No. 06-15677

**UNITED STATES COURT OF APPEALS**
**FOR THE NINTH CIRCUIT**

JAMES SIRACUSANO AND NECA-IBEW PENSION FUND, On Behalf of Themselves and All Others Similarly Situated,

Plaintiffs-Appellants,

vs.

MATRIXX INITIATIVES, INC., et al.,

Defendants-Appellees.

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APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA
NO. CIV-04-0886-PHX-MHM
THE HONORABLE MARY H. MURGUIA

# DEFENDANTS-APPELLEES' ANSWERING BRIEF


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## CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, Defendant-Appellee Matrixx Initiatives, Inc. ("Matrixx") respectfully submits this disclosure of interest.

Matrixx does not have a parent corporation and no publicly traded corporation owns 10% or more of Matrixx's stock.

DATED: October 4, 2006

Respectfully submitted,

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**RULES**

## I. STATEMENT OF JURISDICTION

This Court has jurisdiction over this appeal under 28 U.S.C. § 1291. Because this action arises under the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. §§ 78j(b), 78t(a), the trial court had jurisdiction under 15 U.S.C. § 78aa and 28 U.S.C. § 1331.

## II. ISSUES PRESENTED

1. Whether the district court ruled correctly that plaintiffs-appellants ("plaintiffs") failed to plead with particularity a material misrepresentation or omission, as required by the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), 15 U.S.C. § 78u-5(c).

2. Whether the district court ruled correctly that plaintiffs failed to "state with particularity facts giving rise to a strong inference that the defendant[s] acted with the required state of mind," as required by the PSLRA, 15 U.S.C. § 78u-4(b)(2).

## III. STATEMENT OF THE CASE

### A. Case Background.

Plaintiffs have appealed the district court's dismissal of the putative securities class action claims set forth in plaintiffs' Consolidated First Amended Complaint. Plaintiffs claim that defendants and appellees Matrixx Initiatives, Inc. ("Matrixx") and three of its current officers knowingly made false or misleading

statements or knowingly failed to disclose material information in order to artificially inflate Matrixx's stock price during the proposed class period of October 22, 2003 through February 6, 2004 (the "Class Period"). The individual defendants are: Carl Johnson, Matrixx's CEO; William Hemelt, Matrixx's CFO; and Timothy Clarot, Matrixx's Vice President and Director of Research and Development (collectively, the "Individual Defendants"). (Plaintiffs-Appellants' Opening Brief ("Pl. Br.") at 3.)

## B. Procedural History

### 1. Plaintiffs File Their Consolidated First Amended Complaint.

On April 24, 2004, the first of two related complaints was filed in the United States District Court for the District of Arizona; the second was filed shortly thereafter. (Court Docket ("CD") 1.)

Following the trial court's consolidation of the two related cases and appointment of lead plaintiffs and class counsel (CD59), plaintiffs filed a Consolidated First Amended Complaint (the "Complaint") on March 8, 2005. (CD68.) The Complaint alleged two causes of action: (1) for violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder against Matrixx and the Individual Defendants; and (2) for violations of Section 20(a) of the Exchange Act against defendants Johnson and Hemelt as control persons. (Excerpts of Record ("ER") 68 ¶¶ 71-85.) Plaintiffs alleged that defendants' Class Period statements

failed to disclose: (1) that over a four-year period, Matrixx had allegedly received a limited number of complaints of loss of sense of smell – also known as anosmia – by users of its Zicam cold remedy product (*id.* ¶¶ 25-26, 28); and (2) that just prior to and during the Class Period, Matrixx was sued by nine individual plaintiffs in four product liability lawsuits that alleged Zicam caused anosmia (*id.* ¶¶ 5, 49).

### 2. Defendants Move to Dismiss the Complaint for Failure to State a Claim and Concurrently Move to Strike From the Complaint Certain Post-Class Period Allegations.

