresentation "did not lead to a distortion of price." *Id.*, quoting Basic, 485 U.S. at 248.

In attempting to rebut the presumption of reliance, therefore, defendants may, and typically will, present expert testimony that the alleged fraud had no impact on the transaction price. Plaintiffs in turn will be forced to anticipate or rebut the defendant's expert with an expert of their own. Moreover, although the Supreme Court rejected the Fifth Circuit's requirement that plaintiffs prove loss causation, it did leave open the door to defendants rebutting the presumption of reliance by showing that the eventual disclosure of the fraud did not cause any decline in the market price. Although defendants' proof of a lack of price impact from the disclosure of the fraud will be offered to rebut the presumption of reliance by severing the link between the alleged fraud and plaintiffs' purchase price, that proof will also serve to demonstrate a lack of loss causation. Accordingly, one can anticipate in the wake of the *Halliburton* opinion that defendants will provide evidence of a lack of loss causation at the class certification stage, and class plaintiffs thus will be required to provide evidence establishing loss causation at that stage. Such evidence will invariably include expert opinions based on event studies, which are statistical regression analyses that attempt to isolate the causal link, if any, between the fraud and the movement of the market price of a security.

The Supreme Court's decision, therefore, will undoubtedly create mini-trials on the issue of reliance and loss causation at the class certification stage. Those mini-trials will in turn dramatically increase the costs of litigation on the threshold issue of class certification. Parties can be expected to undertake extensive discovery prior to class certification and engage experts as part of this process at even the earliest stages of a lawsuit.