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STRIKE FOUR: ASSESSING PUTATIVE SECURITIES CLASS FOR FOURTH TIME, SECOND CIRCUIT TIGHTENS LINK BETWEEN GENERIC ALLEGED MISSTATEMENTS AND SPECIFIC CORRECTIVE DISCLOSURES

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After twelve years of litigation, the Second Circuit has decertified an investor class action lawsuit for the third—and perhaps last—time.[1] In 2011, following disclosures of conflicts of interest that caused the defendant bank to pay a $550 million fine to the SEC, plaintiffs sued the company for securities fraud, alleging that its earlier public statements such as "Integrity and honesty are at the heart of our business" and "We have extensive procedures and controls that are designed to identify and address conflicts of interest" were false and misleading. After three certifications by the district court, a reversal and affirmance by the Second Circuit, and a reversal by the Supreme Court, the case landed back at the Second Circuit's doorstep.

The key issue at class certification in *ATRS IV*, as the opinion is known, was whether the plaintiffs could show class-wide reliance on such generic alleged misstatements. In holding against the plaintiffs, the Second Circuit found that generic alleged misstatements must be more closely tethered to specific corrective disclosures. The salient question, the court found, is not "what would have happened if the company had spoken *truthfully*"—by disclosing the full "details and severity of [its] misconduct"—but, instead, "what would have happened if the company had spoken *truthfully* at an *equally generic level*" as the generic alleged misstatement.[2]

The opinion heightens the requirements for plaintiffs pleading class-wide reliance, and should be welcome news to defendants (current and future) in securities cases. It also suggests that some platitudinally generic alleged misstatements—think "Integrity and honesty are at the heart of our business"—should rarely, if ever, be actionable.

Background

The opinion is the latest installment in the "long and difficult history" of a securities class action. [3] The case began in April 2010, when the SEC began an enforcement action against the bank and an employee regarding a CDO transaction known as Abacus 2007 AC-1.[4] The SEC said that the bank had not disclosed to institutional customers that a hedge fund (Paulson & Co.) had had an active role in the CDO's asset-selection process, and had claimed that Paulson had a long (rather than short) interest in the CDO.[5] The next day, the company's stock declined by nearly 13%. [6]

The bank ultimately paid $550 million as part of a consent judgment. Though it neither admitted nor denied the SEC's allegations, the company "'acknowledged' that the Abacus marketing materials were 'incomplete' and that it was a 'mistake' to state that the reference portfolio was 'selected by' ACA Management LLC without disclosing the role of Paulson.'" [7]

In 2011, plaintiffs filed a consolidated class action complaint against the bank and certain former executives in the United States District Court for the Southern District of New York, accusing the defendants of violating Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder.[8] The plaintiffs accused the defendants of making material misstatements about the bank's business practices and management of conflicts of interest.[9] These alleged misrepresentations fell into two buckets. First, there were statements about business principles. For example:

- "We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us. Our continued success depends upon unswerving adherence to this standard."[10]
- "Integrity and honesty are at the heart of our business." [11]

Second, there were statements about what the bank identified as conflict-of-interest-related "Risk Factors" in its yearly Form 10-Ks. In particular:

- "We have extensive procedures and controls that are designed to identify and address conflicts of interest, including those designed to prevent the improper sharing of information among our businesses."[12]

The plaintiffs sought more than $13 billion in damages.[13]

Class certification: To the Supreme Court and back again (with many stops in between)

Twelve years of litigation followed. In 2012, the district court denied the defendants' motion to dismiss, [14] and in 2015 it certified a class.[15] In January 2018, the United States Court of Appeals for the Second Circuit vacated and remanded;[16] that August, the district court again certified a class.[17] This time, in 2020, the Second Circuit affirmed.[18] The Supreme Court granted certiorari in 2020,[19] and vacated and remanded in 2021;[20] the Second Circuit likewise vacated and remanded later that year.[21] Also in 2021, the district court certified a class for a third time.[22] Then—on August 10, 2023, in the decision discussed here—the Second Circuit reversed.[23]

The primary issue driving this decade of litigation was the class-certification requirement of predominance. "That requirement, set forth in Rule 23(b)(3), demands that common questions of law or fact predominate over individual questions that pertain only to certain class members."[24] As applied to the securities context, the question became whether there was class-wide "reliance upon the misrepresentation or omission." [25]

Securities plaintiffs frequently seek to prove reliance through what is known as the *Basic* presumption. The presumption excuses securities class action plaintiffs from proving that each individual class member relied on the alleged misrepresentations.[26] "Courts can instead presume that stock trading in an efficient market incorporates into its price all public, material information—including material misrepresentations—and that investors rely on the integrity of the market price when they choose to buy or sell that stock."[27] This is also known as the "fraud-on-the-market" theory, and assumes that the alleged misrepresentation caused stock to trade at an inflated price or served to maintain an already-inflated price.[28] But this presumption is rebuttable; a defendant may show, by a preponderance of the evidence, that the alleged misrepresentations did not actually affect the stock price.[29] This is what the bank attempted to do.[30]

