

2nd Circ. Won't Ruffle Key Theory As Goldman Case Plows On

By **Dean Seal**

Law360 (April 8, 2020, 10:33 PM EDT) -- The Second Circuit was split on whether to decertify a class of Goldman Sachs investors on Tuesday, but unanimous in declining to augment a key theory on which the class is asserting securities claims against the investment bank.

The appellate panel agreed that a lower court did not err in its application of the “inflation maintenance” or “price maintenance” theory — the idea that misstatements can fraudulently keep an artificially boosted stock price from dropping — to long-running litigation alleging Goldman lied about conflicts of interest in collateralized debt obligation transactions it underwrote over a decade ago.

In its second appeal of class certification, Goldman had argued that a federal district judge erroneously extended the price maintenance theory to encompass the bank's general statements about business principles and conflicts warnings, despite the fact that the theory has historically applied only to “concrete, unduly optimistic” statements made in order to prevent an expected stock drop.

Goldman’s argument for narrowing the application of the theory caught the eye of many in the securities class action industry, given its implications for proving securities fraud writ large. Gayle Klein of McKool Smith PC said the appellate panel was right to reject “the notion of injecting a merits-based analysis of materiality into the procedural exercise of class certification decision-making.”

“As the Second Circuit noted, defendants are not left without an avenue to pursue these types of arguments,” Klein told Law360. “Instead, the Second Circuit confirmed that these kinds of merits-based arguments are best left to dispositive motions.”

The Second Circuit interpreted the bank’s argument as an invitation to, at the class certification stage, only apply the theory to alleged misstatements that fit a narrow guideline of specificity and, in essence, materiality. The panel declined to do so.

“Whether alleged misstatements are too general to demonstrate price impact has nothing to do with the issue of whether common questions predominate over individual ones,” the Second Circuit ruled. “While Goldman’s test might weed out potentially unmeritorious claims, Rule 23 is not a weed whacker for merits problems.” The Federal Rules of Civil Procedure’s Rule 23 governs class certification requirements.

The functional outcome of the ruling — that the Goldman investor class can retain recertification — was not necessarily unexpected. At a hearing over the summer, the appellate panel seemed dubious of the bank's attempt to "revisit materiality," as one judge said, with its second challenge to class certification.

The investor suit itself was filed shortly after the U.S. Securities and Exchange Commission sued Goldman in 2010 for allegedly helping a client short a collateralized debt obligation that the bank was simultaneously selling to customers, ultimately losing those customers \$1 billion. The SEC action was settled for \$550 million, while the Goldman shareholder action claims the firm lied about being conflict-free to maintain an artificially inflated stock price, which was deflated when the SEC action revealed conflicts of interest involved with the CDO.

The Second Circuit reversed certification for the class of Goldman investors in January 2018, finding the district judge had held Goldman to too high a standard of proof for showing that its alleged misstatements about being conflict-free hadn't affected its stock price. When the class was recertified in August 2018, Goldman appealed again.

A central facet of Goldman's argument on appeal was that the lower court had improperly expanded the scope of the price maintenance theory to apply to the bank's general statements about business principles and conflicts warnings, contending that allowing certification on those grounds would mean that "investor plaintiffs could just point to any general statement about the company's business principles or risk controls and proclaim 'price maintenance.'"

"This would indeed be troubling," the Second Circuit responded Tuesday, "but our law already beats back this parade of horrors in three meaningful ways."

Goldman was essentially trying to twist application of the price maintenance theory into an assessment of materiality of alleged misstatements at the class certification stage, the panel said, but such a materiality challenge has a right place and right time — namely, at the dismissal phase before certification or at the summary judgment phase after certification. The bank can also try to disprove price impact at the certification stage, as Goldman attempted in this appeal.

"In sum, while securities class action defendants have numerous avenues for challenging materiality, Rule 23 is not one of them," the panel said. "The inflation-maintenance theory does not discriminate between general and specific misstatements."

The Goldman case seems far from over. A spokeswoman for the investment bank told Law360 on Tuesday that it would pursue an en banc rehearing of the appeal given the "important and recurring legal issues impacting securities class actions generally" presented by the challenge.

While the three appellate judge agreed as to the lower court's application of the theory, Tuesday's ruling did present a split between the judges as to whether Goldman had rebutted the so-called Basic presumption of reliance stemming from *Basic Inc. v. Levinson* — that shareholders relied on its misstatements in purchasing Goldman stock.

One of the three appellate judges sided with the investment bank's claim that the lower court ignored the substance of the 36 press reports about Goldman's conflicts of interest published before the SEC action was filed and the market's nonreaction to their release. Finding that the lack of reaction rebutted the notion that investors were relying on Goldman's alleged "generic" misstatements about being conflict-free, the dissenting judge found that recertification should not be granted.

That finding goes directly to the third “avenue” for challenging materiality outlined in the panel majority’s opinion, so while the price maintenance theory is left intact, the materiality questions left in the Goldman case persist.

Todd Cosenza of Willkie Farr & Gallagher LLP noted that the dissenting judge’s opinion indicates a bigger upcoming fight over whether the Basic presumption can be rebutted for Goldman’s generic statements and if materiality and price impact can be viewed holistically at the certification phase.

“I don’t think this opinion is the end,” said Cosenza, who represented former SEC officials and law professors backing Goldman’s argument for decertification. “This is something that could launch further appellate review, including potentially at the Supreme Court, though it doesn’t seem likely that a [Second Circuit] en banc review would take up the price maintenance theory in and of itself.”

--Editing by Jill Coffey and Alanna Weissman.