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Second Circuit Holds That Ascertainability Requirement Of Class Certification Does Not Include “Administrative Feasibility” And That Extraterritoriality Issues Can Preclude Predominance

Introduction

On July 7, 2017, in *In re Petrobras Securities Litigation*, No. 16 Civ. 1914, the Second Circuit addressed the standards for certifying Rule 23(b)(3) classes in securities fraud cases concerning over-the-counter securities that trade in a global market.¹ While acknowledging the administrative difficulties of determining which transactions are “domestic,” and thus subject to the U.S. securities laws, the Second Circuit joined the Ninth Circuit in rejecting the Third Circuit’s holding (and the Second Circuit’s own prior dicta) that Rule 23’s implied requirement of ascertainability includes a requirement of “administrative feasibility.” The Second Circuit went on to hold that the District Court’s finding of predominance was inadequate in light of the same extraterritoriality issues.²

Background

Petróleo Brasileiro S.A. (“Petrobras”) is an oil and gas corporation that is majority-owned by the Brazilian government. In 2014, Brazilian investigators uncovered a corruption scheme: Petrobras officials had received bribes in exchange for providing information, approvals, and other assistance to a cartel of private companies that formed to bid on Petrobras’s construction projects. As details of the investigation became public, the price of Petrobras’s securities declined sharply.

Investors in Petrobras securities filed putative class actions under the Securities Act of 1933 and the Securities Exchange Act of 1934 against Petrobras, along with its officers, subsidiaries, auditor, and underwriters, alleging false and misleading statements regarding Petrobras’s value, management, and controls.

¹ Paul, Weiss represented the Securities Industry and Financial Markets Association (“SIFMA”) as *amicus curiae* in support of defendants-appellants before the Second Circuit.

² In addition to the issues described below, the Second Circuit held that the District Court did not abuse its discretion by applying a “blended method” of determining market efficiency. Plaintiffs in securities actions must show reliance. Reliance will be presumed if plaintiffs can establish that there was an efficient market in the securities at issue. This is called the “fraud on the market” theory of reliance. The District Court found that there was an efficient market in Petrobras securities based on a “blended method” that used both direct and indirect evidence. The Second Circuit held that the District Court did not abuse its discretion, and left open the possibility that market efficiency can be established using only indirect evidence.

While Petrobras's common and preferred stock are listed on a Brazilian stock exchange and are thus exempt from registration under the U.S. securities laws, Petrobras's American Depositary Shares ("ADSs") trade on the New York Stock Exchange ("NYSE"), and its debt securities, like most corporate debt, trade in the over the counter ("OTC") market.

A key issue in the case is whether the U.S. securities laws apply to OTC trades in Petrobras's debt. In *Morrison v. Australian National Bank*, 561 U.S. 247, 247 (2010), the Supreme Court held that the U.S. securities laws apply only "to [i] transactions in securities listed on domestic exchanges and [ii] domestic transactions in other securities." The Second Circuit has held that the latter prong requires that "irrevocable liability to carry out the transaction" was incurred in the United States.³

In February 2016, the U.S. District Court for the Southern District of New York (Rakoff, J.) certified classes of investors who purchased Petrobras ADSs on the NYSE and who purchased Petrobras's debt securities in "domestic transactions."⁴ The defendants appealed the District Court's certification order to the Second Circuit under Federal Rule of Civil Procedure 23(f), and the Second Circuit agreed to hear the appeal.

The Second Circuit Clarifies that Ascertainability Does Not Require "Administrative Feasibility"

One question before the Second Circuit was whether the debt class satisfied Rule 23's implied requirement of ascertainability, which the Second Circuit acknowledged in *Brecher v. Republic of Argentina*, 806 F.3d 22, 24 (2d Cir. 2015). The defendants argued that it would be difficult to determine which of the many OTC trades in Petrobras's debt were domestic, and thus that class membership could not be defined by reference to "domestic transactions."

While acknowledging the underlying difficulties, the Second Circuit held that they posed no ascertainability problem. The court held that the ascertainability requirement is satisfied if the class is "defined using objective criteria that establish a membership with definite boundaries." Applying this standard to the certified class, the Second Circuit found that the District Court's criteria, "securities purchases identified by subject matter, timing, and location," were "clearly objective," and it was therefore "objectively possible" to determine which securities were acquired in domestic transactions.⁵ The certification order therefore satisfied the ascertainability test.

