Simpson Thacher

Securities Law Alert

In This Edition:

June/July 2021

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– Chambers USA

Supreme Court: The *Basic* Presumption Can Be Rebutted by Showing There Was No Price Impact Even Though That Evidence Is Also Relevant to Materiality

On June 21, 2021, in *Goldman Sachs Group v. Arkansas Teacher Retirement System*, 2021 WL 2519035 (2021) (Barrett, J.), the Supreme Court vacated the Second Circuit's class certification affirmance in a securities fraud class action brought under Section 10(b).[1] The Court unanimously held that a court must consider all probative evidence, including the nature of the alleged misrepresentations, in assessing price impact at the class certification stage. An eight-justice majority of the Court further held that it was not clear that the Second Circuit properly considered the generic nature of the alleged misrepresentations at issue and for that reason vacated and remanded back to the Second Circuit. The Court directed the Second Circuit on remand to reassess the district court's price impact determination, taking into account "*all* record evidence relevant to price impact, regardless [of] whether that evidence overlaps with materiality or any other merits issue." A six-justice majority of the Court also held that a defendant seeking to overcome the *Basic* presumption bears the burden of persuasion to prove a lack of price impact, which must be carried by a preponderance of the evidence.

1. Simpson Thacher filed an *amici curiae* brief on behalf of the Securities Industry and Financial Markets Association, the U.S. Chamber of Commerce, the Bank Policy Institute, the American Bankers Association, and the American Property Casualty Insurance Association in support of defendants-appellants.

Background

Plaintiff stockholders commenced this securities fraud class action against a bank and certain of its executives alleging that defendants made misstatements about its ability to manage conflicts of interest, such as "[w]e have extensive procedures and controls that are designed to identify and address conflicts of interest." Plaintiffs relied on a stock price inflation-maintenance theory asserting that the alleged misrepresentations caused the bank's stock price to remain inflated until the truth regarding certain conflicts of interest was revealed and the bank's stock price fell. Plaintiffs sought to certify a class of stockholders by invoking the rebuttable presumption of reliance established in *Basic v. Levinson*, 485 U.S. 224 (1988). Defendants sought to defeat class certification by rebutting the *Basic* presumption with evidence that their alleged misrepresentations had no stock price impact. Both parties submitted expert testimony on the issue of price impact. The district court determined that defendants failed to carry their burden of proving a lack of price impact and certified the class, and the Second Circuit affirmed.

The Nature of the Alleged Misrepresentations Is Relevant to Price Impact

Before the Court, defendants argued that the Second Circuit erred in holding that the generic nature of their alleged misrepresentations was irrelevant to the price impact inquiry. The Court held that a court must consider all probative evidence, including the nature of the alleged misrepresentations, in assessing price impact at the class certification stage and observed that the "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." In assessing price impact at the class certification stage, the Court stated that courts "should be open to *all* probative evidence on that question—qualitative as well as quantitative—aided by a good dose of common sense."

The Court explained that under the inflation-maintenance theory, price impact is the amount of price inflation maintained by an alleged misrepresentation. The Court reasoned that when the alleged misrepresentation is generic and the back-end corrective disclosure is specific, the argument that the back-end price drop equals front-end inflation starts to "break down" and it is less likely that the disclosure corrected the alleged misrepresentation, meaning that there is less reason to infer price impact.

Defendant Bears the Burden of Persuasion to Prove a Lack of Price Impact

Defendants also argued that the Second Circuit erred by assigning defendants the burden of persuasion to prove a lack of price impact. The Court stated that "the best reading of our precedents . . . is that the defendant bears the burden of persuasion to prove a lack of price impact" and that defendants must do so by a preponderance of the evidence. Quoting *Basic*, the Court stated that the presumption of reliance may be rebutted if defendants make "any showing that severs the link" between the alleged misrepresentation and the price paid (or received) by the plaintiff. The Court noted that the allocation of the burden of persuasion should rarely be outcome determinative as "the defendant's burden of persuasion

will have bite only when the court finds the evidence in equipoise—a situation that should rarely arise."

Justices Sotomayor and Gorsuch Write Dissents

Justice Sotomayor dissented from the court's decision to vacate and remand because she believed that the Second Circuit properly considered the generic nature of the alleged misrepresentations. Justice Gorsuch, joined by Justices Thomas and Alito, dissented from the Court's burden of persuasion holding, stating that the Court has never placed the burden of persuasion on the defendant in this area and it "is incumbent on the plaintiff to prove reliance, not the defendant to disprove it."

Ninth Circuit: Affirmative Misrepresentation Allegations "Push" Mixed Securities Fraud Case Outside of *Affiliated Ute*'s Presumption of Reliance

On June 25, 2021, the Ninth Circuit reversed the denial of summary judgment to a defendant auto manufacturer in a putative securities fraud class action alleging that defendant made omissions and affirmative misrepresentations in offering memoranda relating to its secret use of defeat devices in its vehicles to hide unlawfully high emissions. *In re Volkswagen "Clean Diesel" Mktg., Sales Pracs., & Prods. Liab. Litig.*, 2021 WL 2621171 (9th Cir. 2021) (Smith, J.). The Ninth Circuit held that the presumption of reliance established by *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), did not apply because plaintiff's allegations could not be characterized "primarily" as claims of omission. The Ninth Circuit remanded the case to the district court to further consider whether a triable issue of material fact exists.

