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DEFEATING CLASS CERTIFICATION IN SECURITIES FRAUD ACTIONS

by
Timothy S. Bishop
Kermit Roosevelt
Mayer, Brown & Platt, Chicago

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I. INTRODUCTION

A court may certify a class action under Federal Rule of Civil Procedure 23(b)(3) only if it is satisfied, "after a rigorous analysis,"[1] that the plaintiffs have met the requirements of Rule 23(a)–**numerosity**, **commonality**, **typicality**, and **adequacy**–and also shown that "the [common] questions of law or fact . . . **predominate** over any questions affecting individual members and that a class action is **superior** to other available methods for a fair and efficient adjudication of the controversy." The text of the Rule might seem to erect formidable barriers, but for years it has been received wisdom that how difficult it is to get a class certified depends on the substantive theory of recovery. Often, allegations of securities fraud have been treated as particularly suitable for class certification. *Basic v. Levinson*[2] cut the individualized issue of reliance out of the standard Rule 10b-5 cause of action, replacing it with the common issues of materiality and market efficiency, and the rest is history.[3] In *Amchem Products, Inc. v. Windsor*,[4] the Supreme Court seemed to confirm the common understanding when it commented that "[p]redominance is a test readily met in certain cases alleging consumer or securities fraud." Securities class actions now typically follow what one court has called an "all too familiar path":[5] motions practice and discovery "of massive proportions,"[6] followed by settlement on the eve of trial.

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[1] *General Telephone Co. v. Falcon*, 457 U.S. 147, 161 (1982).

[2] 485 U.S. 224 (1988).

[3] *Basic* endorsed the "fraud-on-the-market" theory, which allowed plaintiffs to forego individual proof of reliance on the grounds that they had purchased securities on the market "in reliance on the integrity of that price." *Basic*, 485 U.S. at 247. In an efficient market, where "most publicly available information is reflected in market price," public misrepresentations will be impounded in the price, and "an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Ibid.* Making reliance a common issue, rather than an individual one, dramatically alters the Rule 23(b)(3) calculus. Plaintiffs typically have great difficulty obtaining class certification for common law fraud claims, precisely because the individualized nature of the reliance analysis tends to predominate over common issues. See, *e.g.*, *Castano v. American Tobacco Corp.*, 84 F.3d 734, 745 (5th Cir. 1996) ("[A] fraud class action cannot be certified when individual reliance will be an issue"). Moreover, the presumed effect on the market may allow plaintiffs to demonstrate the fact of injury by common proof—proof that the market price declined after the truth came to light. See *Newton v. Merrill Lynch, Pierce, Fenner & Smith*, 259 F.3d 154, 179-80 (3d Cir. 2001).

[4] 521 U.S. 591 (1997).

[5] *In re Activision Securities Litig.*, 723 F.Supp. 1323, 1374 (N.D. Cal. 1989).

[6] *Ibid*; see also, *e.g.*, Thomas W. Willging, et al., *An Empirical Analysis of Rule 23 to Address the Rulemaking Challenges*, 71 N.Y.U. L. Rev. 74, 91 (1996).

How familiar is this pattern? A recent empirical survey of class actions in four federal districts over the two-year period from mid-1992 to mid-1994 found that "a b(3) class was certified in 94% to 100% of the securities cases."[7] Such data have led one commentator to opine that the securities class action is no longer best understood as a lawsuit at all. Instead, he argues, these suits "have more in common with business deals than they do with traditional adversarial litigation," and "the attorneys' activities are primarily business-oriented, not legal, in nature."[8]

In fact, things are not quite as bad as all that (or quite as good, depending on which side of the case caption you are on). In many securities cases, class certification is not a foregone conclusion, and defense counsel would be well advised to oppose it vigorously. We explore here some of the situations in which opposition to certification has the best chance of success. We first examine the easiest case for class certification; then, we discuss the ways in which allegations of securities fraud may depart from that paradigm case. Next, we examine a recent decision of the Third Circuit denying certification that illustrates the correct approach to certification analysis. Finally, we sketch what we think are the most promising arguments with which to oppose motions for class certification in the securities fraud context.

