INSIDE THE MINDS

Recent Developments in Securities Law

Leading Lawyers on Understanding Recent Decisions, Navigating New SEC Initiatives, and Establishing Compliance Policies

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A New Battleground: Class Certification Trends in Securities Class Actions

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Emerging Trends in Securities Laws – An Overview of Recent Developments in Class Certification Inquiries

Historically, federal courts deciding whether to certify a class in a securities action have tried to avoid "turn[ing] the class-certification proceeding into an unwieldy trial on the merits." *E.g.*, *In re New Motor Vehicles Can. Export Antitrust Litig.*, 522 F.3d 6, 24 (1st Cir. 2008). Thus, a plaintiff seeking class certification needed to present only basic facts—the courts reserved litigation of the actual merits for summary judgment or trial. Id. at 25. While some circuits continue to follow this model, others (most notably the Fifth Circuit and the Second Circuit) have taken a different approach in recent years and opened the door for securities class action defendants around the country to raise substantive issues at an earlier stage in the litigation.

In *Oscar Private Equity Invs. v. Allegiance Telecom Inc.*, 487 F.3d 261, 267 (5th Cir. 2007), the Fifth Circuit required plaintiffs to demonstrate loss causation before having the class certified. And, in *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008), the Second Circuit (while not going quite as far as the Fifth Circuit) mandated that defendants be given an opportunity to introduce evidence aimed at rebutting an initial presumption of fraud-on-the-market reliance. These decisions give defendants in a securities class action an early opportunity to dispose of a case by forcing an in-depth consideration of the merits at the class certification stage.[1]

Because of the heightened pleading standards imposed by the Private Securities Litigation Reform Act (PSLRA) and the Supreme Court's recent focus on pleading standards in *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007), *Tellabs Inc. v. Makor Issues & Rights*, 551 U.S. 308 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), many defendants view the motion to dismiss as the critical stage in a securities class action. But with the new trend in merits inquiries at the class certification stage, including a willingness on the part of many courts to bifurcate class and merits discovery, defendants are

[1] The Fourth and Seventh Circuits have also held that district courts must resolve bona fide disputes about the merits of plaintiffs' claims when considering whether to certify a class certification. *Gariety v. Grant Thornton LLP*, 368 F.3d 356, 366 (4th Cir. 2004); *Szabo v. Bridgeport Machines Inc.*, 249 F.3d 672 (7th Cir. 2001). The Third Circuit has taken a step in that direction by holding that district courts could "weigh conflicting expert testimony at the certification stage." *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 323 (3d Cir. 2008).

increasingly able to exert substantial leverage even following a loss on a motion to dismiss. As a result, the class certification inquiry is now becoming a rigorous and increasingly challenging burden for plaintiffs—as borne out by the recent Courts of Appeals decisions discussed below.[2]

Because class certification typically forms the basis for the amount of damages a plaintiff can reasonably expect, plaintiffs often regard success at the class certification stage as providing substantial negotiating leverage and paving the way for settlement discussions aimed at a significant monetary recovery for the plaintiff class. The trend toward heightening the examination of the merits at the class certification stage (and thus filtering out weaker claims) presents a critical opportunity for defendants to dispose of a case at a relatively early stage.[3] At a minimum, this trend has resulted in class certification proceedings that are considerably more involved than in the past and are often akin to mini-trials on the merits. Many in the defendants' bar view this as a positive development, creating fairer and more favorable outcomes for defendants. The plaintiffs' bar, on the other hand, tends to bemoan the trend as making class certification an unnecessarily onerous and inefficient process requiring lengthy briefing, expert reports, and evidentiary hearings. While this trend is occurring in all federal class actions, it has been driven by securities class actions where the stakes are often so large that defendants are willing to expend substantial resources even in the early stages of the litigation.

