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Second Circuit Holds that Defendants' Rebuttal of Fraud-on-the-Market Presumption of Reliance Need Not Be "Conclusive" and that District Courts Must Consider Evidence of a Lack of "Price Impact" on Disclosure Days Other than Plaintiffs' Alleged Corrective Disclosure Dates

In *Arkansas Teacher Retirement System* v. *Goldman Sachs Group, Inc.*, No. 16-250 (2d Cir. Jan. 12, 2018), the Second Circuit vacated the certification of a securities fraud class action due to two errors by the district court in its rejection of defendants' rebuttal of the fraud-on-the-market presumption of reliance. *First*, the Second Circuit held that the district court's statement that defendants had failed to "conclusively" prove a "complete absence of price impact" created doubt as to whether the district court had correctly applied the preponderance standard. *Second*, the Second Circuit held that the district court should have considered defendants' evidence that Goldman Sachs's stock price did not drop on thirty-four dates—prior to plaintiffs' alleged corrective disclosure dates—on which news sources reported alleged conflicts of interest in Goldman Sachs's CDO business.[1]

Background

In April 2010, Goldman Sachs's stock price dropped 13% after the Securities and Exchange Commission ("SEC") sued Goldman Sachs and one of its employees for fraud in the structuring and marketing of the Abacus 2007 AC-1 CDO transaction. The SEC alleged that Goldman Sachs had failed to disclose that Paulson & Co., an investor holding a "short" position, had played a role in selecting the collateral for the Abacus CDO. Later that month, the stock price dropped another 9% after the existence of a Department of Justice ("DOJ") criminal investigation into Goldman Sachs's CDO business was reported. And in June 2010, the stock price dropped another 2% after another SEC investigation into a different CDO transaction was reported.

Shortly after the SEC's lawsuit, several putative securities fraud class actions were filed in the Southern District of New York. The consolidated class action complaint alleged that Goldman Sachs made false statements about its efforts to avoid conflicts of interest. For example, "[w]e have extensive procedures and controls that are designed to identify and address conflicts of interest," and "[o]ur clients' interests always come first." On defendants' motion to dismiss, the district court (Crotty, J.) rejected defendants'

[1] Paul, Weiss, Rifkind, Wharton & Garrison LLP represented the Securities Industry and Financial Markets Association as an amicus curiae in support of defendants-appellants before the Second Circuit.

argument that these statements were inactionable puffery, but did dismiss claims related to Goldman Sachs's failure to disclose its receipt of a "Wells Notice" from the SEC.[2]

Plaintiffs moved for class certification, relying upon *Basic*'s fraud-on-the-market presumption of reliance.[3] In opposing class certification, defendants attempted to rebut the presumption by showing that (i) the alleged misstatements did not increase Goldman Sachs's stock price when made and (ii) Goldman Sachs's stock price did not decrease on thirty-four other dates—prior to the dates in April and June 2010 when an SEC enforcement action and DOJ and SEC investigations were revealed—when the press reported Goldman Sachs's conflicts of interest in CDO transactions.

The district court certified the class.[4] Although the district court acknowledged that defendants' rebuttal was subject to a preponderance-of-the-evidence standard of proof in a footnote, it went on to reject defendants' rebuttal because it did not provide "conclusive evidence" of a "complete absence of price impact." The district court also refused to consider the lack of stock price drops on the thirty-four prior disclosure dates, calling the argument an "inappropriate truth on the market defense." The district court also stated that the evidence failed to "conclusively" sever the link between the alleged misstatements and Goldman Sachs's stock price.

Defendants filed a 23(f) petition with the Second Circuit. The Second Circuit granted defendants leave to appeal. On appeal, defendants argued, among other things, that (1) the district court imposed an improper burden by requiring "conclusive evidence"; and (2) the district court erroneously rejected defendants' rebuttal.

The Second Circuit's Decision

In an opinion by Judge Richard C. Wesley, joined by Judge José A. Cabranes and Vermont district court judge William K. Sessions III (sitting by designation), the Second Circuit vacated the class certification order and remanded for further proceedings.

Defendants May Rebut the Fraud-on-the-Market Presumption by the Preponderance of the Evidence, Which Does Not Require "Conclusive" Evidence

Adhering to its prior decision in *Waggoner* v. *Barclays PLC*,[5] the Second Circuit held that defendants' rebuttal of the fraud-on-the-market presumption must carry not only a burden of production (as under

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2 *Richman* v. *Goldman Sachs Grp., Inc.*, 868 F. Supp. 2d 261 (S.D.N.Y. 2012).

3 *See Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988).