Revisiting these issues is particularly timely given the 1998 adoption of Federal Rule of Procedure 23(f), which allows, at the circuit court's discretion, immediate appeal of class certification rulings. Rule 23(f) appeals may well transform the law of class certification, and do so in short order. Prior to the adoption of Rule 23(f) the district court's decision on class certification frequently ended the case, one way or the other, as a practical matter. The defendants would often settle if the class was certified, and the plaintiffs would give up if it was not.[9] Despite the

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[7] Willging, et al., *supra* note 6, at 89 (reviewing cases from the Eastern District of Pennsylvania, the Southern District of Florida, the Northern District of Illinois, and the Northern District of California).

[8] William B. Rubenstein, *A Transactional Model of Adjudication*, 89 Geo. L. J. 371, 372 (2001).

[9] Class certification can be a powerful inducement to settlement. With a large plaintiff class certified, the magnitude of potential liability can cow even defendants who believe the possibility of being held liable is slight. See, *e.g.*, *In re Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293, 1298 (7th Cir. 1996) (describing settlements induced by small probability of immense judgment as "blackmail settlements"). Conversely, it has long been recognized that denials of certification can sound the death knell for a class action if plaintiffs lack a sufficient stake to proceed individually. See generally *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 470 (1978) (rejecting "death knell" doctrine as a basis for appellate jurisdiction). As the Advisory Committee Notes indicate, Rule 23(f) was enacted to allow appellate review in just such circumstances, and most circuits to have considered the issue now hold that practical termination of the case, coupled with a substantial question as to the correctness of the certification decision, warrants exercise of appellate jurisdiction. See Advisory Committee Note to Rule 23 (appeal is appropriate when "as a practical matter, the decision on

importance of the class certification decision, with appellate review usually unavailable, most of the development of the Rule 23(b)(3) standards took place at the district court level. Rule 23(f) has let the appellate courts back into the process, and they have given every indication that they intend to take an active role. As Judge Easterbrook put it recently, district courts for too long have been forced to rely on "only decisions from other district judges, most in cases later settled and thus not subject to appellate consideration. By granting review now, we can consider whether these cases correctly understood the applicable principles."[10] We predict that as more Rule 23(f) appeals are decided, the conventional wisdom on Rule 23(b)(3) certifications in securities fraud cases will undergo substantial revision, with more rigorous analysis of the class certification factors becoming the norm and denial of certification in securities cases becoming more commonplace.

II. PARADIGM CASES, OR, WHAT WAS JUSTICE GINSBURG THINKING IN AMCHEM?

The Supreme Court's dictum in *Amchem* (the case before the Court was a mass tort) seems neatly to encapsulate the conventional wisdom. But as the Court was careful to say, its observation applied only to *certain* securities fraud cases, and only to the predominance requirement. *Amchem* certainly does not support the proposition that certification is appropriate for all securities fraud cases. But *some* securities fraud allegations are easier cases than others for class certification. After *Basic*, there is one easy candidate, the paradigm case that, presumably, informed Justice Ginsburg's statement in *Amchem*.

The paradigm case involves a single public misrepresentation about the underlying value of the security and, a short time thereafter, a single public disclosure of the truth. Following the misrepresentation, the security's price rises sharply, and after disclosure it exhibits an equally sharp correction. Many small investors purchased the security on the open market after the misrepresentation and before the corrective disclosure; they bring suit.

The requirements of Rule 23 fit those facts well. The plaintiffs are all in essentially the same position: they purchased securities the market prices of which were inflated, to an identical extent, by a single misrepresentation (thus satisfying commonality). And each plaintiff, in an individual suit, would be seeking to prove facts that would also entitle the other class members to recover (thus satisfying typicality and adequacy). The common issues would encompass almost all the elements

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certification is likely dispositive of the litigation"); see also, *e.g.*, *In re Sumitomo Copper Litig.*, 262 F.3d 134, 139 (2d Cir. 2001); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 163-65 (3d Cir. 2001).

[10] "Which," the Seventh Circuit went on, "they did not." *Szabo v. Bridgeport Machines*, 249 F.3d 672, 675 (7th Cir. 2001). See James D. Weidner, *Rule 23(f) Appeals*, 1269 PLI/Corp. 717, 739 (2001) (because of its "propensity to hear Rule 23(f) appeals" the Seventh Circuit "has the potential to create a highly developed law of class actions, which other courts will look to for guidance"). The same could now be said of the Third Circuit.

of the Rule 10b-5 cause of action—materiality, scienter, causation, and injury, with materiality doing double duty for reliance under *Basic*—and would predominate over whatever individual issues there might be. Finally, because small investors with little at stake might not be able to attract plaintiffs' lawyers if forced to proceed individually, the class action form appears superior.

