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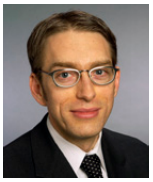
Rebutting the **Presumption Of Reliance** in Securities Class Actions

'GAMCO' presents an 'extraordinary case.'

BY ROGER A. COOPER, MATTHEW M. BUNDA AND ANTHONY M. SHULTS

Since *Basic v. Levinson*,[1] investors bringing claims under §10(b) of the Securities Exchange Act of 1934 have enjoyed a rebuttable presumption of reliance on alleged material misstatements or omissions, provided the shares they transacted traded in an efficient market. Because few securities cases go to trial, there have been few cases in which courts have considered whether defendants have, on an individual basis, rebutted the presumption of reliance. A recent decision by Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York, however, "is just such an extraordinary case."[2] Scheindlin's decision in *GAMCO v. Vivendi* demonstrates that the presumption is indeed rebuttable, particularly where shareholders made investment decisions based on sophisticated valuations detached from a security's market price and the defendant's alleged misrepresentations.

In *GAMCO*, plaintiffs alleged that the defendant company failed to disclose its liquidity problems, thus inflating the price of its shares.[3] After a bench trial, Scheindlin ruled that defendants had rebutted the presumption that plaintiffs relied on Vivendi's misrepresentations because the evidence showed that plaintiffs determined that Vivendi was an attractive investment regardless of the liquidity concerns allegedly hidden from the market.[4] As more defendants consider the feasibility of litigating securities fraud cases through trial, *GAMCO* offers a useful template for how to try questions of individual reliance.



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The 'Basic' Presumption

Under *Basic*, a plaintiff in a §10(b) securities fraud case may establish a rebuttable presumption of reliance on the defendant's alleged misrepresentations through the "fraud-on-the-market" theory.[5] The "premise" of this theory "is that the price of a security traded in an efficient market will reflect all publicly available information about a company," including the impact of any material misrepresentations.[6] Therefore, if the market for that particular security "is shown to be efficient, courts may presume that investors who traded securities in that market relied on public, material misrepresentations regarding those securities."[7] A central assumption is that investors "rely on the security's market price as an unbiased assessment of the security's value."[8] Where, however, defendants demonstrate that a particular plaintiff did not rely on market price in making its purchase or sale, the presumption of reliance may be rebutted.[9]

Because securities fraud cases rarely proceed to trial, there are few instances of defendants attempting to rebut the *Basic* presumption on the merits, especially with a fully developed record. The case law that does treat the issue generally arises in class

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actions, where defendants have argued at the class certification stage that the proposed class representative's claims are not typical of the class claims or that common issues will not predominate because the plaintiffs did not in fact rely on the integrity of the market. For example, in *In re Pfizer Securities Litigation*, defendants asserted that the lead plaintiffs' reliance on their advisors' sophisticated valuation analyses, rather than "information in the marketplace," meant that plaintiffs "did not [truly] rely on market price when deciding to invest," thus rendering their claims atypical of the class claims.[10] Similarly, in *In re WorldCom Securities Litigation*, defendants argued that the named plaintiffs were "atypical and subject to unique defenses" because they "relied on the advice of highly sophisticated investment managers" who believed that the market price "understated" the defendant company's true value.[11] Finally, in *In re Initial Public Offering Securities Litigation*, defendants argued that individual issues would predominate over common questions because the plaintiff class included "thousands of day and momentum traders [who] were not concerned about the integrity of [the] stock's market price" in making their "decision to purchase."[12] In none of these cases, however, did the defendants' arguments prevail.

The lack of success by defendants at the class certification stage has introduced skepticism into courts' reception of reliance arguments. For example, the *Pfizer* court observed that "the unique defense rule…is not rigidly applied," and described it as "intended to protect [the] plaintiff class—not to shield defendants from potentially meritorious suit."[13] In this context, courts have stressed the "well established" precedent "that reliance on the advice of third parties does not, in and of itself, constitute non-reliance, so long as the third party, in turn, relied on the integrity of the market,"[14] and that the use of "sophisticated investment managers" does not necessarily sever the link between plaintiffs' investment decisions and market integrity.[15] Moreover, even in the rare case outside of the class certification context, defendants have had little luck in rebutting the presumption. In *Black v. Finantra Capital*, for example, the Second Circuit reversed a decision that overturned a jury's determination of material reliance on market price, holding that the jury was free to discredit testimony indicating that "market price was 'not really relevant'" to the plaintiff's investment decision and credit testimony that the plaintiff "took market price into account" to "determine[] whether he was 'making a good deal.'"[16] That the plaintiff "also took other considerations, such as [the company's] future prospects, its business plan, and his trust in the people soliciting his investment, into account in making his investment decision [did] not foreclose a finding of material reliance upon market price."[17]

Because securities fraud cases rarely proceed to trial, there are few instances of defendants attempting to rebut the 'Basic' presumption on the merits, especially with a fully developed record. **'GAMCO' is a significant counterweight** to this developing trend.