4 *In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10 Civ. 3461 (PAC), 2015 WL 5613150 (S.D.N.Y. Sept. 24, 2015).

5 875 F.3d 79 (2d Cir. 2017). The time for Barclays to seek Supreme Court review has not yet expired. Barclays's rehearing petition, which has been denied, raised two issues: (i) whether plaintiffs were required to present direct empirical evidence of

Fed. R. Evid. 301), but also a burden of persuasion by a preponderance of the evidence.[6] In light of the district court's statement that defendants' rebuttal failed to "conclusively" prove a "complete absence of price impact," the Second Circuit held that it was "unclear" whether the district court had "required more of defendants than a preponderance of the evidence."[7] Accordingly, the Second Circuit vacated and remanded for the district court to "reconsider defendants' evidence in light of the *Barclays* standard."[8]

A District Court Must Consider Evidence of a Lack of "Price Impact" on Disclosure Days Other than Plaintiffs' Alleged Corrective Disclosure Dates

The Second Circuit held that the district court had also erred by refusing to consider the evidence that Goldman Sachs's stock price did not decline on thirty-four news dates prior to the alleged corrective disclosure dates. The Second Circuit held that this evidence was not an inappropriate "truth on the market" defense—which seeks to argue that, prior to a particular plaintiff's purchases, accurate information regarding the subject matter of the claim had already been revealed and thus that defendants' stock price had already declined accordingly—but rather a permissible "price impact" rebuttal.[9]

Although the Second Circuit "espouse[d] no views as to whether the evidence is sufficient to rebut the *Basic* presumption," it held that the district court had erred in "declining to consider" it.[10] The Second Circuit encouraged the district court, on remand, to "hold any evidentiary hearing or oral argument it deems appropriate under the circumstances."[11]

Analysis

The *Goldman Sachs* case—along with *Barclays* and *In re Petrobras Securities*[12]—is one of three recent 23(f) petitions granted and decided by the Second Circuit concerning the fraud-on-the-market presumption of reliance. The *Goldman Sachs* decision reminds district judges that the opportunity to introduce evidence in opposition to class certification, recognized by *Halliburton II*,[13] needs to be a

market efficiency to invoke the fraud-on-the-market presumption of reliance; and (ii) whether Barclays's rebuttal was subject to Fed. R. Evid. 301, which imposes only a burden of production, not a burden of persuasion.

6 Slip Op. at 19–21.

7 Slip Op. at 21.

8 *Id.*

9 *Id.* at 22–24.

10 *Id.* at 24.

11 *Id.*

12 862 F.3d 250 (2d Cir. 2017).

13 *Halliburton Co.* v. *Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014).

meaningful one. Whether defendants attempt to show a lack of price impact or otherwise rebut the fraud-on-the-market presumption of reliance, courts must conduct a searching inquiry. And defendants should be held only to a preponderance standard.

The inquiry is meaningful in a case, as here, with many corrective disclosure dates. Plaintiffs should not be permitted to cherry-pick a few of the dozens of dates on which similar information is revealed, arbitrarily label the few with stock price drops as corrective disclosure dates, and then simply ignore dozens of prior dates. This is particularly so when other, inactionable bad news is revealed on the dates picked by plaintiffs. A rebuttal of the sort proposed by the *Goldman Sachs* defendants would seem to make it more likely than not that the correction of the alleged misstatements did not cause the stock price drops on the corrective disclosure dates. If the existence of conflicts of interest—as opposed to the existence of government enforcement actions—caused the stock price drops, then the stock price should have dropped on the prior disclosure dates.

The decision continues to leave open the scope of the "price maintenance" theory of price impact in the Second Circuit. Under that theory, plaintiffs argue that a misstatement "maintained" an inflated stock price, even though the misstatement caused no observable stock price increase. The Second Circuit's opinion does not discuss that theory, even though the district court had invoked it to certify the class. Prior Second Circuit decisions have accepted the theory in certain contexts, with caveats.[14] The *Goldman Sachs* defendants have argued that a finding of price maintenance is impermissibly speculative in light of the non-reaction of Goldman Sachs's stock price on the thirty-four other dates. That argument remains available on remand.

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[14] *See, e.g.*, Paul Weiss Client Memorandum, Second Circuit Holds That Direct Evidence of Price Impact Is Not Always Necessary to Establish Market Efficiency Under the Fraud-on-the-Market Doctrine (Nov. 9, 2017); Paul Weiss Client Memorandum, In *Vivendi* Appeal, Second Circuit Rejects Challenge to "Price Maintenance" Theory of Price Impact (Sept. 30, 2016).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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