But the fact that a particular, idealized securities fraud case is suitable for class treatment does not mean that all, or even most, are. The hold that this paradigm case exerts is regrettable, because many securities fraud cases differ in crucial respects that make them wholly unsuitable for class adjudication. They do not involve single misrepresentations or disclosures. Sometimes the representations do not relate to the underlying value of a security. They feature long time periods and ambiguous price movements. The purchasers include large institutions as well as small investors. The following section discusses the ways in which the facts of securities fraud cases frequently depart from the paradigm sketched above, and the implications of those departures for the certification requirements.

III. PARADIGMS LOST: COMPLICATIONS

Allegations of securities fraud may differ from the paradigm case in several ways that raise complications for plaintiffs seeking class certification.

A. Long class periods

As class periods grow longer, the efficacy of a plaintiff's invocation of the fraud-on-the-market theory decreases. In the Rule 10b-5 context, the theory works essentially by substituting a materiality analysis for what would otherwise be an individualized inquiry into reliance: if the misrepresentation was material, then it affected the market price, and plaintiffs relying on the integrity of the market price can be deemed also to have relied on the misrepresentation. It is important to realize that the commonality thus created exists only for plaintiffs purchasing at the same time. Whether a misrepresentation is material depends on how it affects the "total mix" of information available to an investor,[11] and as the total mix of information changes over time, so too does the materiality analysis. Publicly-held corporations issue earnings statements and press releases, file SEC disclosure forms, and are the subject of analyst reports. Information about the economy in general, or the prospects of an industry or sector, also affect a company's value. Because the total mix of information available is constantly changing, it will frequently be impossible to establish materiality by common proof. A misrepresentation that was material when made may soon become immaterial as it is overtaken by a welter of new information coming to the marketplace.[12]

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[11] See *TSC Indus., Inc v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[12] See, *e.g.*, *J.H. Cohn & Co. v. American Appraisal Assocs, Inc.*, 628 F.2d 994, 998 (7th Cir. 1980) (an early purchaser "would face a different question of proof on the materiality issue" than one who purchased "after a great deal more information . . . was available"); *Gelman v. Westinghouse Corp.*, 73 F.R.D. 60, 68 (W.D. Pa. 1976), *aff'd*, 612 F.2d 799 (3d Cir. 1980) ("the question of materiality

B. Multiple misrepresentations or disclosures

As class periods grow longer, the chances increase that the case will feature either multiple misrepresentations or multiple corrective disclosures. Multiple misrepresentations or disclosures not only complicate the materiality and reliance analyses, as discussed above; they also create the potential for conflicts among class members. Each plaintiff can maximize his damages by showing that the price of the security was inflated when he purchased it, but not when he sold it. Because class members buy and sell from each other, they will have opposite incentives with regard to proof of price inflation. Each will want to stress the importance of misrepresentations occurring before his purchase and of disclosures occurring before his sale while downplaying the significance of others. This conflict threatens the adequacy of any single class representative.[13] The existence of multiple misrepresentations or disclosures also dramatically increases the magnitude and complexity of the proceedings necessary to establish materiality and loss causation, and to calculate damages.

C. Atypical or nonpublic misrepresentations

In some cases, the misrepresentations on which plaintiffs base their 10b-5 claim will either not relate directly to the value of the underlying security, or will be made to individual investors rather than disseminated to the public. Either of these features can prevent plaintiffs from using the fraud-on-the-market theory to establish materiality, reliance, or fact of injury. Plaintiffs who cannot rely on the fraud-on-the-market theory face an uphill battle in seeking certification. There are few other ways to establish these elements by common proof, and the need for individualized analysis of even one element of the cause of action may preclude a finding of predominance or make a trial unmanageable.[14]

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as it pertains to the claim of a shareholder who sold stock in May or June is vastly different from the question as it pertains to claims stemming from sales in November or December").

[13] See, *e.g.*, *Ziemack v. Centel Corp.*, 163 F.R.D. 530, 540-42 (N.D. Ill. 1995) (discussing conflict among securities fraud class members who bought and sold at different times); *In re Seagate Technology II Securities Litig.*, 843 F.Supp. 1358-62 (N.D. Cal. 1994) (same); *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 482-85 (W.D. Mich. 1994) (same); see generally Ross, *Do Conflicts Between Class Members Vitiate Class Action Securities Fraud Suits?*, 70 St. John's L. Rev. 209 (1996).

