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SECOND CIRCUIT REVIEW

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On Class Certification, Rule 23; Settlements, Private Securities Act

IN THIS MONTH'S column, we discuss three recent U.S. Court of Appeals for the Second Circuit decisions addressing significant issues in the area of securities law and civil procedure: *Parker v. Time Warner Entertainment Co.* (class certification under Rule 23);[1] *Gerber v. MTC Electronic Technologies Co.* (settlement of claims under the Private Securities Litigation Reform Act);[2] and *Spielman v. Merrill Lynch, Pierce, Fenner & Smith* (appealability of district court remand order under the Securities Litigation Uniform Standards Act).[3]

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'Parker v. Time Warner'

Cable television subscribers brought suit in the U.S. District Court for the Eastern District of New York, alleging that Time Warner violated the subscriber privacy provisions in §551 of the Cable Communication Policy Act, 47 USC §§521, et seq., as well as the consumer protection laws of 23 states, by disclosing and selling personally identifiable information about its subscribers to third parties and by failing to provide subscribers with a clear and conspicuous notice of its disclosure of such information. Plaintiffs indicated in their complaint that they would move for certification of a class of approximately 12 million cable subscribers in 23 states, under FedRCivP 23(b)(2) and (3). Prior to any discovery and before plaintiffs moved for class certification, defendants moved for denial of class certification as a matter of law under both subdivisions. All discovery was stayed in the action, pending decision on defendants' motion.

Adopting the recommendations of the magistrate judge, the district court limited class certification under Rule 23(b)(2) to declaratory and injunctive relief claims only, denied class certification under Rule 23(b)(3) and declined to exercise supplemental jurisdiction over the state law claims. Plaintiffs petitioned for interlocutory review of the district court's decision under Rule 23(f), and the Second Circuit granted plaintiffs' petition.

In an opinion written by District Judge Stefan R. Underhill (sitting by designation) and joined by Judges Fred I. Parker and Jon O. Newman, who also concurred in a separate opinion, the Second Circuit vacated the district court's decision and remanded the case to the district court to conduct fact finding and, with respect to certification under Rule 23(b)(2), to apply the ad hoc approach outlined in the Second Circuit's 2001 decision in *Robinson v. Metro-North Commuter* — a decision issued after the district court's ruling.

Under Rule 23(b)(2), an action may be maintained as a class action if, "in addition to the threshold requirements of numerosity, commonality, typicality and adequacy of representation, 'the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole.' "[4]

In the absence of any Second Circuit authority, the district court relied on the U.S. Court of Appeals for the Fifth Circuit's decision in *Allison v. Citgo Petroleum Corp.*[5] in considering defendants' motion to deny class certification. Under *Allison's* analysis of Rule 23(b)(2) certification, monetary relief predominates over equitable relief "unless it is incidental to requested injunctive or declaratory relief."[6] Subsequent to the district court's decision, the Second Circuit articulated its own standard for class certification under Rule 23(b)(2), which rejected the "predominance" calculus of *Allison.*[7] In *Robinson*, the court held that a district court considering Rule 23(b)(2) certification where the claims seek both equitable relief and non-incidental money damages must adopt an ad hoc approach, considering "the evidence presented at a class certification hearing and the arguments of counsel, and assess[ing] whether (b)(2) certification is appropriate in light of the relative importance of the remedies sought, given all of the facts and circumstances of the case."[8] Because the district court applied a legal standard that had been rejected by the

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Second Circuit, the court vacated the district court's Rule 23(b)(2) decision and remanded for further fact finding under *Robinson's* ad hoc approach.

Under Rule 23(b)(3), class certification is appropriate where "questions of law or fact common to the members 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."[9]

The district court focused its Rule 23(b)(3) analysis on the technical nature of the violations alleged, and the statutory damages provision of the Cable Act, 47 USC §551, which provides that each claimant may be awarded damages in the amount of $1,000, or $100 per day of violation, whichever is higher. The district court balanced the relative harm to the respective parties and noted that a class of 12 million subscribers would expose Time Warner to a potential damages judgment of $12 billion, even though, as plaintiffs conceded, no actual harm had been sustained by individual subscribers. Accordingly, the district court held "a class action is not the superior manner of proceeding where the liability defendant stands to incur is grossly disproportionate to any actual harm sustained by an aggrieved individual."[10]

Because the district court considered this question as a matter of law, the Second Circuit found that the district court's findings were based on assumptions of facts rather than on factual findings. The court noted, for example, that plaintiffs had given no indication that they would seek class certification for all 12 million cable subscribers and, when questioned by the magistrate judge, stated that they could not provide a number without discovery.