But how to prove that an alleged misrepresentation did not actually affect the stock price? The relationship between misrepresentation and stock drop may be relatively straightforward: if, for example, "an automobile manufacturer's earlier statement to the market that its best-selling vehicle passed all safety tests is followed by later news that, in fact, the car failed several crash tests," and a stock drop ensues. [31] A "clean match," as the Second Circuit put it.[32] On the other hand, the alleged misrepresentation may be more generic, such as if the manufacturer instead stated that it "strives to ensure that all its vehicles are road-ready, that it has an elaborate testing protocol to that effect, but that the task is tall, the goal difficult to achieve."[33] There is a potential mismatch.

The Supreme Court's decision offered a framework for how to analyze such mismatches. As it explained:

> [T]hat 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. That may occur when the earlier misrepresentation is generic (*e.g.*, "we have faith in our business model") and the later corrective disclosure is specific (*e.g.*, "our fourth quarter earnings did not meet expectations"). Under those circumstances, it is less likely that the specific disclosure actually corrected the generic misrepresentation, which means that there is less reason to infer front-end price inflation—that is, price impact—from the back-end price drop[34].

Thus, the Court held that "[t]he generic nature of a misrepresentation often will be important evidence of a lack of price impact, particularly in cases proceeding under the inflation-maintenance theory."[35] "That is so regardless [of] whether the evidence is also relevant to a merits question like materiality. As we have repeatedly explained, a court has an obligation before certifying a class to 'determine that Rule 23 is satisfied, even when that requires inquiry into the merits.'" [36] The Court therefore remanded to the Second Circuit "because it is unclear whether the Second Circuit properly considered the generic nature of [the bank]'s alleged misrepresentations," [37] and the Second Circuit returned the case to the district court to address the issue in the first instance.[38]

Class certification: Third time not the charm

The district court again certified upon remand.[39] The bank appealed, and raised two main arguments as relevant here:[40]

1. That "the district court understated the genericness of the alleged misrepresentations and, in setting them against the more detailed corrective disclosures, failed to meaningfully apply the Supreme Court's mismatch framework."[41]

2. "[T]hat by using the price drop following the detailed, specific corrective disclosures as a proxy for the inflation-maintaining capacity of the broad, generic misrepresentations, the district court improperly extended the theory."[42]

First, the Second Circuit proposed that it "makes sense" to "go to a baseline question: how generic are the alleged misrepresentations?"[43] The district court, when analyzing the alleged "business principles" misstatements, had found that while "some may present as platitudes when read in isolation, . . . when read in conjunction with one another (and particularly in conjunction with statements *specifically* concerning conflicts), [they] may reinforce misconceptions about [the bank]'s business practices, and thereby serve to sustain an already-inflated stock price."[44] And as to the conflict-of-interest-related statements, the district court saw them as "quite a bit more specific in form and focus." [45]

The Second Circuit found the business-principles holding to be clearly erroneous: "The business principles and conflicts statements were separately disseminated to shareholders in separate reports at separate times, and plaintiffs offered no evidence . . . to support a finding that, notwithstanding that space in medium and time, investors would still **conjunctively** consume those statements."[46] Nor, the court continued, does case law suggest "that investors read one statement in conjunction with separately disseminated statements, at least where, as here, those statements do not obviously build off one [another]."[47]

The Second Circuit upheld, however, the district court's analysis of the conflicts-related statements. It found "no merit" to the bank's "claim that, in labeling the conflicts disclosure as, essentially, less generic than the business principles statements, the district court similarly understated that statement's generic nature." [48] Rather, "[t]he district court assessed the conflicts disclosure, and, again, found that it was 'quite a bit more specific in form and focus' than the business principles statements." [49]

Second, the Second Circuit analyzed the plaintiff's inflation-maintenance theory. The court began by looking at two previous cases which had upheld such a theory. In *Waggoner v. Barclays PLC*, the court had found actionable statements that Barclays was "safe from" and "taking steps to protect" against aggressive trading, when a later complaint by the New York Attorney General revealed that no special protections existed, and aggressive traders were rewarded rather than removed.[50] This case, the Second Circuit noted in *ATRS IV*, "presented a tight fit between corrective disclosure and misrepresentation." [51] Meanwhile, in *In re Vivendi, S.A. Securities Litigation*, the court upheld a theory based on statements attesting to its comfortable liquidity, followed by disclosures which showed a severe cash-flow problem.[52] "As in *Waggoner*," the *ATRS IV* court noted, "among the various disclosures identified by the plaintiffs in Vivendi were back-end reports or investigations *expressly* implicating the alleged misstatements."[53] In both cases, "the strong link between misrepresentation and corrective disclosure provided sturdy ground to use the back-end price drop as a proxy for front-end inflation. The back-end disclosures' corrective effect upon the affirmative misrepresentations was obvious."[54]