[14] As discussed in greater detail in Part III, the atypicality of the alleged misrepresentation was enough to preclude certification in *Newton v. Merrill Lynch, Pierce, Fenner & Smith*, 259 F.3d 154, 179-80 (3d Cir. 2001). See also, *e.g.*, *In re LifeUSA Holding Inc.*, 242 F.3d 136 (3d Cir. 2001) (finding no predominance in fraud case based on numerous non-uniform "sales pitches" for annuity contracts); *Baum v. Great Western Cities, Inc., of New Mexico*, 703 F.2d 1197 (10th Cir. 1983); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880 (5th Cir. 1973).

D. Differences among investors

While the paradigm case assumes a large number of homogenous small investors, the truth is that large institutional investors own a substantial and increasing percentage of securities. Sixty years ago, Harry Kalven and Maurice Rosenfield argued for the appropriateness of class actions in cases in which many individuals have "a small stake in a large controversy" and might be unwilling to proceed on an individual basis.[15] That may once have been an apt description of securities fraud cases; in 1950, institutional investors held only 7.2% of outstanding equities.[16] But by 1997, that proportion had increased to 47.7%.[17] Many, if not most, securities fraud cases now count many large institutions, with large holdings of the stock in issue, among the potential plaintiffs—institutions such as mutual funds, pension funds, hedge funds, and large corporations with the resources and economic incentive to pursue individual claims.

The presence of institutional investors not only undermines one of the policy bases for class treatment, it also destroys the uniformity among plaintiffs presumed by the paradigm case. Institutional investors are more sophisticated than the average individual investor, usually relying on their own specialist analysts. Differing sophistication may destroy commonality on several 10b-5 issues. The materiality analysis depends on the sophistication of a plaintiff,[18] as does the assessment of reasonable reliance,[19] and the application of the Securities Act's tolling provision (§ 13).[20] The presence of institutional investors within the plaintiff class prevents resolution of these issues by common proof and undermines the predominance of common issues.

Another distinct class of investors is short sellers, who sell shares of stock they do not own in anticipation that the price will decline. Short sellers may fall within a class definition based on sale, or even one based on purchase, as they buy stock to cover their short positions. However, to say that a short seller relies on the integrity of the market price is a stretch. Traders short stocks precisely because they believe the market overestimates their true value. More significantly, a trader who knew that a misrepresentation was inflating a security's price would be *more* (not less) likely to

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[15] Kalven & Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. Chi. L. Rev. 684, 684 (1941).

[16] New York Stock Exchange, 1998 Fact Book 61-62.

[17] *Ibid.*

[18] See *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3d Cir. 1976) (no materiality when a plaintiff acting with "due care" should have known the relevant facts, taking into account the plaintiff's "sophistication" and "access to the relevant information").

[19] See *Brown v. E.F. Hutton*, 991 F.2d 1020, 1032 (2d Cir. 1993).

[20] See *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 528 (5th Cir. 1987).

execute his short sale, so proving transaction causation is all but impossible. Finally, short sellers are unlikely to have been injured. Inclusion of short sellers in a class can thus prevent plaintiffs from establishing materiality, reliance, or fact of injury with common proof, threatening predominance.[21]

E. Frankenstein's Monsters

As the facts of a securities fraud case depart from the certification paradigm, it becomes less possible to establish the elements of the claim by common proof. That makes it more likely that individual issues will be found to predominate. But it has additional legal significance, especially in larger cases, for the superiority requirement.

Rule 23(b)(3) requires a would-be class representative to show "that a class action is superior to other available methods for the fair and efficient resolution of the controversy," and the rule explicitly instructs courts to consider "the difficulties likely to be encountered in the management of a class action." These difficulties are seldom faced because of the frequency with which fraud class actions are settled before trial. But the fact that a case is likely to be settled if a class is certified[22] does not mean that the difficulties of trying the case can be ignored in the certification calculus (unless, of course, the class presented for certification is a settlement class), as the Supreme Court made clear in *Amchem*.[23]

In consequence, departures from the paradigm case can take on an added significance. Even if they are insufficient to lead the court to conclude that common issues predominate, the practical burdens of performing even a brief individualized analysis for every member of a large class may overwhelm the trial system's resources. As the Ninth Circuit put it, "[i]t cannot be lightly overlooked that as a class gets larger it may transform the litigation into a gigantic burden on the Court's resources beyond its capacity to manage or control."[24] For very large classes, the demands of trial can approach the absurd. In one case, the court estimated that actual trial of individual

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[21] See *Ganesh v. Computer Learning Ctrs, Inc.*, 183 F.R.D. 487, 490-91 (E.D. Va. 1998).

