LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
THURSDAY, JANUARY 7, 2021

PERSPECTIVE

High court to again address class cert in securities fraud cases

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New York Times News Service
The Goldman Sachs headquarters in Manhattan, July 17, 2018.

Reliance on an alleged misrepresentation when entering into a securities transaction is an essential element of a federal securities fraud claim. As a result, securities fraud lawsuits cannot be certified as class actions unless the plaintiffs can show that the reliance element can be proven on a class-wide basis. To do so, plaintiffs generally seek to invoke the "fraud-on-the-market" presumption of class-wide reliance recognized in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Under the *Basic* presumption, a plaintiff is presumed to rely on a statement if it is incorporated in the market price when the plaintiff buys the stock. In essence, *Basic* held that a misrepresentation that distorts a stock's market price operates as a "fraud on the market."

Whether reliance can be proven on a class-wide basis — i.e. whether the *Basic* presumption applies — is often the key contested issue in class certification proceedings in securities fraud cases. In a series of decisions over the past decade, the U.S. Supreme Court has addressed the requirements for plaintiffs to trigger the presumption and for defendants to rebut it at the class certification stage. *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. 804 (2011) (*Halliburton I*); *Amgen Inc. v. Conn. Ret. Plans and Tr. Funds*, 568 U.S. 455 (2013); and *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014) (*Halliburton II*). Most recently, in *Halliburton II*, the court confirmed that a plaintiff can trigger the presumption by showing that the defendant's stock price traded in an efficient market during the class period, but also held that the defendant must be afforded an opportunity at the class certification stage to rebut the presumption by showing that the specific alleged misstatement did not actually affect the stock's market price — i.e., the alleged misstatement did not have "price impact." The court will address the application of the *Basic* presumption during class certification once again this term in *Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System*, 20-222.

In Goldman, the court will consider whether defendants seeking to rebut the *Basic* presumption bear only a burden of production to raise evidence of a lack of price impact or bear the ultimate burden of persuasion to establish the absence of price impact by a preponderance of the evidence. Given the challenges in proving the reasons for the movement of stock prices in an open market — particularly where there is no meaningful stock price movement at the time an alleged misrepresentation is made — the allocation of burdens can be highly significant (even dispositive) in class certification proceedings in securities fraud actions. Thus, while the allocation of evidentiary burdens in class certifications proceedings may seem like an arcane issue, given the significance of class certification in securities cases, *Goldman Sachs* may wind up being one of the court's most significant securities decisions in recent years.

The *Basic* Presumption: Predominance, Reliance and Price Impact

Plaintiffs seeking to certify class actions for money damages must prove that "questions of law or fact common to class members predominate over any questions affecting only individual members." Fed. R. Civ. P. 23(b)(3). Because reliance on a misrepresentation is an essential element of a securities fraud claim, individual questions of reliance will predominate in a securities fraud class action — precluding class certification — unless the plaintiff can establish reliance on a class-wide basis. To do so, securities fraud class action plaintiffs typically seek to invoke the *Basic* presumption.

In *Basic*, the Supreme Court held that plaintiffs are entitled to a presumption of reliance upon a showing, among other things, that "the stock traded in an efficient market." *Halliburton II*, 573 U.S. at 277-78. But "*Basic* emphasized that the presumption of reliance was rebuttable rather than conclusive." *Halliburton II*, 573 U.S. at 268. Thus, even if the plaintiff establishes that a stock traded in an efficient market, "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." Id.

The *Basic* presumption addresses the "merits" issue of reliance. Because the presumption permits plaintiffs to meet Rule 23's requirements for class certification, however, whether the presumption applies must be considered at the class certification stage, when courts generally are not supposed to decide the underlying merits of the case. Further complicating matters, the key underlying factual question — whether an alleged misstatement affected the stock's market price — is also relevant to other "merits" issues, particularly whether the alleged misstatement was material and whether correction of the alleged misstatement caused the plaintiffs' investment loss.

In the past decade, the Supreme Court addressed the application of the *Basic* presumption during class certification proceedings in *Halliburton I* (holding that plaintiffs need not establish loss causation to invoke the presumption at the class certification stage), in *Amgen* (holding that plaintiffs need not establish materiality to invoke the presumption at the class certification stage), and in *Halliburton II* (holding that "defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that ... the alleged misrepresentation had no price impact"). Since *Halliburton II*, there has been substantial debate about the proper evidentiary burden that should be applied at the class certification stage to defendants seeking to rebut the *Basic* presumption by showing the absence of price impact.