Background

Plaintiff commenced this securities fraud class action after government regulators issued notices of violation to defendant relating to its use of defeat devices, which were designed to only neutralize vehicle emissions during emissions testing. Defendant moved for summary judgment exclusively on the element of reliance in Rule 10b-5, arguing that plaintiff had no evidence that it or its investment advisor relied on the offering memoranda and that the *Affiliated Ute* presumption of reliance did not apply. The district court denied defendant's motion for summary judgment and then certified the decision for interlocutory appeal on the scope of the *Affiliated Ute* presumption of reliance in "mixed" securities fraud cases—cases alleging both omissions and affirmative misrepresentations.

The Ninth Circuit Examines the Presumption of Reliance

The court began its analysis by discussing *Affiliated Ute*, which established the presumption of reliance in a case where plaintiff stockholders alleged "primarily a failure to disclose."[2] The Supreme Court reasoned that if the stockholders were required to affirmatively prove reliance under these circumstances, they "would have been forced to prove a speculative negative: that they would have relied on information about the secondary market before selling their stock had the bank disclosed it." Subsequently, *Binder v. Gillespie*, 184 F.3d 1059 (9th Cir. 1999), distinguished between "pure omissions" cases and "mixed" cases that allege both omissions and affirmative misrepresentations. In *Binder*, the Ninth Circuit held that the "presumption should not be applied to cases that allege both misstatements and omissions unless the case can be characterized as one that primarily alleges omissions."

Alleged Reliance on Affirmative Misrepresentations Pushed the Case Outside of *Affiliated Ute*'s Presumption of Reliance

After acknowledging that plaintiff alleged an overarching omission (that for years defendant failed to disclose that it was secretly installing defeat devices), the Ninth Circuit pointed out that plaintiff also alleged "more than nine pages of affirmative misrepresentations that were made by [defendant] and relied upon by Plaintiff and its investment advisor." The court observed that plaintiff "does not face the difficult or

2. In *Affiliated Ute*, plaintiffs alleged that bank officers bought restricted stock from them without disclosing that the bank created a secondary market in which that stock could be resold for profit, which allowed the bank officers to purchase the stock below market value and then sell it on the secondary market for a profit.

impossible task of proving a speculative negative." The Ninth Circuit concluded that while this is a mixed case, plaintiff's "allegations cannot be characterized primarily as claims of omission, so the *Affiliated Ute* presumption of reliance does not apply." The court determined that "[t]hese affirmative misrepresentations, which Plaintiff alleges it relied upon when purchasing the bonds, push this case outside *Affiliated Ute*'s narrow presumption." The Ninth Circuit explained that to hold otherwise would make the presumption available for all securities fraud claims "because all misrepresentations can be cast as omissions, at least to the extent they fail to disclose which facts are not true."

District of Maryland: Denies Dismissal of Securities Fraud Suit Alleging Suspect Sales Practices in Light of Allegations in an SEC Cease-And-Desist Order

On May 18, 2021, the District of Maryland denied the dismissal of the complaint in a putative securities fraud class action alleging that an apparel company and its former CEO misled investors concerning the company's revenue growth and product demand and engaged in pull forward sales[3] and other allegedly suspect sales practices. *In re Under Armour Sec. Litig.*, 2021 WL 1985015 (D. Md. 2021) (Bennett, J.). The court held that plaintiffs adequately alleged securities law violations when their allegations were "read in light of and in combination with the allegations" in an SEC cease-and-desist order entered against the company.

Plaintiffs' Allegations

Plaintiffs alleged that defendants misled investors by, among other things, falsely claiming that consumer demand for the company's products was strong; leading investors to believe that the company's 26-consecutive quarter year-over-year revenue growth streak was "safely intact" when product demand was actually in decline; and manipulating the company's financial results with pull forward sales.

SEC Cease-And-Desist Order Is Entered Against the Company

Defendants sought to dismiss, asserting that the complaint generally failed to plead adequate factual details to support plaintiffs' claims. While the motion to dismiss was pending, the SEC entered an order instituting cease-and-desist proceedings against the company for violations of various federal securities laws and ordering it to pay a $9 million civil penalty. The SEC order stated that in anticipation of cease-and-desist proceedings, the company submitted an offer of settlement, which was accepted. While the company consented to entry of the order, it neither admitted nor denied the SEC's findings. Following plaintiffs' request, the court took judicial notice of the SEC order.

The SEC Order Lends Support to Plaintiffs' Allegations

Taking into consideration the SEC order, the court held that it was "satisfied that Plaintiffs' allegations survive the Defendants' Motion to Dismiss." The court clarified that the SEC order did not supply dispositive evidence as it stated that its findings were not binding. Nevertheless, the court determined that the SEC order lent support to plaintiffs' allegations.

