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High Court Should Review Goldman's Maintenance Theory

By **Miguel Estrada, Mark Perry and Kellam Conover** (June 24, 2020, 6:12 PM EDT)

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Now that the full U.S. Court of Appeals for the Second Circuit has denied rehearing in Arkansas Teacher Retirement System v. Goldman Sachs Group Inc.,[1] the U.S. Supreme Court should grant certiorari to review the Second Circuit's flawed "inflation maintenance" theory of price impact.

Inflation maintenance is a theory endorsed by the Second Circuit in certain Rule 10b-5 class actions that supposes that alleged misstatements affect a stock price not by artificially inflating it, but by maintaining preexisting inflation.

In recent years, the theory has become increasingly popular among securities plaintiffs seeking to lower the bar to class certification. In Goldman, the Second Circuit permitted plaintiffs to obtain class certification based on an issuer's generic public statements without any showing that the statements actually inflated the stock price.

That theory is wrong because it relieves plaintiffs of their burden to prove price impact, thereby permitting class certification in inappropriate cases. It also weakens plaintiffs' ultimate burden of proving loss causation. It is time for the Supreme Court to rein in the Second Circuit's extreme brand of inflation-maintenance theory.

Inflation-Maintenance Theory Before Goldman

Over the past decade, the Supreme Court has repeatedly made clear that price impact — the principle that an alleged misstatement must actually affect the stock's market price — is an essential precondition to class certification in securities actions.[2]

If alleged misstatements do not affect the stock price, there is "no grounding for any contention that investors indirectly relied on those misrepresentations through their reliance on the integrity of the market price."[3]

Without proof of price impact, therefore, plaintiffs cannot invoke the Basic Inc. v. Levinson presumption of reliance on a classwide basis and hence cannot satisfy the predominance requirement for damages class actions under Federal Rule of Civil Procedure 23(b)(3).[4]

In the wake of these decisions, securities plaintiffs increasingly have turned to inflation-maintenance theory. Rather than show that alleged misstatements actually inflated a stock price, in 71% of recent cases involving the Basic presumption, plaintiffs have asserted that the statements merely maintained the price at inflated levels and that the stock price dropped when the alleged fraud became public. In each case, the plaintiffs successfully established price impact.[5]

Not all applications of inflation-maintenance theory are controversial. Where a plaintiff actually shows that a statement prevented inflation from leaving the stock price, for example, that showing can satisfy the price-impact requirement because there is proof that the statement "stop[ped] the price from declining" more than it would have absent the statement.[6]

But where no such showing is required, inflation-maintenance theory effectively circumvents the price-impact requirement.[7] Indeed, as the Second Circuit observed in the Vivendi litigation, inflation-maintenance models now commonly and successfully make no "reference to the timing or nature of [the] defendant's alleged misstatements" at all.[8]

Goldman's Flawed Extension of Inflation-Maintenance Theory

Goldman is the most problematic extension of inflation-maintenance theory yet. The Goldman plaintiffs alleged that Goldman Sachs' generic statements about its business principles and conflict warnings omitted material information about alleged conflicts of interest.

But the plaintiffs made no showing that the statements affected Goldman Sachs' stock price when made. In fact, their expert "concede[d] that Goldman's stock price did not move" in response to any statement.[9]

The Second Circuit nevertheless upheld class certification based on the plaintiffs' bare showing that the stock price subsequently declined when public enforcement activity concerning Goldman Sachs' alleged conflicts of interest was publicly announced.[10] In so doing, the Second Circuit made two critical missteps that eliminated any meaningful price-impact requirement.

First, the Second Circuit relieved the plaintiffs of the burden to show that the alleged fraud caused inflation, holding that the "issue is simply whether Goldman's share price was inflated."[11]

For there to be liability under Rule 10b-5, however, fraud must actually cause inflation to enter the stock price. The majority then compounded this error by not requiring the plaintiffs to show that Goldman Sachs' statements in fact prevented inflation from leaving the stock price. The majority admitted that such inflation maintenance can simply be inferred from a later price drop and, thus, the burden shifted to Goldman Sachs to show an absence of inflation maintenance.[12]

Taken together, these rulings allowed the plaintiffs to establish price impact without ever distinguishing between inflation allegedly caused by Goldman Sachs' statements and preexisting inflation that would have continued even if Goldman Sachs had remained silent. Whether Goldman Sachs spoke or was silent, the plaintiffs' evidence of price impact — a subsequent price drop — would have been the same.