'GAMCO v. Vivendi'

The *GAMCO v. Vivendi* decision is a significant counterweight to this developing trend. Based on a complete trial record, Scheindlin gave teeth to *Basic*'s directive that "*[a]ny* showing that severs the link between the alleged misrepresentation and…the plaintiff['s]…decision to trade at a fair market price…will be sufficient to rebut the presumption of reliance."[18]

Beginning in 2002, investors in Vivendi, S.A., a French multimedia conglomerate, brought suit against the company under §10(b), alleging that they purchased Vivendi shares at artificially inflated prices as a result of Vivendi's alleged material misrepresentations and omissions regarding its liquidity. One group of plaintiffs included GAMCO Investors, a registered investment advisor and asset management service that was a subsidiary of Gabelli Asset Management (collectively, GAMCO).[19]

Vivendi was collaterally estopped by a prior judgment from challenging any aspect of the §10(b) claim other than GAMCO's reliance on the integrity of the market price of Vivendi securities, which was to be presumed under the fraud on the market theory.[20] The prior judgment also precluded Vivendi's use of a truth on the market defense.[21] As a result, the only open issue in *GAMCO* was whether defendants could rebut the presumption of reliance "without arguing that the market for Vivendi…was inefficient, that there was no price impact, that the truth about Vivendi's misstatements was known to the market, or that the plaintiffs were in possession of corrective non-public information."[22]

During a two-day bench trial that put plaintiffs' investment strategy in the spotlight, defendants established how GAMCO investment analysts used proprietary valuation techniques to determine a company's intrinsic value—referred to as its Private Market Value or PMV, which "is the price that an informed industrialist would be willing to pay for [the company], if each of its segments were valued independently in a private market sale."[23] GAMCO's investment strategy was to "invest[] in a company when its PMV is substantially higher than its market capitalization, and there is a 'catalyst'…that is going to [attract investor attention, unlock intrinsic value, and] cause the market price to rise to the level of" its PMV.[24] During the relevant period, GAMCO analysts concluded that Vivendi securities were trading well below the company's true PMV and, considering "the spread between that PMV and the market price of Vivendi securities,…consistently gave a 'buy' or 'hold' recommendation."[25]

At this time, Vivendi was experiencing a "liquidity crisis" after taking on significant debt, and the material misstatements and omissions made by Vivendi related to attempts to conceal this crisis.[26] Following a series of corrective disclosures, GAMCO analysts became aware of Vivendi's liquidity problems, but determined that they were only a short-term concern.[27] Moreover, by reducing Vivendi's market price without impacting the company's PMV, the corrective disclosures widened the gap between market price and intrinsic value and only increased the attractiveness of the investment to GAMCO.[28] As a result, GAMCO "doubled or tripled" its holdings of Vivendi securities during the corrective disclosure period.[29]

Based on these facts, Scheindlin determined that plaintiffs did not in fact "rely on the market price of [the] securities as an accurate measure of their intrinsic value."[30] Rather, "the market price…factored into Plaintiffs' investment decision only as a comparator with PMV."[31] GAMCO's PMV assessment was "completely independent" of Vivendi's market price and liquidity problems.[32] Thus, the court stressed that it was PMV that determined plaintiffs' choice to purchase Vivendi shares and that "market price…was not the 'motivating driving force' behind Plaintiffs' investment decision."[33] Scheindlin concluded, therefore, that Vivendi had successfully rebutted the reliance presumption.

Importantly, the mere fact that plaintiffs were sophisticated investors who employed private valuation methods did not mean that the presumption of reliance could not apply to them.[34] Rather, the key factor was that plaintiffs could not demonstrate that "but for the claimed misrepresentations or omissions, [they] would not have entered into the detrimental securities transaction."[35] In fact, in the "counterfactual" circumstances of the *GAMCO* case, plaintiffs would have been more likely to purchase Vivendi securities had the company fully disclosed its liquidity problems, leading to a further decrease in market price and increase in the spread between market capitalization and PMV.[36]

In reaching her decision, Scheindlin rejected two central arguments raised by plaintiffs. Initially, plaintiffs asserted that to rebut the presumption of reliance, the defense must demonstrate that plaintiffs would have purchased the securities at the same price had they been fully aware of Vivendi's liquidity misrepresentations. In Scheindlin's view, however, demonstrating "a plaintiff's willingness to trade at the same price, even knowing of the fraud, is *one way* that the presumption may be rebutted," but not the "*only* way."[37] Plaintiffs were similarly unsuccessful in arguing that defendants were required to offer "convincing proof that price played no part whatsoever in [plaintiffs'] decision making process."[38] Such a holding "would effectively convert the fraud on the market theory into an irrebuttable presumption"[39] and run afoul of *Basic*'s observation that "[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, will be sufficient to rebut the presumption of reliance."[40]

Scheindlin also rejected plaintiffs' suggestion that the Second Circuit held in *Black v. Finantra Capital* that any plaintiff who transacts in a security at market price or considers market price in determining whether the security is "a good deal" would be entitled to the presumption.[41] As Scheindlin acknowledged, this interpretation is "overly broad: had the Second Circuit intended to announce such a sweeping principle, it would have done so."[42] It also runs against *Basic*'s recognition that the presumption can be "rebutted when the plaintiff would have transacted in the security regardless of market price"[43] and a court's responsibility to determine whether the plaintiff in fact materially relied on the integrity of the market price as an assessment of the security's value.