On April 4, 2005, defendants moved to dismiss the Complaint on the grounds that: (1) the Complaint failed to allege with the requisite particularity any actionable misstatement or omission of material fact; (2) the Complaint did not give rise to a strong inference of scienter on the part of defendants; and (3) plaintiffs' allegations of false financial reporting in violation of Generally Accepted Accounting Principles ("GAAP") lacked the requisite specificity. (CD73.)

Defendants concurrently moved to strike from the Complaint all allegations regarding post-Class Period user complaints and lawsuits, on the ground that such matters were not relevant to Matrixx's Class Period disclosures or omissions, nor to defendants' state of mind during the Class Period. (CD72.)

### 3. The District Court Grants Defendants' Motion to Dismiss With Leave to Amend.

On December 15, 2005, the district court granted defendants' motion to dismiss. (CD88.)

In ruling on defendants' motion, the district court first addressed whether plaintiffs had pled a misstatement or omission of material fact, and held that plaintiffs had not. The district court found that the limited user complaints and lawsuits allegedly known by Matrixx during the Class Period were not "material," noting that case law has established that "test results and user complaints are not always material, requiring disclosures." (ER88:11.) The district court concluded that plaintiffs here alleged "minimal evidence of Zicam complaints during the class period" with "no data as to the reliability and accuracy of the [alleged] user complaints." (*Id.*) And, "[e]ven if there were data as to the reliability," the court held, "12 user complaints [as alleged by plaintiffs] is not statistically significant." (*Id.*)

The district court also addressed plaintiffs' allegations regarding a poster presentation prepared by a Dr. Bruce Jafek of the University of Colorado. Plaintiffs alleged that in September 2003, Matrixx learned of Dr. Jafek's poster presentation, which claimed that 10 patients reported loss of sense of smell following Zicam use. Plaintiffs further alleged that after the close of the Class Period, Dr. Jafek and his co-researchers published their research in a peer-reviewed

journal. The district court found that plaintiffs had failed to "allege that ***during the class period***, Defendants were presented with any evidence that the [poster presentation] was reliable, the methodology used, or that it was subject to peer review." (*Id.*) (emphasis added). Without such particularized allegations, the district court found that Dr. Jafek's alleged poster presentation was not material. (*Id.*)

The district court next addressed whether the Complaint alleged with particularity facts giving rise to a strong inference that defendants acted with the required mental state – actual knowledge for "forward-looking statements" and deliberate recklessness for all other representations and omissions. (*Id.* at 12.) The court found that plaintiffs failed to allege any state of mind or motive with regard to the alleged omissions. (*Id.* at 12-13.)

The district court also addressed whether scienter could be inferred from a letter sent by Matrixx after it learned of Dr. Jafek's poster presentation. Plaintiffs argued that scienter was evidenced by this letter, in that it informed Dr. Jafek that he did not have permission to use the Zicam name in his poster presentation. The district court found this argument "not well taken." (*Id.* at 13.) "It is just as reasonable to infer," reasoned the district court, "that Defendants were appropriately protecting Zicam's good name and marketability." (*Id.*) The district court pointed out that in the same letter, defendants told Dr. Jafek that they would

be interested in learning more about his poster presentation and even asked Dr. Jafek to provide them "immediately" with any clinical data supporting his conclusions. (*Id.*)

Lastly, the district court held that *per se* violations of GAAP and generally accepted standards for financial reporting are alone insufficient to state a claim for securities fraud, although they could support such a claim if combined with other circumstances establishing fraudulent intent. (*Id.* at 13.) Here, no scienter was shown because "other than the conclusory allegation there was a duty to disclose the one product liability lawsuit filed at the time of the third quarter 10-Q," plaintiffs failed to allege a loss was reasonably foreseeable or any other overstatement giving rise to an inference of deliberate recklessness. (*Id.* at 13-14.)

