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Heightened Requirements for Class Certification

Defending against class-action claims is an arduous, time-consuming and costly endeavor. Congress has sought to reduce (but by no means eliminate) some of those burdens through legislation, including the Private Securities Litigation Reform Act of 1995 (PSLRA),[1] the Securities Litigation Uniform Standards Act of 1998 (SLUSA)[2] and the Class Action Fairness Act of 2005 (CAFA).[3]

The PSLRA imposes substantive and procedural restrictions on securities class action claims, while SLUSA and CAFA provide a federal forum for many class-action defendants on the presumption that federal courts will be a more sympathetic forum to defendants than state courts have proven to be.

And the federal courts have in fact tightened their supervision of class-action litigation. Where class certification was once almost a foregone conclusion, in the past two years the U.S. Court of Appeals for the Second Circuit has issued two decisions which substantially raise the bar for plaintiffs seeking class certification. Taking their cue from those decisions, judges from the U.S. District Court for the Southern District of New York have recently denied class certification, and even decertified previously certified classes, in cases that do not meet the heightened requirements articulated by the Second Circuit.

Class Certification Under Rule 23

Federal Rule of Civil Procedure 23(a) contains four prerequisites for every class action: (1) the class must be so numerous that joinder of all members is impracticable (numerosity); (2) there must be questions of law or fact common to the class (commonality); (3) the claims or defenses of the representative parties must be typical of the class claims or defenses (typicality); and (4) the representative parties must fairly and adequately protect the interests of the class (adequacy). In addition, the class action must meet the requirements of one of three types of class actions described in Rule 23(b).

The cases discussed below all turn on Rule 23(b)(3), which requires that common questions of law or fact predominate over individual questions and that a class action is superior to other available methods. The predominance requirement of Rule 23(b)(3) has been described as testing whether the "proposed classes are sufficiently cohesive to warrant adjudication by representation."[4]

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Recent Guidance From the Second Circuit

Expressing some surprise that the law was to that point so unsettled, the Second Circuit in its December 2006 decision in *In re Initial Public Offerings Securities Litigation (In re IPO)*[5] set forth the legal standards that a district court must employ in deciding a motion for class certification under Rule 23. The Supreme Court had previously directed that the district court conduct a "rigorous analysis" on such a motion,[6] but following Second Circuit precedent that cautioned against inquiry into issues overlapping with the merits, district courts had approached motions for class certification much the same way they assessed the adequacy of pleadings on a motion to dismiss—accepting as true the allegations relating to class certification, and granting certification where the plaintiffs had made "some showing" that the Rule 23 requirements had been met.[7]

In *In re IPO*, Southern District Judge Shira A. Scheindlin certified the proposed plaintiffs' classes under this "some showing" standard. On appeal from that decision, the Second Circuit retreated from its own earlier decisions, rejecting the "some showing" approach and holding that the district court must resolve whatever factual disputes are present in order to make a determination that each requirement of Rule 23 has been met.[8] It specifically held that "the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue," even where those issues are identical, but that the court should not delve into merits issues unrelated to the class certification requirements.

In April 2008, the Second Circuit provided additional clarification and guidance on the need to avoid certification of class actions where individualized issues of proof would defeat the predominance requirement of Rule 23(b)(3). At issue on appeal in *McLaughlin v. American Tobacco Co.*,[9] was certification of a fraud-based, RICO putative class action brought by smokers alleging that they had been deceived into purchasing "light" cigarettes through marketing campaigns and branding that implied that light cigarettes were healthier than "full-flavored" cigarettes. Observing that "not every wrong can have a legal remedy…at least not without causing collateral damage to the fabric of our laws," the Second Circuit ordered that the class be decertified because the plaintiffs' claims suffered from an "insurmountable deficit of collective legal or factual questions."[10]

Among the issues the court found could not be determined on a classwide basis was the requirement that plaintiffs demonstrate reliance on the alleged misrepresentations concerning light cigarettes. The district court had accepted plaintiffs' argument that reliance could be shown on a classwide basis, using generalized proof, because defendants employed a uniform national marketing campaign for that product. The Second Circuit found that proof of a uniform misrepresentation would satisfy only half the reliance equation, concluding that demonstrating reliance on that alleged misrepresentation was not susceptible to generalized proof. It noted that individualized evidence would be needed to overcome the possibility that purchasers of light cigarettes had done so for some reason other than the belief that lights were a healthier alternative. The Second Circuit rejected the notion—urged by the plaintiffs and adopted by the district court—that the rebuttable presumption of reliance available in securities fraud cases where the market is efficient[11] could be adapted to permit a presumption of classwide reliance in this context. Although the court stopped short of the Fifth Circuit's blanket rule that no fraud class action can be certified when individual reliance will be an issue,[12] it found that the market for consumer goods was not efficient enough to support a presumption of reliance. The court illustrated just how unresponsive the market for light cigarettes was by pointing to the absence of a change in price or sales of light cigarettes following a report published by the National Cancer Institute rejecting the notion that there were any health benefits to smoking lights.

