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Client Alert

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Supreme Court Addresses Presumption of Reliance in Securities Class Actions

On June 21, 2021, the Supreme Court issued its highly anticipated decision in *Goldman Sachs Group, Inc. v. Arkansas Teacher Retirement System*, No. 20-222. *Goldman* concerned the standards to be applied by courts when securities defendants seek to rebut the "fraud-on-the-market" presumption of class-wide reliance established by the Supreme Court in its 1988 ruling in *Basic Inc. v. Levinson.*

In *Goldman*, the Court held that: (1) defendants can point to the generic nature of alleged misstatements to argue that such misstatements had no price impact; and (2) defendants bear the burden of persuasion, not just the burden of production, in rebutting the *Basic* presumption of reliance.

The Court ultimately remanded the case back to the Second Circuit Court of Appeals to consider whether the alleged misstatements by Goldman were too general to have had a price impact.

This partial victory for the Goldman defendants could provide valuable strategy for defendants in securities class actions seeking to rebut the fraud-on-the-market presumption of reliance. The ultimate impact of the decision will depend on whether the Second Circuit finds that Goldman's statements were too generic to have a price impact.

THE BASIC PRESUMPTION OF RELIANCE

A securities fraud plaintiff must establish reliance on a misrepresentation or omission to state a claim. Traditionally, this was done through evidence that a plaintiff was aware of a misrepresentation and relied upon that misrepresentation in a securities transaction. However, in *Basic*, the Supreme Court held that a plaintiff can invoke a rebuttable presumption of reliance based on the fraud-on-the-market theory. Under that theory, investors rely on the market price of a company's security, which in an efficient market, reflects all of the company's public misrepresentations. By invoking the *Basic* presumption, a class-action plaintiff can prove reliance through evidence common to the entire class.

A defendant, however, may rebut this presumption. In *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. 258 (2014) (*Halliburton II*), the Supreme Court held that defendants may rebut the *Basic* presumption at class certification by showing than an alleged misrepresentation did not have a price impact – that it did not actually affect the market price of the stock at issue.

GOLDMAN BACKGROUND

This long-running dispute, which included two trips to the Second Circuit, involves allegations by the Arkansas Teacher Retirement System that Goldman violated federal securities laws by making misstatements regarding its issuance of collateralized debt obligations prior to the subprime mortgage crisis. Specifically, Plaintiffs alleged that Goldman made false or misleading statements regarding conflicts of interest relating to these securities.

The alleged misstatements were largely generic, including "[w]e have extensive procedures and controls that are designed to identify and address conflicts of interest," "[o]ur clients' interests always come first," and "[i]ntegrity and honesty are at the heart of our business."

After Goldman unsuccessfully moved to dismiss the case, Plaintiffs moved for class certification, invoking the *Basic* presumption of reliance. Plaintiffs relied on the inflation maintenance theory, alleging that Goldman's prior statements regarding its controls artificially maintained an inflated stock price, which dissipated upon the issuance of corrective disclosures. Goldman sought to rebut the *Basic* presumption by showing a lack of price impact. The District Court, however, certified the class.

On interlocutory appeal, the Second Circuit vacated the District Court's class certification order. It held that Goldman bore the burden of persuasion in rebutting the *Basic* presumption, but that the District Court erred in holding Goldman to a higher burden of proof and by refusing to consider some of Goldman's price impact evidence. The District Court, on remand, once again granted class certification, and the Second Circuit again granted Goldman's petition for an interlocutory appeal. But this time, the Second Circuit, in a divided decision, affirmed the grant of class certification.

MAJORITY OPINION

Justice Barrett wrote the majority opinion, joined by Chief Justice Roberts and Justices Breyer, Kagan, and Kavanaugh. Justice Sotomayor wrote an opinion concurring in part and dissenting in part, while Justice Gorsuch, joined by Justices Thomas and Alito, also wrote an opinion concurring in part and dissenting in part.

