

Not so Fast in Certifying Class: Supreme Court Holds That Courts Must Consider Generality of Alleged Misstatements in Deciding Whether to Certify Securities Fraud Class

by James K. Langdon, Thomas P. Swigert, Michael Rowe, and Jack Huerter

Yesterday, the Supreme Court issued its much-anticipated decision in *Goldman Sachs v. Arkansas Teacher Retirement System*, Case No. 20-222. But because there was not much “daylight” left between the parties’ arguments by the time of oral argument, as Chief Justice Roberts observed, the decision was not the blockbuster some expected.

At issue in *Goldman* was whether a defendant could rebut *Basic v. Levinson*’s fraud-on-the-market presumption at class certification by demonstrating an alleged misstatement was too generic to have actually influenced the defendant’s stock price. A second related issue was whether the defendant bears the burden of persuasion to rebut the *Basic* presumption, or if a plaintiff bears the burden to demonstrate class wide reliance after the defendant produced evidence to rebut such reliance. For the first question, the Court unanimously agreed—as did the parties, apparently—that courts must consider the generic nature of an alleged misstatement when determining if a class relied upon an alleged misstatement to purchase a company’s stock. For the evidentiary issue, a six-vote majority concluded the defendant bears the burden of persuasion to rebut the *Basic* presumption.

The Origins of the Case

This decade-old dispute arose from allegations that Goldman had a conflict of interest when it underwrote certain securities for a client while also assisting another client to short those securities. After the news of the SEC’s interest in the transactions surfaced, Goldman’s stock price dropped and a group of investors sued Goldman under Section 10(b) of the Securities Exchange Act of 1934. In their lawsuit, the investors alleged the company had artificially inflated its stock price by purportedly misrepresenting in SEC filings and annual reports that it had “extensive procedures and controls that are designed to identify and address conflicts of interest,” that its “clients’ interests always come first,” and that “integrity and honesty are at the heart of our business.” The investors argued these statements artificially inflated Goldman’s stock price, which fell after the conflicts of interest were revealed, and that the investors were injured when

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they purchased Goldman's stock at an artificially high price.

At class certification, Goldman argued the alleged misrepresentations were so generic that they could not possibly have influenced the company's stock price. According to Goldman, exposing the generic nature of the alleged misrepresentations was sufficient to rebut the *Basic* presumption and plaintiffs had otherwise failed to meet their burden to establish class wide reliance (a burden that plaintiffs insisted rested with Goldman to prove in the negative). Thus, Goldman argued the class action plaintiffs were unable to prove reliance through the fraud-on-the-market theory. Goldman also argued the class action plaintiffs failed to establish the predominance requirement under Rule 23 for class certification because plaintiffs were unable to establish through common evidence that they relied upon Goldman's alleged misstatements.

The district court rejected Goldman's argument. In certifying the class, the court found Goldman's expert testimony failed to establish that its alleged misrepresentations had no price impact and therefore failed to rebut the *Basic* presumption of class-wide reliance. In so holding, the district court instructed that Goldman, not Plaintiffs, bore the burden of persuasion with respect to the price impact of the alleged misstatements. Goldman appealed, and the Second Circuit affirmed that Goldman bore the burden of persuasion, but remanded the decision to the district court to assess whether Goldman met its burden to rebut the presumption by a preponderance of evidence—a more lenient standard than had been previously applied by the district court.

On remand, the district court again found Goldman's expert testimony did not establish its alleged misrepresentations had no price impact, this time applying the preponderance of evidence standard. Goldman again appealed, but this time, a split Second Circuit affirmed and found the district court's price impact determination was not an abuse of discretion. The dissenting opinion, however, contended that the "generic quality of Goldman's alleged misstatements," coupled with the fact that Goldman disclosed "the falsity of the alleged misstatements" on numerous occasions before the drop in the stock price, "clearly compels the conclusion that the stock drop following the corrective disclosures was attributable to something other than the misstatements alleged in the complaint."