The Second Circuit went on to note that "[w]e do not suggest that the inflation-maintenance theory requires a precise match. It may frequently be the case that what is *corrective* about a 'corrective disclosure' is situated among details which, in the aggregate, make for a somewhat more specific back-end disclosure."[55] But it attempted to close the loop by noting that in *Vivendi*, "had the company spoken truthfully regarding its debt problems at an *equally generic level*, the market would have reacted."[56] Thus, the court wrote that "where the corrective disclosures do not expressly identify the alleged misrepresentation as false (as in *Waggoner*), the 'truthful substitute' should align in genericness with the alleged misrepresentation." [57]

Turning to the Supreme Court's decision, the court noted that it further limited a plaintiff's options. Beforehand, the court wrote, "plaintiffs might still attempt to (a) identify a highly specific corrective disclosure, and (b) identify and extract a generic truth purportedly embodied therein, in order to (c) craft a link between a generic misrepresentation and specific corrective disclosure."[58] But it determined that the Supreme Court's decision "dispels that notion. The Court explained that a gap in genericness between misrepresentation and corrective disclosure reduces the likelihood that investors would understand the 'specific disclosure to have actually corrected the generic misrepresentation,'" and, therefore, the decision "requires that any gap among the front- and back-end statements as written be limited."[59]

Turning to the case at hand, the court noted that none of the corrective disclosures expressly referred to the business-principles or conflict-of-interest statements. There was also "a considerable gap in specificity between the corrective disclosures and alleged misrepresentations."[60] The court concluded that the appropriate question was not simply "what would have happened if the company had spoken *truthfully*," but "what would have happened if the company had spoken *truthfully* at an *equally generic level*."[61] It thus determined that the district court erred by focusing on how investors would have reacted had the bank originally disclosed the "details and severity of [its] misconduct," rather than had it issued a truthful, but generic, statement.[62]

Finally, in a majority opinion joined by a concurrence, the court vacated the district court's order and remanded with instructions to decertify the class.[63] The court determined that although "the district court did not have the benefit of our analysis," the "mountain of evidence" submitted by the parties made "remand for further factfinding unnecessary."[64] It then declared that "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. Defendants have demonstrated, by a preponderance of the evidence, that the misrepresentations did not impact [the bank]'s stock price, and, by doing so, rebutted *Basic*'s presumption of reliance."[65]

Guidance moving forward

The impact of the opinion was not lost on the *ATRS IV* court. The penultimate section of the opinion, after all, is entitled "Guidance moving forward." [66] The court's words thus bear quoting at length:

> [A] searching price impact analysis must be conducted where (1) there is a considerable gap in front-end–back-end genericness, as the district court found here, (2) the corrective disclosure does not directly refer, as it did in *Waggoner*, to the alleged misstatement, and (3) the plaintiff claims, as plaintiffs claim here, that a company's generic risk-disclosure was misleading by omission. . . .
>
> Where a gap exists, courts should ask, under *Vivendi*, whether a truthful—but equally generic —substitute for the alleged misrepresentation would have impacted the stock price. Importantly, unlike the classic inflation-maintenance case—where the back-end price drop is itself the evidence (albeit indirect) of the front-end price impact—the value of the back-end proxy, given the gap in specificity, will be diminished.
>
> As such, courts should consider other indirect evidence of price impact, directed at either the inflation-maintaining nature of the generic misstatement, or the price-dropping capacity of an equally generic corrective disclosure. Ultimately, a court must determine not just whether the defendant spoke on topics generally important to investment decision-making, but instead whether the defendant's generic *statements* on that topic were important in that regard. For instance, pre- or post-disclosure discussion in the market regarding a generic front-end misstatement can be a useful indicator of its inflation-maintaining capacity, as well as of the fact that a truthful, equally generic substitute would likewise not go unnoticed by the market as an inflation dissipator.[67]

All in all, *ATRS IV* unquestionably holds plaintiffs to a higher burden when moving to certify a class. To plead class-wide reliance (and thus the Rule 23 requirement of predominance), plaintiffs will have to more closely tie alleged corrective disclosures to the alleged material misstatements. And *ATRS IV* suggests that certain particularly generic statements—such as "We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us" or "Integrity and honesty are at the heart of our business" —should rarely be actionable unless there is specific evidence that investors relied on them.

