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Case Study: In Re Boston Scientific

Law360, New York (August 06, 2012, 1:04 PM ET) -- In In re Boston Scientific Corp. Securities Litigation (1st Cir. July 12, 2012), the United States Court of Appeals for the First Circuit affirmed the dismissal of a securities class action lawsuit against Boston Scientific Corporation (the "BSC"). The court held that the alleged misstatements or omissions were not sufficiently material to support a claim under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and that the complaint's allegations failed to meet the heightened requirements for pleading scienter under the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4. In so holding, the First Circuit reconfirmed that the federal securities laws do not impose an affirmative duty on management to disclose all information that might affect the price of a company's stock.

BSC manufactures and distributes medical devices. In August 2009, it was alerted to possible compliance violations by its Cardiac Rhythm Management ("CRM") sales team. BSC initiated an internal investigation and decided to terminate 10 CRM sales persons for violations of the company's code of ethics. This investigation coincided with a subpoena from the U.S. Department of Health and Human Services, received in September 2009, requesting information regarding certain donations to charities made by the CRM group.

BSC publicly disclosed the subpoena in November 2009, but did not disclose the dismissals until February 2010 due to the ongoing internal investigation. During this time, BSC continued to make allegedly optimistic statements about earnings and future sales while the firing and subsequent hiring by a competing company of the CRM sales employees, purportedly led to an estimated $100 million in lost revenue and a ten percent drop in the company's stock price.

In April 2010, a putative class of BSC investors filed suit in the United States District Court for the District of Massachusetts charging securities fraud in violation of Sections 10(b) and 20(a) of the Exchange Act. Plaintiffs alleged that, by knowingly making misleading statements or omissions regarding the CRM sales team, BSC executives caused the class members to purchase BSC stock at an artificially inflated rate. The district court dismissed the action, holding that none of the statements made in 2009 were materially false or misleading, while the allegations of scienter as to the remaining 2010 statement were inadequate.

The First Circuit affirmed. The court held that all the alleged misleading statements made in 2009 were immaterial as a matter of law, as a reasonable investor would not have found that the statements "significantly altered the total mix of information made available." The court explained that the standard for materiality of omissions does not require companies to immediately disclose all information with the potential to affect stock price at a later time. Such a standard would impose an overwhelming burden on management and a potential competitive disadvantage to the company and its shareholders.

Instead, when information merely creates the possibility that an event affecting the company will later occur, materiality will depend upon "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." The court went on to examine each of the alleged misrepresentations in turn, finding that the outcome of the investigation was uncertain at the time of each statement made in 2009, whether because the investigation was still ongoing, the decision to fire employees had not yet been made or only a fraction of the firings had occurred. More generally, the court noted that "the possible or imminent discharge of a tiny fraction of sales personnel for a single line of products remains of minimal expected consequence for a company with global operations and 25,000 employees."

The court did find as plausibly material BSC's failure to disclose the hiring of the fired employees by a competitor in January 2010. The court held, however, that the complaint did not contain sufficient particularized allegations giving rise to a strong inference that the omission was made with scienter, i.e., an intent to mislead investors or reckless disregard that the omission presented a high risk of misleading investors.

Specifically, plaintiffs failed to plead facts to provide a clear indication that when the BSC officer spoke favorably about the company's sales force in January 2010, he was either dishonest or reckless in not mentioning the salespeople hired by BSC's competitor. The court noted further that the omitted information was not "of such powerful importance that a wrongful intent can be reasonably inferred," given that the salespeople fired were a small percentage of the CRM sales force and an even smaller percentage of the overall sales force at the time the statement was made.

There are three main takeaways from this decision. First, it confirms that Section 10(b) does not impose a general duty on management to disclose publicly all material information that might affect the price of a company's stock. Second, it illustrates that in appropriate circumstances, courts will rule on the facial immateriality of allegedly omitted information at the pleadings stage. Third, it reflects that the relative immateriality of allegedly omitted information can bear on the strength of an inference of defendants' scienter.

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