ALERT MEMORANDUM

Second Circuit Addresses Price-Maintenance Theory of Securities Fraud and Defendants' Burden to Rebut Basic Presumption at Class Certification Stage

April 15, 2020

On April 7, 2020, in *Arkansas Teacher Retirement System v. Goldman Sachs Group, Inc.* ("*ATRS II*"), a divided panel of the Second Circuit Court of Appeals declined to limit its cases discussing the price-maintenance theory of securities fraud to their facts and built on prior cases addressing defendants' burden in rebutting the *Basic* presumption of reliance at the class certification stage.[1] The Second Circuit also reiterated that district courts should not consider the materiality of alleged misrepresentations at the class certification stage, even when weighing defendants' attempts to disprove price impact to rebut the *Basic* presumption.[2]

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Judge Sullivan's dissent, however, may still provide a roadmap for defendants to attempt to rebut the Basic presumption at the class certification stage based on different facts in the circumstances of another case, given that the majority did not substantively disagree with many of the points raised in Judge Sullivan's dissent and instead only took the view that the district court had not clearly abused its discretion (even if they would have taken a contrary view in the first instance). Judge Sullivan's dissent adopted arguments regarding the evidence required to rebut the *Basic* presumption that were included in an amicus brief Cleary Gottlieb filed on behalf of the United States Chamber of Commerce.

[1] No. 18-3667 (2d Cir. Apr. 7, 2020).
[2] *See id.*, slip op. at 28-30; *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258, 281-82 (2014) ("*Halliburton II*").

Background

Plaintiffs' allegations. Plaintiffs are investors who acquired shared of Goldman Sachs common stock between February 5, 2007 and June 10, 2010.[3] In July 2011, Plaintiffs brought a securities fraud action against Goldman and several of its directors alleging that the company's statements about its procedures and controls designed to address potential conflicts of interest were false and misleading because Goldman purportedly had undisclosed conflicts of interest with its clients in four CDO transactions between 2006 and 2007.[4] Plaintiffs further contended that the allegedly false and misleading statements maintained artificial inflation in Goldman's stock price, which dropped when the conflicts were allegedly revealed to the market in mid-2010 through reports of enforcement actions by federal regulators against the company.[5]

ATRS I. Plaintiffs' initial complaint survived a motion to dismiss, in which the district court held that the challenged statements about integrity were not immaterial as a matter of law, notwithstanding their general and aspirational nature.[6] The district court subsequently certified a class for the first time in September 2015.[7] The Second Circuit then granted Defendants leave to appeal under Federal Rule of Civil Procedure 23(f).[8] The case's first trip to the Second Circuit focused on the standard that applied to Defendants' attempt to rebut the *Basic* presumption in seeking to defeat class certification.[9] In January 2018, the Second Circuit in *ATRS I* vacated the district court's certification order and remanded the case to the district court, holding that the district court failed to apply the "preponderance of the evidence" standard at the rebuttal stage as required by the court's intervening decision in *Waggoner v. Barclays PLC*.[10] The *ATRS I* court also held that the district court erroneously failed to consider evidence "that the market learned the truth about Goldman's conflicts of interest[] . . . without any accompanying decline in the price of Goldman stock," which Goldman argued showed that "statements about [its] efforts to avoid conflicts of interest 'did not actually affect the stock's market price.'"[11]

Proceedings on remand. On remand, the district court again concluded that Defendants had not rebutted the *Basic* presumption and again certified a class.[12] The district court found Plaintiffs' theory that Defendants' alleged misstatements "served to maintain an already inflated stock price" had sufficient support from Plaintiffs' expert, who "establishe[d] a link between the news of Goldman's conflicts" in the alleged corrective disclosures and "subsequent stock price declines."[13] The district court was not persuaded by Goldman's rebuttal experts.[14] The first expert showed that Goldman's stock price did not move on any of 36 previous dates on which he claimed the falsity of the

[3] *See Ark. Teachers Retirement Sys. v. Goldman Sachs Grp., Inc.*, 879 F.3d 474, 478 (2d Cir. 2018) ("*ATRS I*"). For additional background, see our Alert Memorandum on the Second Circuit's decision in *ATRS I*, available at: https://www.clearygottlieb.com/-/media/files/alert-memos-2018/second-circuit-further-addresses-defendants-burden-in-rebutting-basic-presumption.pdf.