The district court granted plaintiffs leave to amend. (*Id.* at 14.) However, with respect to possible amendment, the district court noted that "[a]bsent allegations Defendants *knew* there was a definitive and statistically significant link between Zicam and anosmia *during the Class Period* that was sufficiently serious and frequent to affect future earnings any amendment would be futile." (*Id.*; emphasis in original.) The district court added that plaintiffs should "take note" that the post-Class Period events alleged "are wholly insufficient to cure the deficiencies" in the Complaint. (*Id.*)

By the same order, the district court also granted in part, and denied in part, defendants' motion to strike. Specifically, the court denied defendants' motion to strike alleged post-Class Period "complaints and lawsuits," ruling that they may be "relevant to Defendants' knowledge of user complaints [during the Class Period]." (*Id.* at 6.) However, the district court granted defendants' motion to strike allegations regarding "Dr. Jafek's ultimate conclusions, published post-Class Period, because what Dr. Jafek's study may ultimately show is not relevant to what Defendants knew at the time statements were made and is highly prejudicial." (*Id.* at 6.)

#### 4. Plaintiffs Choose Not to Amend and Instead Appeal the District Court's Ruling.

Having no additional facts to support their purported claims, plaintiffs declined the leave to amend granted by the district court. On March 8, 2006, the district court entered a final judgment of dismissal. (CD89.) This appeal followed. (CD91.)

On this appeal, plaintiffs have abandoned their claim that defendants violated GAAP. (Pl. Br. at 7.)

## IV. SUMMARY OF ALLEGATIONS AND JUDICIALLY NOTICEABLE FACTS

Matrixx is a Phoenix-based company engaged in the development, manufacture and marketing of over-the-counter pharmaceuticals under the brand

name Zicam. (ER68 ¶ 2.) Matrixx debuted its line of cold remedies in 1999, with the introduction of its patented Zicam nasal gel, which is clinically proven to significantly reduce the severity and duration of the common cold. (*Id.* ¶ 25.)[1] Matrixx produces, markets and sells Zicam remedies for cold, allergy, sinus and cough relief in a variety of forms, including nasal gel, chewable tablets, oral spray mist and swabs. (*Id.* ¶ 2.) Carl Johnson, William Hemelt and Timothy Clarot are Matrixx's CEO, CFO, and Vice President and Director of Research and Development, respectively. (ER68 ¶¶ 17-19.) During the Class Period, Johnson held 70,315 shares, Hemelt 41,000 shares and Clarot 16,900 shares of Matrixx stock and options. (Supplemental Excerpts of Record ("SER") 74:183-210.) ***None of the Individual Defendants, nor any other Matrixx director or officer, is alleged to have sold – nor did sell – any of his Matrixx holdings during the Class Period.***

### A. A Limited Number of User Complaints are Allegedly Communicated to Matrixx Between 1999 and the Close of the Class Period, February 6, 2004.

Plaintiffs allege that over a four-year period, from the time Zicam debuted in 1999, until the close of the Class Period on February 6, 2004, Matrixx on three separate occasions learned of complaints by Zicam users regarding

[1] As with homeopathic remedies in general, prior to Zicam's introduction on the market, its active ingredient, zinc gluconate, was approved for inclusion in the Homeopathic Pharmacopeia. *See* 21 U.S.C. §§ 201(g)(1), 501(b). (SER74:158-162.)

claimed loss of sense of smell. Although plaintiffs assert that a "barrage of complaints" (Pl. Br. at 26) regarding the "horrors of anosmia" (*id.*) were received by Matrixx, the Complaint makes clear that the purported user complaints allegedly communicated to Matrixx through the end of the Class Period were limited and sporadic.

First, plaintiffs allege that "at least one" complaint of anosmia by a Zicam user was allegedly relayed to Matrixx in December 1999, when a Dr. Alan Hirsch called the Matrixx customer service hotline. (ER68 ¶ 25.)

Second, plaintiffs allege that, some three years later, in September 2002, a Dr. Linschoten spoke over the telephone with defendant Clarot. During this conversation, plaintiffs allege that Clarot mentioned that an unspecified number of user complaints had been received by Matrixx, and that Dr. Linschoten informed Clarot of one user complaint of which she was aware. (*Id.* ¶ 26.)

