Updates

On March 29, the U.S. Supreme Court will hear oral argument in *Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System*, No. 20-222, a case that revisits the critical issue of how a securities class action defendant can prevent the certification of a class by rebutting the *Basic* presumption of reliance.[1] While a fraud claim typically is not suitable for class treatment because each plaintiff must prove their reliance on the defendant's misstatement, the "fraud-on-the-market" theory allows reliance to be presumed when a stock trades on an efficient market—publicly available information is incorporated into the stock price, and everyone who buys or sells relies on the market price. In its 2014 *Halliburton II* decision,[2] the Court held that a defendant must have an opportunity to rebut the *Basic* presumption at the class certification stage (and thus prevent certification) by showing that the statements at issue did not affect the stock price. But it did not provide much guidance as to how defendants can make such a showing. And, in the more than 2,000 securities class actions

filed since *Halliburton II*, defendants have successfully refuted price impact in only five cases. Plainly, lower courts have been reluctant to deny class certification on this basis, tilting the balance in favor of plaintiffs.

Goldman Sachs Group, Inc. (Goldman) appeals the certification of a class on claims arising from statements it contends are far too generic to possibly have had an impact on its stock price. In its briefing, Goldman makes two important practical points about the impact on public companies of the existing uneven playing field.

First, as noted above, courts perceive the bar for rebutting the *Basic* presumption to be incredibly high—empirically, it is nearly impossible for a defendant to defeat class certification on this basis. Second, the "inflation maintenance" theory adopted by the plaintiffs in this case (and increasingly used by securities class action plaintiffs generally) makes it even harder for defendants to defeat class certification. The theory, which has never been endorsed by the Supreme Court, posits that an alleged misstatement can have actionable "price impact" by maintaining a previously inflated stock price (rather than increasing the stock price). It does not require the plaintiff to identify the statements (if any) that created the inflation in the first place. And, importantly, it allows a plaintiff to show price impact just from the fact of a stock price drop following an alleged "corrective disclosure"—without requiring proof that the challenged statement ever caused the stock price to avoid an earlier drop. Goldman explains in some detail how the inflation maintenance theory makes it extremely difficult for defendants to rebut the Basic presumption, particularly where the alleged misrepresentations are "general and aspirational."

In short, Goldman persuasively argues that the presumption of class-wide reliance, as applied by the lower courts since 2014 and as litigated under the inflation maintenance theory, has become effectively irrebuttable. It argues that clear guidance from the Court is necessary to restore balance and prevent meritless securities fraud suits from being certified as class actions. The Court may not fully adopt Goldman's position, but it seems likely that the Court will utilize this case to level the playing field, at least to some degree, in the ongoing class certification wars.

Legal Backdrop

The *Goldman Sachs* case follows a trio of cases in which the Supreme Court tilted the playing field toward securities class action plaintiffs by making it more difficult for defendants to defeat class certification. In *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804 (2011) (*Halliburton I*), the Court held that plaintiffs could obtain class certification without proof of loss causation. Next, in 2013, the Court extended this logic to the issue of materiality, holding that it, too, need not be proven at class certification because the materiality of a statement is susceptible to class-wide proof at trial. *Amgen Inc. v. Conn. Ret. Plans & Tr. Funds*, 568 U.S. 455 (2013). The following year, in *Halliburton II*, the Court reaffirmed the *Basic* presumption but held that it may be rebutted at the class certification stage through the defendant's direct evidence that the alleged misrepresentation or omission did not actually affect the stock's market price. 573 U.S. at 281–82. The Court reasoned that, unlike loss causation and materiality, the fraud-on-the-market theory was necessary to class certification because, without it, reliance could not be proved on a class-wide basis. While the Court has yet to opine on the appropriate standard for rebutting the *Basic* presumption by showing a lack of price impact, as Goldman emphasizes, lower courts have set a very high bar for defendants to escape class certification and the accompanying increase in settlement pressure.