[4] *ATRS I*, 879 F.3d at 478.

[5] *Id.* at 479-80.

[6] *See Richman v. Goldman Sachs Grp., Inc.*, 868 F. Supp. 2d 261, 271-72, 279 (S.D.N.Y. 2012).

[7] *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).

[8] *ATRS I*, 879 F.3d at 482.

[9] *See id.* at 482-85. The presumption announced by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 241 (1988), allows plaintiffs in a securities class action to establish class-wide reliance on defendants' alleged misrepresentations by showing "(1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed." *Halliburton II*, 573 U.S. at 268. Defendants, in turn, may rebut the *Basic* presumption with "any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff," including by showing that "the alleged misrepresentation did not, for whatever reason, actually affect the market price." *Id.*

[10] *See id.* at 485 (citing *Waggoner v. Barclays PLC*, 875 F.3d 79, 101 (2d Cir. 2017)).

[11] *Id.* at 486 (quoting *Halliburton II*, 573 U.S. at 282).

[12] *In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10 Civ. 3461, 2018 WL 3854757, at *1-2 (S.D.N.Y. Aug. 14, 2018).

[13] *Id.* at *2, 4.

[14] *Id.* at *4-6.

alleged misstatements was revealed in news articles prior to the first alleged corrective disclosure in an SEC complaint against the company.[15] The district court, however, held that this evidence was "not sufficient to sever the link between the first corrective disclosure and the subsequent stock price drop"[16] because the SEC complaint "included new material information" that was "not described in any of the 36 more generic [news] reports on conflicts."[17] The second expert conducted an event study and opined that, because "the conflicts were reported on 36 separate occasions with no price movement, the . . . price drops [following the alleged corrective disclosures] must have been due exclusively to the news of enforcement activities," rather than "the revelation of Goldman's client conflicts."[18] The district court rejected the second expert's conclusion for several reasons, however, including because he analyzed only one of three alleged corrective disclosures and did so using "arbitrary characteristics" that were "not generally accepted in the field."[19] In light of the "deficiencies inherent in the opinions" of Defendants' experts, the district court held that Defendants "failed to rebut the *Basic* presumption by a preponderance of the evidence."[20] The Second Circuit again granted Defendants leave to appeal under Federal Rule of Civil Procedure 23(f).[21]

The Second Circuit's *ATRS II* Decision

The Second Circuit issued its second decision in the case, *ATRS II*, on April 7, 2020. The majority (1) declined to limit its prior case law concerning the price-maintenance theory of securities fraud; (2) reiterated that considering the materiality of alleged price-maintaining misrepresentations at the class certification stage is improper, even when considering defendants' attempts to disprove price impact to rebut the *Basic* presumption; and (3) held that the district court had not abused its discretion in concluding that Defendants failed to rebut the *Basic* presumption. Judge Sullivan dissented on the latter two points.

Majority Opinion

Price-maintenance theory. Building on its decision in *In re Vivendi, S.A. Securities Litigation*,[22] the court first held that the district court correctly applied the "price-maintenance theory" (or "inflation-maintenance theory") of securities fraud.[23] The court explained that "two types of false statements can have price impact," one of which is price-maintaining statements.[24] Statements actionable under the price-maintenance theory "have price impact not because they introduce inflation into a share price, but because they 'maintain' it."[25] Under this theory, misstatements can be actionable if a plaintiff shows price inflation, that the misstatements "maintained" that inflation, and that "a disclosure caused a reduction in a defendant's share price."[26] From that price reduction, the court "can infer that the price was inflated by the amount of the reduction."[27]

