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SECOND CIRCUIT REVIEW

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Predominance Requirement for Class Certification

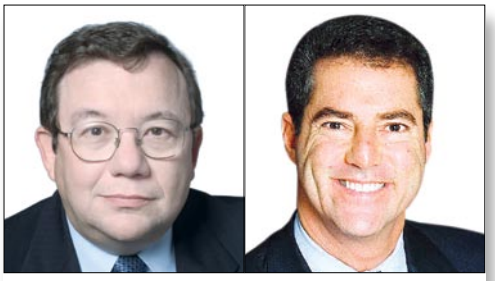
In this month's column, we discuss *McLaughlin v. American Tobacco Co.*,[1] in which the U.S. Court of Appeals for the Second Circuit, in a decision written by Judge John Walker Jr. and joined by Judges Ralph Winter and Rosemary Pooler, reversed the District Court's certification of a class action by smokers alleging they were deceived by the defendant tobacco companies' marketing of so-called light cigarettes as a healthier alternative to regular, or "full-flavored," cigarettes.

The court ruled that class certification was inappropriate because "numerous issues" in the case, including issues of reliance, causation, and injury, were "not susceptible to generalized proof."[2] Although this decision received media attention for its high-profile subject matter, it is extremely significant legally for the high bar it sets for putative class-action plaintiffs seeking class certification of fraud-based claims.

Background

Since the 1950s, the Federal Trade Commission (FTC) has barred tobacco companies from making any "health claims" in cigarette advertising, except claims that a cigarette was "low in nicotine or tars," provided that such a claim was, in fact, true and that "such difference or differences [we]re significant."[3] In 1967, the FTC went further and established a specific, mechanical procedure for testing the tar and nicotine "yield" of a cigarette for branding purposes.

As the court explained, however, the problem with the FTC's mechanical test was that the test failed to account for the actual behavior of smokers. In fact, smokers of light cigarettes tended to compensate for the lower tar and nicotine levels in these cigarettes: they inhaled more deeply; they covered the vents of cigarettes to obtain more smoke; or they simply smoked more cigarettes. Although, as the court noted, "[c]igarette manufacturers have apparently been aware of this phenomenon for some time," at least some smokers "continued at least until 2000 to believe that [light cigarettes] were healthier than full-flavored cigarettes."[4]



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The lack of any health benefit from smoking light cigarettes instead of regular cigarettes was confirmed in a 2001 report by the National Cancer Institute. That report found "no convincing evidence that changes in cigarette design between 1950 and the mid 1980s have resulted in an important decrease in the disease burden caused by cigarette use either for smokers as a group or for the whole population."[5]

The Institute's report prompted the *McLaughlin* lawsuit (as well as a lawsuit by the federal government). Plaintiffs, a putative class of "tens of millions" of smokers of light cigarettes manufactured by the defendants, filed suit in the U.S. District Court for the Eastern District of New York in May 2004, alleging claims under the federal Racketeer Influenced and Corrupt Organizations Act (RICO).[6] Plaintiffs' legal theory was that the defendant tobacco companies conspired, through their marketing and branding of light cigarettes, to deceive smokers into believing that these cigarettes were healthier than other types of cigarettes due to their lower tar and nicotine content. Plaintiffs argued that the tobacco companies' branding and marketing of these cigarettes amounted to mail and wire fraud, and thus formed the necessary predicate acts for a civil RICO claim. Plaintiffs' complaint sought trebled damages of $800 billion, largely based on the difference between "the value people were led to believe they were getting when they bought 'light' cigarettes for safety, and what they received, a non-safe product."[7]

In September 2006, the District Court granted plaintiffs' motion for class certification. In a lengthy opinion, which also, among other things, denied a motion for summary judgment by defendants, Judge Jack Weinstein held that all of the requirements for certification had been met.[8] In particular, with regard to the requirement of Rule 23(b)(3) that the court find that "questions of law or fact common to class members predominate over any questions affecting only individual members," the court held that "[t]he defendants' conduct and the impact of that conduct will be substantially the same for most class members" and that "[i]t would be both inefficient and unjust to force plaintiffs to re-ligitate the same issues concerning the existence, scope, and effect of what appears to be a uniform fraudulent scheme—whatever minor variations might have existed in its execution."[9]

