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SECOND CIRCUIT REVIEW

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Another 23(f) Class Cert Petition Granted

This month, we examine the U.S. Court of Appeals for the Second Circuit's June 30 order in *Miles v. Merrill Lynch & Co.*,[1] granting a petition for leave to appeal, pursuant to Rule 23(f), Judge Shira Scheindlin's opinion and order certifying six test classes in *In re Initial Public Offering (IPO) Securities Litigation*.[2]

The court's order directs the parties to brief two specific questions: "Whether the Second Circuit's 'some showing' standard …is consistent with the 2003 Amendments to FedRCivP 23; and Whether the presumption of reliance established in *Basic v. Levinson*…was properly extended to plaintiffs' claims against the non-issuer defendants and to the market manipulation claims." Together, the Second Circuit's treatment of these two issues will significantly alter the current landscape of securities class action litigation.

'Init. Public Offering Secs. Litig.'

The *IPO* litigation involves 310 separate consolidated, putative class actions against 310 IPO issuers and 55 underwriters, among

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other defendants. The plaintiffs have alleged a far-reaching, market-manipulation scheme in which IPO issuers and underwriters allegedly artificially inflated the prices of the underlying securities in the aftermarkets in an effort to make the IPOs seem more successful than they actually were. Specifically, the plaintiffs in the *IPO* litigation allege that, rather than allocating stock to initial purchasers and then allowing sales to occur freely in the aftermarket, the issuers and underwriters required an agreement from initial purchasers to make additional purchases in the aftermarket, in an effort both to inflate trading volume and stock price. The resultant inflated market price, the plaintiffs allege, created the illusion of success with respect to the subject IPOs. Plaintiffs additionally allege that analysts employed by the underwriters issued materially false or misleading analyst reports in order artificially to inflate the IPO issuers' stock prices and to attract and maintain their investment banking business.

At the district court's suggestion, plaintiffs in six of the actions filed motions for class certification. The court indicated its intent to treat those six cases as "test" cases for the remaining 304 putative class actions. On Oct. 13, 2004, Judge Scheindlin issued an opinion and order granting in substantial part the plaintiffs' motions, with slight modifications to the class definitions.[3] In so doing, the district court observed that its "Opinion is intended to provide strong guidance, if not dispositive effect, to all parties when considering class certification in the remaining actions."[4]

As an initial matter, the district court considered the appropriate standard of proof applicable to an evaluation of whether a proposed class satisfies the requirements of Rule 23. Although noting that the Supreme Court requires district courts to engage in a "rigorous analysis" of whether the Rule 23 requirements have been met, Judge Scheindlin concluded that she was not required to make "findings" in resolving the pending class certification motions.[5] In so doing, the district court rejected the approaches recently adopted by the U.S. Courts of Appeal for the Fourth and Seventh Circuits—which both expressly concluded that a district court must receive evidence and resolve factual disputes, even if those disputes overlap with the ultimate merits of the case, in evaluating class certification motions—and instead concluded that the Second Circuit's rulings in *Caridad v. Metro-North Commuter Railroad* and *In re Visa Check/MasterMoney Antitrust Litigation* required only that plaintiffs seeking class certification make "some showing" that the Rule 23 requirements had been met.[6] The district court noted that plaintiffs can satisfy this burden simply by proffering expert opinions, if necessary, and other evidence, including documentary evidence or live testimony—and that the court, then, would accept that evidence without testing whether it actually supports the conclusions plaintiffs seek to draw.[7]

The Second Circuit granted the *IPO* defendants' Rule 23(f) petition in part to evaluate whether the district court's application of the "some showing" standard is consistent with Rule 23, as amended. Rule 23(c)(1)(A), which previously required district courts to make the class certification decision "as soon as practicable," was amended in 2003 to require district courts to make the class certification decision "at an early practicable time."[8] The Advisory Committee Notes reflect that this change was necessitated so Rule 23 would "reflect [the] prevailing practice" and to permit district courts to "gather information necessary to make the certification decision."[9] Among other things, the Committee Notes observe that it is "appropriate to conduct controlled discovery into the 'merits,' limited to those aspects relevant to making the certification decision on an informed basis."[10]

The Second Circuit's interest in evaluating whether the "some showing" standard is consistent with the Rule 23 amendments may signal the court's willingness to tighten the evidentiary threshold plaintiffs must meet before they can obtain class certification. The "some showing" standard is, as demonstrated by the district court's decision, quite lax: it permits plaintiffs to provide the district court with "evidence" that the district court does not have to—indeed, under the district court's formulation, cannot—test. Plaintiffs, thus, can obtain certification without actually demonstrating that the putative class meets the Rule 23 requirements. The Second Circuit's resolution of this issue will determine whether plaintiffs may continue, in this circuit, to avoid those requirements.

