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HEADLINE: In re IPO Securities Litigation: Second Circuit Adopts Stricter Class Certification Standards

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BODY:

On December 5, 2006, the Second Circuit handed down a significant decision vacating the District Court's order granting class certification in the *In re Initial Public Offering Securities Litigation.* 1 In its decision, the Second Circuit clarified the legal standard of proof that is to be applied in resolving motions for class certification where fact issues relevant to whether the class should be certified overlap with fact issues going to the merits of the claims in the lawsuit. The decision establishes new rules that must be met in order to obtain class certification; they increase the burden plaintiffs faced under prior decisions of the Second Circuit.

The Requirements of Rule 23

For a class to be certified it must meet all four requirements of Rule 23(a) of the Federal Rules of Civil Procedure. Rule 23(a) provides that one or more members of a class may sue or be sued as representative parties on behalf of all class members only if:

* The class is so numerous that joinder of all members is impractical;

* There are questions of law or fact common to the class;

* The claims or defenses of the representative parties are typical of the claims or defenses of the class; and

* The representative parties fairly and adequately protect the interests of the class. 2

In addition to these four requirements, the class must establish that the action is "maintainable" by satisfying one of the three Rule 23(b) categories. The Rule 23(b) prong that is frequently resorted to in securities class actions, and which was relied on by the Plaintiffs in the *In re IPO Securities Litigation,* is Rule 23(b)(3) which provides that an action may be maintained as a class action if:

(3) the court finds that the questions of law or fact common to the members or of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or

undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action. 3

The *In re IPO Securities Litigation* Decision

Background

By any measure, the claims raised in the *In re IPO Securities Litigation* are massive. In 2001, thousands of investors filed class actions against 55 underwriters, 310 issuers, and hundreds of individual officers. Each class action lawsuit alleges a scheme to defraud the investing public in connection with one of the 310 separate initial public offerings (IPOs). All of these class actions have been consolidated for pretrial purposes in the Southern District of New York before Judge Shira A. Scheindlin. The Consolidated Class Action Complaint alleges violations of both the Securities Act of 1933 and the Securities Exchange Act of 1934. The Plaintiffs support their claims with, among others, allegations that the Underwriter Defendants:

* Conditioned allocations of shares at the offer price on the recipient's agreement also to purchase shares in the aftermarket;

* Required customers to pay the underwriters excessive commissions on transactions in other securities in exchange for allocations of shares in "hot" IPOs; and

* Failed to disclose conflicts of interest relating to analyst reports prepared in connection with the IPOs.

Upon agreement by the parties, six of the 310 consolidated class actions were chosen as "focus cases" for class certification.

On October 13, 2004, the District Court granted in part Plaintiffs' motion for class certification in the six focus cases, ruling that Plaintiffs met the requirements of Rule 23 under a "some showing" burden of proof standard. On June 30, 2005, the Second Circuit granted Defendants' petition to appeal this ruling under Rule 23(f).

Legal Standards for Rule 23 Requirements

District Court's Opinion

In deciding the motion for class certification, the District Court carefully analyzed the standard of proof a plaintiff must meet in order to succeed on a motion for class certification under Rule 23. The District Court found that the only parameters the US Supreme Court had articulated to guide lower courts in deciding motions for class certification were that a court must conduct a "rigorous analysis" in which it "may be necessary for the court to probe behind the pleadings." 4

In determining the "rigor" to be applied and the depth to which the pleadings should be "probed," the District Court considered recent decisions by the Fourth and Seventh Circuits that ruled that "plaintiffs must establish the requirements of Rule 23 by a preponderance of the evidence, even if resolving those issues requires a 'preliminary inquiry into the merits,' or there is an 'overlap with issues on the merits.'" 5 Ultimately, however, the District Court concluded, pursuant to the Supreme Court decision *Eisen v. Carlisle & Jacquelin*, 6 that "applying the preponderance of the evidence standard was inappropriate where those elements were 'enmeshed' with the merits of the case." 7

In *Eisen*, the Supreme Court determined that the district court was not authorized to conduct a preliminary hearing on the merits for the purpose of deciding which party would bear the costs of providing notice to all identifiable class members under Rule 23(c)(2). The Supreme Court held that there is "nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits in order to determine whether it may be maintained as a class action." Indeed, the Court observed that a preliminary inquiry into the merits at the class

certification stage could result in substantial prejudice to a defendant in later proceedings, 8 and cautioned that such findings could "color" the ultimate findings on the merits of the case. 9

Rather than adopt the preponderance of the evidence standard applied by other Circuits, the District Court applied the less stringent "some showing" standard established in Second Circuit precedents that relied on *Eisen, see, e.g., Caridad v. Metro-North Commuter Railroad* 10 and *In re Visa Check/Master Money Antitrust Litigation,* 11 and applied by courts within the Circuit without event prior to the Second Circuit's decision in *In re IPO Securities Litigation.* 12 The District Court found that the Plaintiffs had made "some showing" that the Rule 23 requirements were met and certified the class. Relying on the holdings in *Eisen, Caridad,* and *Visa Check,* the Court declined to review with greater "rigor" factual disputes related to the specific prongs of Rule 23 that also involved the merits of the case beyond the "some showing" threshold. Similarly, in reliance on *Caridad* and *Visa Check,* the District Court ruled both that it was inappropriate for it to weigh the competing expert reports submitted by the parties at the class certification stage and that the Plaintiffs' expert report sufficiently established a theory of loss causation for purposes of its class certification motion because the report was not "fatally flawed." 13