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Southern District Decisions

Focusing on the invigorated predominance requirement of Rule 23(b)(3), Southern District Judge Denny Chin denied class certification in *McCracken v. Best Buy Stores L.P.*[13] The plaintiffs in that action alleged that they had been improperly charged for magazine subscriptions offered to them as "risk free" at Best Buy checkout counters. Perhaps to avoid the need to prove classwide reliance, plaintiffs did not allege fraud, but instead proceeded on theories of breach of contract and unjust enrichment.

Judge Chin nevertheless determined that individualized issues of proof required denial of the motion for class certification. Because the two named plaintiffs had each signed an electronic signature pad containing a statement disclosing that they would be charged for the magazines after an eight-week trial period during which they could cancel their subscriptions, Judge Chin found that plaintiffs could only prevail based on oral representations made by individual sales clerks to individual customers. Because the sales clerks in this case were not using a standardized sales script, but were instead encouraged to personalize their sales pitch, the lack of materially uniform misrepresentations would result in an individualized inquiry requiring denial of the motion for class certification.

Decertification

In *In re Credit Suisse First Boston Corp. (Lantronix Inc.) Analyst Securities Litigation*,[14] Southern District Judge Loretta A. Preska took the unusual step of decertifying a class in an action claiming fraud based on allegedly false and misleading analyst reports. Judge John E. Sprizzo had certified the case as a class action in November 2006, but Judge Preska (to whom the case was transferred) concluded that that decision warranted reconsideration in light of the intervening Second Circuit opinion in *In re IPO*.

Judge Preska first considered whether the presumption of reliance could ever be expanded beyond the realm of statements made by issuers to apply to analyst statements. She noted that no Court of Appeals had issued a clear directive on this question, but that the Second Circuit had, in dicta, expressed doubt that the presumption of reliance could "'be extended, beyond its original context, to tie-in trading, underwriter compensation, and analysts' reports.'"[15]

Ultimately, Judge Preska found that she did not need to resolve whether the presumption of reliance could ever apply in a case based on an analyst's statement, because in this case, after consideration of extensive expert affidavits and testimony, the plaintiff had failed to show that the challenged statements had had any impact on the market. Judge Preska thus adopted the theory, suggested, but not expressly embraced by the Second Circuit in *Hevesi v. Citigroup Inc.*, that if the presumption of reliance was applicable to an analyst case, it could only fairly be applied "'where the publication of the [analyst] report clearly moved the market in a measurable fashion.'"[16]

Judge Preska noted in a footnote that even if the presumption of reliance was available, defendants had rebutted that presumption through evidence that the market was not moved by the alleged misrepresentation that outweighed the plaintiff's "modest showing of market impact."[17] In a decision filed last month in *Lapin v. Goldman Sachs & Co.*,[18] Southern District Judge Richard J. Sullivan took issue with Judge Preska's suggestion that weighing evidence related to loss causation was appropriate at the class certification stage. He held that plaintiffs need not establish loss causation in order to invoke the presumption of reliance on a motion for class certification. He stressed that the operative inquiry at that stage was whether loss causation could be proven by classwide evidence, not whether that evidence would ultimately prevail. Inasmuch as defendants had failed to show that the methodology of plaintiff's expert was incapable of establishing loss causation on a classwide basis, the presumption of reliance was available, and Judge Sullivan certified the class. *[See Author's Note[19]]*

Grand Theft Auto

Because the presumption of reliance is such a potent tool for plaintiffs seeking class certification, the Second Circuit's refusal in *McLaughlin* to extend that presumption beyond the securities fraud context is significant. That significance is illustrated by Southern District Judge Shirley Wohl Kram's decision in *In re Grand Theft Auto Video Game Consumer Litigation*,[20] decertifying a class in direct reliance on *McLaughlin*, after the parties had reached a settlement and she had conditionally certified a settlement class. At issue in that putative consumer fraud class action was a hidden, sexually explicit game-within-a-game that could be accessed only through the use of unauthorized modification software by users of the popular Grand Theft Auto: San Andreas video game. Plaintiffs alleged that defendants marketed the game under an improper content rating that they were only able to obtain by withholding information concerning the sex mini-game.

