GENERIC STATEMENTS AND CLASS ACTIONS: THE BALANCE SHIFTS TOWARD DEFENDANTS

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When corporate executives discuss important company news in SEC filings or on stock-analyst conference calls, they know their words will be scrutinized by listeners and the broader market. Misstatements could give rise to securities-fraud litigation.

Companies also make more generic statements in their public filings that one might not intuit would be grist for plaintiffs' lawyers – for example, that the company has a policy of complying with laws and regulations or has procedures to prevent violations of law or improper business practices. Yet these sorts of anodyne declarations have become the focus of significant securities class action litigation.

A key issue with generic statements is whether investors really pay attention to them. A recent decision in Arkansas Teacher Retirement System et al. v. Goldman Sachs et al. by the U.S. Court of Appeals for the Second Circuit sheds important light on liability risks and bolsters defendants' prospects in defeating certification of a class of investors alleged to have relied on generic statements.

In securities litigation, the issue of whether investors care about generic disclosures might be raised in a motion to dismiss on the basis that the pleaded statements are not material to investors. Where courts decline to dismiss a case at the outset based on failure to plead materiality, permitting discovery and leaving materiality to be determined at summary judgment or trial, defendants nonetheless may raise the generic nature of alleged misstatements in another critical pretrial proceeding, plaintiffs' motion to certify a class. Such class certification motions have become an important battleground in securities cases.

Under case law dating back to the 1980's, plaintiffs seeking to certify a class may satisfy the requirement to show class-wide reliance on an alleged misrepresentation by presuming that the information is incorporated in the market price of the company's stock. But defendants on a class certification motion may rebut that presumption by demonstrating that the alleged misstatements had no effect on the stock price.

The Second Circuit's recent *Goldman Sachs* decision, on August 10, 2023, applied an earlier decision by the U.S. Supreme Court in the long-running case, which did not resolve the matter but held that the generic nature of a company's statements is a factor to be considered in determining whether alleged misstatements affected the company's stock price.

The challenged statements in the case give a flavor of what is meant by generic in this context: For example, Goldman stated in its annual report: "We are dedicated to complying with the letter and spirit of the laws, rules and ethical principles that govern us" and "Our clients' interests always come first." In risk factors in its Form 10-K, Goldman further stated, regarding the issues of potential conflicts between its clients' interests and its own proprietary trading interests: "We have extensive procedures and controls that are designed to identify and address conflicts of interests, including those designed to prevent the improper sharing of information among our businesses."

Plaintiffs alleged that Goldman corrected misstatements regarding its policies to prevent conflicts of interests on three dates in 2010, beginning with the disclosure that on April 16, 2010, the SEC brought an enforcement action against Goldman. The SEC alleged that the firm failed to disclose in its marketing materials to institutional customers for a collateralized debt obligation ("CDO") that a hedge fund played an active role in the CDO's asset selection process and that Goldman stated to investors that the hedge fund held a long interest in the CDO when in fact it held a short position. That was followed by additional public disclosures that the Department of Justice was investigating Goldman in connection with certain unspecified CDOs and that the SEC was investing Goldman in connection with another transaction.

Each of the disclosures led to a decline in Goldman's stock price. And plaintiffs alleged that these disclosures revealed the falsity of Goldman's earlier, generic statements about its compliance with the law and its procedures to avoid conflicts of interest.

As typically occurs in securities litigation, Goldman moved to dismiss, including on the grounds that the alleged statements were too vague and general to be material. The district court denied that motion. Plaintiffs then moved to certify a class, setting off a series of decisions and appeals culminating in the Second Circuit's August 10 decision decertifying a class.

In 2015, the district court granted the motion to certify; the Second Circuit in 2018 vacated and remanded to the district court. On remand, the district court that same year again certified the class. This time, on appeal in 2020, the Second Circuit affirmed. That gave rise to the Supreme Court's 2021 decision, which remanded the case back to the Second Circuit.

In its decision, the Supreme Court noted that the parties had narrowed their dispute, since defendants were no longer arguing for a categorical rule that generic statements could not affect stock price, and plaintiffs conceded that the generic nature of a misrepresentation could be evidence regarding price impact that a court should consider on class certification. The Supreme Court remanded because it said it was not clear whether the Second Circuit had considered such

evidence in affirming the district court. Upon this remand, the Second Circuit again remanded to the district court, directing it to consider "all record evidence relevant to price impact and apply the legal standard as supplemented by the Supreme Court."

On its third consideration of the issue, the district court again certified a class, and the Second Circuit again granted defendants leave to pursue an appeal of the certification order.

In its August decision reversing the district court, the Second Circuit focused on the Supreme Court's discussion of generic statements in cases based on the "inflation maintenance theory," as *Goldman Sachs* was. In a case under that theory, plaintiffs contend not that the alleged misstatements caused the company's stock price to increase, but rather that the statements maintained an inflated price by hiding the bad news that emerged later at the time of the alleged corrective disclosure. In such a case, plaintiffs seek to prove the front-end price impact (the inflation that was maintained) by showing the back-end price impact (the price decline upon the corrective disclosure).

The Supreme Court noted that inflation-maintenance cases are based on the inference that the inflation resulting from statements during the class period, or front-end, can be demonstrated by the decline in stock price after the corrective disclosures, or back-end. But it cautioned that the "final inference – that the back-end price drop equals front-end inflation—starts to break down when there is a mismatch between the contents of the misrepresentation and the corrective disclosure." And it further stated where the misrepresentation is generic and the disclosure specific, "it is less likely that the specific disclosure actually corrected the generic misrepresentation."

In decertifying the class in *Goldman*, the Second Circuit found, in essence, that there was too large a mismatch between Goldman's challenged statements and the alleged corrective disclosures. None of the corrective disclosures referred back to the earlier statements about Goldman's conflict of interest practices. Moreover, the court found "a considerable gap in specificity between the corrective disclosures and alleged misrepresentations." It further noted that Goldman had introduced an expert's analysis of 880 analyst reports during the class period, none of which referred to Goldman's disclosures regarding conflicts. Thus, the court concluded, "a searching review of the record leaves us with the firm conviction that there is an insufficient link between the corrective disclosures and the alleged misrepresentations."

The Second Circuit's decision was authored by Judge Richard Wesley, joined by Judge Denny Chinn. Judge Richard Sulllivan wrote a concurring opinion, agreeing with the result but stating that the majority unnecessarily complicated the analysis. Judge Sullivan contended, as he had in dissent when the case was first before the Second Circuit, that the expert testimony introduced by Goldman compelled a conclusion that defendants had shown a lack of price impact.

The decision also reflected an anomaly in securities fraud analysis, where, assuming materiality has been pleaded sufficiently to survive a motion to dismiss, the materiality of the defendant's challenged statements becomes an issue of fact for the jury. Thus courts considering class

certification motions cannot decide materiality. But the factual issues relating to price impact overlap significantly with materiality. Nonetheless, it is now clear that courts must consider those issues on a class certification motion.

And it is also clear that defendants' efforts to oppose class certification based on lack of price impact will be energized in the wake of *Goldman Sachs.*

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