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In *Vivendi* Appeal, Second Circuit Rejects Challenge to "Price Maintenance" Theory of Price Impact

On September 27, 2016, in related appeals arising from a long-pending securities fraud class action against Vivendi, the Second Circuit ruled on several important issues, including the proof necessary to both sustain and defeat the fraud-on-the-market presumption of reliance.

Most significantly, in *In re Vivendi, S.A. Securities Litigation*, Nos. 15-180-cv(L), 15-208-cv(XAP) (2d Cir.), the Second Circuit rejected defendants' *per se* challenge to the so-called "price maintenance" theory, which posits that confirmatory misstatements can fraudulently maintain an artificially high stock price by preventing the stock price from declining. The Second Circuit held that misstatements that do not cause stock price increases are, at least in some circumstances, actionable under the fraud-on-the-market presumption of reliance. The Second Circuit's decision, however, was rendered in the context of a challenge to the admissibility of plaintiffs' damages expert's event study, and the full scope of this theory, which continues to be contested, remains to be decided.

Additionally, in *GAMCO Investors, Inc.* v. *Vivendi Universal, S.A.*, Nos. 13-1194(L), 13-1377(XAP) (2d Cir.), the Second Circuit affirmed the District Court's finding that defendants had successfully rebutted the fraud-on-the-market presumption of reliance by showing that a group of opt-out plaintiffs—self-described "value investors"—would have made the same purchasing decisions even if they had known about the fraud. Such fact-intensive rebuttals will remain important to the defense of securities fraud claims by sophisticated investors, including in the increasingly frequent opt-out cases that commonly proceed alongside many class actions.

Background

In 1998, *Compagnie Générale des Eaux*, a French water utility, changed its name to Vivendi S.A. and later Vivendi Universal S.A. ("Vivendi") and began an "overnight transformation" into an entertainment and media conglomerate. *Vivendi* Slip Op. at 4. It achieved this profile by aggressively pursuing a strategy of growth and diversification through a series of leveraged mergers and acquisitions. Vivendi financed these acquisitions by issuing stock and/or debt.

By late 2001, Vivendi "was running critically low" on cash. *Id.* at 4-5. Notwithstanding, Vivendi "made numerous representations to the market suggesting that the course ahead for the company was smooth sailing." *Id.* at 5. For example, while internal communications at Vivendi in December 2001 suggested that the Company was extremely concerned about a credit rating downgrade, it externally communicated

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in a press conference that its transactions were "not putting pressure" on it, and that it anticipated maintaining "a very comfortable . . . credit rating." *Id.* at 14.

In January 2002, Vivendi was forced to sell treasury shares to raise cash, and in May 2002, Moody's downgraded Vivendi's credit rating. In July 2002, Standard & Poor's and Moody's both downgraded Vivendi and signaled the possibility of further downgrades. Following each of these events, Vivendi's stock price declined. This lawsuit followed.

District Court Proceedings

In mid 2002, consolidated class actions were filed in the Southern District of New York against Vivendi and its former CEO and CFO. The shareholder plaintiffs alleged that Vivendi violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 and that the CEO and CFO were liable under Section 20(a) of the Exchange Act.

The proceedings in the District Court spanned more than a decade before three different District Court judges.[1] A three-month jury trial was held in late 2009. The jury found Vivendi (but not the CEO or CFO) liable for all 57 statements listed on the verdict form and found daily stock-price inflation to be approximately half of what plaintiffs' expert had opined.

Post-trial motions subsequently were filed. Of particular relevance, the District Court rejected the argument that plaintiffs had not shown loss causation because Vivendi's stock price did not increase on the dates of most of the alleged misstatements. The District Court (Holwell, J.) ruled that the misstatements could have caused inflation either "by adding to the inflation or helping to maintain it."[2] In December 2014, the District Court (Scheindlin, J.) entered a partial final judgment of approximately $50 million, inclusive of prejudgment interest, against Vivendi.

