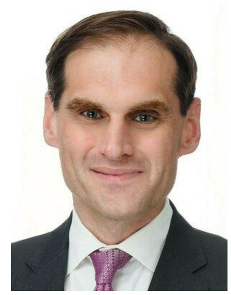
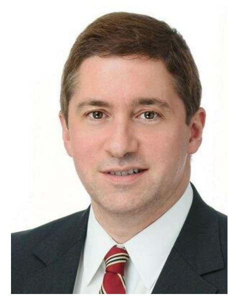
Law360

2nd Circ. Goldman Ruling May Hinder Securities Classes

By **Todd Cosenza, Charles Cording and Madeleine Tayer** (August 28, 2023)



Todd Cosenza



Charles Cording

Madeleine Tayer

On Aug. 10, the U.S. Court of Appeals for the Second Circuit issued its much-anticipated ruling in Arkansas Teacher Retirement System v. Goldman Sachs Group Inc., reversing the district court's order certifying a class of investors.

The decision reinforces the U.S. Supreme Court's 2021 decision, issued in this same case, which instructed district courts to carefully consider the degree of so-called mismatch between the alleged misstatements and the corrective disclosures in securities cases brought under the inflation-maintenance theory.[1]

Following remand from the Supreme Court, the U.S. District Court for the Southern District of New York again certified the class based on a strained reading of Goldman. The Second Circuit has now reversed the district court.

In doing so, it emphasized that the district court "fail[ed] to heed Goldman's cautionary guidance that the back-end—front-end inference starts to 'break down' when there is a mismatch in genericness at the front and back ends."[2]

Arising out of events that took place during the financial crisis, this case has been the subject of a class certification fight for nearly a decade.

Given that the Second Circuit decertified the class, rather than remanding to the district court for further consideration, however, this decision likely ends the class certification dispute in the case, subject to any attempts by the plaintiffs to pursue further appellate review.

Background

In 2010, plaintiffs brought this action on behalf of a putative class of Goldman Sachs shareholders in the Southern District of New York, alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, as well as Section 20(a), the provision for "control person" liability.

The plaintiffs alleged that defendants made material misrepresentations with respect to two categories of statements:

- Aspirational goals, including statements such as "[o]ur clients' interests always come first" and "[i]ntegrity and honesty are at the heart of our business"; and

- Warnings about the risks of conflicts of interest, including statements such as "[c]onflicts of interest are increasing and a failure to appropriately identify and deal with conflicts of interest could adversely affect our businesses."[3]

The plaintiffs alleged that the challenged statements were fraudulent because Goldman Sachs had undisclosed client conflicts with respect to some of their financial instruments, such as collateralized debt obligations, and subsequent news reports of government enforcement activity relating to alleged conflicts of interest demonstrated the falsity of the challenged statements to the market.

The defendants moved to dismiss, arguing that the alleged misstatements were immaterial as a matter of law. The court denied the motion in relevant part.

Thereafter, the plaintiffs moved to certify the class, invoking the Basic presumption and relying on the inflation maintenance theory, which makes certain statements actionable merely because they maintained an already inflated stock price.

As background, the Basic presumption — which was established in the Supreme Court's 1988 Basic Inc. v. Levinson decision — applies in cases where plaintiffs allege misrepresentations and have demonstrated market efficiency.

That is, if plaintiffs establish that the stock at issue traded in an efficient market, it is presumed that anyone who bought or sold the stock relied on the alleged misrepresentations. Defendants then have an opportunity to rebut the Basic presumption by demonstrating a lack of price impact or making any other showing that severs the link between the alleged misrepresentation and the price of the stock.

In this case, to rebut the Basic presumption, Goldman Sachs presented evidence showing that the alleged misstatements had no price impact.

Goldman Sachs argued that the generic, aspirational nature of the alleged misstatements could not have affected the stock price, and that Goldman Sachs' stock price had not declined in response to news reports on 36 separate dates before the purported "corrective disclosures" — despite the fact that those reports included allegations about Goldman Sachs' conflicts of interest. The district court granted the plaintiffs' motion for class certification.

The Second Circuit then granted Goldman Sachs' petition for an interlocutory appeal and vacated the district court's order, holding in relevant part that the district court failed to apply the preponderance of the evidence standard for determining whether Goldman Sachs rebutted the Basic presumption, and erred by refusing to consider the petitioners' evidence that Goldman Sachs' generic statements had no price impact.

On remand, Goldman Sachs detailed the generic nature of the statements, and presented economic and empirical evidence showing that the challenged statements had no price impact and that the decreases in stock price following the corrective disclosures were not attributable to the alleged misstatements.

Despite that evidence, the district court again granted the plaintiffs' motion for class certification. The Second Circuit then granted Goldman Sachs' second petition for an interlocutory appeal and affirmed the decision below to certify the class, finding that the petitioners failed to rebut the Basic presumption.

Characterizing the petitioners' burden as a heavy one, the Second Circuit explained that the Basic presumption could be rebutted only by showing that the entire price decline on the corrective-disclosure dates was due to something other than its alleged misstatements.

Goldman Sachs then filed a writ of certiorari to the Supreme Court, which led to the Supreme Court's 2021 Goldman decision, in which the Supreme Court held that courts must consider all record evidence of price impact — including the generic quality of the alleged misstatements — in determining whether the Basic presumption has been rebutted.