Second Circuit Review

The Second Circuit Panel disapproved of the District Court's use of the "some showing" standard of proof. While ruling that the lower court had erred by applying that standard in determining Plaintiff's class certification motion, the Panel openly acknowledged that its precedents had been "less than clear as to the applicable standards for class certification" and had "understandably led Judge Scheindlin astray." 14 The Panel then reviewed both its precedents and Supreme Court antecedents in order to trace where the mistake lay.

The Panel held that the "no merits inquiry" language in *Eisen* was taken out of context in earlier Second Circuit decisions. The proscription against conducting a merits inquiry in *Eisen* arose in the context of the district court's examination of an issue that "had nothing to do with determining the requirements for class certification," *i.e.,* the determination of whether to shift the cost of providing notice to the class from the plaintiffs to the defendants. Accordingly, far from proscribing a merits inquiry into the Rule 23 factors that must be satisfied for a class to be certified, the Panel found that, properly understood, the *Eisen* decision did not purport to even address that question. 15

The Panel then turned to the Second Circuit's analysis in *Caridad* and *Visa Check,* which the District Court relied on in certifying the class, and the Second Circuit's recent decision in *Heerwagen v. Clear Channel Communications.* In *Caridad,* the Second Circuit reversed the lower court's decision denying class certification in part because of the lower court's "weighing of the evidence," which it resolved in defendant's favor. The court ruled that class certification would not be warranted in the absence of "some showing" of commonality and typicality under Rule 23(b)(3) in connection with the defendant's challenged practices and the impact of those practices. After confirming that the plaintiffs were required to demonstrate that the prerequisites of Rule 23 were met in order to win certification, the *Caridad* court stated that "statistical dueling" between experts on issues concerning the merits of plaintiffs' claim was not appropriate at the class certification stage and remanded the case for further proceedings on the class certification motion. 16 The Panel disavowed Caridad to the extent that it might have implied that a "some showing" standard suffices for class certification. 17

Similarly, the Second Circuit in *Visa Check,* relying on *Caridad,* held that a district judge could not "weigh conflicting expert evidence or engage in the 'statistical dueling' of experts." The Panel disavowed this decision because it suggested that plaintiffs' expert evidence alone was "sufficiently reliable for class certification purposes" so long as the methodology was not "fatally flawed." 18

In *Heerwagen,* which was decided after the District Court's decision in *In re IPO Securities Litigation,* the Panel found that the Second Circuit had properly moved away from the "'some showing' and 'not fatally flawed' language of *Caridad* and *Visa Check*" and had applied the correct preponderance of the evidence standard to its class certification review. However, the Panel still disavowed the decision, finding that it, too, misapplied the "no merits inquiry"

admonition in *Eisen* by only authorizing the weighing of all evidence on class certification issues that were "sufficiently independent" of the merits. 19

In its analysis of the case law in other circuits, the Panel concluded that the predominant view is that a district judge must find that all of the Rule 23 requirements have been met by a preponderance of the evidence, even if doing so involves an inquiry into the merits. For example, prior to the Panel's decision, the Seventh Circuit in *Szabo* had held that "a judge should make whatever factual and legal inquires are necessary under Rule 23 even if 'the judge must make a preliminary inquiry into the merits.'" 20 Similarly, the Fourth Circuit in *Gariety*, agreeing with *Szabo*, had held that "Rule 23 factors 'must be addressed through findings, even if they overlap with issues on the merits.'" 21 The Third, Fifth, Eight, and Eleventh circuits had each also determined prior to the Panel's decision that a district judge must resolve factual disputes relating to whether Rule 23 requirements have been met, even if such issues also go to the merits of the putative class's claims. 22

The Panel also considered the 2003 amendments and commentary to Rule 23 in its decision, noting that they did not "explicitly resolve the split of authority" between the Second Circuit and the other circuits. 23 While the Advisory Committee on Civil Rules stated that "an evaluation of the probable outcome on the merits is not properly part of the certification decision," the Panel concluded, as it did in its analysis of *Eisen*, that the Committee was referring only to merits issues unrelated to the requirements of Rule 23. 24 As support for its conclusion that such evaluation should be made for class certification purposes where the class certification and merits issues overlap, the Panel noted that the Committee deemed it "appropriate to conduct controlled discovery into the 'merits,' limited to those aspects relevant to making the certification decision on an informed basis" when discovery at the certification stage includes "information required to identify the nature of the issues that actually will be presented at trial." 25

