

# HEALTH LAW

## Update

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

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## Federal Court Rules that Public Companies Must Disclose Present *and Anticipated* Regulatory Risks

June 15, 2006

In April of 2006, the U.S. District Court for the Eastern District of Pennsylvania rejected in part a defendant company's motion to dismiss a securities fraud suit, and allowed to proceed to trial a claim that the company and four of its officers and directors should be found liable for securities fraud based on their failure to disclose proposed regulatory changes that had not yet been announced by the government. The case (*Marsden v. Select Medical Corp.*, 04-4020, E.D. Pa., 4/6/06) involves Select Medical Corp. (Select), a publicly-held company that operates long-term acute care hospitals (LTCHs). A number of Select's LTCHs are located in space leased from a general acute care hospital – a practice known as the “hospital within a hospital” model.

Select issued a press release in May of 2004 announcing regulations proposed by the Centers for Medicare and Medicaid Services (CMS) that would restrict reimbursements for patients transferred from host hospitals to LTCHs. These regulations, if implemented, would have a significant adverse effect on Select's business. This announcement precipitated a 40% decline in Select's stock price over the next two days.

After the rapid stock price decline, shareholders of Select brought a class action suit, alleging that in the year preceding this stock price decline, Select misled investors by, among other things, failing to discuss the potential regulatory changes in various conference calls, press releases and reports. Select moved to dismiss the case, arguing that it had no legal duty to predict the actions of a regulatory agency, but the court rejected Select's argument, finding that Select must have known that the regulatory changes were imminent based on publicly available reports and on Select's interaction with CMS officials. The claim against Select and its executives was based, said the court, not on their failure to predict, but on their failure to “relate what they actually knew and to factor that knowledge into the projections and statements provided to stockholders and the market.”

The court noted that one of the defendants, an officer and director of Select, acted as a panelist at a Healthcare Summit sponsored by the American Bar Association in November 2003 that was also attended by several senior CMS officials. The panel discussed possible Medicare regulations, including a change similar to the one finally proposed. The court also noted that in January 2004, Select hired Thomas Scully, former Chief Administrator at CMS, to provide government relations and regulatory

advice. These interactions between Select executives and CMS officials, according to the court, supported the plaintiff's claim that Select knew that regulatory changes were imminent.

Finally, the court noted that there had been discussion of possible regulatory changes in various reports and recommendations such as the Fiscal 2003 Work Plan issued by the Office of Inspector General of the Department of Health and Human Services (OIG), as well as public meetings and reports by the Medicare Payment Advisory Commission (MedPAC) (an independent federal body formed to advise Congress on issues affecting Medicare).

Select's failure to discuss these potential regulatory changes in several of its press releases, conference calls and reports made those communications potentially "misleading," according to the court, and supported a claim of securities fraud. Specifically, the court found that the company's 10-K filing, along with press releases and conference calls that communicated optimism about the company's economic prospects for the coming year, may have misled investors by failing to discuss the impact of anticipated regulatory changes.

Select countered that these communications should not subject the company to liability because they contained cautionary language about not relying on forward-looking statements. However, the court found that "boilerplate warnings merely are generally inadequate" and that "to be meaningful, cautionary language must be 'substantive' and 'tailored' to the specific forward looking statements they accompany."

Although the court refused to dismiss the case against Select, it remains to be seen whether this case will ultimately go to trial, be settled, or be overturned on appeal. Regardless of the outcome, this case provides a cautionary note to healthcare companies and executives that courts may construe their securities law disclosure obligations to include both existing regulatory risks and anticipated risks related to potential changes to the law.

If you would like to discuss healthcare regulatory issues unique to your company, or if you have any questions about this Health Law Alert, please contact one of the Bass, Berry & Sims attorneys in the Health Law Practice shown below and on the following page.

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