Having resolved the evidentiary question in favor of requiring the plaintiffs to make only "some showing," the district court easily determined that the proposed classes satisfied the Rule 23(a) requirements of numerosity, commonality, typicality, and adequacy of representation. Judge Scheindlin also readily concluded that the proposed classes were "ascertainable"—i.e., that members of the classes could be ascertained by reference to objective criteria. Judge Scheindlin also found that the proposed classes satisfied the Rule 23(b) requirements of superiority. In this regard, the district court specifically observed that the proposed classes were superior in part because the defendants failed to offer any proposed alternative means of adjudicating plaintiffs' claims.

The bulk of the district court's analysis was directed to addressing the final requirement of Rule 23(b)—whether questions common to the six putative classes predominate over individualized questions peculiar to each class member. The defendants contested predominance by arguing, among other things, that the plaintiff classes could not demonstrate transaction causation on a classwide basis.

As Judge Scheindlin noted, transaction causation requires plaintiffs to demonstrate a causal link between the defendant's alleged misconduct and the plaintiff's decision to buy or sell securities. In the class action context, typically, if transaction causation must be proved on an individual basis—i.e., if plaintiffs must demonstrate that each member of the class made a decision to buy or sell securities relying upon the alleged misstatement—individual issues will predominate over classwide issues and class certification is improper. To escape this problem, courts have fashioned several theories that establish a classwide rebuttable presumption of reliance if certain conditions are met.

Specifically, in *Basic v. Levinson*,[11] the Supreme Court held that it is appropriate to presume that public, material misrepresentations by issuers affect the market prices of securities traded in efficient markets. Accordingly, investors purchasing or selling securities in that market are presumed to have relied on the market price that has been artificially inflated or deflated as a result of the issuer's misrepresentation. Class members, thus, can be said to have indirectly relied upon the material misrepresentation, due to their reliance upon market price.[12]

The *IPO* defendants challenged plaintiffs' efforts to employ the fraud-on-the-market presumption on several grounds. First, the defendants argued that the markets at issue were not efficient. Second, the defendants asserted that individual class members employed a variety of different investment strategies, many of which did not depend upon the price of the securities at issue. Third, the defendants argued that many, if not all, of the plaintiffs had knowledge of the manipulative scheme and therefore knew that the stock prices were distorted by any misleading information.

Judge Scheindlin readily concluded that the subject market, the Nasdaq National Market, was efficient. Judge Scheindlin also recognized that the stocks were traded actively at high volumes and were the focus of numerous analyst reports and extensive media attention. Thus, plaintiffs satisfied their burden to make "some showing" that the stocks in question traded on an efficient market.

In rejecting the defendants' second argument, Judge Scheindlin concluded that plaintiffs' investment strategies are irrelevant to whether the class may employ the fraud-on-the-market presumption, unless the defendants demonstrate that the investment strategies at issue do not rely upon the market price of the subject securities. In so concluding, Judge Scheindlin rejected the notion that day traders, momentum traders, and short sellers were not concerned about the integrity of a stock's market price, noting that investors are not "reckless gamblers engaged in a 'crooked crap game.'"[13] Unless the defendants could provide "convincing proof that price played no part whatsoever" in class members' decision-making process, the *Basic* presumption properly applied.[14]

Finally, in rejecting the defendants' third argument that plaintiffs had knowledge of the fraudulent scheme, Judge Scheindlin observed that whether plaintiffs were on notice of the scheme as a result of widespread media reports was an issue common to the class and, therefore, properly could be adjudicated in the class action context. The district court noted that if "any of defendants' proffered publications is determined to have been so relevant, clear and widely disseminated that knowledge of the alleged scheme must be imputed to the universe of investors in the stock market, then reliance cannot be proven individually or collectively,"[15] but this does not provide a reason not to certify the proposed classes.

Non-Issuer Statements

• ***The Applicability of the Fraud-on-the-Market Presumption to Non-Issuer Statements.*** The Second Circuit's order granting the defendants' Rule 23(f) petition

evidences a particular interest in one aspect of the district court's analysis that is addressed only in a footnote: whether, in certifying the class, the district court properly extended the *Basic v. Levinson* fraud-on-the-market presumption to statements of non-issuers and to the market manipulation claims. Of course, *Basic* itself concerned an issuer that, throughout the class period, falsely denied that it was engaged in merger discussions. On this basis, the Supreme Court comfortably concluded that "common sense and probability" supported a presumption that the issuer's false statements concerning its merger plans affected the market price of its securities. It was, therefore, appropriate to conclude that purchasers of those securities indirectly relied upon the false statements made by the issuer.

Whether this presumption is equally supported by "common sense and probability" in the context of allegedly false statements made by non-issuers, such as statements of opinion made by research analysts, is a question that has captured the attention of the Second Circuit. Specifically, in *Hevesi v. Citigroup, Inc.*,[16] the Second Circuit issued a lengthy opinion in support of its grant of a Rule 23(f) petition filed by Citigroup, one of the defendants in the WorldCom class action. In *Hevesi,* Citigroup argued that the district court improperly employed the fraud-on-the-market presumption to certify a class of WorldCom investors to litigate claims that Citigroup issued false and misleading analyst reports concerning WorldCom. The Second Circuit granted Citigroup's Rule 23(f) petition due to the novelty of the underlying question: whether the district court properly applied the fraud-on-the-market presumption to analyst statements of opinion without first determining whether those statements actually impacted the market price of WorldCom securities.