A price-impact theory that cannot distinguish between alleged fraud and silence is incompatible with Basic. As the Supreme Court has explained, where the alleged fraud did not cause any inflation — that is, where it "did not, for whatever reason, actually affect the market price" — the Basic presumption cannot apply because "'the basis for finding that the fraud ha[s] been transmitted through market price [is] gone.'"[13]

Second, the Goldman majority permitted the plaintiffs to base price impact on nothing more than the company's routine, generic public statements. The majority refused to inquire into the general nature of those statements, reasoning that such an inquiry "is really a means for smuggling materiality into Rule 23."[14]

A materiality inquiry, however, is not the same as whether statements are too general to prevent the dissipation of preexisting inflation. Unlike materiality, the nature of a statement is not an "indispensable [element] of a Rule 10b-5 claim."[15] And where a statement is too general to maintain inflation, that indicates only that a plaintiff cannot presume reliance on a classwide basis; it does not automatically establish that the statement is immaterial, as well.[16]

In Halliburton II, the Supreme Court declined to "artificially limit the inquiry at the certification stage to indirect evidence of price impact," because without proof of price impact, "the fraud-on-the-market theory underlying the [Basic] presumption completely collapses, rendering class certification inappropriate."[17]

Given the foundational importance of price impact to the Basic presumption of reliance, defendants must be free to defeat the Basic presumption using any price-impact evidence — direct as well as indirect — even if that evidence overlaps with a later merits inquiry.[18]

By precluding district courts from considering whether a statement is the sort that can maintain inflation, the Second Circuit imposed the same type of artificial limitation that Halliburton II rejected. In the process, the Second Circuit rendered the price-impact inquiry toothless.

The Need for Supreme Court Review

The Supreme Court should review the Second Circuit's wayward inflation-maintenance theory. There is already an entrenched circuit split on the viability of inflation-maintenance theory.

The Fifth and Eighth Circuits have held that mere confirmatory statements that do not add to what is already public cannot establish price impact.[19] In contrast, the Second, Seventh, and Eleventh Circuits have held that, under an inflation-maintenance theory, such statements can establish price impact even without proof that any specific statement affected the stock price.[20]

Now, after Goldman, it would appear that plaintiffs can establish price impact merely by pointing to a company's generic, aspirational statements and a subsequent stock drop in response to some enforcement activity. The floodgates are wide open.

The Goldman majority's assumption that dispositive motions practice or even trial will weed out unmeritorious claims rings hollow. Because the most controversial forms of inflation-maintenance theory do not tie inflation to any specific statement, they present a moving target.

In Vivendi, for example, the plaintiffs did not even identify the supposedly actionable statements until their summation, yet the Second Circuit upheld liability because the jury was free to assume that all 56 statements maintained inflation that otherwise "could have dissipated."[21]

The Second Circuit's expansive inflation-maintenance theory also makes it substantially easier for securities plaintiffs to establish loss causation. As Vivendi again illustrates, inflation-maintenance theory is allowing claims to survive — indeed, to go to judgment — merely because the plaintiffs allege that investors purchased stock at inflated prices and later suffered losses.

That is the same error the Supreme Court reversed in Dura when it emphasized that "the logical link between the inflated share purchase price and any later economic loss is not invariably strong."[22] The securities laws protect investors only "against those economic losses that misrepresentations actually cause"— and do not "provide investors with broad insurance against market losses."[23]

For the price-impact requirement to have meaning, Rule 10b-5 plaintiffs must be required to show how each alleged misstatement actually maintained inflation in a way distinguishable from mere silence, and courts must be allowed to consider whether the statement is the sort of statement that can prevent dissipation of preexisting inflation.

Because only the Supreme Court can establish those meaningful guardrails now, it should grant certiorari in Goldman.