Several investment funds managed by Gabelli & Co. opted out of the class action. These opt-outs were "value investors," who invested in stocks that they believed had intrinsic values that exceeded their prevailing stock prices and had "catalysts" that might cause the stock prices to increase to those intrinsic values. After a bench trial, Judge Scheindlin held that defendants had rebutted the fraud-on-the-market

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1 Prior to a partial final judgment being entered in December 2014, the case was assigned to the late Judge Harold Baer, Jr., Judge Richard Holwell (ret. 2012), and Judge Shira Scheindlin (ret. 2016).

2 *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 562 (S.D.N.Y. 2011). After the Supreme Court's decision in *Halliburton Co.* v. *Erica P. John Fund, Inc.* (*Halliburton II*), 134 S. Ct. 2398 (2014), Vivendi requested permission to file a new motion for judgment as a matter of law, arguing that plaintiffs had failed to show "price impact." Judge Scheindlin did not permit the motion, but noted that Vivendi had raised an "interesting" issue that it could pursue on appeal. *In re Vivendi Universal, S.A. Sec. Litig.*, 2014 WL 4080950, at *2 (S.D.N.Y. Aug. 18, 2014).

presumption of reliance by showing that the opt-outs likely would have made the same purchasing decisions even if they had known about the fraud. Judge Scheindlin thus dismissed the Gabelli opt-outs' claims.[3]

The Second Circuit's Decisions

Vivendi appealed from the class action partial final judgment, arguing, among other things, that plaintiffs' expert, Dr. Nye, should have been precluded from testifying. The Gabelli opt-outs also appealed from the dismissal of their claims, arguing that defendants had failed to rebut the fraud-on-the-market presumption of reliance. In an opinion by Judge Livingston, joined by Judges Cabranes and Lynch, the Second Circuit affirmed the class action judgment. The same panel affirmed the Gabelli judgment.

The "Price Maintenance" Theory

The Second Circuit next held that the District Court did not abuse its discretion in admitting expert testimony from plaintiffs' damages expert, Dr. Nye. In reaching this conclusion, it rejected Vivendi's argument that Dr. Nye's analysis was defective because it failed to connect most of Vivendi's misstatements with stock price movements, and instead relied on the proposition that some of the misstatements had "maintained" artificial inflation already in Vivendi's stock price.

Dr. Nye had performed an event study designed, first, to identify statistically significant stock price movements specific to Vivendi (and not the industry or market at large), and, second, to identify the statistically significant price movements on dates when news about Vivendi's liquidity risk became public. After calculating the total artificial inflation relating to Vivendi's unknown liquidity risk, Dr. Nye then calculated the inflation for each day of the class period by applying an "inflation trajectory" model that assumed that the inflation grew over the relevant period. Dr. Nye did not, however, measure the amount of inflation that the various alleged misstatements actually caused.[4] Further, for most of the misstatements presented to the jury, Dr. Nye did not identify any inflation at all that entered the stock price as a result of that misstatement. Vivendi argued that this rendered Dr. Nye's testimony unreliable and inadmissible.

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[3] *GAMCO Investors, Inc.* v. *Vivendi, S.A.*, 927 F. Supp. 2d 88 (S.D.N.Y. 2013).

[4] Dr. Nye's model thus purported to measure "actual inflation" (the difference between the stock price and the stock price that would have prevailed if the truth had been known), and *not* "fraud-induced inflation" (the amount of inflation caused by the actionable misstatements). *Vivendi* Slip Op. at 66-67, 76-78 & n.19. Actual inflation sets the "maximum amount" of fraud-induced inflation. *Id.* at 77. It remains for a jury to determine "how much, if any" of the actual inflation was fraud-induced. *Id.* at 66.