Factual and Procedural Background

In 2010, the share price of petitioner Goldman Sachs Group, Inc. declined after disclosure of significant government enforcement activity—a filed SEC action and a DOJ investigation—focusing on whether Goldman should have disclosed certain conflicts of interests related to several collateralized debt obligation (CDO) transactions. Shareholders sued, claiming that these alleged "corrective" disclosures revealed the falsity of representations that Goldman had made in earlier SEC filings regarding its potential conflicts of interest, such as "we have extensive procedures and controls that are designed to identify and address conflicts of interest" and "integrity and honesty are at the heart of our business." Plaintiffs did not claim that these allegedly false statements artificially increased Goldman's stock price. Rather, they pursued an "inflation maintenance" theory, which, as discussed, posits that false statements can have actionable price impact by maintaining a previously inflated stock price and preventing it from decreasing.

At class certification, Goldman produced expert testimony that the alleged misrepresentations were too generic to have affected the company's stock price and could not have done so because, on 36 occasions prior to the alleged "corrective" disclosures, allegations about Goldman's conflicts of interests were disclosed in press reports without any material effect on the stock price; thus, the decline following the disclosure of the SEC and DOJ enforcement activity must have been caused by the fact of the enforcement activity itself rather than a revelation that the alleged misrepresentations were false. Goldman's other experts supported this theory by testifying that the decline in Goldman's stock price was consistent with declines in the stock prices of other companies facing SEC enforcement actions and that the analysts who covered Goldman did not mention any of the challenged statements because they were too generic to be relevant to investment decisions.

Initially, the district court refused to consider Goldman's expert evidence because it believed that the evidence went to the materiality of the statements and under *Amgen* could not be considered at class certification. 2015 WL 5613150 (S.D.N.Y. Sept. 24, 2015). On interlocutory appeal, the Second Circuit reversed and directed the district court to consider Goldman's expert evidence on remand. 879 F.3d 474 (2d Cir. 2018). The district court held an evidentiary hearing and again certified the class. 2018 WL 3854757 (S.D.N.Y. Aug. 14, 2018). A divided (and different) panel of the Second Circuit affirmed the district court's certification decision, finding that the trial court did not abuse its discretion, either in weighing the expert testimony or in declining to consider Goldman's argument that the challenged statements were too generic as a matter of law to have had a price impact. 955 F.3d 254 (2d Cir. 2020).

The Supreme Court granted certiorari on two legal questions: (1) whether a defendant may show a lack of price impact by submitting evidence regarding the generic nature of the alleged misstatements, even though such evidence is also relevant to the substantive element of materiality (which plaintiffs need not prove at class certification); and (2) whether a defendant seeking to rebut the presumption bears only a burden of production (as opposed to also bearing the burden of persuasion).

Key Arguments

There ought to be little suspense going into the oral argument regarding the Supreme Court's broad answer to the first question presented: Goldman, the United States—appearing as amicus curiae in support of neither

party—and plaintiffs are all in agreement that courts can consider the generic nature of an alleged misstatement in assessing price impact, notwithstanding the overlap with the materiality inquiry. Thus the Court will undoubtedly answer the first question in the affirmative; what remains to be seen, independent of the burden of persuasion issue, is (1) what guidance the Court may offer regarding how courts should consider the generic or specific nature of alleged misstatements in assessing the evidence regarding price impact, especially in the context of the inflation maintenance theory, and (2) whether the Court will, as Goldman requests, reverse the Second Circuit judgment and order decertification of the class or merely vacate and remand for further proceedings.

