

Second Circuit Provides Clarity on Key Investor Protections

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The Second Circuit Court of Appeals this week handed down two decisions important to investor rights: *In re Vivendi, S.A. Securities Litigation* ("Vivendi") and *GAMCO Investors, Inc. v. Vivendi Universal, S.A.* ("GAMCO"). In *Vivendi*, the Second Circuit (i) clarified the requirements for proving "loss causation" in securities fraud cases and (ii) endorsed the "inflation-maintenance" theory of liability, under which defendants may be liable for false statements that maintain (but do not increase) the price of a company's stock. Meanwhile, in *GAMCO*, the Second Circuit made clear that the fraud-on-the-market theory may be rebutted in efficient-market cases where a security's price is inflated by fraud only in the extraordinary instance where plaintiff would have bought the security even if it had *actual knowledge* of the alleged fraud. ***Vivendi*: Misstatements That Maintain Artificial Price Inflation Are Actionable, and Loss Causation Does Not Require an Admission of Fraud** In *Vivendi*, the Second Circuit rejected defendants' attempt to overturn a jury verdict finding that Vivendi violated the securities laws and awarding investors approximately \$50 million. The Second Circuit in its affirmance joined the Seventh and Eleventh Circuits in holding that a defendant may be liable for a misstatement that *maintains* a security's artificially high price, even if the misstatement does not cause an *increase* in the price of the security. The Second Circuit's approval of this "inflation-maintenance" theory of liability is particularly critical to investor rights because securities frauds often involve repeated misstatements over a long period of time professing that a company has met market expectations when, in reality, it fell short. In another important part of its decision, the Second Circuit rejected defendants' arguments that plaintiffs failed to prove "loss causation" - a legal doctrine that says a company's misrepresentations caused an investor loss - an essential element for claims under Section 10(b) of the Securities Exchange Act of 1934. The defendants argued that plaintiffs failed to show loss causation because news of Vivendi's liquidity problems and other financial struggles did not specifically mention or correct any of defendants' prior misstatements about the Company's liquidity. The Court disagreed, holding that plaintiffs adequately proved loss causation by showing that news about Vivendi's liquidity problems "revealed the truth about Vivendi's liquidity risk," even if defendants never admitted that their prior statements were untrue. In so holding, the Second Circuit reinforced the commonsense rule that violators of the securities laws are not allowed to escape liability merely by never admitting specifically to the falsity of their prior misstatements. ***GAMCO*: Fraud-on-the-Market Presumption for a Security Whose Price Was Inflated by Fraud Can Only Be Rebutted by Proof That Investor Would Have Purchased the Security Even with Knowledge of the Alleged Fraud** The Second Circuit this week also issued an opinion in *GAMCO*, an individual action based on the same fraud at issue in the *Vivendi* class action. In *GAMCO*, the Second Circuit confirmed that the fraud-on-the-market presumption (that investors can rely on the market price of the stock as reflecting all publicly available information about a company) is alive in individual actions, generally applies to value investors, and may only be rebutted in a case where fraud inflated a security's price by proof that the investor would have purchased the security even if the investor had *known* of the fraud. Although the Second Circuit affirmed the district court's finding that the presumption had been rebutted in that case, it did so on the narrow ground that it found no "clear error" by the district court. As the Court explained, there was unusually compelling evidence in that case that "GAMCO would have purchased Vivendi securities even had it known of Vivendi's alleged fraud." The Second Circuit reiterated that the presumption of reliance on a

security price inflated by fraud is rebuttable only upon a strong showing of this kind, which is a very high hurdle for defendants to clear.