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[1] *Ark. Tchr. Ret. Sys. v. Goldman Sachs Grp.* (*ATRS IV*), No. 22-484, ---F.4th---, 2023 WL 5112157 (2d Cir. Aug. 10, 2023).

[2] *Id*. at *19–20 (alterations incorporated) (citation omitted) (quotation marks omitted) (quoting *In re Vivendi*, *S.A. Sec. Litig*., 838 F.3d 223, at 258 (2d Cir. 2016)).

[3] *Id.* at *24.

[4] *Id.* at *4

[5] *Id.*

[6] *Id.*

[7] Id. at *5 (alteration incorporated).

[8] *Id.* at *2.

[9] *Id.* at *5.

[10] *Id.* at *2.

[11] Id. at *3.

[12] *Id.*

[13] *Id.* at *5.

[14] *Richman v. Goldman Sachs Grp.*, 868 F. Supp. 2d 261 (S.D.N.Y. 2012).

[15] *In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10-cv-3461, 2015 WL 5613150 (S.D.N.Y. Sept. 24, 2015).

[16] *Arkansas Tchrs. Ret. Sys. v. Goldman Sachs Grp.* (*ATRS I*), 879 F.3d 474 (2d Cir. 2018).

[17] *In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10-cv-3461, 2018 WL 3854757 (S.D.N.Y. Aug. 14, 2018).

[18] *Arkansas Tchr. Ret. Sys. v. Goldman Sachs Grp.* (*ATRS II*), 955 F.3d 254 (2d Cir. 2020).

[19] *Goldman Sachs Grp. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 950 (2020).

[20] *Goldman Sachs Grp. v. Arkansas Tchr. Ret. Sys* (*Goldman*), 141 S. Ct. 1951 (2021).

[21] *Arkansas Tchr. Ret. Sys. v. Goldman Sachs Grp.* (*ATRS III*), 11 F.4th 138 (2d Cir. 2021).

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

[23] *ATRS IV*, 2023 WL 5112157, at *24.

[24] *Id.* at *6.

[25] *Id.* at *6 n.3 (quoting *Erica P. John Fund, Inc. v. Halliburton Co.* (*Halliburton I*), 563 U.S. 804, 810 (2011)). "The elements of a private securities fraud claim based on violations of § 10(b) and Rule 10b–5 are: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Halliburton I*, 563 U.S. at 809–10.

[26] *ATRS IV*, 2023 WL 5112157, at *1.

[27] *Id.*

[28] *Id.* at *6.

[29] *Id.* at *1.

[30] *Id.* at *6.

[31] *Id.* at *1.

[32] *Id.*

[33] *Id.*

[34] *Goldman*, 141 S. Ct. at 1961.

[35] *Id.*

[36] *Id.* at 1960–61 (alteration incorporated) (quoting *Comcast Corp. v. Behrend*, 569 U.S. 27, 35 (2013)).

[37] *Id.* at 1963.

[38] *ATRS III,* 11 F.4th at 143–44.

[39] I*n re Goldman Sachs Grp., Inc. Sec. Litig.*, 579 F. Supp. 3d at 520.

[40] The bank also argued that "the district court again misweighed [the parties'] expert submissions, and in doing so made untenable credibility findings." *ATRS IV*, 2023 WL 5112157 , at *11. The Second Circuit found no clear error by the district court on this issue. *Id.* at *13.

[41] *Id.* at *11.

[42] *Id.*

[43] *Id.* at *14.

[44] *In re Goldman Sachs Grp., Inc. Sec. Litig*., 579 F. Supp. 3d at 534.

[45] *Id.*

[46] *ATRS IV*, 2023 WL 5112157, at *14.

[47] *Id.* at *15.

[48] *Id.* at *16.

[49] *Id.* (quoting *In re Goldman Sachs Grp., Inc. Sec. Litig.*, 579 F. Supp. 3d at 534).

[50] 875 F.3d 79 (2d Cir. 2017).

[51] 2023 WL 5112157, at *17.

[52] 838 F.3d 223 (2d Cir. 2016).

[53] *ATRS IV*, 2023 WL 5112157, at *18.

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.* at *19.

[59] *Id.* (alteration incorporated) (quoting *Goldman*, 141 S. Ct. at 1961).

[60] *Id.*

[61] *Id.* (alterations incorporated) (citation omitted) (quotation marks omitted) (quoting *In re Vivendi, S.A. Sec. Litig.*, 838 F.3d at 258).

[62] *Id.* at *20 (quoting *In re Goldman Sachs Grp., Inc. Sec. Litig.*, 579 F. Supp. 3d at 534).

[63] *Id.* at *24.

[64] *Id.* at *23.

[65] *Id.* at *24.

[66] *Id.* at *22.

[67] *Id.* (footnote omitted).

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