[22] *See supra* note 9. That a large class has substantial *in terrorem* potential is not an unmitigated good for plaintiffs. Federal courts properly are growing more sensitive to the coercive aspects of certification and may be *less* likely to certify a class that threatens such massive liability as to make merits defense unthinkable. See *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 167 n.8 (3d Cir. 2001) ("[T]he size of the class and number of claims may place acute and unwarranted pressure on defendants to settle. It is a factor we weigh in our certification calculus").

[23] 512 U.S. at 619. Moreover, the more coercive the certification, the more likely is Rule 23(f) review.

[24] *In re Hotel Telephone Charges*, 500 F.2d 86, 90 (9th Cir. 1974).

damage claims would require "well over one hundred years."[25] At that point, the class action can no longer be called a superior form of resolution; it can only be considered "a Frankenstein monster masquerading as a class action."[26]

IV. APPLICATIONS: NEWTON v. MERRILL LYNCH, PIERCE, FENNER & SMITH

In *Newton v. Merrill Lynch, Pierce, Fenner & Smith*,[27] the Third Circuit encountered a putative class action that differed significantly from the paradigm case. The named plaintiff sought to represent a class of investors who purchased and sold securities on the NASDAQ market between November 4, 1992, and August 28, 1996. The defendants were the broker-dealers who had executed the plaintiffs' orders, and the theory of liability was that the broker-dealers had violated their duty of best execution by executing the investors' orders at the price offered by the National Best Bid and Offer system (NBBO) without consulting alternative sources of liquidity such as SelectNet or Instinet (private on-line services).[28] Failure to disclose the alleged breach of duty leveraged the common law tort into a Rule 10b-5 claim.

The defendants initially prevailed before the district court on the theory that the scope of the duty of best execution with regard to alternative sources of liquidity was not sufficiently well-defined during the class period for the plaintiffs to establish either materiality or scienter.[29] A divided panel of the Third Circuit affirmed, but the court *en banc* reversed: when better prices were reasonably available, the *en banc* court held, NBBO execution might be a breach of the duty of best execution, and failure to disclose the practice of not consulting alternate sources might be a 10b-5 violation.[30]

That clarification of the potential liability set the stage for the district court's class certification decision. The defendants had (according to the complaint) engaged in a uniform course of conduct that might in some circumstances amount to a violation of Rule 10b-5. Was that common conduct

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[25] *Galloway v. American Brands, Inc.*, 81 F.R.D. 580, 586 (E.D.N.C.). The claims in *Galloway* were antitrust claims, but similar principles govern securities fraud cases. Fact of damage is an element of the 10b-5 cause of action, just as it is with a Sherman Act claim. See 15 U.S.C. § 15(a).

[26] *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 169 (1974).

[27] 259 F.3d 154 (3d Cir. 2001) ("*Newton II*"). The authors represented the underwriters in *Newton II*.

[28] For a detailed description of these alternative sources, see the district court opinion granting summary judgment to defendants, *In re Merrill Lynch Sec. Litig.*, 911 F.Supp. 754, 759-60 (D.N.J. 1995), *rev'd*, *Newton v. Merrill Lynch, Pierce, Fenner & Smith*, 135 F.3d 266 (3d Cir. 1998) (*en banc*) ("*Newton I*").

[29] See *Newton II*, 259 F.3d at 171.

[30] See *ibid* (discussing *en banc* holding).

enough to support certification under Rule 23(b)(3)? Judge Debevoise answered no, and the plaintiffs appealed.

The plaintiffs' central theme on appeal was the defendants' common conduct. Every proposed class member, they argued, had been treated identically, and this "common scheme" made class treatment appropriate.[31] Not so, the defendants replied: determining whether a better price was actually available for any particular trade, and whether that plaintiff would have wanted a broker-dealer to spend the time to look for it at the risk of intervening price deterioration, would require consideration of the particular circumstances of every plaintiff's every trade—individualized issues that would predominate over common ones and overwhelm any court's factfinding ability.