Judge Kram found that because the plaintiffs' claims revolved around a uniform course of conduct in the design, rating, marketing and sale of the game, there were many common issues of law and fact. She reasoned however, citing *McLaughlin*, that the alleged uniformity of the defendants' fraudulent conduct was insufficient, on its own, to satisfy Rule 23(b)(3)'s predominance requirement—noting that the settlement did not relieve the court of the obligation to perform a robust analysis of the predominance showing. First, she observed that, as was the case in *McLaughlin*, there were many reasons why individual plaintiffs may have purchased the game unrelated to the allegedly fraudulent rating. (In fact, she posited that some may have bought the game precisely because they hoped it would contain sex, violence, and other controversial content, noting that defendants had presented evidence that as many as three-quarters of the game's purchasers did not consider its content rating.) She concluded that the presence of these individual questions of reliance required decertification.

Judge Kram went on to find additional individualized questions that defeated the plaintiffs' efforts to establish predominance. Specifically, because the class members' claims would need to be determined under the laws of the state where each purchase was made, the states' differing consumer fraud laws created individualized issues concerning the conduct of individual class members. For example, some state laws require individualized proof on the questions of ascertainability of loss and privity, and others afford defenses such as unclean hands, requiring individualized rather than classwide inquiry. Based on these individualized elements of proof, Judge Kram concluded that despite the great time and resources expended by the parties in reaching the settlement and providing notice to the proposed class, the settlement class did not possess the cohesiveness required to satisfy the predominance requirement.

These cases indicate that Southern District judges have heeded the Second Circuit's directive to engage in a more probing, robust analysis of the requirements for certifying a class under Rule 23. It is likely that at least in the short run, these rulings will result in more, rather than less litigation as class-action participants engage in a legal tug of war to pull their cases over the dividing line between cases that turn on individualized questions and those where classwide determinations will predominate. In the long run, this heightened supervision of class litigation may result in greater efficiencies for both sides of the class action divide.

1. Pub. L. No. 104-67, 109 Stat. 737 (codified in part at 15 U.S.C. §§77z-1 & 78u-4).
2. Pub. L. No. 105-353, 112 Stat. 3227 (codified in part at 15 U.S.C. §§77p & 78bb(f)).
3. Pub. L. No. 109-2, 119 Stat. 4 (codified in part at 28 U.S.C. §1332(d)). See also Edward M. Spiro, "Class Action Litigation Reform Update," NYLJ, April 5, 2007.
4. *Amchem Prods. Inc. v. Windsor*, 521 U.S. 591, 623 (1997).
5. 471 F.3d 24 (2d Cir. 2006).
6. *Gen. Tel. Co. of the Sw. v. Falcon*, 457 U.S. 147, 161 (1982).
7. See *Lapin v. Goldman Sachs & Co.*, 2008 WL 4222850, at *2 (S.D.N.Y. Sept. 15, 2008) (Sullivan, J.).
8. Characterizing its own previous approach as "ambiguous," the *In re IPO* court disavowed *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); and *Heerwagen v. Clear Channel Commc'ns*, 435 F.3d 219 (2d Cir. 2006), to the extent they prescribed a less searching inquiry on the part of the district court.
9. 522 F.3d 215 (2d Cir. 2008).
10. Id. at 219.
11. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).
12. *McLaughlin*, 522 F.3d at 224-25 (citing *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996)).
13. 248 F.R.D. 162 (S.D.N.Y. 2008).
14. 250 F.R.D. 137 (S.D.N.Y. 2008).
15. Id. at 140 (quoting *In re IPO*, 471 F.3d at 43).
16. Id. (citing *Hevesi v. Citigroup Inc.*, 366 F.3d 70, 79 n.7 (2d Cir. 2004) (quoting opinion of "prominent scholar of federal securities law," Professor John C. Coffee Jr.)).
17. Id. at 143 n.11.
18. 2008 WL 4222850 (S.D.N.Y. Sept. 15, 2008).
19. *Author's Note:* On Sept. 30, 2008, in *In re Salomon Analyst Metromedia Litigation*, No. 06-3225-cv, the Second Circuit ruled that the *Basic* presumption of reliance is available in analyst cases, but reversed the district court's class-certification order because the district court had failed to afford defendants the opportunity at the class-certification stage to attempt to rebut the presumption.
20. 251 F.R.D. 139 (S.D.N.Y. 2008). (The authors represent a defendant in related litigation.)