ALERT MEMORANDUM

# Second Circuit Holds General Statements of Regulatory Compliance Cannot Sustain Securities Fraud Claim

*March 8, 2019*

It has been a not infrequent occurrence over the past years that, after a company announces bad news or corporate mismanagement, securities class actions have been filed challenging general statements made by the company about its compliance with regulatory requirements or its own ethics policies and procedures. Earlier this week, in *Singh v. Cigna Corp.*, the Second Circuit issued yet another strong decision rejecting that tactic. In the wake of *Cigna*, it is now clear in the Second Circuit that generalized statements that a company has established policies to comply with regulatory requirements, and that it expects every employee to act with integrity and to comply with regulatory requirements, cannot provide a basis for a securities fraud claim—even if it turns out that during the time the company is making such public statements, the company is not complying with regulatory requirements and its employees are not acting with integrity.

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## Background

The general facts alleged in *Cigna* will be familiar to the readers of many recent securities fraud complaints, although they are particular in their detail. During the relevant time period, Cigna, a multi-national health services organization, filed annual reports with the SEC on Form 10-K in which Cigna stated, among other things, that it had "established policies and procedures to comply with applicable requirements" and that it "expect[ed] to continue to allocate significant resources to various compliance efforts."[1] During this time period, it also published a "Code of Ethics and Principles of Conduct" that "includ[ed] statements from senior Cigna executives affirming the importance of compliance and integrity."[2] The Code of Ethics stated that it was "important for every employee . . . to handle, maintain, and report on [Cigna's financial] information in compliance with all laws and regulations" and that Cigna employees had "a responsibility to act with integrity in all [they] do, including any and all dealings with government officials."[3]

The complaint alleged that at the same time Cigna was making these statements, a Medicare insurer, HealthSpring Inc., which Cigna had just acquired, was experiencing a series of regulatory compliance failures in its Medicare operations.[4] Specifically, during the time period after Cigna had made the statements touting its compliance efforts in the Form 10-Ks and after it had published its Code of Ethics, it received more than seventy-five notices from the Centers for Medicare and Medicaid Services ("CMS"), a federal agency within the United States Department of Health and Human Services that administers the Medicare program, for a variety of regulatory compliance infractions.[5] In fact, CMS determined that Cigna had "'substantially failed to comply with CMS requirements' regarding coverage determinations, appeals, benefits administration, compliance program effectiveness and similar matters" and had a "longstanding history of non-compliance with CMS requirements."[6] Cigna did not disclose the notices of non-compliance contemporaneous with their receipt.

CMS ultimately sent Cigna a notice setting forth Cigna's history of noncompliance and imposing sanctions on Cigna, including the suspension of enrollment of Medicare beneficiaries.[7] Cigna immediately filed a Form 8-K disclosing receipt of the notice from CMS and the accompanying sanctions.[8] "Cigna's stock price fell substantially,"[9] and Plaintiffs sued, alleging that Cigna's statements about its policies and procedures and its commitment to regulatory compliance, ethics and integrity were materially misleading in light of the contemporaneous, undisclosed history of regulatory non-compliance with Medicare regulations.[10] Several months later, "Cigna announced that it had already spent nearly $30 million to remedy the compliance violations, but that it [might] 'not be able to address matters arising from the [CMS Sanctions] Notice in a timely and satisfactory manner.'"[11] Cigna's stock price again fell, and Plaintiffs filed an amended securities fraud complaint extending the class period through the later disclosure and stock price drop.[12]

On September 28, 2017, the United States District Court for the District of Connecticut, Hon. Vanessa L. Bryant, dismissed the complaint for failure to allege materially false statements and scienter.[13] She held that, among other things, the Code of Ethics statements "reflect the precise meaning" of "puffery."[14]

[1] *Singh v. Cigna Corp.*, No. 17-3484-CV, 2019 WL 1029597, at *2 (2d Cir. Mar. 5, 2019) (citation omitted).
[2] *Id*.
[3] *Id*. (first and second alterations in original) (citation omitted).
[4] *Id*. at *1-2.
[5] *Id*. at *2.
[6] *Id*. (citation omitted).
[7] *Id.*
[8] *Id*.
[9] *Id*. at *3.
[10] *Id*.
[11] *Id*. (second alternation in original) (citation omitted).
[12] *Id*.
[13] *Singh v. Cigna Corp.*, 277 F. Supp. 3d 291 (D. Conn. 2017), *aff'd*, No. 17-3484-CV, 2019 WL 1029597 (2d Cir. Mar. 5, 2019).
[14] *Id*. at 311 (citing *City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014)).

Moreover, the court stated that Plaintiffs "[did] not allege at what point these individuals actually made these statements": the executives "could have uttered these words years before they were actually published in the Code of Ethics."[15] Thus, Plaintiffs failed to make the requisite showing that the statements were false at the time they were made.[16]

As to the statements in the Form 10-K, the District Court stated that, "although a company cannot be expected to maintain 100% compliance with every applicable regulation, the existence of 'ongoing and substantial' violations of regulations that are left undisclosed can lead to a material misstatement or omission if a reasonable investor would consider such information important."[17] Here, however, the omissions regarding the violations at the time the Form 10-K statements were made were "'*obviously* unimportant to a reasonable investor' because these early stage notices could [have] be[en] rectified at any time without risking a threat to earnings."[18] And, while the 2013 Form 10-K stated that Cigna "established policies and procedures to comply with applicable requirements, . . . Cigna made no contention that it was in 'substantial compliance' with all laws."[19]

## The Second Circuit's Decision

In a unanimous decision affirming the District Court, the Second Circuit held that Plaintiffs had failed to allege a materially false statement as a matter of law.[20] The Second Circuit's ruling was broader than the District Court's decision.