The Second Circuit rejected Vivendi's argument. It held that statements that "maintain" inflation *can*, in certain circumstances, have a price impact. For instance, pre-existing inflation may dissipate over time as the truth comes out on its own, or if a defendant remains silent in the face of escalating concerns. In this case, however, Vivendi did *not* remain silent, but made affirmative statements that prevented the inflation from dissipating from its stock. The Second Circuit noted the legal principle that once an issuer chooses to speak, it assumes the obligation to "tell the whole truth." *Vivendi* Slip Op. at 72. In a footnote, the Second Circuit clarified that it was only rejecting Vivendi's argument that statements unassociated with an increase in inflation "categorically" lack price impact. *Id.* at 78 n.20. The Second Circuit allowed that this principle will not hold true for every misstatement that does not cause the stock price to rise, saying "there may be other reasons . . . why some statements unassociated with an increase in inflation do not affect a company's stock price." *Id.* On these facts, however, the Second Circuit held that the District Court did not abuse its discretion in allowing Dr. Nye to testify.

Rebuttal of the Fraud-on-the-Market Presumption

In the Gabelli opt-out appeal, the Second Circuit affirmed, as not clearly erroneous, the District Court's finding that defendants had successfully rebutted the fraud-on-the-market presumption of reliance. While declining to "explicate the contours of *Halliburton* here, further theorize on the presumption, or otherwise address the relevance of the typical value investing model to a rebuttal showing," the Second Circuit affirmed on the "much narrower theory" that "Vivendi proved that GAMCO would have purchased Vivendi securities even had it known of Vivendi's alleged fraud." *GAMCO* Slip Op. at 8.

The Second Circuit left open the issue of whether such a *Halliburton II* rebuttal requires a showing that the plaintiff, had it been aware of the fraud, would have purchased "at the same price." *Id.* at 8 n.4. The Second Circuit found that the record of the bench trial supported Judge Scheindlin's finding that the opt-out plaintiffs would indeed have purchased at the same prices. *Id.* at 16-18.

Analysis

The Second Circuit's at least partial acceptance of the "price maintenance" theory is a significant development in this Circuit. It will allow plaintiffs greater flexibility to assert fraud claims premised on allegations that the stock price decreased after "bad news," regardless of whether it can be shown the allegedly false "good news" previously caused a stock-price increase. That theory is arguably in tension with the Eighth Circuit's holding that a "front end" showing—*i.e.*, a showing that alleged misstatements did not cause a statistically significant stock-price increase when made—is generally sufficient to rebut the fraud-on-the-market presumption of reliance.[5]

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[5] *IBEW Local 98 Pension Fund* v. *Best Buy Co., Inc.*, 818 F.3d 775 (8th Cir. 2016).

That said, the range of cases in which the Second Circuit will accept the price maintenance theory remains to be seen. As the Second Circuit acknowledged, on its facts, the *Vivendi* case was "remarkable in part because the problem that Vivendi sought to conceal from the public was so vast, and touched upon so many aspects of its business, that a few scattered misstatements would not have sufficed to mask it." *Vivendi* Slip Op. at 52. Further, the *Vivendi* court was evaluating the expert evidence after trial under a very permissive abuse-of-discretion standard. In other, less-remarkable cases, there may be no reason to believe it likely that the stock price would have deflated but for the allegedly confirmatory misstatement. In the absence of evidence that an allegedly confirmatively misstatement actually counteracted an anticipated decline, courts may find the price maintenance theory to be unacceptably speculative.

The Second Circuit's ruling with respect to the Gabelli opt-outs also leaves open the precise contours of a *Halliburton II* rebuttal based upon a particular plaintiff's indifference to a fraud on the market. Regardless of the precise standard, the Second Circuit's ruling makes clear that defendants may successfully rebut the fraud-on-the-market presumption by developing evidence that the alleged fraud likely would not have affected the plaintiffs' investment decisions. This factual development will be important, in particular, in the opt-out cases filed by sophisticated investors that often accompany class action litigation.

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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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