Securities Regulation Daily Wrap Up, FRAUD AND MANIPULATION—2d Cir.: Goldman Sachs re-do on class certification upheld over dissent, (Apr. 8, 2020)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

A two-judge majority upheld the certification of a class action against Goldman Sachs because, on remand, the district court applied the correct standard to evaluate if Goldman Sachs had rebutted the *Basic* presumption of reliance.

The Second Circuit took a second look at the securities class action brought against Goldman Sachs Group, Inc. over an allegedly conflicted collateralized debt obligation (CDO) dating to just before the onset of the Great Recession and concluded that this time the district court had properly certified the case as a class action. Previously, the second Circuit had remanded the case to district court to apply the preponderance of the evidence standard to Goldman Sachs' rebuttal evidence regarding price impact per the Supreme Court's *Halliburton II* opinion and to consider some additional evidence. This time, the Second Circuit upheld the district court's certification of a class action albeit over a dissent by Judge Sullivan who, among other things, urged reviewing courts to examine misrepresentations regarding price impact at this stage of litigation despite cases cautioning against prematurely addressing issues of materiality (*Arkansas Teacher Retirement System, Goldman Sachs Group, Inc.*, April 7, 2020, Wesley, R.).

Conflicted CDO. The complaint had alleged that Goldman Sachs falsely represented its ability to remain conflict-free in the transactions it offered to clients under the premise that Goldman Sachs' interests and those of its clients were aligned. The complaint pointed to the Abacus 2007 AC-1 CDO of subprime mortgages in which Goldman Sachs allowed a hedge fund to select part of the portfolio while the hedge fund shorted or bet against that same portfolio. Goldman Sachs would later pay a $550 million penalty to the SEC for its failure to disclose the conflict of interests in the CDO. The complaint alleged that the SEC enforcement action was a corrective disclosure that resulted in a steep decline in Goldman Sachs' stock price following the period during which Goldman Sachs attempted to maintain an inflated stock price through its statements about its reputation for avoiding conflicts of interest.

Inflation-maintenance theory. The Second Circuit majority opened its analysis with a brief review of how price impact can be established in the circuit. One theory holds that price impact can result from inflation introducing statements that introduce inflation into a firm's stock price. Alternatively, the inflation-maintenance theory holds that price impact can be shown by evidence that a firm's statements maintained an already inflated stock price.

Goldman Sachs had argued that the inflation-maintenance theory only applies if a firm's statements sustain "fraud-induced" inflation. Goldman Sachs also argued that "general statements" cannot support price impact based on the inflation-maintenance theory. In any event, Goldman argued that the district court had not made any findings about whether the firm's stock price was inflated.

The Second Circuit majority said it is axiomatic that a court must make a finding regarding whether a firm's stock price was inflated (neither plaintiffs nor Goldman Sachs disagreed). The question, said the majority, was simply whether the district court made a finding about price inflation. Here, the majority noted that the district court found that the corrective disclosure revealed the price inflation and credited the plaintiffs' expert who opined that the stock drop after the corrective disclosure was caused by revelations about Goldman Sachs' conflicts. The Second Circuit majority found no abuse of discretion in this finding by the district court.

"[S]muggling materiality into Rule 23." The Second Circuit majority then declined Goldman Sachs' invitation to narrow the scope of the inflation-maintenance theory. Goldman Sachs had argued that the inflation-maintenance theory had been applied by courts in only two narrow special circumstances: (1) "unduly optimistic statement[s]" and (2) statements about meeting "market expectations." In both instances, Goldman Sachs said the statements would have to relate to specific, material issues.

The majority suggested a number of reasons why Goldman Sachs' argument was wrong, but a key motivation for the majority was that Goldman Sachs' argument would result in courts having to address materiality at the class certification stage, something the Supreme Court declined to require in *Amgen*. "Goldman's authority for what constitutes an impermissibly 'general statement' provides further evidence that its 'special circumstances' test is really a means for smuggling materiality into Rule 23." A series of footnotes in the majority opinion also noted that *Halliburton II* had resolved any ambiguity about proving material at the class certification stage and noted the FRCP 12(b)(6) tends to cause courts to reject weak cases before class certification.

The majority, however went on to give three addition reasons for rejecting Goldman Sachs' argument: (1) a test focused on the generality of alleged misstatements regarding price impact would be inconsistent with FRCP 23(b)(3)'s required predominance inquiry; (2) the "special circumstances" approach would treat inflation introducing and inflation maintenance theories as separate categories in conflict with the Second Circuit's opinion *Vivendi*; and (3) the Second Circuit in *Waggoner*, "implicitly" declined to adopt a "special circumstances" approach.

Lastly, the majority rejected Goldman Sachs' claim that the majority's approach would open the floodgates to meritless cases. The majority cited three reasons this would not happen: (1) FRCP 12(b)(6) materiality challenges functions to dismiss cases where the statements would be "too general to induce reliance;" (2) summary judgment allows defendants to reassert materiality (the majority noted that Goldman Sachs has moved for summary judgment in the district court); and (3) a defendant can present evidence in the district court to disprove price impact in seeking to rebut the basic presumption of reliance.

Judge Sullivan's dissent. Judge Sullivan would reverse the district court and decertify the class for essentially two reasons. For one, the dissent faulted the majority for not doing enough to evaluate the district court's conclusion regarding the evidence needed to rebut the *Basic* presumption of reliance. The dissent said both the district court and the plaintiffs' expert couched the evidence in terms of market efficiency, which the dissent observed was insufficient by itself to "refute persuasive rebuttal evidence" that there was no price impact.

Further, the dissent questioned why the majority deemphasized one of Goldman Sachs' experts who opined that the SEC and DOJ enforcement matters caused the stock drop instead of the "underlying factual allegations." On this point, the dissent also distinguished *Waggoner* because media reports pre-dating the enforcement actions against Goldman Sachs did not move the firm's stock price, which the dissent said showed the link had been severed between Goldman Sachs' alleged misrepresentations and the price the plaintiffs paid for their stock.

Second, the dissent argued that a reviewing court should be able to consider misrepresentations for their price impact. The dissent would allow such examination even if it looks like the court is assessing materiality. In the instant case, the dissent said no reasonable investor would have been moved by Goldman Sachs' "generic statements."

Despite his disagreement with the majority's and the district court's views on whether Goldman Sachs had rebutted the Basic presumption of reliance by showing a lack of price impact, Judge Sullivan did "agree with the majority's conclusion in Section I that the district court did not misapply the inflation-maintenance theory of price impact." Citing *Vivendi*, Judge Sullivan acknowledged that the inflation-maintenance theory was the law of the circuit.

The case is No. 18-3667.

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