The Second Circuit based its ruling largely on its earlier decision in *City of Pontiac Policemen's & Firemen's Retirement System v. UBS AG*, 752 F.3d 173 (2d Cir. 2014). In that earlier decision, the Second Circuit held that "[t]o be 'material' within the meaning of § 10(b), [an] alleged misstatement must be sufficiently specific for an investor to reasonably rely on that statement as a guarantee of some concrete fact or outcome which, when it proves false or does not occur, forms the basis for a § 10(b) fraud claim."[21] In *City of Pontiac*, plaintiffs alleged that the company represented that it "(1) avoided 'concentrated positions' of assets; (2) implemented asset portfolio limits, and (3) engaged in limited 'proprietary' investing."[22] The court held that representations that the company "prioritized '*adequate* diversification of risk' and 'avoidance of *undue* concentrations,' [were] too open-ended and subjective to constitute a guarantee that [the company] would not accumulate a $100 billion RMBS portfolio, comprising 5% of [its] overall portfolio, or 16% of its trading portfolio."[23]

And *City of Pontiac* itself built upon *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187 (2d Cir. 2009), in which the Second Circuit held that statements about the defendant bank's risk management and integrity were inactionable generalizations, cautioning that "[p]laintiffs conflate the importance of a bank's reputation for integrity with the materiality of a bank's statements regarding its reputation" and declining to broaden the scope of the securities laws to statements that "almost every investment bank makes," stating that "[n]o investor would take such statements seriously in assessing a potential investment."[24]

Following *ECA* and *City of Pontiac*, the Court found that Cigna's statements in its Code of Ethics were "a textbook example of 'puffery.'"[25] According to the

[15] *Id*. at 312.
[16] *Id*. (citing *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110 (2d Cir. 2011); *In re BioScrip, Inc. Sec. Litig.*, 95 F. Supp. 3d 711, 728 (S.D.N.Y. 2015)).
[17] *Id*. at 313 (citing *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245, 251-52 (2d Cir. 2014)).
[18] *Id*. at 315 (quoting *ECA, Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 197 (2d Cir. 2009)) (citing *Jinkosolar*, 761 F.3d at 252).
[19] *Id*. at 314 (citation omitted).
[20] *Singh*, 2019 WL 1029597, at *1. The court did not reach the separate question of whether the complaint adequately alleged scienter. *Id*. at *3.
[21] *City of Pontiac*, 752 F.3d at 185 (citing *ECA*, 553 F.3d at 206; *Lasker v. N.Y. State Elec. & Gas Corp.*, 85 F.3d 55, 59 (2d Cir.1996)).
[22] *Id*. (citation omitted).
[23] *Id*. at 186 (citation omitted).
[24] *ECA*, 553 F.3d at 206.
[25] *Singh*, 2019 WL 1029597, at *4 (citing *City of Pontiac*, 752 F.3d at 183).

court, they amounted to "general declarations about the importance of acting lawfully and with integrity" on which no reasonable stockholder would rely.[26] The court also rejected the argument that the statements regarding Cigna's compliance contained in its Form 10-K were materially misleading, noting that they were "simple and generic assertions about having 'policies and procedures' and allocating 'significant resources'" to assure regulatory compliance.[27] The court highlighted the fact that the statements were "framed by acknowledgments of the complexity and numerosity of applicable regulations" and, read in that context, reflected Cigna's uncertainty about whether it could maintain compliance in the face of the complex web of government regulations.[28]

Perhaps most significantly, the court distinguished its earlier decision in *Meyer v. Jinkosolar Holdings Co.*, 761 F.3d 245 (2d Cir. 2014). There, the court sustained a securities fraud complaint where the defendant company had both "described its compliance mechanisms in confident detail" and pointed out its "clean compliance record."[29] In particular, in *Jinkosolar*, the company had highlighted particular features of its compliance program, such as having environmental teams on duty twenty-four hours a day and maintaining such teams at each of the company's manufacturing facilities.[30] The Second Circuit distinguished the statements made by Cigna from the "actionable assurances of actual compliance" in *Jinkosolar*.[31]

## Significance of *Cigna*

The Second Circuit's decision in *Cigna*, along with its earlier decisions in *City of Pontiac* and *ECA*, provides powerful ammunition to companies sued for securities fraud in the wake of announcements of corporate mismanagement or regulatory violations. The shareholders of such companies frequently suffer through a stock price drop when such bad news is announced, and the companies then become the target of litigation. *Cigna* is a welcome reminder that in the absence of well-pled allegations of actual material misstatements on which stockholders could have relied in the purchase of their securities, the company and its current shareholders should not be punished a second time through the cost and burden of a securities fraud lawsuit.

The decision also gives comfort that a company's disclosure of its Code of Ethics and description of its compliance efforts cannot provide the basis for an investor to later turn around and sue the company when—and if—it turns out that company employees have violated its ethics or compliance policies. A Code of Ethics is not a guarantee that every employee has acted legally, ethically or with integrity.

At the same time, for disclosure lawyers, *Cigna* makes clear that companies should avoid making overly confident and detailed "assurances of actual compliance," or using language that could be read as a guarantee of such compliance.

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[26] *Id*.
[27] *Id*. at *5.
[28] *Id*.
[29] *Singh*, 2019 WL 1029597, at *4 (citing *Jinkosolar*, 761 F.3d at 247-48).
[30] *Id*. (citing *Jinkosolar*, 761 F.3d at 247-48).
[31] *Id*. (citing *Jinkosolar*, 761 F.3d at 251).