Finally, the Panel acknowledged that the standards for class certification in the Second Circuit needed clarification and set forth new rules governing the requisite showing for obtaining class certification. These rules provide that (1) a district judge may not certify a class without making a determination that each Rule 23 requirement has been met, (2) such determination can be met only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that the requirement has been met, and (3) the court's obligation to determine whether a Rule 23 requirement has been met is not lessened even if that determination overlaps with an issue going to the merits of the putative class's claims. While observing that its ruling did create a risk that Rule 23 hearings might extend into mini-trials of substantial "merits" issues, the Panel found that the risk could be avoided by district court judges exercising their "considerable discretion" to limit both discovery and the scope of a Rule 23 hearing. 26

Rather than remand the case to the District Court for reconsideration under its newly articulated standards, the Panel found it appropriate to apply them on its own based on its finding that the Plaintiffs' own allegations and evidence demonstrated that the Rule 23 requirements for class certification could not be met. Accordingly, the Panel returned the case to the District Court after ruling that "the cases pending on this appeal may not be certified as class actions." 27

Conclusion and Postscript

This decision brings the Second Circuit in line with its sister circuits in resolving class certification motions and provides district courts within the Circuit with a much clearer set of rules to apply in deciding such motions. Under these rules, class action plaintiffs will now have to demonstrate that all of the prerequisites of Rule 23 have met the familiar preponderance of the evidence standard and will no longer be able to invoke the more lenient "some showing" standard that previously passed muster in the Second Circuit. Further, while district judges previously were foreclosed from reviewing facts related to the merits of plaintiffs' claims in the context of Rule 23 motions, they are now mandated to weigh the evidence submitted by both plaintiffs and defendants on such issues and resolve them.

On January 8, 2007, Plaintiffs' filed a petition for rehearing and rehearing *en banc.* As a decision granting or denying Plaintiffs' petition has yet to be rendered by the Second Circuit, it remains to be seen if the final word has been written on this important issue.

FOOTNOTES

1 *In re IPO Securities Litigation*, 2006 WL 3499937 (2d Cir. Dec. 5, 2006).

2 Fed. R. Civ. P. 23(a).

3 Fed. R. Civ. P. 23(b).

4 *In re IPO Securities Litigation*, 2006 WL 3499937, at * 4 *citing General Telephone Co. of the Southwest v. Falcon*, 457 U.S. 147 (1982).

5 *Id. citing Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004); *Szabo v. Bridgeport Machines, Inc.*, 249 F.3d 672 (7th Cir. 2001).

6 *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974).

7 *Id. citing Eisen*, 417 U.S. at 177-178.

8 *Eisen* at 177-178.

9 *Id.* at 178.

10 *Caridad v. Metro-North Commuter Railroad*, 191 F.3d 283 (2d Cir. 1999).

11 *In re Visa Check/MasterMoney Antitrust Litig.*, 280 F.3d 124 (2d Cir. 2001).

12 *See, e.g., In re Salomon Analyst Metromedia Litig.*, 236 F.R.D. 208, 220-221 (S.D.N.Y. 2006) (District Court applied the "some showing" standard where Rule 23 issues overlapped with merits, finding that the preponderance of the evidence standard, used by the Court in *Heerwagen*, applied only to Rule 23 issues that were "sufficiently independent" of the merits); *In re Natural Gas Commodities Litig.*, 231 F.R.D. 171, 181 (S.D.N.Y. 2005) (applied "some showing" standard to Rule 23 requirements); *DeMarco v. Robertson Stephens Inc.*, 228 F.R.D. 468, 470 (S.D.N.Y. 2005) (same); *Latino Officers Ass'n City of New York v. City of New York*, 209 F.R.D. 79, 89 (S.D.N.Y. 2002) (same).

13 *In re IPO Securities Litig.*, 2006 WL 3499937, at * 5.

14 *Id.* at * 7.

15

Id. at * 15.

16

Caridad, 191 F.3d at 292-293.

17

In re IPO Securities Litig., 2006 WL 3499937, at * 15.

18

Id.; Visa Check, 280 F.3d at 135.

19

Id.; Heerwagen v. Clear Channel Communications, 435 F.3d 219, 232-233 (2d Cir. 2006).

20

Szabo, 249 F.3d at 676.

21

Gariety, 368 F.3d at 366.

22

See Newton v. Merrill Lynch Pierce, Fenner & Smith, Inc., 259 F.3d 154 (3d Cir. 2001); *Unger v. Amedisys, Inc.*, 401 F.3d 316 (5th Cir. 2005); *Blades v. Mosanto Co.*, 400 F.3d 562 (8th Cir. 2005); *Love v. Turlington*, 733 F.2d 1562 (11th Cir. 1984); *but see In re Polymedica Corp. Securities Litig.*, 432 F.3d 1 (1st Cir. 2005) (First Circuit aligned itself with other circuits by permitting merits inquiry but limited inquiry by "prohibiting a district court from inquiring into whether a plaintiff will *prevail* on the merits at class certification.").

23

In re IPO Securities Litig., 2006 WL 3499937, at * 13.

24

Id.; Fed. R. Civ. P. 23 Adv. Comm. Notes 2003.

25

Fed. R. Civ. P. 23 Adv. Comm. Notes 2003.

26

In re IPO Securities Litig., 2006 WL 3499937, at * 15.

27

Id. at * 1, 16.

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