Class Certification – An Overview

In *General Telephone Co. of the Southwest v. Falcon*, 457 U.S. 147 (1982), the United States Supreme Court held that courts must conduct a "rigorous analysis" before deciding whether to certify a class and found that courts may "probe behind the pleadings" as part of that analysis. From this case

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[2] Not all circuits have gone the way of the Second, Fourth, Fifth, and Seventh Circuits. The First Circuit, for example, described those circuits' approaches as being "around the more rigorous end of this spectrum" and stated that in a securities fraud class certification, the district court should merely "probe the factual basis of the fraud-on-the-market presumption to make sure it will be a viable form of proof in a given case." *In re New Motor Vehicles Can. Export Antitrust Litig., 522 F.3d 6, 24-25 (1st Cir. 2008).*

[3] The denial of class certification, while technically not a final disposition, often leads a plaintiff to drop its suit because pursuing a substantial securities class action usually only makes sense from an economic perspective for a class of plaintiffs, not an individual.

flows the concept that a court should consider evidence on the merits at the class certification stage. *Falcon* represented the Court's first step away from *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 160 (1974), which had prohibited "preliminary inquiry into the merits" during the class certification analysis.

Under Rule 23(b)(3), a plaintiff must establish five requirements: (1) numerosity of plaintiffs, (2) typicality of the lead plaintiff's claim, (3) commonality of the lead plaintiff's claim, (4) adequacy of lead plaintiff's representation, (4) predominance of common claims, and (5) superiority of a class action as a method of adjudication. Federal courts have largely adopted a "preponderance of the evidence" standard as the putative class plaintiff's burden of proof at the class certification stage.[4]

The Commonality and Predominance Prongs in Securities Class Actions

Merits disputes at the class certification stage typically arise under the "commonality" and "predominance" requirements. If the court is willing to conduct an inquiry into this issue before certifying the class—as at least the Second, Fourth, Fifth, and Seventh Circuits have indicated they are—these requirements can present a difficult burden for a plaintiff.

In fraud cases involving public market securities transactions, plaintiffs must establish the following six elements to state a claim: (1) a material misrepresentation or omission; (2) scienter; (3) connection between the misrepresentation (or omission) and a securities transaction; (4) that the plaintiff relied on the material misrepresentation; (5) economic harm; and (6) loss causation. *Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). The fourth and sixth factors—reliance (which requires the plaintiff to prove that she bought or sold a security in reliance on a misrepresentation) and loss causation (which requires that the plaintiff prove that a defendant's alleged misstatement or omission "actually moved the market")—in particular have become key inquiries at the class certification stage.

[4] *See, e.g., In re Flag Telecom Holdings Ltd. Sec. Litig.,* 574 F.3d 29, 35 (2d Cir. 2009); *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305, 320 (3d Cir. 2009); *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, 228 (5th Cir. 2009).

A rebuttable presumption of reliance exists if the statements at issue become public. This concept is known as the "fraud on the market" presumption or the *Basic* presumption (first articulated in *Basic v. Levinson*, 485 U.S. 224 (1988)). The presumption assumes that all public information is reflected in the market price of the security, and that an investor who buys or sells stock at the market price relies upon the public misrepresentations that artificially inflated the price of the security. A court will presume reliance existed under this theory if the plaintiff can show that: (1) the defendant made public material misrepresentations, (2) the defendant's shares were traded in an efficient market,[5] and (3) the plaintiffs traded shares between the time the misrepresentations were made and the time the truth was revealed. *Oscar Private Equity Invs. v. Allegiance Telecom*, *Inc.,* 487 F.3d 261, 264 (5th Cir. 2007). Use of the fraud-on-the-market presumption is strong weapon for a plaintiff seeking to certify a class. The fraud-on-the-market theory allows a court to presume that all putative plaintiffs had the same information when determining to buy stock. As a result, a plaintiff can easily establish that common claims will "predominate"—all of the putative class plaintiffs are presumed to have relied on the exact same alleged misrepresentations.

Loss causation, as articulated by the Supreme Court in *Dura*, flows directly from the reliance requirement. To demonstrate loss causation, the plaintiff must show that the stock price increased following the alleged misrepresentation (hence showing the artificial inflation in the stock price) and that the stock price decreased following a corrective disclosure of the alleged misrepresentation (hence showing the removal of the artificial inflation). To demonstrate loss causation, a plaintiff must, therefore, prove that he (i) purchased securities after the alleged conduct causing the artificial inflation in the stock price and (ii) held those securities until after the corrective disclosure removing the artificial inflation from the value of the holder's securities (and, thus, causing the loss).

