

# Second Circuit Further Addresses Defendants' Burden in Rebutting *Basic* Presumption

January 22, 2018

On January 12, 2018, in *Arkansas Teachers Retirement System v. Goldman Sachs Group, Inc.*, the Second Circuit Court of Appeals reaffirmed its recent holding that defendants seeking to defeat class certification by rebutting the *Basic* presumption of reliance must do so by a preponderance of the evidence, but clarified that defendants need not provide “conclusive evidence” that there was no link between the price decline and the alleged misrepresentation.<sup>1</sup> Moreover, the Second Circuit held that district courts deciding whether the presumption of reliance has been rebutted must consider defendants’ evidence that the alleged fraud was revealed before the purported corrective disclosures, and that there was no significant price reaction on those dates. Cleary Gottlieb filed an amicus brief in support of defendants on behalf of the United States Chamber of Commerce.

These holdings present an additional way that defendants may be able to rebut the *Basic* presumption at the class certification stage, and indicate that event studies remain an important tool in establishing that burden.

## Background

Plaintiffs, investors who acquired their shares of Goldman Sachs common stock between February 2007 and June 2010, brought a securities fraud action in the Southern District of New York in July 2011 against the company and several of its directors. Plaintiffs alleged that defendants had violated section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 promulgated under the law.<sup>2</sup>

<sup>1</sup> No. 16-250, 2018 WL 385215 (2d Cir. Jan. 12, 2018).

<sup>2</sup> 15 U.S.C. § 78j(b); 17 C.F.R. 240.10b-5.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

**Jared Gerber**  
+1 212 225 2507  
[jgerber@cgsh.com](mailto:jgerber@cgsh.com)

**Abena Mainoo**  
+1 212 225 2785  
[amainoo@cgsh.com](mailto:amainoo@cgsh.com)

One Liberty Plaza  
New York, NY 10006-1470  
T: +1 212 225 2000  
F: +1 212 225 3999



Plaintiffs' allegations centered on statements in Goldman's 10-K filings and annual report, in which the company stated that it had extensive procedures and controls designed to address potential conflicts of interest.<sup>3</sup> They alleged that these statements were false and misleading, because the company had acted in a way that conflicted with the interests of its clients. Specifically, Plaintiffs alleged that Goldman actually had undisclosed conflicts of interest with its clients in four CDO transactions between 2006 and 2007.<sup>4</sup> According to the Plaintiffs, disclosures of these conflicts, after reports of several government investigations in mid-2010, were responsible for several declines in the value of Goldman stock in the class period.<sup>5</sup> These "corrective disclosures" allegedly revealed to the market that Goldman's statements regarding its "extensive" protections against potential conflicts of interest were materially false.<sup>6</sup>

After the complaint survived Defendants' motion to dismiss,<sup>7</sup> Plaintiffs moved to certify a class of "all persons or entities who, between February 5, 2007 and June 10, 2010, purchased or otherwise acquired the common stock of The Goldman Sachs Group, Inc. . . . and were damaged thereby."<sup>8</sup>

### ***The District Court's Certification Decision***

To satisfy Rule 23(b)(3)'s predominance requirement with respect to class-wide reliance upon Defendants' alleged misrepresentations, Plaintiffs invoked the presumption announced by the Supreme Court in *Basic Inc. v. Levinson*.<sup>9</sup> According to this presumption, plaintiffs in a securities class action can establish class-wide reliance on defendants' alleged misstatements by showing that these misrepresentations were material and widely known, that defendants' shares traded in an efficient market and that plaintiffs purchased the shares at the market

price after the alleged misrepresentations were made but before the truth was revealed.<sup>10</sup> When these requirements are met, the court will presume that the market price of the securities reflected the alleged misrepresentations. However, Defendants may rebut the *Basic* presumption by presenting direct and indirect evidence suggesting that the alleged misstatements did not, in fact, impact the stock's price: "if a defendant could show that the alleged misrepresentation did not, for whatever reason, actually affect the market price . . . then the presumption of reliance would not apply."<sup>11</sup>

Opposing class certification, Defendants attempted to rebut the *Basic* presumption in two ways. First, Defendants presented evidence that there was no price increase on the day of the alleged misstatements regarding Defendants' efforts to avoid conflicts. Second, they presented evidence that Goldman stock did not fall in response to 34 other press reports regarding Goldman's alleged conflicts of interest in the CDO transactions, in order to show that the alleged corrective disclosures had no price impact either.<sup>12</sup>

The district court rejected these arguments and certified the class.<sup>13</sup> Although the court noted that the Defendants could rebut the presumption by demonstrating a lack of price impact by "a preponderance of the evidence," it nevertheless concluded that Defendants had failed in their effort because they "merely marshal[ed] evidence which suggests a price decline for an alternate reason, but [did] not provide *conclusive evidence* that no link exists between the price decline and the misrepresentation."<sup>14</sup> Defendants subsequently sought

<sup>3</sup> *Arkansas*, at \*2.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at \*3.