The Supreme Court's Decision

Goldman asked the Supreme Court to review the Second Circuit's affirmance of class certification, and presented two questions for review:

1. Whether a defendant in a securities class action may rebut the presumption of class wide reliance recognized in *Basic* by pointing to the generic nature of the alleged misstatements to show the statements had no impact on the stock price; and
2. Whether a defendant seeking to rebut the *Basic* presumption has the ultimate burden of persuasion as to price impact.

With respect to the first question, the Court unanimously concluded that in "assessing

price impact at class certification, courts 'should be open to *all* probative evidence on that question—qualitative as well as quantitative—aided by a good dose of common sense.’” This means that the generic nature of an alleged misrepresentation should be considered by courts at class certification, because the “generic nature of a misrepresentation often will be important evidence of a lack of price impact, particularly in cases under the inflation-maintenance theory.” The more generic a misstatement, the less likely a stock drop could be explained by a later specific disclosure on the same issue. For instance, the Court noted that if a company communicates to the market that it “has faith in [its] business model,” its later disclosure that its “fourth quarter earnings did not meet expectations” does not correct that alleged misstatement—the latter is more specific and does not necessarily contradict the former. In the event of a drop in the stock price following the second disclosure, the Court reasoned the market is more likely reacting to the later-in-time specific disclosure, not the generic misstatement that does not communicate the specifics of the company’s operations or performance. In other words, an alleged misstatement of a generic nature is much less likely to artificially inflate a company’s stock price than a specific misstatement, and the generic nature of a statement therefore bears directly on the issue of price impact. Accordingly, courts must consider the generality of the statement when determining if the *Basic* presumption should apply.

Against that backdrop, the Court remanded the class certification decision to the Second Circuit to appropriately consider the generic nature of Goldman’s alleged misrepresentations. The Court specifically directed the Second Circuit to “take into account *all* record evidence relevant to price impact, regardless of whether that evidence overlaps with the materiality or any other merits issue.”

With respect to the evidentiary issue, the Court affirmed the standard applied by the Second Circuit. In so holding, the Court rejected Goldman’s argument that because it offered evidence to rebut the *Basic* presumption, Federal Rule of Evidence 301 placed the burden of persuasion on Plaintiffs to establish price impact. The Court explained that *Basic* permits defendants to rebut the presumption of reliance if they “*show* that the misrepresentation *in fact* did not lead to a distortion of price” and explained that doing so requires defendants to make any “*showing* that *severs the link* between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff.” To hold otherwise, the Court noted, would effectively require plaintiffs to prove price impact to invoke the *Basic* presumption—a proposition previously rejected by the Court in *Halliburton II*. In any event, the Court noted that the allocation of the burden is “unlikely to make much difference on the ground” because the issue of price impact is typically decided by competing experts and the Court’s task in weighing that evidence is to “determine whether it is more likely than not that the alleged misrepresentations had a price impact.” Therefore, the burden of persuasion would only dictate the outcome in the rare circumstance where the evidence is in equipoise.

Outcome

Goldman provides a roadmap for defendants to challenge class certification for investor-

plaintiffs premised upon alleged misstatements of a generic nature—a somewhat common feature in 10b-5 securities fraud cases. Although the Court did not hold that generic statements are immaterial as a matter of law (as Goldman initially argued at the Second Circuit), the Court upheld the common sense principle that generic statements are less likely to be market moving and that allegations of fraud premised upon those generic misstatements are subject to attack. The Court also seemingly endorsed the ability of defendants to use merits-based evidence, *i.e.*, materiality evidence, to resist class certification. As numerous circuit courts have previously held, defendants will continue to bear the burden to “sever the link” between those alleged generic misstatements and the drop in a stock price. Nevertheless, *Goldman* preserves an important line of defense in stock-drop cases—to earn class certification, plaintiffs’ claims must be premised on alleged misstatements that are sufficiently specific to withstand a challenge as to their immateriality under the *Basic* presumption.

Left open in the Court’s ruling is the viability of plaintiffs’ inflation-maintenance theory. As the Court observed, several lower courts have endorsed this theory of liability, but the Supreme Court has yet to weigh-in. As this theory gains traction in the plaintiffs’ bar and among lower courts, it may be only a matter of time before the Court considers the issue. Stay tuned.

End note: The authors are appreciative of the helpful contributions of summer associate Alex Salazar.