



SECOND CIRCUIT REVIEW

Expert Analysis

## Rebuttal of Fraud-on-the-Market Presumption Post ‘Halliburton II’

For the first time since the Supreme Court issued its decision in *Halliburton v. Erica P. John Fund*, 134 S.Ct. 2398 (2014) (*Halliburton II*), the U.S. Court of Appeals for the Second Circuit discussed one of the key issues in securities litigation—how to rebut the fraud-on-the-market presumption of reliance.

In *GAMCO Investors v. Vivendi Universal*, 838 F.3d 214 (2d. Cir. 2016) (*GAMCO*), the Second Circuit affirmed the District Court’s finding that the defendants had successfully rebutted the presumption by demonstrating that certain opt-out plaintiffs would have purchased the securities at issue even if they had known of the fraud. This case is only the second appellate decision post *Halliburton II* to address the circumstances under which defendants can successfully rebut the presumption, the first being the U.S. Court of Appeals for the Eighth Circuit’s decision in *IBEW Local 98 Pension Fund v. Best Buy*, 818 F.3d 775 (8th Cir. 2016), released in April of this year, which addressed rebuttal through lack of price impact.

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contours” of *Halliburton II* in *GAMCO*, the decision demonstrates one method of defeating the presumption—proving that the fraud would not have affected the plaintiffs’ purchasing decisions.

### The Presumption

The fraud-on-the-market presumption was established by the Supreme Court’s 1988 decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). In *Basic*, the Supreme Court held that investors could satisfy the reliance element in a private securities fraud action by invoking a presumption that the price of a stock traded in an efficient market reflects all public, material information—including material misrepresentations. The Supreme Court did note, however, that the presumption was rebuttable. It held that the presumption could be rebutted by “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or

paid) by the plaintiff, or his decision to trade at a fair market price” or a showing that plaintiffs traded “without relying on the integrity of the market.” *Id.* at 248-49.

In *Halliburton II*, the Supreme Court had another opportunity to opine on the presumption. Although it declined to overrule the presumption, the Supreme Court held that defendants could seek to rebut the presumption at the class certification stage using evidence that an alleged misrepresentation did not

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affect the stock price. Importantly, the court noted that a defendant could rebut the presumption by showing “that a plaintiff would have bought or sold the stock even had he been aware that the stock’s price was tainted by fraud.” 134 S.Ct. at 2408, 2414. Because the court was focused on the issue of rebuttal through proof of lack of price impact, the court did not expand on the factual circumstances that would

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support rebuttal of the presumption on this basis.

### 'GAMCO'

The GAMCO case provided the Second Circuit with a factual application of the Supreme Court's dicta in *Halliburton II*. The GAMCO action was brought in the District Court for the Southern District of New York by certain plaintiffs who had opted out of a class action against Vivendi Universal and its former CEO and CFO. The opt-out plaintiffs in GAMCO were so-called "value investors," who purchased Vivendi securities between 2000 and 2002 when the market price of those securities was less than their estimation of the securities' value, betting that the market price of those securities would rise over time. *GAMCO Investors v. Vivendi*, 927 F.Supp.2d 88, 94-98 (S.D.N.Y. 2013).

Both the class action plaintiffs and GAMCO plaintiffs brought claims against Vivendi Universal S.A. and/or Vivendi S.A. (collectively, Vivendi) under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The class action and opt-out plaintiffs alleged that, between 2000 and 2002, Vivendi made material misstatements and omissions to conceal liquidity problems caused by its accumulation of significant debt, thereby artificially inflating the price of Vivendi's securities, which declined precipitously when Vivendi's true liquidity position was revealed.

Due to a judgment for plaintiffs in the class action, in GAMCO, Vivendi was collaterally estopped from denying any of the elements of the opt-out plaintiffs' Section 10(b) claim except for reliance. *Id.* at 90. Thus, the only issue for determination by the district court was whether Vivendi could rebut the fraud-on-the-market presumption of reliance invoked by the opt-out plaintiffs. After conducting a bench trial on the issue, Judge Shira

Scheidlin held that Vivendi had successfully rebutted the presumption by demonstrating that "plaintiffs would have transacted in [the] securities notwithstanding any inflation in their market price caused by fraud." *Id.* at 104. She held that a successful rebuttal of this type would be "exceedingly rare," but that it was warranted in this case "lest the securities laws slip the restraints of causation entirely and become a judicially created investor insurance scheme." *Id.*

The Second Circuit affirmed the district court's ruling, 838 F.3d at 223. As an initial matter, it "decline[d] to explicate the contours of *Halliburton*..., further theorize on the presumption, or otherwise address the relevance of the typical value investing model to a rebuttal showing" because, contrary to the plaintiffs' contention, the district court did not find that the presumption was rebutted on the basis that the plaintiffs were value investors.

Rather, the Second Circuit held that the lower court's decision was "based on a much narrower theory: that, given the facts in the record, Vivendi proved that [the plaintiffs] would have purchased Vivendi securities even had it known of Vivendi's alleged fraud." It concluded that "the record in this case includes sufficient evidence supporting the district court's finding that... even if aware of Vivendi's liquidity problems and its concealment of those problems, [plaintiffs] would still have believed the deal it made was a good one."

Even if the plaintiffs had known of Vivendi's liquidity problems, it would still have believed "first, that Vivendi's securities were substantially undervalued by the market and second, that an event was likely to happen in the [following] few years that would awaken the market to that fact." The Second Circuit also held that "the record provided sufficient evidence to find that [the plaintiffs] would have believed

that, even if the liquidity crisis in fact came to light, it would resolve within a short period of time" such that there was still the potential for long-run profit.

The court also took into account the fact that plaintiffs continued to purchase the Vivendi securities after the full extent of the alleged fraud was revealed. The court noted that "[i]t may seem unlikely, in the abstract, that an investor, aware of fraud, would opt to purchase a given security." But it held that, on the trial record, it was not clearly erroneous for the district court to find that the plaintiffs would have made the choice to buy the same securities purchased even if they had known of the liquidity problems at Vivendi. *Id.* at 218-223.

### Conclusion

In GAMCO, the Second Circuit held that a defendant could rebut the fraud-on-the-market presumption by demonstrating that plaintiffs would have purchased the securities at issue even if they had known of the fraud. Because the court explicitly declined to provide broader guidance on rebuttal of the presumption, practitioners still await guidance from the Second Circuit on other theories of rebuttal, particularly where a defendant seeks to rebut the presumption on the basis of lack of price impact.

That issue was addressed by the Eighth Circuit in *Best Buy*, but is also currently pending on appeal before the Second Circuit in *In re Goldman Sachs Group*, No. 16-250 (2d Cir.) (appeal from *In re Goldman Sachs Grp., Inc. Sec. Litig.*, No. 10 Civ. 3461 (PAC), 2015 WL 5613150 (S.D.N.Y. Sept. 24, 2015).)