The Second Circuit indicated that combining the level of damages sought by each plaintiff with the certification of a very large class of plaintiffs posed due process concerns under the Supreme Court's *State Farm* and *BMW* decisions. The court stressed that a damages award grossly disproportionate to the actual harm suffered by plaintiffs could, in effect, create punitive damages awarded as a matter of strict liability — an unintended consequence that "distorts the purpose of both statutory damages and class actions."[11] Given that no evidence was presented on the amount of damages, however, the Second Circuit found these concerns hypothetical. The court held that factual findings were necessary to support the district court's conclusions and, accordingly, remanded for fact finding.

Separate Concurrence

In a separate concurrence, Judge Jon Newman, though deferring to the precedent of *Robinson*, questioned whether a Rule 23(b)(2) class is appropriate in claims for monetary damages, noting that (b)(2) "is designed for claims for injunctive and declaratory relief. The (b)(3) class, with its opt-out protection, is available for monetary claims."[12] Regarding Rule 23(b)(3), Judge Newman suggested two novel approaches to address the due process concerns: (1) interpreting the statute to preclude all but the named plaintiffs from receiving statutory damages; or (2) granting the trial judge discretion under Rule 23(c)(4) to impose a ceiling on the aggregate statutory damages.

PSLRA provisions relating to settlement do not apply to a suit filed before the PSLRA was passed, even when parties were added after PSLRA passage.

Whether or not Judge Newman's pragmatic approach is adopted, the *Parker* decision suggests that the Second Circuit will join the U.S. Court of Appeals for the Seventh Circuit in approaching petitions for interlocutory appeal under Rule 23(f) with greater flexibility — particularly in circumstances where the granting of class certification subjects a defendant to crippling potential liability — and ensuring that such determinations are based on an adequate and fully developed evidentiary record.

'Gerber v. MTC Elec. Tech.'

In *Gerber*, an opinion written by Judge Sonia Sotomayer and joined by Judges Dennis Jacobs and Rosemary S. Pooler, the court held that the provisions of the Private Securities Litigation Reform Act (PSLRA) relating to settlement do not apply to a lawsuit filed before the PSLRA was passed, even where parties were added to the complaint after the passage of the PSLRA.[13]

On Jan. 23, 1995, nine shareholders of MTC Electronics Technologies Co. (MTC) brought suit against the company, alleging that its telecommunications joint ventures were fraudulent.[14] On Dec. 22, 1995, almost one year later, Congress enacted the PSLRA. In April 1996 and again in March 1997, plaintiffs amended their complaint to add a total of 19 additional plaintiffs. In late 2000, plaintiffs reached a settlement with certain of the defendants (the "settling defendants").[15]

The settling parties sought and obtained an order approving the settlement and barring contribution and indemnity claims by nonsettling defendants, but not imposing the reciprocal bar on settling defendants (the "bar order").[16] In other words, the settling defendants were free to seek contribution from the non-settling defendants. The district court (adopting the magistrate judge's holding) found that, while such a nonreciprocal bar order is disallowed under the PSLRA, the PSLRA was not applicable since it was enacted after the action was filed.[17] Accordingly, the district court affirmed the bar order and the nonsettling defendants appealed.

The Second Circuit affirmed. The court explained that §108 of the PSLRA provides that the PSLRA's provisions relating to settlement "shall not affect or apply to any private action [brought under the Securities and Exchange Act of 1934] commenced before and pending" on Dec. 22, 1995.[18] The court also noted that the statute refers to "actions" rather than "claims" and that, under the Federal Rules of Civil Procedure, the action in this case was commenced when the complaint was filed on Jan. 23, 1995.[19] The court found that amending the complaint to add additional parties did not create a new action, stating:

> [I]n the absence of any indication to the contrary, we doubt that Congress intended the courts would apply different sets of substantive and procedural rules to groups of plaintiffs asserting identical claims in a single action, depending upon when those plaintiffs were added to the complaint.[20]

Thus, the court concluded that the PSLRA's settlement provisions did not apply even as against the newly added plaintiffs and affirmed the district court judgment. The court's holding in *Gerber* has implications beyond the PSLRA, making clear that, absent specific statutory language to the contrary, a plaintiff cannot seek to apply retroactively a statute enacted after the filing of a complaint simply by amending the complaint to add additional plaintiffs.

'Spielman v. Merrill Lynch'

In *Spielman v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, the Second Circuit, in an opinion written by Judge Fred I. Parker and joined by District Judge Stefan R. Underhill (sitting by designation) and Judge Jon O. Newman, also concurring in a separate opinion, dismissed an appeal from a district order remanding claims removed to federal district court under both the Securities Litigation Uniform Standards Act of 1998 (SLUSA), 15 USC §§77p & 78bb(f), which permits removal of class actions alleging state law claims based on "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security," 15 USC §78bb(f)(1)-(2), and the general removal statute, 28 USC §1441(b), which permits removal of civil actions over which federal courts have original jurisdiction.[21] In so ruling, the court held that a remand order based on a perceived lack of subject matter jurisdiction in a case previously removed under SLUSA's preemption provision is governed by 28 USC §§1447(c) and (d), and is therefore not reviewable on appeal.