[5] Whether a market is an "efficient" market depends on: (1) the average trading volume; (2) the number of securities analysts tracking the stock; (3) the number of market makers; (3) whether a company is entitled to file a registration statement for trading; and (5) evidence of a cause and effect relationship between news and stock-price changes. *In re Nature's Sunshine Prods. Inc. Sec. Litig.*, 251 F.R.D. 656, 662 (D. Utah 2008). The most important factor is whether the plaintiff can demonstrate that stock prices regularly rose or fell in response to market information. Id. at 663-64. This inquiry typically depends on expert witness testimony.

The Fifth Circuit's Decision in *Oscar*

In *Oscar*, the Fifth Circuit held that plaintiffs could only receive the fraud-on-the-market reliance presumption upon a determination that the complained of misconduct actually moved the price of the stock at issue and caused their losses. In other words, the *Oscar* Court required the plaintiffs to fully establish the causal link between the alleged misconduct and the complained of loss by showing that the defendant's alleged misstatement or omission "actually moved the market" (i.e., that loss causation had occurred). *Oscar*, 487 F.3d at 265-66. Because the court in *Oscar* found that plaintiffs had not shown by a preponderance of the evidence that the market reacted in a material way to the alleged corrective disclosure, the court determined that common issues did not predominate and the district court had erroneously certified the class.

In reaching its decision, the *Oscar* Court analyzed scenarios where a material misstatement or omission failed to move an otherwise efficient market. The *Oscar* Court hypothesized that even an efficient market could function inefficiently with respect to the particular type of information conveyed or withheld by the alleged misrepresentation. *Oscar*, 487 F.3d at 269. The *Oscar* Court concluded that if the misstatement did not affect the stock price because it contained information that analysts and market participants did not digest or consider material, the link between the misstatement and class-wide reliance is necessarily missing. Accordingly, the class of plaintiffs must necessarily have invested for reasons other than reliance on the misrepresentation. *Oscar*, 487 F.3d at 269-70. Put simply, while an individual class representative may purchase securities in reliance on a misrepresentation, if that plaintiff cannot show (by relating the reaction of the stock price to the conduct at issue) that the broader class that he or she seeks to represent reacted similarly, then the class representative's claims do not predominate over the claims (or lack thereof) common to the class at large. Indeed, where the stock price has not been artificially inflated by the complained of misconduct, a class of stockholders suffers no economic loss and cannot maintain a claim under *Dura*. Thus, the *Oscar* Court determined that while certain of the elements of fraud were alleged, the class plaintiff had failed to carry its burden in demonstrating commonality with the class of plaintiffs he sought to represent.

The *Oscar* Court noted that it found no reason to consider loss causation later rather than earlier in the proceedings. The Court reasoned that loss causation usually involves relatively little discovery and factual proof (because the underlying pricing information for the securities is public). Loss causation typically only requires a limited review of the facts and a weighing of competing expert reports analyzing the movement of the stock price in relation to the factual allegations contained in the complaint. *Oscar*, 487 F.3d at 267. Thus, the Fifth Circuit, borrowing from both the logic of *Dura* and the growing judicial focus on resolving securities cases of doubtful merit earlier in the litigation, engaged in a relatively far-reaching analysis of the merits of the case during class certification. Other circuits and the securities defense bar have certainly begun to take notice.

The Second Circuit's Decision in *In re Salomon Analyst Metromedia Litig.*

The Second Circuit, widely regarded as the most influential circuit for securities matters, provides plaintiffs with a reliance presumption through the fraud-on-the-market theory but mandates that defendants have an opportunity to challenge it. *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008). While, on its face, the decision in *In re Salomon* does not go as far as *Oscar*, it too has resulted in increased merits inquiries at the class certification stage.

Following a denial of defendants' motion to dismiss, the district court in *In re Salomon* granted a motion to certify the class. The defendants argued that individual, not class, questions of reliance would predominate. In response, the plaintiffs invoked the fraud-on-the-market presumption, which the district court adopted. The district court refused to allow the defendants to rebut that presumption until later in the litigation. The Second Circuit reversed on that basis. Id. at 479.

