

The Second Circuit Alters Standard Used in Review of Class Certification Motions

December 7, 2006

On December 5, 2006, a panel of the United States Court of Appeals for the Second Circuit issued a decision in the consolidated IPO Securities Litigation that alters the standard applied by a district judge adjudicating a motion for class certification. In a decision issued without dissent, the Panel vacated the district court's ruling that class certification may be granted if a plaintiff makes "some showing" with respect to the requirements of Fed. R. Civ. P. 23, and held that a district court can certify a class only if the court resolves factual disputes with respect to each requirement of Rule 23 and is persuaded to rule, based on the facts and the applicable legal standard, that each requirement has been met. *In re Initial Pub. Offering Sec. Litig.*, No. 05-3349 (2d Cir. Dec. 5, 2006) ("Panel Decision").

Background

The Panel's decision was issued in the IPO Securities Litigation, the consolidation of suits filed by thousands of investors in 2001 alleging that 55 underwriters, 310 issuers and hundreds of their officers had engaged in a scheme to defraud the investing public in violation of Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. Specifically, plaintiffs allege that defendants improperly conditioned allocation of IPO shares on agreements to purchase the issuers' shares in the aftermarket, often at escalating prices, and required customers who received allocations of IPO shares to pay undisclosed compensation to the underwriters. Plaintiffs also allege that the underwriters inflated the price of the securities by preparing analyst reports that contained inaccurate information and improper recommendations influenced by conflicts of interest under which the analysts allegedly operated.

The suits were transferred for pretrial coordination to Judge Scheindlin, of the Southern District of New York, who consolidated the suits by issuer. In 2003, the District Court denied defendants' motions to dismiss and for judgment on the pleadings. In an opinion dated October 13, 2004, the District Court granted plaintiffs' motion for class certification in six focus cases, while making certain revisions to the proposed class. *In re IPO Sec. Litig.*, 227 F.R.D. 65 (S.D.N.Y. 2004). In its ruling, the District Court held that plaintiffs needed to make "some showing" with respect to the requirements of Fed. R. Civ. P. 23 (*i.e.*, numerosity, commonality, typicality, adequacy of representation, predominance and superiority), and that they had met this standard. The District Court noted that recent appellate decisions from other circuits suggested that plaintiffs must establish the Rule 23 requirements by a preponderance of the evidence, but declined to apply that standard where the Rule 23

requirements were "enmeshed" with the merits because of concern that doing so might prejudice the defendant and run afoul of Supreme Court precedent. *Id.* at 92.

The Second Circuit's Decision

The Panel rejected the District Court's "some showing" standard. In doing so, it recognized that the Second Circuit's precedent regarding the applicable standard was ambiguous, and noted in particular that some of its prior rulings were influenced by an inaccurate reading of *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974), in which the Supreme Court stated, "We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action." That statement, the Panel explained, concerned a merits inquiry conducted by a trial court to determine whether the court could fairly impose the cost of class notice on defendants. Panel Decision at 20–25. Even though the merits inquiry was unrelated to a determination concerning Rule 23 prerequisites, the Panel observed that prior Second Circuit rulings had been influenced by the Supreme Court's statement when determining the extent to which a district court may engage in a merits inquiry when analyzing a plaintiff's showing concerning Rule 23 prerequisites. Panel Decision at 25–32.

The Panel then reviewed precedent from other circuits and concluded that case law in the Third, Fourth, Fifth, Seventh, Eighth and Eleventh Circuits has generally supported an obligation on the part of the district court to make a determination that Rule 23 requirements are met, rather than applying a standard akin to "some showing." *Id.* at 33–36. The Court identified only the First Circuit as having expressed disagreement with this line of authority, *id.* at 35, and decided to align itself with the courts that have "required definitive assessment of Rule 23 requirements, notwithstanding their overlap with merits issues." *Id.* at 41. The Panel ruled that a district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met by "resolv[ing] factual disputes relevant to each Rule 23 requirement and find[ing] that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and [being] persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met [,]" and that "the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement." *Id.* at 42.

Applying this standard to the plaintiffs' motion for class certification, the Panel held that the six focus cases could not be certified as class actions because plaintiffs' own allegations and evidence demonstrate that the Rule 23 requirement of predominance of common questions over individual questions cannot be met. Specifically, in order to allege reliance on defendants' alleged misrepresentations, plaintiffs invoked the presumption of reliance that is available under *Basic Inc. v. Levinson*, 485 U.S. 224, 245–47 (1988), when shares are traded in an efficient market. However, the Panel found that this presumption is not available to plaintiffs, since their "own allegations as to how slow the market was to correct the alleged price inflation despite what they also allege was widespread knowledge of the scheme indicate the very antithesis of an efficient market." Panel Decision at 44–46. Without this presumption, the Panel ruled, individual questions of reliance would predominate over common questions. *Id.* at 46. Similarly, the Panel noted that plaintiffs would have to establish that they traded the issuers' securities without knowledge of the fact that the prices of the shares were affected by misrepresentations, and ruled that plaintiffs' assertion that common questions of

knowledge predominate over individual questions was "thoroughly undermined" by the plaintiffs' allegations as to the widespread knowledge of the alleged scheme. *Id.* at 47.

Key Impacts

- The Panel's ruling that district courts must resolve factual disputes with respect to each Rule 23 requirement significantly raises the bar for obtaining class certification in the Second Circuit. Defendants in cases pending in district courts in the Second Circuit will devote greater resources to opposing class certification motions and have a greater likelihood of success.
- According to the latest year-end review produced by Cornerstone Research, the Second Circuit had the highest number of securities class action filings in 2005 and the second highest number of filings from 1996 to 2004. Thus, the Panel's decision is binding precedent in a circuit that has historically attracted a great deal of class action securities litigation. Plaintiffs may tend to view the Second Circuit as a less hospitable venue for future filings. At the same time, defendants in cases pending in other circuits can be expected to point to the Panel's decision to argue either for the adoption of a similar standard for the adjudication of motions for class certification, or for renewed vigor in the application of existing standards.
- Defendants in securities litigation sometimes turn to serious consideration of settlement after motions to dismiss are denied. In the wake of the Panel's ruling, defendants may be less willing to engage in settlement discussions after the denial of motions to dismiss, and may prefer in many instances to await a decision regarding class certification.
- The Panel's decision raises the question of the fate of settlement agreements reached in class actions pending in the Second Circuit that are currently awaiting court approval, including at least two substantial settlement agreements reached previously by defendants in the IPO Securities Litigation.