In sum, the *GAMCO* decision makes clear that efforts to rebut the presumption of reliance can be successful. One such way, the case demonstrates, is with a factual record that convincingly severs the link between a plaintiff's investment decision and the market price that incorporated the defendant's alleged misrepresentations.

Observations

GAMCO provides defendants in securities fraud cases with useful guideposts in challenging a plaintiff's entitlement to the *Basic* presumption. First, the decision reiterated that purchasing *at* the market price, or based on an investment strategy that compares an internal valuation *with* the market price, does not necessarily entitle plaintiffs to the presumption. Second, facts that divorce a plaintiff's purchasing decision from the subject matter of the defendant's allegedly fraudulent statements offer powerful evidence that the plaintiff did not rely on those statements. For example, the court concluded that GAMCO's PMV model did not take Vivendi's liquidity issues into account and that the truth about Vivendi's liquidity would not have negatively affected its PMV or made Vivendi a less attractive investment to GAMCO.[44]

Still, Scheindlin was careful to note that her holding was "sharply limited to its unusual facts, and should not be taken to suggest that sophisticated institutional investors or value-based investors are not entitled to the fraud on the market presumption in general."[45] Nevertheless, the increasing use of complex models and valuation strategies by sophisticated investors suggests that the factual circumstances of *GAMCO* may not prove "unusual" for long. And, while the *GAMCO* decision reaffirmed that simply establishing an investor's level of sophistication will not be sufficient to rebut the presumption, Scheindlin's approach makes clear that defendants going forward should delve deeply into a plaintiff-investor's decision-making process in attempt to sever the link with market price. As part of their discovery efforts, defendants should thoroughly examine the mechanics of plaintiffs' investment strategies to determine what were the principal factors informing plaintiffs' decisions and to learn what role, if any, market price played.

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[1] 485 U.S. 224 (1988).

[2] *GAMCO Investors v. Vivendi*, 2013 WL 765122, at *8 (S.D.N.Y. Feb. 28, 2013).

[3] Id. at *1.

[4] Id. at *8.

[5] 485 U.S. 224.

[6] *Amgen v. Connecticut Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1190, 1192 (2013).

[7] Id. at 1192.

[8] Id.

[9] Id. at 1193.

[10] 282 F.R.D. 38, 45-46 (S.D.N.Y. 2012).

[11] 219 F.R.D. 267, 281 (S.D.N.Y. 2003); see also *Pfizer*, 282 F.R.D. at 45 (Plaintiffs' advisor believed "that the sell-off [of Pfizer stock] was overdone and the attractiveness of Pfizer as an investment had not been diminished and therefore at a lower price it was perhaps even more attractive than it had been before").

[12] 227 F.R.D. 65, 108 (S.D.N.Y. 2004).

[13] *Pfizer*, 282 F.R.D. at 45; see also *In re IPO*, 227 F.R.D. at 96 ("'[U]nique' investment strategies do not defeat typicality. The classes as pled include many investors with similar investment strategies, so any 'unique defenses' based on those strategies are in fact common questions"); *Saddle Rock Partners v. Hiatt*, 2000 WL 1182793, at *5 (S.D.N.Y. Aug. 21, 2000) ("[E]ven a successful defense rebutting reliance would still leave intact the basic issues of defendants' liability for the alleged fraud…[which] are common to all class members…").

[14] *Pfizer*, 282 F.R.D. at 45.

[15] *WorldCom*, 219 F.R.D. at 281-82.

[16] 418 F.3d 203, 209-10 (2005).

[17] Id. at 210.

[18] *GAMCO*, 2013 WL 765122, at *11 (quoting *Basic*, 485 U.S. at 248) (emphasis in original).

[19] Id. at *1-2.

[20] Id.

[21] Id. at *1.

[22] Id.

[23] Id. at *4.

[24] Id.

[25] Id.

[26] Id. at *2.

[27] Id. at *4-5.

[28] Id. at *5.

[29] Id.

[30] Id. at *6.

[31] Id. at *5.

[32] Id. at *8.

[33] Id. at *10.

[34] Id. at *9.

[35] Id. at *8.

[36] Id.

[37] Id. at *10 (emphasis in original).

[38] Id.

[39] Id.

[40] Id. (quoting *Basic*, 485 U.S. at 248).

[41] Id. at *9-10.

[42] Id. at *9.

[43] Id.

[44] Id. at *5.

[45] Id. at *9.

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