The facts of *Newton* parted company with the paradigm case on a central point. The alleged misrepresentations or omissions had no connection to the underlying value of any security, relating instead to the manner in which orders were executed.[32] The Third Circuit began its analysis with this observation,[33] and went on to demonstrate how one divergence from the paradigm may be enough to bar certification.

The defendants argued that each of the elements of a 10b-5 cause of action would require individualized analysis. The Third Circuit found the materiality issue decided by its *en banc* holding that a broker-dealer who accepted a customer's order "while intending to breach that duty [of best execution] makes a misrepresentation that is material."[34] With respect to reliance, it found that the atypical nature of the misrepresentations (their lack of connection to the underlying value of any security) prevented the plaintiffs from using the fraud-on-the-market theory to create a presumption of reliance.[35] As a consolation prize, it gave the plaintiffs a rebuttable presumption of reliance under

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[31] See *ibid.*

[32] See *id.* at 173.

[33] See *ibid* ("It is important to recognize that the facts of this case do not resonate with those typical of securities violations under Rule 10b-5. Customarily those claims involve a fraudulent material misrepresentation or omission that affects a security's value").

[34] *Newton I*, 135 F.3d at 269. This analysis of the materiality issue seems obvious—an intent to breach the duty of best execution certainly *sounds* material—but on the facts of *Newton* it is highly questionable. The form the alleged breach took was automatic NBBO execution, and some buyers (those who anticipated a rapid price increase) would presumably have preferred the speed of that execution to the delay required to search for alternate sources of liquidity. Moreover, some of the putative plaintiff class were sophisticated institutional investors who were quite aware of both the defendants' practice of NBBO execution and the existence of alternatives.

[35] *Newton II*, 259 F.3d at 175-76.

Affiliated Ute Citizens of Utah v. United States,[36] which allows such a presumption with regard to omissions on the grounds that it is unfair to require a plaintiff to prove reliance on an omission.[37] The defendant's ability to rebut on a plaintiff-by-plaintiff basis tends, however, to shift reliance out of the "common" column and into the "individual."[38] With respect to the fact of injury, the unavailability of the fraud-on-the-market theory likewise prevented plaintiffs from establishing this element via common proof. Whether an investor had suffered the injury necessary for a Rule 10b-5 claim depended on whether a better alternative price was in fact available, and whether the investor would have wanted his broker to spend the time needed to look for it. That obviously raised individualized questions.[39]

With fact of injury requiring a trade-by-trade analysis and reliance subject to plaintiff-by-plaintiff rebuttal,[40] the court found that individual issues predominated, plaintiffs' invocation of the *Amchem* dictum notwithstanding.[41] The need to "[e]xamin[e] millions of trades to ascertain whether or not there was injury . . . overwhelmed common questions."[42]

The plaintiffs proposed to "gloss over this [injury] requirement" by having their expert develop a statistical formula that would calculate aggregate damages and then allocate these damages among class members.[43] But that suggestion, the court observed, would allow the plaintiffs to substitute a statistical calculation of hypothetical damages for the proof of actual individual injury that the 10b-5

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[36] 406 U.S. 128 (1970).

[37] See *Newton II*, 259 F.3d at 174-75

[38] See *id.* at 176-77. In *Newton II*, that rebuttal could have taken the form of showing that a particular plaintiff either valued speed of execution over the potential for lower prices or was indifferent, or that the plaintiff knew of defendants' practice and the possible alternatives—precisely the same possibilities the court erroneously ignored in supposing that materiality presented a common issue.

[39] See *id.* at 177-81.

[40] *Id.* at 181.

[41] *Id.* at 189 (noting plaintiffs' citation of *Amchem*).

[42] *Id.* at 187.

[43] *Ibid.*

cause of action requires.[44] And that would allow plaintiffs to dispense with proof of one element of their claim, a substantive alteration of rights forbidden by the Rules Enabling Act.[45]

Predominance aside, the court also found that determining whether each plaintiff had been injured and evaluating the individual defenses that could be raised was simply too massive and complex a task to be undertaken on a class wide basis. Trial of the proposed class action would require examination of "hundreds of millions of transactions executed over several years"; it would be simply unmanageable, indeed flatly impossible without a lot of impermissible shortcuts.[46]

Newton II holds important lessons for securities fraud defense counsel with regard to both of the grounds on which it was decided. Its predominance analysis demonstrates that when the effect of an allegedly common course of conduct depends on characteristics of the individual plaintiff or the individual transaction, common conduct is not enough. Securities fraud or not, the alleged offense becomes conceptually similar to a mass tort and class certification is inappropriate for the same reasons that apply to mass torts.[47] *Newton II*'s superiority analysis shows that as a proposed class grows larger, it becomes more vulnerable to manageability challenges. Even if injury could have been presumed, the task of calculating damages for each plaintiff "would require hundreds of millions of individual assessments,"[48] something no court could do.[49] Even a single individualized inquiry may thus be enough to bring down a truly massive class. As the Fourth Circuit has put it,

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[44] See *id.* at 187-90.