Goldman and amici supporting them are hopeful that the Court will recognize the power that inflation maintenance affords the plaintiffs' bar to extract *in terrorem* settlements based upon any significant stock drop. If even the most anodyne of corporate statements can be rendered materially false or misleading by the subsequent disclosure of negative financial or enforcement developments, it creates essentially a strict liability regime in which a company insures its investors against any and all downside risk. As Goldman cogently argues in its reply brief,

[W]hen the inflation-maintenance theory is invoked, a court should carefully scrutinize the nature of the alleged misstatement, and compare it to the nature of the alleged "corrective disclosure" to determine whether the back-end price drop in fact supports an inference of front-end price inflation. . . . [T]he more general the supposedly inflation-maintaining statement, the less likely an alleged "corrective disclosure" actually corrected the statement, and thus the less likely the price drop was attributable to the alleged correction.

Allowing judges to consider the generic nature of a statement in determining whether it, in fact, artificially maintained a company's stock price will help restore some balance by requiring plaintiffs to demonstrate a closer nexus between the alleged material misrepresentation and the disclosure that actually caused the stock drop—for example, to ground an accounting fraud case on a company's misstated financials rather than on boilerplate in the annual report about the company's commitment to maintaining robust financial controls.

Plaintiffs, attempting to cabin the scope of the Court's expected ruling, argue that the Court should at most vacate the Second Circuit judgment and direct the district court on remand to consider only expert evidence regarding price impact and the generic nature of the challenged statements. Plaintiffs repeatedly argue that courts should not rely on their "intuition" or "common sense" as part of the factual price impact inquiry. Goldman responds that it is unwise if not impossible to require a judge to set aside his or her own common sense in weighing all of the evidence. Indeed, plaintiffs did not object when the district court, in certifying the class, relied on common sense in stating that it "is only natural that economically significant negative news . . . would at least contribute to the stock price declines." 2018 WL 3854757, at *4. The Court is unlikely to adopt the plaintiffs' proposed rule here.

Goldman urges the Court not to remand for a third round of class certification litigation and to instead decide itself (on what is undeniably a voluminous record) that the class should be decertified based on a lack of price impact, thereby providing clear guidance on the application of *Halliburton II* in the context of an inflation maintenance case. Oral argument may provide some clues as to whether there is a majority inclined to give Goldman a complete win. The likelier outcome is that the Court will provide guidance to the lower courts regarding the price impact inquiry (including consideration of the general or specific nature of statements)—and may also provide guidance on (or even a narrowing of) the inflation maintenance theory—but will ultimately remand for further proceedings.

On the second question presented, regarding the level of a defendant's burden to rebut the *Basic* presumption, the arguments are more technical, and it seems harder to predict where the Court will land. Goldman argues that the text of Federal Rule of Evidence 301 dictates that defendants have only a burden of producing evidence to rebut

a presumption (including the *Basic* presumption) and that the ultimate burden of persuasion remains on plaintiffs. Plaintiffs contend that the *Basic* presumption is not a presumption subject to Rule 301 and that, even if it were, courts are empowered to allocate burdens in deciding substantive law and that the Supreme Court did so in connection with the *Basic* presumption. They also argue that in *Halliburton II*, the Court held that it was the defendant's burden to rebut the presumption by showing a lack of price impact. Goldman responds that, by enacting Rule 301, Congress intended to limit the authority of courts to shift the ultimate burden of persuasion and questions plaintiffs' reading of *Halliburton II*. If it were to rule in Goldman's favor on this issue, the Court would likely provide some guidance regarding the nature and quanta of evidence defendants must produce to carry their burden of production to rebut the *Basic* presumption.

Conclusion

The *Goldman Sachs* case presents the Supreme Court with an opportunity to provide needed clarification and guidance to lower courts that have been extraordinarily reluctant since *Halliburton II* to find that defendants have proffered sufficient evidence to rebut the *Basic* presumption. Whether or not it embraces all of Goldman's arguments, we expect that this Court—which has not had the opportunity to decide a securities case since its composition changed last year—will provide important guidance that should strengthen the position of defendants in securities class actions.

Endnotes

[1] *Basic Inc. v. Levinson*, 485 U.S. 224 (1988)
[2] *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014) (*Halliburton II*)

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