³ *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 69 (2d Cir. 2012).

⁴ *In re Petrobras*, 312 F.R.D. 354, 372 (S.D.N.Y. 2016).

⁵ Plaintiffs had argued that all transactions that were settled through the Depository Trust Company ("DTC") or another domestic securities depository were domestic transactions. The District Court rejected that argument, and the Second Circuit agreed, holding that settlement was an action needed to carry out a transaction, but did not itself constitute a transaction. The

In reaching this conclusion, the court clarified that ascertainability does not require “a showing of administrative feasibility at the class certification stage.” While acknowledging that *Brecher* had suggested such a requirement, the court concluded that this language “was not strictly part of the holding.” The Second Circuit acknowledged that its holding squarely conflicts with the “heightened ascertainability test” applied by the Third Circuit, which does require administrative feasibility.

The Second Circuit Vacates the Class Certification Order Due to an Insufficient Showing of Predominance

The Second Circuit went on to hold that the District Court’s finding of “predominance”—i.e., that “questions of law or fact common to class members . . . predominate over any questions affecting only individual class members”—was insufficient. The Second Circuit held that the extraterritoriality issue was a “merits question” and a “material question.” As a result, the Second Circuit found the predominance inquiry required consideration of whether the extraterritoriality issue is “susceptible to generalized class-wide proof.” The District Court had made no such finding. Indeed, the District Court “did not mention *Morrison* at all” in its predominance analysis. The Second Circuit thus vacated the “domestic transactions” portion of the class certification order and remanded to the District Court to conduct a full predominance analysis.

The Second Circuit noted that, based on the record before the court, the question of whether a transaction was domestic implicated “transaction-specific facts” related to the acquisition of each security, and therefore “appears to be an individual question requiring putative class members to present evidence that varies from member to member.” The court instructed that the District Court “must account for such individual questions,” without taking a position as to how the District Court should rule.

Implications

The Second Circuit’s decision has significant implications for securities litigation concerning securities that are traded in the OTC market. Because debt securities are more likely than stocks to be traded OTC, rather than on a domestic or foreign exchange, litigation involving debt securities is particularly likely to be affected. If the District Court’s order had been affirmed, plaintiffs would have faced an easy path to class certification, simply by defining classes with reference to “domestic transactions,” thus deferring any extraterritoriality issues until post-verdict proceedings. Such post-verdict proceedings rarely occur because cases involving certified classes typically settle pre-trial. The practical result of deferring resolution of these issues would be to increase defendants’ potential exposure and thus potentially increase plaintiffs’ leverage in settlement negotiations. This would have substantially burdened international debt markets, and could have resulted in efforts by issuers to restrict how their securities

Second Circuit also credited the District Court’s observation that if DTC settlement alone sufficed to make a transaction domestic, “the entire thrust of *Morrison* and its progeny would be rendered nugatory.”

trade. For example, while much corporate debt is currently issued with both a domestic and foreign component so that it can trade globally, issuers could restrict their debt to trade only in the U.S. market, or only outside the U.S. market. If the District Court certifies a similar class on remand, the likely result will be another Rule 23(f) appeal.

The Second Circuit's ascertainability ruling will have implications not only for securities class actions, but for class actions generally. By accepting class definitions whose application is "objectively possible," even if not "practical[]," the Second Circuit's new standard may make it more difficult for defendants to estimate their exposure and for absent potential class members to determine their membership. Such issues will be relegated to post-verdict proceedings, which will only occur if defendants lose at trial or settle. Settling defendants may also have a greater interest in how settlement funds are administered, and may seek a larger role in the process.

In rejecting the Third Circuit's heightened requirement of ascertainability, the Second Circuit has aligned itself with the Ninth Circuit (which, unlike the Second Circuit, does not acknowledge an implied requirement of "ascertainability"). Given the split among the circuits as to ascertainability, the Supreme Court may grant certiorari in a case that raises the issue to resolve the conflict.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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