In so ruling, the court rejected defendants' argument that the predominance requirement was not met because of the number of factual questions individual to each smoker, including reasonable reliance, loss causation, the amount of damages, and the statute of limitations. The District Court found such concerns to be "overstated," ruling that "variation among plaintiffs' reactions to defendants' representations is not great in ways that matter to the outcome of this case." The court pointed out that defendants' own documents say that smokers who decide to switch to "light" cigarettes are "concerned about [their] health, and…[are] willing to do something about it."[10]

Defendants requested an immediate interlocutory appeal of the District Court's class certification decision under Federal Rule of Civil Procedure 23(f). The Second Circuit granted defendants leave to appeal.

The Second Circuit Decision

The Second Circuit held that the District Court abused its discretion by certifying the class. It held, contrary to the District Court, that common

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questions of fact and law did not, in fact, predominate over questions affecting only individual members. In particular, the court found substantial individualized issues with regard to reliance, loss causation, injury, and defendants' statute of limitations defenses.

The court first discussed plaintiffs' obligation in proving their claims of mail and wire fraud—plaintiffs' alleged "predicate acts" under the RICO statute—to show that the plaintiffs reasonably relied upon the misrepresentations of the tobacco companies. In arguing that common issues of fact predominate on the issue of reliance, plaintiffs relied on the Second Circuit's decision in *Moore v. PaineWebber Inc.* In that case, the court stated that fraud claims based on "uniform misrepresentations made to all members of the class" are properly certified as class actions because such misrepresentations are subject to "generalized proof."[11]

The *McLaughlin* court limited this seemingly broad language of *Moore*, noting that proof of a widespread and uniform misrepresentation "only satisfies half of the equation; the other half, reliance on the misrepresentation, cannot be the subject of general proof." The court went on to note that smokers could conceivably choose to smoke light cigarettes not for health reasons, but because they prefer the taste or "as an expression of personal style."[12]

The court also distinguished this case from a securities fraud action, where the efficiency of the stock market allowed for a reasonable presumption that any material misrepresentation will be relied upon by investors. The court found no evidence that "the market at large internalized the misrepresentation to such an extent that all plaintiffs can be said to have relied on it." The court pointed out that, to the contrary, the publication of the National Cancer Institute's 2001 report on light cigarettes produced no appreciable change in either the sales or the price of light cigarettes, thus suggesting that the "consumer market in Light cigarettes" is, in fact, unresponsive to new health information.

Although the court's holding appears to impose an exacting standard on class-action plaintiffs seeking to allege a fraud claim outside of the securities context, the court did stop short of adopting the "blanket rule," endorsed by the Fifth Circuit, that "a fraud class action cannot be certified when individual reliance will be an issue."[13] Thus, in conducting the predominance analysis, district courts may still consider whether other elements of the fraud claim more susceptible to generalized proof might override the individualized nature of the reasonable reliance element.

The court next examined the issue of "loss causation," or whether defendants' misrepresentations caused the class to suffer any economic loss. Here, the court rejected plaintiffs' theory that they were overcharged for light cigarettes because defendants' misrepresentations about their healthiness led to increased demand, and, hence, higher prices. The court found that the question of whether it was the perceived health benefits of light cigarettes, as opposed to non-health-related factors, that led to the increased demand required individualized proof of each putative class member's motives for purchasing light cigarettes. The court again pointed to the lack of any appreciable drop in demand after the National Cancer Institute's 2001 report was published as proof that defendants' misrepresentations did not cause any shift in the market.[14]

Calculating Damages

The court then turned to the issue of calculating damages. It held that, as with reliance and loss causation, the calculation of damages was inherently individualized because damages must be based on each plaintiff's out-of-pocket costs resulting from defendants' misrepresentation. The court reasoned that those costs are dependent upon what each plaintiff would have done but for defendants' misrepresentations: some might have smoked the same number of regular cigarettes, some might have smoked fewer, and some might have quit smoking altogether.