First, the Court addressed whether the generic nature of an alleged misstatement is relevant to the price impact inquiry. Slip. Op. at 6. The Court noted that the parties' dispute had "largely evaporated" since the plaintiffs "now concede that the generic nature of an alleged misrepresentation often will be important evidence of price impact because, as a rule of thumb, a more general statement will affect a security's price less than a more-specific statement on the same question." *Id.* at 6-7 (internal quotations omitted). The Court explained that the generic nature of a misrepresentation will "often" be important evidence of the lack of price impact, particularly in cases proceeding under the inflation-maintenance theory. *Id.* at 8. The Court noted that the common inference offered by plaintiffs "that the back-end price drop equals front-end inflation" breaks down where "the earlier misrepresentation is generic . . . and the later corrective disclosure is specific." *Id.* Interestingly, the Court provided an example of an allegation common in securities class actions where such an inference is improper: "when the earlier misrepresentation is generic (*e.g.*, 'we have faith in our business model') and the later disclosure is specific (*e.g.*, 'our fourth quarter earnings did not meet expectations')." *Id.*

Importantly, the Court also stressed that lower courts, in assessing price impact, should be "open to all probative evidence on that question—qualitative as well as quantitative—aided by a good dose of common sense." *Id.* at 7.

This is so, regardless of whether such evidence is relevant to merits questions such as materiality, because a court has an obligation to consider all evidence relevant to price impact. *Id.*

The Court remanded to the Second Circuit, noting that the lower court "must take into account *all* record evidence relevant to price impact, regardless whether that evidence overlaps with materiality or any other merits issue." *Id.* at 9 (emphasis in original).

Second, the Court addressed whether a defendant bears the burden of persuasion, or just the burden of production, as to price impact. The Court rejected Goldman's argument that Federal Rule of Evidence 301, which deals with presumptions, applies to the *Basic* presumption and requires that solely the burden of production be shifted to defendants. *Id.* at 10.

The Court explained that its precedent makes clear that the burden of persuasion in rebutting the *Basic* presumption is assigned to defendants. *Id.* The Court's precedent consistently uses language stating that defendants must "show" a lack of price impact, and the mere production of some competent evidence as to this question does not make such a showing. *Id.* The Court also noted that such an argument is inconsistent with the Court's previous ruling in *Halliburton II* that a plaintiff need not directly prove price impact in order to invoke the *Basic* presumption. If a defendant could shift the burden to a plaintiff with just some competent evidence, then a plaintiff would always end up with the burden, effectively negating *Halliburton II*'s holding. *Id.* at 11.

Thus, the Court ultimately held that, based on a reading of its precedents, the defendant bears the burden of persuasion to prove a lack of price impact. *Id.* The Court noted, however, that this is "unlikely to make much difference on the ground" since in most cases, both parties submit competing expert evidence on price impact. *Id.* at 12.

CONCURRING OPINIONS

First, Justice Sotomayor wrote a short opinion concurring in part and dissenting in part. Justice Sotomayor noted that she agreed with the Court's answers to the questions presented. However, she did not join the majority opinion to vacate and remand because she believed the Second Circuit properly considered the generic nature of Goldman's alleged misrepresentations and rejected Goldman's argument.

Second, Justice Gorsuch wrote an opinion concurring in part and dissenting in part, joined by Justices Thomas and Alito. Justice Gorsuch disagreed with the Court's holding that the defendant, rather than the plaintiff, bears the burden of persuasion on price impact. First, Justice Gorsuch summarized the Court's precedent with regard to other presumptions, explaining that in nearly all of these back-and-forth processes, the burden of persuasion never shifts. He then emphasized that in securities cases, a plaintiff bears the burden of proving the essential element of reliance, and that the *Basic* presumption is just a presumption. Once a defendant produces evidence showing that the fraud-on-the-market theory does not hold in a particular case, the presumption of reliance should collapse, and the burden of persuasion should remain on the plaintiff. Justice Gorsuch then stressed that, in his view, the Court's precedent, including *Basic* and *Halliburton II*, does not preclude such a holding.

IMPLICATIONS OF THE DECISION

The Supreme Court's decision in *Goldman* could prove significant for securities class actions going forward. Defendants will be able to point to the generic nature of an alleged misstatement and argue that such evidence is relevant to the price impact inquiry. Moreover, the Court's analysis of this issue will prove useful to defendants. Defendants often face courts that are reluctant to consider evidence relating to price impact due to that evidence's overlap with merits questions such as materiality and loss causation. Defendants will be able to highlight the Court's language emphasizing that courts are *obligated* to consider such evidence at the class certification stage.

The Court's holding as to the burden of persuasion, while disappointing to defendants in securities class actions, is "unlikely to make much difference on the ground" since, in most cases, both parties submit competing expert evidence on price impact. *Id.* at 12. While this ruling will provide clarification to lower courts confronting this presumption of reliance, the Court emphasized that this "burden of persuasion should rarely be outcome determinative." *Id.* at 2.