Finally, plaintiffs allege that, yet another year later, in September 2003, 10 or 11 user complaints were allegedly referenced in Dr. Jafek's poster presentation to the American Rhinologic Society. (*Id.* ¶ 28.)[2]

[2] It is unclear from the Complaint whether Dr. Jafek's poster presentation referenced 10 total patients (ER68 ¶ 28:14-15) or 10 other Zicam users in addition to the one patient for which Dr. Jafek provided a detailed description (*id.* ¶ 28:25-27).

### B. Matrixx Asks Dr. Jafek to Provide It With Any Existing Adverse Reports and Supporting Clinical Data, While Requesting that Dr. Jafek Not Use Its Name in His 2003 Poster Presentation.

Plaintiffs also allege that in September 2003, Matrixx informed Dr. Jafek that he did not have Matrixx's permission to use the Zicam name in his September 2003 poster presentation. (ER68 ¶¶ 4, 39(e), 64.)

The Complaint mischaracterizes Matrixx's letter to Dr. Jafek as "threatening legal action" (*id.* ¶ 64), and, in their Opening Brief, plaintiffs resort to even greater mischaracterization, asserting that Matrixx sought to "squelch truthful information about Zicam." (Pl. Br. at 38.) On the contrary, the letter itself[3] establishes that Matrixx specifically asked Dr. Jafek to provide it with information about any adverse medical reports and supporting clinical data, while informing Dr. Jafek that "as a legal matter [he] did not have [Matrixx's] permission to use our company name or product trademarks." (SER74:6-7.) Plaintiffs do not allege that Dr. Jafek ever provided Matrixx any adverse medical reports or supporting clinical data, as requested by Matrixx.

[3] The district court properly considered the letter's contents: "while the Court's primary focus is on allegations contained in the pleadings, the Court may also consider documents attached to the complaint or incorporated therein by reference." (ER88, at 6, citing *In re Northpoint Comm. Group, Inc., Secs. Litig.*, 221 F. Supp. 2d 1090 (N.D. Cal. 2002).) *See also Branch v. Tunnell,* 14 F.3d 449, 453-54 (9th Cir. 1994).

### C. Matrixx Issues Its Sole Class Period Public Filing in November 2003.

Matrixx's sole public filing during the Class Period was its third quarter Form 10-Q, filed November 12, 2003. The 10-Q cited specific risk factors that could "contribute to or cause actual results to differ materially from our expectations," among them, "material litigation involving . . . product liabilities or consumer issues." (SER74:67.) As the Complaint acknowledges, the 10-Q contained a comprehensive risk disclosure concerning product liability claims. (ER68 ¶ 35; SER74:70.)[4] Matrixx's earnings-related press releases during the Class Period also featured safe harbor warnings – sufficient risk disclosures to protect these forward looking statements under the Reform Act. (SER74:9, 76.)[5]

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[4] The disclosure read, "We may incur significant costs resulting from product liability claims. We are subject to significant liability should use or consumption of our products cause injury, illness or death. Although we carry product liability insurance, there can be no assurance that our insurance will be adequate to protect us against product liability claims or that insurance coverage will continue to be available on reasonable terms. A product liability claim, even one without merit or for which we have substantial coverage, could result in significant legal defense costs, thereby increasing our expenses and lowering our earnings. Such a claim, whether or not proven to be valid, could have a material adverse effect on our product branding and goodwill, resulting in reducing market acceptance of our products. This in turn could materially adversely affect our results of operations and financial condition." (ER68 ¶ 35.)

[5] In addition, Matrixx provided a safe harbor warning at the outset of its October 23, 2003 analyst teleconference. (SER74:13.) Judicial notice of statements made in Matrixx's analyst teleconference is proper because the teleconference is referenced in the Complaint. *See Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1240-41 (N.D. Cal. 1998).