The court went on to reject, as a matter of law, two alternative, aggregate methods of calculating damages offered by the plaintiffs. The first of these methods, the "loss of value" theory, would have used expert analysis to measure the difference between the price plaintiffs actually paid for light cigarettes and the price plaintiffs would have paid had they known that they were no healthier than regular cigarettes. The court rejected this theory on the grounds that RICO damages may only compensate for injury to "business or property" and are not intended to give plaintiffs the "benefit of their bargain," and that, in addition, even if such damages were available, plaintiffs' theory was "pure speculation."

Plaintiffs' second method for calculating aggregate damages, the "price impact" method, fared no better. This method sought to demonstrate, through "multiple regression analysis," that demand for light cigarettes would have been reduced had defendants disclosed that light cigarettes were no safer than regular cigarettes. The court again found that this method required "speculative calculations" involving "a number of exogenous variables," and was therefore also unsound as a matter of law.[15]

Finally, the court held that many class members' claims may be barred by the four-year statute of limitations for civil RICO claims and that this too created individualized issues that could not efficiently be resolved in a class action. The court noted that "a substantial number of class members" were on notice of defendants' alleged fraud before the class period. Although conceding that the presence of individual defenses "does not by its terms preclude class certification," the court found that given the evidence that two of the class representatives as well as the public at large may have understood that light cigarettes were just as harmful as regular cigarettes prior to May 2000, the statute of limitations defense would also present myriad individual factual questions. The court rejected plaintiffs' argument that defendants should be precluded from relying on a statute of limitations defense because of their "tremendous efforts" to hide the truth about light cigarettes, explaining that the evidence of plaintiffs' knowledge of the dangers of light cigarettes before 2000 militates against any "presumption" that plaintiffs were unaware of the danger.

In its conclusion, the court not only reiterated that class certification of the entire matter is inappropriate given the individualized issues at stake, but also emphasized that even certification of the common issue of the alleged "scheme to defraud," permitted under Rule 23(c)(4), would be improper. The court reasoned that certification of this issue would not "materially advance the litigation because it would not dispose of larger issues such as reliance, injury, and damages."

Conclusion

McLaughlin makes clear that plaintiffs seeking to bring a class action for fraud cannot meet the "predominance" requirement of Rule 23(b)(3) merely by alleging that defendants made "uniform misstatements" to class members through their branding and marketing. Instead, plaintiffs must show that at least many of the other elements of their fraud claim, such as reliance, loss causation, and injury, are "susceptible to generalized proof." In cases in which these elements cannot be proved for the class as a whole, or where such proof would be unduly "speculative," *McLaughlin* suggests that class certification is not appropriate. Importantly, however, in refusing to adopt any "blanket rule" on these issues, *McLaughlin* also appears to recognize that these issues must continue to be resolved on a case-by-case basis.

1. Docket No. 06-4666-cv, 2008 U.S. App. LEXIS 7093 (2d Cir. April 3, 2008).
2. Id. at *47.
3. Id. at *6 (brackets in original) (quoting *United States v. Philip Morris USA Inc.*, 449 F. Supp. 2d 1, 432 (D.D.C. 2006)).
4. Id. at *7.
5. Id. at *8.
6. *Schwab v. Philip Morris USA Inc.* 449 F. Supp. 2d 992, 1019 (E.D.N.Y. 2006).
7. Id. at 1021.
8. Id. at 1097-1132.
9. Id. at 1123.
10. Id. at 1124.
11. *Moore v. PaineWebber Inc.*, 306 F.3d 1247, 1253 (2d Cir. 2002).
12. *McLaughlin*, 2008 U.S. App. LEXIS 7093, at *14.
13. Id. at *19 (quoting *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996)).
14. Id. at **24-26.
15. Id. at **34-37 (citing *Anza v. Ideal Steel Supply Corp.*, 547 U.S. 451, 459 (2006)).