Following remand from the Supreme Court, the district court again found that Goldman Sachs had failed to rebut the Basic presumption notwithstanding the mismatch between the generic alleged misstatements and specific alleged corrective disclosures, certifying the plaintiffs' class once again. Goldman Sachs then petitioned for the third time for interlocutory appeal.

The Opinion

On the third time around, the Second Circuit ruled that the district court's price impact analysis was based on an overly expansive application of the inflation-maintenance theory as set forth in In re: Vivendi SA Securities Litigation in 2016.

In Vivendi, the Second Circuit held that the proper "inquiry into price impact is not what might have happened had a company remained silent, but what would have happened if it had spoken truthfully."[4]

The Second Circuit explained that Vivendi's analysis is straightforward in cases where the alleged misstatement is directly implicated by the corrective disclosure — the strong link between the two "provide[s] sturdy ground to use the back-end price drop as a proxy for front-end inflation."[5]

However, where the corrective disclosure does not directly implicate the alleged misrepresentation, Vivendi provides that the truthful substitute should align in detail with the alleged misrepresentation.[6] And even then, the court made clear that Goldman requires not only that the subject matter of the misstatement and the corrective disclosure match, but that the gap in genericness between the two is limited.[7]

Applying this framework, the court found that the alleged misstatements about conflicts — for example, "we have extensive procedures and controls that are designed to identify and address conflicts of interest" — and the corrective disclosures, such as a U.S. Securities and Exchange Commission enforcement action involving a failure to disclose a conflict of interest, bore on the same subject: conflicts of interest management.

Crucially, however, none of the corrective disclosures directly implicated the alleged misstatements given the considerable gap in specificity between the two.[8] Because of this, the district court should have asked what would have happened had Goldman Sachs spoken truthfully at an equally generic level.[9]

Instead, when asking what would have happened had Goldman Sachs spoken truthfully — "in what amounts to the crux of [its] misstep" — the district court substituted the details and severity of the corrective disclosure in place of the generic statements, notwithstanding the district court's own finding that the front-end statements are much more generic than the back-end disclosures.[10]

The court found that "requiring only a general front-end—back-end subject matter match" to effectively "concoct a highly specific truthful substitute does not meaningfully account for the Supreme Court's guidance in Goldman."[11]

The Court's Guidance for Inflation Maintenance Cases Moving Forward

The court concluded its opinion by providing much needed guidance for courts moving forward when faced with class certification motions in securities fraud cases proceeding under the inflation maintenance theory.

Specifically, the court stated that courts must conduct "a searching price impact analysis" in cases "where (1) there is a considerable gap in front-end—back-end genericness ..., (2) the corrective disclosure does not directly refer ... to the alleged misstatement, and (3) the plaintiff claims ... that a company's generic risk-disclosure was misleading by omission."[12]

In those cases, courts can look to case law bearing on materiality for guidance "in considering, as a factual matter, the generic nature of the alleged misrepresentation."[13]

If the court determines that a gap in genericness exists between the alleged misstatement and the corrective disclosure, the "court should ask, under Vivendi, whether a truthful — but equally generic — substitute for the alleged misrepresentation would have impacted the stock price."[14]

In doing so, "courts should consider other indirect evidence of price impact" and ultimately determine "whether the defendant spoke on topics generally important to investment decision-making," and also "whether the defendant's statements on that topic were important in the regard."[15]

Conclusion

This decision is a significant win for Goldman Sachs, as well as other underwriters, issuers and securities defense practitioners in general. Most notably, this decision makes it substantially more difficult for plaintiffs to certify securities classes based on generic misstatements.

In this regard, the decision limits the application of the inflation maintenance theory by preventing plaintiffs from achieving near automatic class certification in such cases.

Under the approach embraced by the district court, the plaintiffs could argue that a generic statement had price impact as evidenced by the stock market reaction when that generic statement was corrected later by a much more specific and detailed disclosure. That approach has now been squarely rejected by the Second Circuit.

Moreover, the court's crucial guidance provides a real path forward for defendants to rebut the Basic presumption at the class certification stage, and a much stronger chance of avoiding significant settlement pressure post-class certification.

The breadth of the decision remains to be determined, but the court's application of the materiality case law when considering the price impact of generic misstatements will also arm defendants with new and additional arguments when moving to dismiss complaints alleging generic misstatements.

And regardless of whether the decision will truly bring to an end this nearly decadelong saga, we expect that the Second Circuit's thoughtful guidance will affect class certification practice for years to come.

Todd G. Cosenza is a partner and co-chair of the securities litigation practice group at Willkie Farr & Gallagher LLP.

Charles Dean Cording is a partner at the firm.

Madeleine Tayer is an associate at the firm.

Willkie associate Amanda M. Payne contributed to this article.

Disclosure: Willkie served as counsel for an amicus group of law professors and former SEC officials, and submitted briefs to the Supreme Court and the Second Circuit on their behalf, in support of defendant-appellant Goldman Sachs in the case discussed here.

[1] See Goldman Sachs Grp., Inc. v. Ark. Tchr. Ret. Sys., 141 S. Ct. 1951 (2021) (Goldman).

[2] Op. at 56 (internal citation omitted).

[3] D. Ct. Dkt. 136, at 5–6.

[4] 838 F.3d at 258.

[5] Op. at 52.

[6] Op. at 53–54.

[7] Op. at 55, 58.

[8] Op. at 55–56.

[9] Op. at 56.

[10] Op. at 56.

[11] Op. at 59.

[12] Op. at 63.

[13] Id.

[14] Id.

[15] Id. at 64.