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Second Circuit Provides Guidance for Defending Against Class Certification in Securities Fraud Actions

Following Supreme Court Decision, Evidence of Mismatch Between Public Company Statements and Alleged Corrective News Subject to Searching Inquiry by Courts

SUMMARY

On August 10, 2023, the Second Circuit handed down its highly anticipated decision in *Arkansas Teacher Retirement System* v. *Goldman Sachs Group, Inc*.[1] The court reversed the district court's decision to certify a class action and remanded with instructions to decertify the class. The decision, described by *Reuters* as a "boon for securities class action defendants,"[2] discusses in detail how defendants may establish a "price impact" defense to class certification. The decision provides an important roadmap, in light of the Supreme Court's 2021 decision in *Goldman Sachs Group, Inc.* v. *Arkansas Teacher Retirement System*,[3] for public corporations and their executives to defend against securities class actions, including so-called "event-driven" securities class actions, in which shareholder plaintiffs assert that negative news of operational events render fraudulent earlier non-specific company statements that broadly implicate the same subject matter. Sullivan & Cromwell LLP has represented the defendants throughout this 13-year litigation.

CONTEXT

Shareholder plaintiffs filed a putative securities-fraud class action in 2010, alleging that the defendants maintained an artificially inflated stock price by making statements about conflicts management—*e.g.*, "We have extensive procedures and controls that are designed to identify and address conflicts of interest"—and publishing aspirational Business Principles—*e.g.*, "Integrity and honesty are at the heart of our business." Plaintiffs alleged that these statements were false or misleading, in violation of Section 10(b) of

the Securities Exchange Act of 1934 and SEC Rule 10b-5, in light of allegedly undisclosed conflicts of interest in collateralized debt obligations. Plaintiffs claimed that, once the purported truth about these conflicts was revealed by a highly publicized SEC enforcement action and subsequent news of further enforcement activity, the company's stock price dropped and its shareholders suffered losses.

The appeal concerned whether defendants had successfully rebutted the "*Basic* presumption"—named after the Supreme Court's decision in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988)—which can allow securities-fraud plaintiffs to invoke a fraud-on-the-market presumption of class-wide reliance for purposes of class certification. Defendants can rebut the *Basic* presumption by showing, by a preponderance of the evidence, that the alleged misrepresentation did not impact the company's stock price.

In 2021, after the Second Circuit twice granted review of the class certified in the case, the Supreme Court accepted review and ruled that "[t]he generic nature of a misrepresentation often will be important evidence of a lack of price impact."[4] Specifically, a "mismatch" between the contents of an alleged misstatement and a corrective disclosure makes it less reasonable to infer that a stock price drop following an alleged corrective disclosure shows price impact.[5] On remand, despite finding a "comfortable" gap between the generic nature of the alleged misstatements and the specific purported "corrective disclosures,"[6] the district court again certified the class, and the court of appeals granted review for a third time.

THE SECOND CIRCUIT'S OPINION

In its decision, the Second Circuit reversed the class certification order. The appeals court first explained that the district court erred in construing Goldman's generic statements of Business Principles in conjunction with the challenged statements about conflicts controls because those statements were made "in separate reports at separate times" with no evidence that the statements "piggyback[ed]" off each other.[7] The court observed that "[s]ecurities law provides no . . . cover" for inactionable general statements to "withstand, for example, motions to dismiss or for summary judgment" by pointing to actionable specific statements.[8]

As to Goldman's statements about conflicts management, the court held that the district court misapplied the inflation-maintenance theory recognized in *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d 223 (2d Cir. 2016). According to that theory, a plaintiff can show that a defendant's misstatement affected the defendant's stock price if it caused the price to remain at an inflated level—*i.e.*, by preventing an inflated stock price from dropping.

The Second Circuit explained that such an inference is possible where the corrective event has "directly rendered false" a company's earlier misstatement.[9] But "where the corrective disclosures do not expressly identify the alleged misrepresentation as false," the inference "is on shakier ground."[10] In such circumstances, the Supreme Court's 2021 decision in *Goldman* "requires that courts pay special attention to mismatches in specificity between a misstatement and corrective disclosure."[11] The Second Circuit

explained that this requires "a searching price impact analysis" that asks "whether a truthful—but equally generic—substitute for the alleged misrepresentation would have impacted the stock price."[12]

Applying this standard, the Second Circuit observed that "not one of the corrective disclosures here expressly identifies either the business principles statements or conflicts disclosure."[13] The court explained that there was a "considerable gap in specificity" between the alleged misstatements and corrective disclosures.[14] Instead of asking what would have happened had defendants spoken truthfully "at an *equally generic level*," the district court "misstep[ped]" by substituting the details and severity of the purported "corrective disclosures" in place of the generic alleged misstatements.[15]