The Second Circuit rejected Goldman's effort to narrow the price-maintenance theory by arguing that the price inflation prior to the allegedly price-maintaining misstatements must have been "fraud-induced."[28] The court held instead that the company need not have "led the market" to the inflated price; the price-maintenance claim could also be viable where the market "originally arrived at [the] misconception" on its own.[29]

Materiality. The Second Circuit then rejected Goldman's argument that "general statements" cannot maintain price inflation as a matter of law for purposes

[15] *Id.* at *3.
[16] *Id.* at *4.
[17] *Id.* at *4-5.
[18] *Id.* at *3.
[19] *Id.* at *5.
[20] *Id.* at *6.
[21] *ATRS II*, No. 18-3667, slip op. at 19.
[22] 838 F.3d 223, 257-59 (2d Cir. 2016).
[23] *ATRS II*, No. 18-3667, slip op. at 19-22.
[24] *Id.*, slip op. at 20-21. The other is "inflation-introducing statements," which cause the market to newly inflate a share price. *Id.*
[25] *Id.*, slip. op at 20-21.
[26] *See id.*, slip op. at 21 & 24.
[27] *Id.*, slip op. 24.
[28] *Id.*, slip op. at 22-25.
[29] *Id.*, slip op. at 23.

of class certification.[30] Goldman argued that the price-maintenance theory had previously only been applied to statements conveying "specific, material financial or operational information" to "stop a stock price from declining" or to "statements falsely conveying that the company has met market expectations about a specific, material financial metric, product, or event."[31] By contrast, Goldman argued, the misstatements at issue were "general" and fell into neither narrow category.[32]

The court, however, characterized Goldman's proposed test as a "means for smuggling materiality into Rule 23"—which would be improper under the Supreme Court's decision in *Amgen*—not as an attempt to disprove price impact.[33] Furthermore, the court noted that it affirmed class certification based on similar statements in *Waggoner*, and held that its precedent forbids imposing separate legal requirements for price-maintenance claims since those claims are not in a "separate legal categor[y]" from claims based on misstatements that introduce price inflation.[34] Though Goldman could not argue materiality at the class certification stage, the court emphasized that Goldman had the opportunity at the motion to dismiss stage and would again have the opportunity at the summary judgment stage prior to trial.[35]

Failure to rebut* Basic *presumption. Reviewing for abuse of discretion, the Second Circuit also affirmed the district court's finding that Goldman failed to rebut the *Basic* presumption by a preponderance of the evidence.[36] The circuit court agreed with the district court that the absence of price movement on earlier press reports prior to the alleged corrective disclosures did not sever the link between the corrective disclosures and subsequent price drops.[37] That was because the district court concluded that they were not the same. In particular, the circuit court noted that, unlike the earlier news reports, some of which were disputed by Goldman, the later corrective disclosures included "new and material information" and "hard evidence" and were "disclosed by a federal government agency."[38] The fact that the market did not respond to the earlier news was, according to the circuit court, irrelevant. The court also court rejected Goldman's argument that the price drops upon disclosure of the federal enforcement actions were attributable to the enforcement actions themselves, not Goldman's alleged issues with managing its conflicts of interest.[39] While the court found that the possibility of fines resulting from those enforcement actions might have caused the price declines "in part," that partial impact was not enough to rebut the *Basic* presumption, which would require showing that the "*entire* price decline on the corrective-disclosure dates was due to something other than the corrective disclosures."[40] The court did not foreclose the possibility, however, that some portion of the losses associated with the announcements of the enforcement actions would be unrecoverable as damages.