Notwithstanding the Second Circuit's keen interest concerning this extension of the fraud-on-the-market presumption, the district court addressed the issue only in a footnote. Specifically, the court concluded that, in the *IPO* cases, "plaintiffs' allegations that conflicts of interest led analysts to issue improperly glowing reports on the manipulated securities do not reflect the whole of plaintiffs' theory of liability.… [a]ccordingly, plaintiffs' claims are not dependent upon a finding that they are entitled to a presumption of reliance on analyst reports; if plaintiffs prove that the scheme as a whole artificially inflated prices, then they may employ the fraud-on-the-market presumption to prove that they relied on those prices as a measure of their intrinsic value."[17] This footnote does not address the fact that at least some portion of the alleged scheme concerns false analyst reports and, therefore, the fraud-on-the-market presumption is being employed to litigate on a classwide basis claims related to statements of analyst opinion; it also fails to address the more fundamental question of whether the presumption should be applied to nonissuer statements more broadly absent a factual basis to support the conclusion that the nonissuer statements impacted the relevant market, a question squarely raised in the *Miles* order.

The Second Circuit's resolution of the two questions posed in *Miles* will have far-reaching impact. In the past year alone, two district courts in the Second Circuit have issued directly contradictory opinions as to whether the fraud-on-the-market presumption can be applied to support class certification to litigate claims related to nonissuer statements and as to the proper evidentiary standard to employ in answering this question.

In *Demarco v. Lehman Brothers, Inc.*,[18] Judge Jed Rakoff refused to employ the *Basic* presumption to certify a plaintiff class to litigate claims related to allegedly fraudulent research analyst reports, because plaintiffs failed to make a prima facie showing that the analyst's statements "materially impacted the market price in a reasonably quantifiable respect."[19] By contrast, in *Demarco v. Robertson Stephens*,[20] Judge Gerard E. Lynch credited expert testimony offered by plaintiffs seeking to certify an analyst opinion class action, employing the "some showing" standard in doing so. Judge Lynch concluded that "plaintiffs have demonstrated that they will be able to make a colorable presentation at summary judgment or trial as to the propriety of applying the fraud-on-the-market theory in this case."[21] In so ruling, Judge Lynch specifically rejected the *Lehman* court's analysis, stating that this "Court declines to adopt a higher standard at class certification for plaintiffs alleging securities fraud by research analysts and their employers."[22]

As a practical matter, because "large class actions can be divorced from the parties' underlying legal positions,"[23] most securities class actions are resolved through settlement if the plaintiffs successfully jump the class certification hurdle. Indeed, as the Second Circuit has observed, Rule 23(f) was adopted, in part, to permit circuit courts to review questionable class certification decisions that would otherwise escape review because the pressure to settle following certification is often overwhelming.[24] Because of this fundamental reality, whether the Second Circuit resolves the questions posed in *Miles* in favor of the defendants and, thus, requires plaintiffs seeking to obtain certification of broad securities class actions involving nonissuer defendants to satisfy the Rule 23 requirements, will significantly determine the future course of securities class actions in the Second Circuit.

1. *Miles v. Merrill Lynch & Co.*, No. 05-3349 (2d Cir. 2005).
2. *In re Initial Pub. Offering Sec. Litig.*, 227 F.R.D. 65 (S.D.N.Y. 2004).
3. See id.
4. *Initial Pub. Offering,* supra note 2 at 73.
5. *Initial Pub. Offering,* supra note 2 at 89-93.
6. See *Caridad v. Metro-North Commuter R.R.*, 191 F.3d 283 (2d Cir. 1999); *In re Visa Check/MasterMoney Antitrust Litig.*, 280 F.3d 124 (2d Cir. 2001).
7. *Initial Pub. Offering,* supra note 2 at 89-93.
8. Fed. R. Civ. P. 23(c)(1)(A) and 2003 Advisory Committee Notes to Rule 23.
9. 2003 Advisory Committee Notes to Rule 23.
10. Id.
11. 485 U.S. 224 (1988).
12. 485 U.S. 224, 246-47 (1988) ("[W]here materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed").
13. *Initial Pub. Offering,* supra note 2 at 108.
14. Id.
15. Id at 110.
16. *Hevesi v. Citigroup, Inc.*, 366 F.3d 70 (2d Cir. 2004).
17. *Initial Pub. Offering,* supra note 2 at 106 n.319.
18. *Demarco v. Lehman Brothers, Inc.*, 222 F.R.D. 243 (S.D.N.Y. 2004).
19. *Lehman Brothers,* supra note 18 at 247.
20. *Demarco v. Robertson Stephens,* 228 F.R.D. 468 (S.D.N.Y. 2005).
21. *Robertson Stephens,* supra note 20 at 474.
22. Id.
23. *Hevesi,* supra note 16 at 80.
24. *In re Sumitomo Copper Litigation,* 262 F.3d 134, 139 (2d Cir. 2001).

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