While the *In re Salomon* court rejected *Oscar's* suggestion that loss causation must be established in order to utilize the fraud-on-the-market presumption for class certification, the court's decision to permit the defendants to rebut the presumption at the class certification stage leads to a substantially similar result. A defendant will necessarily need to address the merits in order to contest the presumption. Although the *Salomon* Court stated that a

Rule 23 hearing should not lead to a "mini-trial," Id. at 485, it nevertheless instructed that the court receive enough information, including affidavits, documents, and testimony, to fully consider the requirements of Rule 23. Id. at 486. As with *Oscar*, the opportunity provided by the *Salomon* Court to present testimony and rebut evidence proffered by a plaintiff provides a defendant with a substantial opportunity to deal a case-ending blow to a plaintiff prior to the commencement of expensive and time-consuming full-blown merits discovery. This is particularly so where a review of the complaint suggests an uncertain relationship between the complained of conduct and the movement of the price of the stock at issue in the case.

When to Challenge Class Certification

Rule 23 requires that a court consider class certification "at an early practicable time after a person sues . . . as a class representative." Thus, class certification is usually one of the first issues considered by a court, sometimes before or simultaneously with motions to dismiss. While defendants typically wait for the plaintiff to make a motion to certify the class, nothing in Rule 23 prohibits defendants from preemptively challenging class certification rather than waiting to respond to a plaintiff's motion for class certification. And with federal courts' newfound willingness to examine the merits when considering class certification, defendants have started to view class certification as a powerful tool in their toolkit as opposed to something to fend off once a plaintiff makes the motion.

Where the propriety of class certification is doubtful based on the face of the pleadings or where loss causation will be a major focus, making a motion to strike class allegations at an early stage, even before discovery, can work to a defendants' strategic advantage. Although some discovery (particularly expert discovery) will generally be necessary to assess class certification, that discovery can be generally limited in scope. Where a defendant assesses the case at an early stage and determines that it may have a strong challenge to class certification, a defendant may request bifurcation of the merits and the class discovery or consent to a partial lift of the PSLRA's automatic stay of discovery in order to have the court resolve a motion to deny class certification before or at the same time as the resolution of the motion to dismiss. While this is not the typical timeline (most courts consider motions to dismiss before resolving class certification motions), the new trend in class certification gives a persistent and determined defendant an opening to quickly move to attack the legitimacy of a class before a court has a chance to address any other aspects of the case.

Impact of Changes on Securities Law Clients

The increasing focus on merits analysis at the class certification stage will likely have a broad impact on the way securities class actions are litigated. Given that many courts have demonstrated a significant interest in conducting a rigorous analysis of Rule 23's requirements in securities fraud suits, defense counsel is well advised to explain the trends in the law and to encourage clients to devote adequate resources and analysis to the class certification stage of the case. Defense counsel should, however, take into account the particular case authority for the relevant circuit and should monitor the law because it is currently evolving and may even be ripe for consideration by the United States Supreme Court in the near future given the division in the circuits. Because some clients may balk at engaging in discovery and incurring more substantial legal fees at such an early stage of a case, defense counsel must carefully explain the opportunity presented by the current developments in the law. Further, the work performed to explore the merits at the class certification stage is work that will be done at some point in the litigation—and any savvy client should be easily persuaded to pursue a strategy that provides a realistic chance of disposing of the case before full-blown fact discovery begins.

Conclusion

Every indication is that the trend toward a heightened consideration of the merits at the class certification stage will continue over the next twelve months. The majority of the circuits have moved in this direction, if they have not already definitively decided the issue, and the district courts have been applying the standards set forth by the Courts of Appeals accordingly. This will mean a new focus on responding to class certification motions for securities defense lawyers—the majority of whom will not be accustomed to litigating the merits at this stage in the litigation—and the possibility that defense lawyers may choose to aggressively pursue class certification before the plaintiffs even move to certify the class.

Key Takeaways

- Given that many courts have demonstrated a significant interest in conducting a rigorous analysis of Rule 23's requirements in securities fraud suits, defense counsel is well advised to counsel clients to devote adequate resources and analysis to the class certification stage of the case.
- Defense counsel's recommendation, however, should take into account the particular law for the relevant circuit and should monitor the law because it is currently evolving.
- Looking ahead, there may be a new focus on class certification for securities defense lawyers, and the possibility that defense lawyers may choose to aggressively pursue class certification before the plaintiffs move to certify the class.

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