

# Supreme Court Gives More Tools for Defendants to Challenge Class Certification in Securities Fraud Cases

## Publications

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## Introduction

On June 21, 2021, the US Supreme Court issued its decision in *Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System*,<sup>[1]</sup> providing guidance to lower courts regarding class certification in securities fraud class actions. On balance, the opinion favors defendants, and potentially signals a backlash against the tide of securities fraud class actions based on vague and generic misstatements. Importantly, the Court instructed that all relevant evidence should be considered when making the class certification decision, sending a message that lower courts must grapple with and cannot ignore relevant evidence at the class certification stage simply because it overlaps with the merits-related evidence. The Court also stressed that the generic nature of a misrepresentation is often important evidence of lack of price impact, which lower courts should consider when deciding whether to grant or deny a class certification motion.

Although the Supreme Court's decision was not as sweeping as the defendants wanted, it does signal the Supreme Court's concern that companies are too frequently held liable for securities fraud as a result of adverse legal or business developments, even where the company had never made any specific statements about the matters in question.

## Background

The underlying facts of this case relate to Goldman's now well-publicized involvement in the Abacus CDO transaction and subsequent settlement with the SEC in the aftermath of the 2008 financial crisis. In the consolidated complaint, which was filed in 2011, plaintiff shareholders alleged that Goldman had violated securities laws by making repeated misrepresentations in its SEC filings and other public statements in connection with the Abacus CDO transaction, beginning in late 2006/early 2007. The alleged misrepresentations were generic statements regarding Goldman's conflict of interest policies and business practices, including statements like: "We have extensive procedures and controls that are designed to identify and address conflicts of interest"; "Our clients' interests always come first"; and "Integrity and honesty are at the heart of our business." According to the plaintiffs, these alleged misrepresentations allowed Goldman to maintain an inflated stock price until 2010, when the SEC filed a complaint against Goldman for securities fraud. Goldman later

disclosed that it had agreed to pay \$550 million as part of a settlement with the SEC and acknowledged that it should have disclosed certain conflicts of interest in 2007 when underwriting the Abacus CDO that cost its clients \$1 billion. The plaintiffs argued that once the SEC enforcement action and related news reports revealed that Goldman in fact engaged in conflicted transactions, the stock price dropped and caused Goldman shareholders to suffer losses.

The Southern District of New York denied Goldman's motion to dismiss, and the plaintiffs moved for class certification. The plaintiffs argued that Goldman's generic statements regarding its business practices and conflict of interest procedures artificially maintained an inflated stock price. Goldman argued that the alleged misstatements were too generic to have any impact on stock price. Following extensive expert testimony on the issue, the District Court certified the class. The Second Circuit vacated the class certification order, holding that the burden was on Goldman to prove a lack of price impact by a preponderance of the evidence, but that the District Court erred by holding Goldman to a higher burden of proof. On remand, the District Court certified the class again, finding that Goldman's expert testimony failed to establish by a preponderance of the evidence that the alleged misrepresentations had no price impact. The Second Circuit affirmed in a divided decision, holding the District Court's price impact determination was not an abuse of discretion.

### **The Supreme Court's Decision**

On appeal, the Supreme Court was asked to resolve two questions: first, whether the generic nature of Goldman's alleged misrepresentations is relevant to the price impact inquiry; and second, whether Goldman has the burden of persuasion to prove lack of price impact.

On the first question, Goldman argued that the Second Circuit erred in holding that the generic nature of alleged misrepresentations was irrelevant to the price impact question. Goldman's initial position was that generic statements could not impact stock price, while the plaintiffs argued that the generic nature of the alleged misrepresentations had no relevance to the price impact inquiry at all. The parties later agreed that the generic nature of the statements was relevant to price impact and should be considered at the class certification stage. The Court agreed, holding that district courts should consider all probative evidence in assessing price impact and clarifying that courts may consider the generic nature of misrepresentations at class certification "regardless whether the evidence is also relevant to a merits question like materiality."<sup>[2]</sup> The Court further explained that the generic nature of an alleged misrepresentation "often will be important evidence of a lack of price impact, particularly in cases proceeding under the inflation-maintenance theory" where it is less likely that a specific, negative disclosure actually corrected a prior generic misrepresentation. <sup>[3]</sup> Ultimately, the Court remanded on this issue and instructed the Second Circuit to "take into account *all* record evidence relevant to price impact" because the Court concluded the Second Circuit's decision left "sufficient doubt" that it properly considered the generic nature of the statements.<sup>[4]</sup>

On the second question, Goldman argued that the Second Circuit erred in placing the burden of persuasion on Goldman, as a defendant, to prove a lack of price impact. According to Goldman, the

presumption of fraud on the market, articulated in the Court’s seminal *Basic v. Levinson* ruling,[5] only shifts the burden of *production* to the defendant, but the defendant can rebut the presumption by producing any competent evidence of a lack of price impact, while the plaintiff carries the burden of *persuasion* to prove price impact. The Court rejected Goldman’s argument, concluding that a defendant “bears the burden of persuasion to prove a lack of price impact” and agreeing with the Second Circuit that the defendant carries that burden by a preponderance of the evidence.[6] However, the Court noted that, because the parties in most securities fraud class actions typically submit competing expert evidence on price impact, its decision regarding the allocation of the burden was “unlikely to make much difference on the ground.”[7]

### **Key Takeaways**

Overall, the Court’s decision favors defendants by holding that all relevant evidence, including merits-based evidence, should be considered when evaluating price impact at the class certification stage, which gives a lower court more discretion to deny class certification based on the entire record before it.

In addition, in cases premised on generic misstatements, the Court’s holding should make it easier for defendants to rebut the *Basic* presumption, given that the Court expressly recognized that the general nature of a misstatement “will often be important evidence of lack of price impact.”[8] Importantly, the Court noted that this is especially true in cases based on the “inflation maintenance” theory, where price impact is the amount of price inflation maintained by an alleged misrepresentation. The Court emphasized that in these type of cases, there is less of a reason to infer front-end price inflation based on a back-end price drop. In doing so, the Court seemed to reject the idea that negative disclosures or allegations of wrongdoing necessarily “correct” prior generic statement by the defendant company. While defendants still bear the burden of disproving price impact, this should make it harder for plaintiffs to succeed in cases relying on inflation maintenance theory unless they can show a link between the front-end price and the back-end price drop.

Finally, on the burden issue, the Court made clear that its holding is unlikely to have much practical effect, noting that the defendant’s burden of persuasion would only become dispositive “in the rare case” in which the parties’ evidence of price impact is perfectly balanced.[9] In most cases, however, the “district court’s task is simply to assess all the evidence of price impact — direct and indirect — and determine whether it is more likely than not that the alleged misrepresentations had a price impact.”[10]

[1] *Goldman Sachs Grp. Inc. v. Arkansas Tchr. Ret. Sys.*, No. 20–222, slip op. (U.S. June 21, 2021).

[2] *Goldman*, slip op. at 7.

[3] *Id.* at 8.

[4] *Id.* at 9.

[5] *Basic v. Levinson*, 485 U.S. 224 (1988).

[6] *Id.* at 11.

[7] *Id.* at 12.

[8] *Id.* at 8.

[9] *Id.* at 3.

[10] *Id.* at 12.

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