

Second Circuit Confirms That Corrective Disclosure Mismatch May Preclude Class Certification

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On August 10, 2023, the US Court of Appeals for the Second Circuit dealt a blow to securities class action plaintiffs when it decertified the investor class in [Arkansas Teacher Retirement System v. Goldman Sachs Group, Inc.](#) After a long history of the case going up to the US Supreme Court and back, the Second Circuit held that the defendants successfully rebutted the presumption of reliance set forth in *Basic Inc. v. Levinson* by demonstrating a mismatch in specificity between the alleged misrepresentations and corrective disclosures. It explained that because the challenged statements were generic compared to the very specific alleged corrective disclosure, it could not conclude that the challenged statements impacted Goldman's stock price. Although only a single datapoint, this decision reiterates that class certification is not a given for securities class action plaintiffs. It also marks an important step toward clarifying when securities class action plaintiffs can – and, more importantly, cannot – rely on the presumption of reliance from *Basic* to overcome weak securities fraud cases, as well as how defendants may establish a price impact defense to class certification.

Background

The underlying securities class action, filed in 2010, accused Goldman and several of its former executives of violating Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder. The plaintiffs alleged that between 2006 and 2010, Goldman maintained an inflated stock price by making repeated misrepresentations about its conflict-of-interest policies and business practices. The alleged misrepresentation included generic statements about Goldman's ability to manage conflicts of interest in its business, such as:

- “Most importantly, and the basic reason for our success, is our extraordinary focus on our clients.”
- “Integrity and honesty are at the heart of our business.”
- “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.”

The plaintiffs alleged that the “truth” about Goldman's conflicts of interest came to light in 2010 when the Securities and Exchange Commission brought an enforcement action against Goldman and one of its employees. The SEC alleged that Goldman failed to disclose in its marketing materials that the hedge fund Paulson & Co. played an active role in the asset selection process for certain collateralized debt obligation (CDO) transactions, and for telling investors that Paulson held a long interest in one specific CDO transaction, known as Abacus 2007 AC-1, when, in fact, Paulson was short. The investigation resulted in a \$550 million settlement with the SEC.

The plaintiffs claimed that, once the truth about these conflicts was revealed by the SEC enforcement action, Goldman's stock price dropped, and its shareholders suffered losses of more than \$13 billion.

Goldman has long argued that the public statements central to the litigation were too generic to have been misleading or to have induced investor reliance. At the motion to dismiss stage, Goldman successfully argued that certain of the alleged misstatements were immaterial as a matter of law. However, [the US District Court for the Southern District of New York held](#) in 2012 that claims based on the business principles and conflicts statements – including the examples cited above – could proceed because they did not qualify as “puffery” and were not “so obviously unimportant to a reasonable investor” as to be immaterial as a matter of law.

In 2015, the plaintiffs moved for class certification, relying on the *Basic* presumption to support classwide reliance. The defendants sought to rebut the *Basic* presumption and defeat class certification by demonstrating that the alleged misstatements were too generic to have any impact on Goldman's stock price. SDNY found the defendants' arguments unpersuasive and certified the class. On appeal, the Second Circuit remanded the case, holding that SDNY applied the wrong standard of proof to the defendants' price impact arguments and failed to consider some of the defendants' price impact evidence.

Upon remand, SDNY again certified the class. On appeal, the Second Circuit affirmed, and the defendants sought review

by the Supreme Court. In June 2021, [the Supreme Court confirmed](#) in *Goldman Sachs Grp., Inc. v. Arkansas Tchr. Ret. Sys.* that:

1. The “generic nature of a misrepresentation often is important evidence of price impact that courts should consider at class certification.”
2. The defendants “bear the burden of persuasion to prove a lack of price impact by a preponderance of the evidence.”

In other words, a “mismatch” in specificity between the contents of an alleged misstatement and a corrective disclosure makes it “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.”

The Supreme Court remanded the case back to the Second Circuit with instructions to consider “the generic nature of Goldman’s alleged misrepresentations” in its price impact analysis. On remand, the Second Circuit determined that it was for SDNY to decide this issue in the first instance and further remanded the case for consideration and briefing.

Upon further remand to SDNY, the class was certified once again. SDNY found in [In re Goldman Sachs Grp., Inc. Sec. Litig.](#) that there was a “comfortable” gap between the generic nature of the alleged misstatements and the specific information conveyed in the alleged corrective disclosures, but nevertheless held that Goldman failed to establish a lack of price impact by a preponderance of the evidence. The defendants appealed yet again. This time, the Second Circuit reversed and remanded with instructions to SDNY to decertify the class.

Second Circuit’s decision

In reversing the class certification order, the Second Circuit applied the analytical framework set forth by the Supreme Court to determine whether Goldman had successfully rebutted the *Basic* presumption:

[“he ‘inference starts to break down’ when the earlier misrepresentation is generic and the later corrective disclosure is specific, and that, ‘under those circumstances it is less likely that the specific disclosure actually corrected the generic misrepresentation’”](#)

In conducting its analysis, the Second Circuit observed that claims such as those brought by plaintiffs “require special attention to the generic nature of the disclosure,” because “the duty to disclose more is triggered only where that which is disclosed is sufficiently specific to evoke a reasonable investor’s reliance.”

“Were it otherwise,” the Second Circuit reasoned, “securities plaintiffs could find a road to success in the rearview mirror: they would need only find negative news, such as the revelation that a company may have committed securities fraud, and then point to any previous disclosure from the company which touches upon a similar subject, such as that company’s commitment to complying with the law – no matter how generic that statement is.”

Citing wide-ranging expert analyses introduced by Goldman, including hundreds of analyst reports and an event study analyzing public discussions about Goldman Sachs’ ability to manage conflicts of interests, the Second Circuit determined that Goldman “managed to sever the link between back-end price drop and front-end misrepresentation.”

The Second Circuit also held that the district court misapplied the inflation-maintenance theory recognized in 2016’s [In re Vivendi, S.A. Sec. Litig.](#) Under this 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. But “where the corrective disclosures do not expressly identify the alleged misrepresentation as false,” the inference “is on shakier ground,” and courts must pay “special attention to mismatches in specificity between a misstatement and corrective disclosure.” 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.”

Significance

Although each of the three judges on the panel agreed that the class should be decertified, Judge Richard J. Sullivan separately wrote a compelling concurrence highlighting what he viewed as the majority’s “needlessly complicate” approach to what “should be a straightforward balancing of the several factors that bear on the question of reliance.” Judge Sullivan cautioned that “the majority has chartered a meandering course that ... obscures what should be an uncomplicated inquiry.” The Supreme Court directive, according to Judge Sullivan, is clear: Courts are to assess “all

probative evidence” of price impact – including the genericness, mismatch and materiality analyses – regardless of the plaintiffs’ specific theory of liability.

Moving forward, the Second Circuit’s 2023 ruling and the Supreme Court’s 2021 decision make clear that courts are required to carefully consider a defendant’s price impact defense, meaning that securities defendants now have a helpful roadmap to defeating class certification. It remains to be seen whether other circuits will follow the Second Circuit’s lead – or take a simpler approach as urged by Judge Sullivan – and, perhaps more critically, whether the panel majority’s prediction that “omeday the Supreme Court will revisit issue” comes to pass in the coming weeks or years.

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