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Disclosure: The authors represented Vivendi SA in In re: Vivendi Securities Litigation, the Second Circuit's first inflation-maintenance case.

[1] Order, Ark. Teacher Ret. Sys. v. Goldman Sachs Grp., Inc., No. 18-3667 (2d Cir. June 15, 2020).

[2] Halliburton Co. v. Erica P. John Fund, Inc. ("Halliburton II"), 573 U.S. 258, 282 (2014); see also Erica P. John Fund, Inc. v. Halliburton Co. ("Halliburton I"), 563 U.S. 804, 813–14 (2011).

[3] Amgen v. Conn. Ret. Plans & Tr., 568 U.S. 455, 473–74 (2013).

[4] Halliburton II, 573 U.S. at 281–82 (discussing Basic Inc. v. Levinson, 485 U.S. 224 (1988)); see also Fed. R. Civ. P. 23(b)(3).

[5] See Ark. Teacher Ret. Sys. v. Goldman Sachs Grp., Inc., 955 F.3d 254, 266 n.9 (2d Cir. 2020) (citing Note, Congress, the Supreme Court, and the Rise of Securities-Fraud Class Actions, 132 Harv. L. Rev. 1067, 1077 (2019)).

[6] Schleicher v. Wendt, 618 F.3d 679, 683 (7th Cir. 2010).

[7] See Mark A. Perry & Kellam M. Conover, The Interrelationship between Price Impact and Loss Causation after Halliburton I & II, 79 NYU Annual Survey of Am. Law 189, 208–10 (2015).

[8] Vivendi, 838 F.3d at 259.

[9] Goldman, 955 F.3d at 278 (Sullivan, J., dissenting) (alteration in original; emphasis removed)

(quoting In re Goldman Sachs Grp., Inc. Sec. Litig., No. 10-cv-3461 (PAC), 2018 WL 3854757, at *4 (S.D.N.Y. Aug. 14, 2018)).

[10] Id. at 265–66, 273.

[11] Id. at 265; see also id. at 273 ("[W]e reject Goldman's contention that the shareholders were required to submit evidence of 'fraud-induced' inflation.").

[12] Id. at 265–66, 270.

[13] Halliburton II, 573 U.S. at 269, 281 (quoting Basic, 485 U.S. at 248).

[14] Goldman, 955 F.3d at 267.

[15] Amgen, 468 U.S. at 474.

[16] Halliburton II, 573 U.S. at 279 ("[A] public, material misrepresentation might not affect a stock's price even in a generally efficient market. … [T]hat is why [Basic] affords defendants an opportunity to rebut the presumption by showing [no price impact].").

[17] Id. at 283.

[18] Id.; see also Halliburton I, 563 U.S. at 813 (noting that price impact is "different from," yet overlaps with, the element of loss causation).

[19] See Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 665–66 (5th Cir. 2004) ("Because the presumption of reliance is based upon actual movement of the stock price, confirmatory information cannot be the basis for a fraud-on-the-market claim."); IBEW Local 98 IBEW Local 98 Pension Fund v. Best Buy Co., 818 F.3d 775, 782 (8th Cir. 2016) ("statements add[ing] nothing to what was already public" cannot establish price impact).

[20] See Goldman, 955 F.3d at 264 ("'[S]ecurities-fraud defendants cannot avoid liability for an alleged misstatement merely because the misstatement is not associated with an uptick in inflation.'" (citation omitted)); Glickenhaus & Co. v. Household Int'l, Inc., 787 F.3d 408, 416–17 & n.4, 419 (7th Cir. 2015) (not requiring plaintiffs to "directly measure inflation caused by false statements," but noting that "[i]f no statement was an alternative, then the model is much less accurate because it measures the effect of the truth, not the effect of silence"); Local 703 v. Regions Fin. Corp., 762 F.3d 1248, 1256 (11th Cir. 2014) (rejecting argument that price impact "requires proof that the alleged misrepresentations had an immediate effect on the stock price").

[21] Vivendi, 838 F.3d at 241, 257.

[22] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 342 (2005).

[23] Id. at 345.