Dissent

Judge Sullivan dissented and stated he would decertify the class based on the district court's misapplication of the *Basic* presumption.[41] He did not disagree with the majority's conclusion that the price-maintenance theory is "clearly the law of [the Second Circuit]," but he did so noting only that the "merits or flaws of [the] theory" are "not for [the] panel to revisit."[42] Judge Sullivan was critical of what he viewed as the district court's "failure to engage" with the theories and arguments advanced by Goldman's experts.[43] Unlike the majority, Judge Sullivan accepted Goldman's argument that earlier news reports "revealed the falsity

[30] *Id.*, slip op. at 35.
[31] *Id.*, slip op. at 25-26 (alterations omitted).
[32] *Id.*
[33] *Id.*, slip op. at 28-30 & n.11 (citing *Amgen Inc. v. Conn. Ret. Plans & Tr. Funds*, 568 U.S. 455, 474 (2013); *Halliburton II*, 573 U.S. at 282).
[34] *Id.*, slip op. at 31-32 (citing *Vivendi*, 838 F.3d at 259).
[35] *Id.*, slip op. at 34-35.
[36] *Id.*, slip op. at 35-46.
[37] *Id.*, slip op. at 38-40.
[38] *Id.*, slip op. at 38-39.
[39] *Id.*, slip op. at 38-40.
[40] *Id.* (emphasis added).
[41] *ATRS II*, No. 18-3667 (Sullivan, J., dissenting).
[42] *Id.*, slip op. at 1-2.
[43] *Id.*, slip op. at 4-8.

of the misstatements in the complaint" without price movement and therefore proved that the later drop upon the alleged corrective disclosures was "caused by something other than disclosure of the alleged conflicts of interest."[44] Similarly, Judge Sullivan accepted the argument that the price drops upon the corrective disclosure were caused by announcement of the enforcement actions, not by the underlying factual allegations regarding Goldman's conflicts of interest.[45]

Judge Sullivan also said he would allow courts to "consider the nature of the alleged misstatements in assessing" their price impact at the class certification stage.[46] In his view, when considering a defendant's evidence to rebut the *Basic* presumption, "a reviewing court is free to consider the alleged misrepresentations in order to assess their impact on price," notwithstanding that such an analysis might involve similarities to a materiality inquiry.[47]

Key Takeaways

ATRS II builds on prior caselaw and provides further guidance on the scope and applicability of a price-maintenance theory in asserting a securities fraud claim and of defendants' ability to rebut the *Basic* presumption at the class certification stage.

First, the majority opinion further illustrates the challenges for defendants in defeating class certification in securities actions invoking the fraud-on-the-market presumption. In particular, the court declined to adopt a limited application of the price-maintenance theory; under its ruling, a plaintiff may seek to apply the fraud-on-the-market presumption based simply on a subsequent share price decline without any showing that the alleged fraud previously inflated the share price. Accordingly, the court's decision will limit defendants' ability to rebut the fraud-on-the-market presumption by showing that the alleged misstatements did not inflate the share price during the class period. Similarly, the majority's refusal to consider certain arguments they interpreted as "really a means for smuggling materiality into Rule 23" further constrains defendants' ability to challenge the nature of the challenged statements at that stage. Of course, defendants can continue to raise materiality arguments at both the motion to dismiss and summary judgment stages.

Second, the decision also underscores the deference given to district courts in weighing price impact evidence submitted by the parties. The Second Circuit's decision was not a legal rejection of the arguments defendant presented through its experts. Thus Judge Sullivan's dissent highlights that those arguments remain available to defendants in these matters, arguments the majority stated it might even have accepted if not for the deferential abuse-of-discretion standard. In another matter, on a different evidentiary record, before a different district court judge, defendants may prevail on those same arguments.

Third, while the majority opinion affirmed the district court's finding that potential price impact from the announcement of enforcement actions, rather than the disclosure of underlying facts, was insufficient to rebut the *Basic* presumption, it did not foreclose the possibility that some portion of the losses associated with the announcements may not be recoverable as damages. Defendants thus remain free to argue that share price declines attributable to the fear of future fines following the revelation of a regulatory investigation are not compensable damages because they do not reflect prior share price inflation.

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[44] *Id.*, slip op. at 4-5.
[45] *Id.*, slip op. at 5-6.
[46] *Id.*, slip op. at 8-9.
[47] *Id.*, slip op. at 9.