Providing guidance to district courts in inflation-maintenance cases, the court explained that "a plaintiff cannot (a) identify a specific back-end, price-dropping event, (b) find a front-end disclosure bearing on the same subject, and then (c) assert securities fraud, unless the front-end disclosure is sufficiently detailed in the first place."[16] "If a stock price decline follows a back-end, highly detailed corrective disclosure . . . courts must be skeptical whether the more generic, front-end statement propped up the price to the same extent."[17]

IMPLICATIONS

For securities class actions that survive a motion to dismiss, the class certification motion is typically the next opportunity for defendants to defeat the class claims. As courts have recognized, once a class is certified, defendants face "hydraulic pressure" to settle when their exposure can often be measured in the many millions or billions of dollars.[18] The Second Circuit's decision provides important guidance to corporations and their senior executives in seeking to defend against class certification of such claims by making it clear that courts are required under Supreme Court precedent to consider carefully a defendant's price impact defense.

In particular, commentators have observed with increasing frequency an increase in so-called "event-driven" securities litigation, in which shareholder plaintiffs file actions in the wake of negative news events concerning the operations of a corporation, as opposed to news of financial or accounting misrepresentations. Within hours or days of negative news events, corporations often experience a deluge of press releases from plaintiff law firms seeking shareholders potentially interested in filing securities litigation claims. In these "event-driven" actions, plaintiffs might seek to capitalize on negative media attention or even public outrage against a corporation, but whether shareholders are victims of the underlying "event" is more dubious. Sometimes, the corporation made no public statement about the specifics of the underlying event before it transpired, but plaintiffs nonetheless assert that general statements—such as statements about corporate policies or business risks—propped up the share price until the negative event revealed those statements to be false.

The Second Circuit's decision provides public corporations and their senior executives with helpful direction in how to defend against securities class action claims, including event-driven claims:

- Although courts have sometimes rejected "price impact" defenses to class certification on grounds that defendants did not show a "complete lack" of price impact, the decision demonstrates that this defense has teeth.[19] In particular, the "mismatch" framework announced by the Supreme Court in the 2021 *Goldman* decision and now explicated in the Second Circuit's decision provides defendants with a meaningful evidentiary pathway to defeat class certification.
- Relying on Supreme Court precedent, the Second Circuit's decision invites a "searching" inquiry of the level of detail contained in alleged misstatements compared with the detail in alleged corrective disclosure events. Defendants facing such claims may want to build evidentiary and expert records to demonstrate where this comparison results in a "mismatch."
- In developing a record supporting a defense of no price impact, evidence of "the inflation-maintaining nature" of the challenged statements (or lack thereof) might be particularly important.[20] The Second Circuit credited, for example, defendants' expert evidence that "880 analyst reports" published during the class period did not "reference" the challenged statements.[21]
- Beyond class certification, the Second Circuit's decision confirms that, at the motion to dismiss and merits stages, plaintiffs may not plead or establish the required element of materiality by stitching together separately disseminated statements, absent evidence that investors actually considered the statements together.
- Relatedly, this decision underscores that securities fraud claims cannot be based on statements that merely "touch[] upon a similar subject" to "negative news."[22] For example, a statement about a "company's commitment to complying with the law" is not "specific enough to evoke investor reliance."[23]

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ENDNOTES

1 *Arkansas Teacher Retirement System* v. *Goldman Sachs Group, Inc.*, No. 22-484, 2023 WL 5112157 (2d Cir. August 10, 2023).

2 Alison Frankel, *Goldman Sachs appellate ruling is boon for securities class action defendants*, REUTERS, Aug. 11, 2023, https://www.reuters.com/legal/government/column-goldman-sachs-appellate-ruling-is-boon-securities-class-action-defendants-2023-08-11/.

3 *Goldman Sachs Group, Inc.* v. *Arkansas Teacher Retirement System*, 141 S. Ct. 1951 (2021).

4 *Id.* at 1961.

5 *Id*.

6 *In re Goldman Sachs Grp., Inc. Sec. Litig.*, 579 F. Supp. 3d 520, 538 (S.D.N.Y. 2021).

7 *Arkansas Teacher*, 2023 WL 5112157, at *14-15.

8 *Id*. at *15.

9 *Id*. at *18.

10 *Id*. at *1, 18.

11 *Id*. at *20.

12 *Id.* at *22.

13 *Id*. at *19.

14 *Id*.

15 *Id*. (emphasis in original).

16 *Id.* at *21.

17 *Id*.

18 *Newton* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001), *as amended* (Oct. 16, 2001); *Hevesi* v. *Citigroup Inc.*, 366 F.3d 70, 80 (2d Cir. 2004).

19 *In re Goldman Sachs*, 579 F. Supp. 3d at 538.

20 *Arkansas Teacher*, 2023 WL 5112157, at *22.

21 *Id*. at *24.

22 *Id*. at *21.

23 *Id*.

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