The jurisdictional issue before the court arose from a complaint filed by Spielman against Merrill Lynch, Pierce, Fenner & Smith Inc. (Merrill Lynch), alleging that Merrill Lynch falsely represented that Mr. Spielman's Cash Management Account would enable him to purchase certain securities without paying a transaction fee. The complaint alleged six causes of action under New York state law, and no federal claim. Merrill Lynch removed the case to the U.S. District Court for the Southern District of New York, pursuant to SLUSA's removal provision and the general removal statute. Mr. Spielman moved to remand the action to state court. The district court determined that Merrill Lynch's alleged misrepresentations were not made "in connection with the purchase or sale" of securities and granted Mr. Spielman's motion.[22] Merrill Lynch appealed.

The Second Circuit observed that SLUSA was intended to stem the flight of plaintiffs asserting securities claims from federal court after enactment of the Private Securities Litigation Reform Act (PSLRA), which imposed strict pleading requirements. SLUSA mandates that federal court be the exclusive venue for, and that federal law exclusively govern, class actions alleging fraud in the sale of certain covered securities.[23] The court reasoned, however, that SLUSA does not completely preempt the field of all securities class actions, and where nondisclosure was not "in connection with" the purchase or sale of a security, a case cannot be removed and consequently must be remanded to state court for lack of federal jurisdiction. The court noted that, "to state the obvious," for federal question jurisdiction to proceed under SLUSA, SLUSA must apply and is triggered only if a claim facially falls within SLUSA's preemptive scope.[24]

Merrill Lynch argued that the district court's remand order relied on the specific language in SLUSA, and not on 28 USC §1447(d), which governs reviewability of remand orders generally and prohibits appellate review of those predicated on any basis, including lack of subject matter jurisdiction, enumerated in §1447(c). Consequently, Merrill Lynch urged that appellate review was available because SLUSA contains no express bar to appellate review of cases remanded for lack of subject-matter jurisdiction. The court was not persuaded and held that SLUSA's preemption provision does not operate to exempt from §1447(c) a remand order based on lack of subject matter jurisdiction. The court reasoned that SLUSA's silence on the issue of appealability cannot trump the clear congressional prohibition on appealability in §1447(d). While the court noted that there are three statutory exceptions to §1447(d)'s bar, each of these exceptions — unlike SLUSA — expressly contains language permitting appeal. The court, therefore, affirmed the remand order.

(1) No. 01-9069, 2003 WL 21254892 (2d Cir. June 2, 2003).
(2) No. 02-7023, 2003 WL 21101283 (2d Cir. May 15, 2003).
(3) No. 01-9189, 2003 WL 21363387 (2d Cir. June 13, 2003).
(4) *Parker*, 2003 WL 21254892, at *5 (quoting Rule 23(b)(2)).
(5) 151 F3d 402 (5th Cir. 1998).
(6) *Parker*, 2003 WL 21254892, at *5 (quoting *Allison*).
(7) *Robinson v. Metro-North Commuter*, 267 F3d 147 (2d Cir. 2001).
(8) Id. at 164 (internal quotation omitted).
(9) *Parker*, 2003 WL 21254892, at *7 (quoting Rule 23(b)(3)).
(10) Id. (quoting district court opinion).
(11) Id. at *8.
(12) Id. at *10.
(13) *Gerber*, 2003 WL 21101283, at *10; see also Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 USC). The court also (1) affirmed the district court's deferral until trial of the allocation of particular settlement amounts to various elements of damages for purposes of the calculation of the nonsettling defendants' judgment credit; (2) affirmed, with slight modification, the bar order; and (3) vacated and remanded the district court's order with respect to the mutuality of the bar order to allow the district court to fully consider the equities involved.
(14) Id at *1.
(15) Id. at *2.
(16) Id. at *8.
(17) See 15 USC §78u-4(f)(7) (stating that a bar order shall "bar all future claims for contribution arising out of the action — (i) by any person against the settling covered person; and (ii) by the settling covered person against any person, other than a person whose liability has been extinguished by the settlement of the settling covered person").
(18) See *Gerber* 2003 WL 21101283, at *10 (quoting 109 Stat. 737, 758 (1995)).
(19) See FedRCivP 3 ("A civil action is commenced by filing a complaint with the court.").
(20) See *Gerber*, 2003 WL 21101283, at *10.
(21) *Spielman*, 2003 WL 21363387, at *2.
(22) Id. at *2.
(23) Id. at *3.
(24) Id. at *5.