"Price Maintenance" as Price Impact

Price impact is shown when a misrepresentation "causes a stock's

price to rise" and the price then falls "when the truth comes to light." *Schleicher v. Wendt*, 618 F.3d 679, 683 (7th Cir. 2010). In theory, a misrepresentation might also have price impact even without causing a price increase if the misrepresentation "stops a price from declining." Id. at 683. While the "price maintenance" theory may be logically sound in some specific circumstances, in other cases, it can be raised based on little more than speculation about what would have happened in a hypothetical, counterfactual world where the alleged misrepresentation was never made. In cases where there was no observable price increase at the time alleged misstatements were made, plaintiffs have increasingly been invoking price maintenance as a substitute for concrete evidence of price impact, irrespective of whether price maintenance actually fits the facts of the case. In such cases, the allocation of the evidentiary burdens is key. If defendants bear only a burden of production, then the *Basic* presumption should be rebutted by showing that the stock price did not increase when the misstatement was made, shifting to the plaintiffs the burden to prove their "price maintenance" theory. *See IBEW Local 98 Pension Fund v. Best Buy Co.*, Civil No. 11-429 (DWF/FLN), 2014 WL 4746195 (8th Cir. Aug. 6, 2014). If, however, defendants bear the ultimate burden of persuasion to affirmatively disprove "price maintenance," plaintiffs may be permitted to invoke the *Basic* presumption based on little more than speculation.

Goldman Sachs Group, Inc. v. Arkansas Teachers Retirement System

The *Goldman* case arises from a subprime-financial-crisis-era SEC enforcement action against Goldman related to alleged conflicts of interest in a complex structured finance transaction. When the SEC announced the enforcement action, Goldman's stock price fell more than 10%. Shareholder class actions followed. The shareholder plaintiffs in Goldman allege that Goldman committed securities fraud by making various vague and generic statements about the firm's management of potential client conflicts, including that Goldman had "procedures and controls" designed "to identify and address conflicts of interest" and that "clients' interests always come first." According to the plaintiffs, the SEC enforcement action revealed the "truth" that had previously been "concealed" by Goldman's statements.

While the parties agreed the alleged misstatements did not increase Goldman's stock price when they were made, the plaintiffs argued that the price drop after the SEC announcement showed price maintenance. In seeking to rebut the presumption, Goldman presented evidence that news articles — including articles appearing on the front pages of the Wall Street Journal and the New York Times — had already publicly reported the information about alleged conflicts that the SEC enforcement action supposedly revealed and that the stock price had not reacted to those reports. Goldman also presented an expert's analysis of stock price reactions to other similar announcements of SEC enforcement actions, which showed the price drop was consistent with market reaction to other announcements of SEC complaints and, thus, likely attributable to the news of SEC litigation (and potential financial penalties) and not to revelation of information about Goldman's policies, procedures, or controls for managing potential client conflicts.

The district court first granted plaintiffs' class certification motion "without holding an evidentiary hearing or oral argument," after declining to consider Goldman's rebuttal evidence because the court concluded that evidence was improper at the class certification stage under *Amgen*. The 2nd U.S. Circuit Court of Appeals vacated and remanded, finding that the district court "erred in declining to consider defendants' evidence at this stage of the litigation."

After the district court again certified the case as a class action on remand, a divided 2nd Circuit panel affirmed. The panel imposed on Goldman the ultimate burden of persuasion to prove the absence of price impact, despite Federal Rule of Evidence 301, which provides that "the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption," but "the burden of persuasion ... remains on the party who had it originally." As a result, the majority held that, to rebut the presumption, Goldman was required to show "by a preponderance of the evidence that the entire price decline on the corrective disclosure dates was due to something other than [the] alleged misstatements." The majority concluded that the district court had not abused its discretion in finding that Goldman failed to make the required showing.

The 2nd Circuit's view of the proper burden on defendants conflicts both with Rule 301's plain language and with the 8th Circuit's decision in *Best Buy Co.*, in which the court applied Rule 301 and found that Best Buy had met its burden of production by showing that the alleged misrepresentation did not cause a price increase when it was made. 2014 WL 4746195.

By imposing a burden of persuasion to account for "the entire price decline on the corrective disclosure dates," the 2nd Circuit imposed an unwarranted burden on defendants seeking to rebut the *Basic* presumption in "price maintenance" cases. Under the 2nd Circuit's standard, plaintiffs unable to muster direct evidence of price impact when an alleged misstatement was made could now point to the price drop at the end of the class period and leave the defendant with the burden to disprove "price maintenance."

In Goldman, the Supreme Court has an opportunity to affirm once again the balance that it first struck in *Basic* and then confirmed in *Halliburton II*: Securities fraud plaintiffs may invoke a presumption of reliance upon a showing of market efficiency, but defendants must have a fair shot to rebut the presumption with evidence of a lack of price impact. When defendants present direct evidence showing that the alleged misstatements did not affect the market price when they were made — the sine qua non of the *Basic* presumption — plaintiffs should not be permitted to overcome that evidence by merely asserting "price maintenance." Rather, once a defendant produces evidence to rebut the *Basic* presumption, plaintiffs should be required to establish by a preponderance of the evidence that the challenged statement in fact had price impact. ■

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