The court concluded that the SEC order undermined defendants' dismissal argument because it provided "specific factual allegations regarding the amount of the products pulled forward and concludes that because of the undisclosed pull forward tactics used, investors were left with a

3. Pull forward sales, sometimes called channel stuffing, occur when a company ships more goods to distributors and retailers than end-users are likely to buy in a reasonable time period, which can accelerate revenue recognition to reach short-term revenue and earnings targets but can result in lower future demand.

misleading impression of how [the company] was meeting or beating analysts' revenue estimates." Further, the court pointed out that the SEC found that the company's reported financial results "did not reflect its natural revenue and revenue growth, and were not indicative of its future financial results."

would still be false or misleading if the company's cooperation with its rivals was lawful and that plaintiffs also acknowledged that "not all forms of cooperation within the industry are illegal."

The court further determined that plaintiffs "failed to plead with particularity that [the company's] coordinated actions with other car manufacturers were unlawful and anticompetitive." Specifically, the court held that plaintiffs' "failure to identify any specific laws or to plead with particularity how [the company's] conduct violated those laws is fatal[.]" The court stated that even though the allegations regarding the company's cooperation with other manufacturers were detailed, plaintiffs did not identify any specific laws violated or explain how the conduct ran afoul of those laws.

Eastern District of New York: Dismisses Securities Fraud Class Action for Failure to Plead With Particularity That the Company's Conduct Violated Antitrust Laws

On May 20, 2021, the Eastern District of New York dismissed a putative securities fraud class action against an auto manufacturer and certain of its executives alleging that the company had engaged in a decades-long anticompetitive conspiracy and that defendants made various false or misleading statements concerning competition, competitive pressures, commodity prices, manufacturing inputs and compliance. *Mucha v. Volkswagen*, 2021 WL 2006079 (E.D.N.Y. 2021) (Irizarry, J.). The court held that plaintiffs failed to state a claim for securities fraud because they failed to adequately allege that the company engaged in any unlawful conduct.

The court determined that plaintiffs "have not alleged adequately that [the company] engaged in any unlawful conduct. Thus, they fail to state a claim for securities fraud." The court pointed out that the company's statements were alleged to be false or misleading because of the company's purportedly unlawful anticompetitive conduct. However, the court observed that plaintiffs did not contend that the statements

District of Oregon: Applies Recent Ninth Circuit Opinion to Hold That the PSLRA's Safe Harbor Protects "On Track" Forward-Looking Statements Concerning Progress Toward an Allegedly Unattainable Goal

On May 24, 2021, the District of Oregon entered summary judgment for a defendant manufacturer, its CEO and its CFO in a securities fraud class action alleging that the company's announced earnings guidance was close to impossible to attain, but that its CEO continued to make materially false and misleading statements that the company was progressing toward its target. *Murphy v. Precision Castparts*, 2021 WL 2080016 (D. Or. 2021) (Beckerman, J.). The court held, in light of the Ninth Circuit's recent opinion in *Wochos v. Tesla*, 985 F.3d 1180 (9th Cir. 2021),[4] that defendants' "relatively generic" statements "were not sufficiently concrete to qualify as a concrete factual assertion about a specific present or past circumstances, nor specific enough for Plaintiffs to establish falsity." After the Ninth Circuit issued its opinion in *Tesla*, defendants moved for reconsideration of the court's July 3, 2020 opinion denying summary judgment as to

4. Please click here to read our discussion of the Ninth Circuit's decision in *Tesla*.

certain statements. Based on *Tesla*, the court reversed its July 3 opinion with respect to the PSLRA's safe harbor for forward-looking statements and falsity under Section 10(b).

The court stated that it interpreted *Tesla*—where an electric vehicle manufacturer and certain executives were alleged to have made false and misleading statements about an allegedly unattainable production goal—to mean "that the Safe Harbor protects statements that a company remains 'on track' to meet its target." The court found that the non-actionable statements in *Tesla* (such as "it's coming in as expected"; "there are no issues"; and "we are on-track") were indistinguishable from the statements at issue here (such as "we're on that slope"; "we're pretty much on that drum beat"; "we hover around that line"; "the framework . . . is all intact"; "nothing has gone negative"; "we've been able to stay on that continuum"; and "there is no change to the . . . framework we laid out"). The court had previously held that the safe harbor did not protect the CEO's statements because they contained facts about the company's current circumstances. However, applying *Tesla*, the court found the CEO's "relatively generic statements do not include sufficiently 'concrete descriptions' of present facts to fall outside the protection of the Safe Harbor."

The court further determined that the statements in this case about the company's current circumstances were just as vague as those in *Tesla* and thus under the Ninth Circuit's reasoning were not actionable. Specifically, the court stated that "under *Tesla*'s reasoning, [the CEO's] statements that 'the framework is intact' cannot be false unless there was no longer any part of the framework intact." As to the statement that the company had achieved incremental benchmarks, the court explained that it read *Tesla* to "instruct that a company must disclose that it reached a *specific* benchmark for the statement to be actionable, not that it reached an undisclosed or non-specific benchmark."

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