<sup>7</sup> See *Richman v. Goldman Sachs Grp., Inc.*, 868 F. Supp. 2d 261, 271-72, 279 (S.D.N.Y. 2012).

<sup>8</sup> *Arkansas*, at \*3.

<sup>9</sup> 485 U.S. 224, 241 (1988).

<sup>10</sup> See *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2413 (2014).

<sup>11</sup> *Id.* at 2408.

<sup>12</sup> *Arkansas*, at \*4.

<sup>13</sup> See *In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10 Civ. 3461, 2015 WL 5613150 at \*3 (S.D.N.Y. Sept. 24, 2015).

<sup>14</sup> *Id.* at \*4 n.3, \*7.

to appeal this ruling under Fed. R. Civ. P. 23(f), and the Second Circuit granted the petition.<sup>15</sup>

### ***The Second Circuit's Intervening Decision in Waggoner***

In November 2017, while the Goldman appeal was pending, the Second Circuit decided *Waggoner v. Barclays PLC*, holding that defendants may rebut the *Basic* presumption by showing, by a preponderance of the evidence, that the alleged misrepresentations did not affect the market price of the defendants' stock.<sup>16</sup> In doing so, the court created a circuit split with the Eighth Circuit, which had held that defendants could defeat the *Basic* presumption by "com[ing] forward with evidence showing a lack of price impact."<sup>17</sup> Applying this burden to the facts of the case, *Waggoner* held that the district court did not abuse its discretion in finding that evidence suggesting that *some* of the price impact "was independent of the specific allegations" of fraud was insufficient to rebut the *Basic* presumption: "merely suggesting that another factor also contributed to an impact on a security's price does not establish that the fraudulent conduct complained of did not also impact the price of the security."<sup>18</sup>

### **The Second Circuit Decision**

The Second Circuit issued its decision in *Arkansas Teachers* on January 12, 2018. Applying *Waggoner*,<sup>19</sup> the Second Circuit reaffirmed that the Defendants can rebut the *Basic* presumption by showing "by a preponderance of the evidence" that the alleged misstatements did not result in a material change in the stock price. Because it was unclear whether the district court, which faulted Defendants for not "conclusively" proving "a complete absence of price impact," had correctly applied this evidentiary

standard in its decision, the Second Circuit vacated the class certification decision and remanded the case to the district court.<sup>20</sup>

The Second Circuit panel also commented on the district court's refusal to consider the Defendants' rebuttal evidence that there was no price decline in response to earlier reports of Goldman's alleged conflicts. The district court described this evidence as an "inappropriate truth on the market defense" or as evidence of the statements' immateriality, which it did not consider to be relevant at the class certification stage.<sup>21</sup>

The Second Circuit held that this was error. The court clarified that "defendants did not present a 'truth on the market' defense" because they did not argue that the alleged conflicts "were already known to the market at the time plaintiffs purchased their shares."<sup>22</sup> Instead, Defendants pointed to "evidence that the market learned the truth about Goldman's conflicts of interests . . . without any accompanying decline in the price of Goldman stock" to show that the alleged misstatements "did not actually affect the stock's market price."<sup>23</sup> The court also observed that price impact differs from materiality and is appropriately considered at the class certification stage.<sup>24</sup> Although the Second Circuit "espouse[d] no views as to whether the evidence [presented by defendants was] sufficient to rebut the *Basic* presumption," it held "that the District Court should consider it on remand, in determining whether defendants established by a preponderance of the evidence that the misrepresentations did not in fact affect the market price."<sup>25</sup> The Second Circuit further "encourage[d] the court to hold any evidentiary hearing or oral argument it deems appropriate" to make that decision.<sup>26</sup>

<sup>15</sup> *Arkansas*, at \*4.

<sup>16</sup> 875 F.3d 79, 101 (2d Cir. 2017).

<sup>17</sup> *IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775, 782 (8th Cir. 2016). The *Barclays* decision insisted that this apparent split was illusory, because on the basis that the extent of the burden was not squarely at issue in *Best Buy. Barclays*, 875 F.3d at 103 n. 36.

<sup>18</sup> *Id.* at 104-05.

<sup>19</sup> 875 F.3d at 101.

<sup>20</sup> *Arkansas*, at \*7.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at \*8

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

***Key Takeaways***

The *Arkansas Teachers* decision is notable for several reasons.

First, it clarifies the burden that defendants need to carry in the Second Circuit to rebut the *Basic* presumption. The decision makes clear that defendants do *not* need to “conclusively” prove a “complete absence of price impact” to rebut the presumption.

Second, in rejecting the district court’s holding that certain rebuttal evidence could be excluded as an improper “truth on the market” or materiality defense, the decision indicates that defendants may be able to rebut the presumption by identifying earlier disclosures of the alleged fraud that did not have any impact on the securities’ price.

Finally, in holding that the district court must consider defendants’ event study showing a lack of price impact upon earlier disclosures of the alleged fraud, the *Arkansas Teachers* decision suggests that event studies remain useful tools in rebutting the *Basic* presumption, notwithstanding earlier dicta by the Second Circuit raising questions about such studies.

...

CLEARY GOTTlieb