

Client Alert

Second Circuit Clarifies Standard for Class Certification

In a ruling that significantly raises the bar for plaintiffs seeking to certify a class, the United States Court of Appeals for the Second Circuit recently vacated a district court order that had granted class certification in what the media has described as one of the largest consolidated securities class actions in United States history. While the district court had found that plaintiffs need only make “some showing” of compliance with the requirements of Federal Rule of Civil Procedure 23 (Rule 23) governing class certification, the Second Circuit rejected that lower standard. It ruled that before a district court may certify a class it must assess all of the evidence and make a determination that each of the Rule 23 requirements has been met, even if such determination overlaps with the ultimate merits in the case.

In Re: IPO Securities Litigation, No. 05-3349-CV (Dec. 5, 2006), resulted from the filing in 2001 of thousands of individual class actions alleging fraud on the part of securities issuers and underwriters in connection with a series of initial public offerings (IPOs). In total, plaintiffs brought suit against 55 underwriters (including several of the nation’s largest), 310 issuers and hundreds of individual officers of the issuing companies. Plaintiffs alleged that defendants had conspired to manipulate the market for IPOs by, among other means, conditioning allocations of shares in IPOs on agreements to purchase shares in the aftermarket and the payment of undisclosed compensation to the underwriters.

These individual class actions, numbering in the thousands, were transferred for pretrial coordination to Judge Shira Scheindlin of the United States District Court for the Southern District of New York. Judge Scheindlin consolidated the cases into 310 consolidated class actions, and then selected six of the consolidated class actions as “focus cases.”

The Plaintiffs in the six focus cases moved for class certification, and in October 2004 Judge Scheindlin issued an opinion granting the motion in substantial part. *In re IPO Securities Litigation*, 227 F.R.D. 65 (S.D.N.Y. 2004). With respect to the standard of proof required for plaintiffs to satisfy the requirements of Rule 23, Judge Scheindlin gave consideration to using a higher, preponderance of the evidence standard. However, Judge Scheindlin found that such a standard, particularly where the Rule 23 elements were “enmeshed” with the ultimate merits of the case, would conflict with the Supreme Court’s admonition that a district court faced with a certification motion may not conduct a preliminary inquiry into the merits. Accordingly, Judge Scheindlin adopted the lower, “some showing” standard. That standard required something more than simply accepting the allegations of plaintiffs’ complaint as true, but something less than a weighing of the evidence. It required that “in order to pass muster, plaintiffs – who have the burden of proof at class certification – must make ‘some showing.’ That showing may take the form of, for example, expert opinions, evidence (by document, affidavit, live testimony, or otherwise) or the “uncontested allegations of the complaint.” 227 F.R.D. at 93.

On appeal, the Second Circuit focused principally on “whether Judge Scheindlin applied proper legal standards in determining the existence of the four prerequisites for every class action: numerosity, commonality, typicality, and adequacy of representation, Fed. R. Civ. P. 23(a), and the two additional requirements for a (b)(3) class action: predominance, *i.e.*, law or fact questions common to the class predominate over questions affecting individual members, and superiority, *i.e.*,

class action is superior to other methods.” (Opinion at 19.) While recognizing that its own prior decisions had been less than clear, and used “language that understandably led Judge Scheindlin astray,” the Second Circuit found that Judge Scheindlin’s use of the “some showing” standard was erroneous. (Opinion at 20.) The Court ruled that: (1) a district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met, and not just supported by some evidence; (2) such determinations can be made only if the judge considers all the evidence, resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant have been established; and (3) 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. (Opinion at 42.)

Applying these standards to the case before it, the Second Circuit acknowledged that ordinarily a remand to the district court for reconsideration in light of the newly articulated standard would be appropriate. In this case, however, the Court ruled against such a remand, because the plaintiffs’ own allegations and evidence demonstrated that Rule 23’s requirement of predominance of common questions over individual questions could not be met. Specifically, the Court found that with respect to the elements of reliance and knowledge, individual questions predominated over common questions, thereby preventing plaintiffs from satisfying Rule 23. Thus, the Court concluded that it must vacate Judge Scheindlin’s order granting class certification.

In requiring district courts to determine that Rule 23’s requirements have been met, even if such determinations require consideration of the merits, the Second Circuit joins a number of other Circuits that have considered the issue. *See, e.g., Szabo v. Bridgeport Machines, Inc.*, 249 F.3d 672, 676 (7th Cir. 2001) (a “judge should make whatever factual and legal inquiries are necessary under Rule 23” even if “the judge must make a preliminary inquiry into the merits.”); *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 366 (4th Cir. 2004) (“the factors spelled out in Rule 23 must be addressed through findings, even if they overlap with issues on the merits.”), *see also, Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 166 (3^d Cir. 2001); *Blades v. Monsanto Co.*, 400 F.3d 562, 575 (8th Cir. 2005); *Unger v. Amedisys, Inc.*, 401 F.3d 316, 319 (5th Cir. 2005); *Love v. Turlington*, 733 F.2d 1562, 1564 (11th Cir. 1984).

In response to the Second Circuit’s Opinion, according to press reports plaintiffs’ counsel have made somewhat conflicting statements. One plaintiffs’ counsel has contended that the case “is not over,” noting that the Second Circuit’s Opinion only affects the six focus cases and that plaintiffs have the right to seek a review *en banc*. Another plaintiffs’ counsel has acknowledged that the Court’s decision appears “fatal” to class certification, and that separate litigation of thousands of individual cases may not be feasible. While the strategy that plaintiffs in this case ultimately pursue cannot be predicted, what appears certain is that the law of the Second Circuit now imposes a significantly higher standard on plaintiffs seeking class certification.

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