[45] See 28 U.S.C. § 2072 (rules "shall not abridge, enlarge or modify any substantive right").

[46] See *Newton II*, 259 F.3d at 191-92.

[47] *Id.* at 189-90 (noting similarity to mass tort cases).

[48] *Id.* at 192.

[49] Bifurcating the trial into a liability phase and a damages phase is often suggested as a solution to the problem of calculating damages. Bifurcation can raise serious constitutional issues, however. Liability and damages issues often intertwine, yet the Seventh Amendment forbids one jury from reviewing another's conclusions. See, *e.g.*, *Castano v. American Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996) (citing bifurcation as a factor weighing heavily against certification where individual issues, such as comparative negligence, were intertwined with common issues). The danger is especially acute with regard to claims (like those under Rule 10b-5) for which actual injury is an element of the cause of action. Any damages-phase jury determination that a plaintiff's damages are zero will contradict the liability-phase finding of injury. See *In re Lower Lake Erie Iron Ore Antitrust Litigation*, 998 F.2d 1144 (3d Cir. 1993) (reversing damages verdict handed down following bifurcated antitrust trial because the jury may have reconsidered fact of injury in determining amount of damages). Beyond that, bifurcation simply postpones the unmanageable part of the litigation. A class action should not be certified if there is no manageable way to calculate damages.

"where the issue of damages and impact does not lend itself to * * * a mechanical calculation, but requires 'separate mini-trial[s]' of an overwhelming[ly] large number of individual claims, courts have found that the 'staggering problems of logistics' thus created make the damage aspect of the case predominate, and render the case unmanageable as a class action."[50]

V. ARGUMENTS AND AUTHORITY

The previous sections have given an abstract description of difficulties for securities fraud class action plaintiffs and a case study. This one aims to offer resources for defendants. Following is a collection of what we believe to be powerful arguments against certification, along with citations to some of the most useful cases in support of those arguments. We group them according to the requirements of Rule 23.

A. Typicality

A named plaintiff fails to satisfy the typicality requirement if he himself has no claim. In *Baffa v. Donaldson, Lufkin & Jenrette Sec. Corp.*,[51] for example, the Second Circuit affirmed the district court's denial of certification on the grounds that the plaintiff's lack of standing made him "an atypical and inadequate representative." Such plaintiffs apparently present themselves with some frequency.[52] More commonly, however, the named plaintiff will simply be subject to unique defenses that might distract from the common issues. As the Seventh Circuit put it, "[t]he presence of even an arguable defense peculiar to the named plaintiff or a small subset of the plaintiff class may destroy the required typicality of the class."[53]

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[50] *Windham v. American Brands, Inc.*, 565 F.2d 59, 68 (4th Cir. 1977). Also encouraging for defense counsel is the *Newton II* court's recognition that certification of an unusually large class "would place hydraulic pressure on defendants to settle, which weighs in the superiority analysis." 259 F.3d at 192. This suggests that large classes may, apart from other defects, sometimes simply fall of their own weight.

[51] 222 F.3d 52, 59 (2d Cir. 2000).

[52] See, *e.g.*, *East Texas Motor Freight System Inc. v. Rodriguez*, 431 U.S. 395 (1977) (plaintiff had not suffered employment discrimination); *McClain v. South Carolina National Bank*, 105 F.3d 898, 903 (4th Cir. 1997) (plaintiff had not paid allegedly illegal loan insurance charges); *Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63 (8th Cir. 1980) (in securities fraud case, plaintiffs did not rely on alleged misrepresentations); *In re American Bank Note Holographics, Inc. Securities Litigation*, 93 F. Supp. 2d 424, 435 (S.D.N.Y. 2000) (aftermarket purchasers could not represent § 12(2) class)

[53] *J.H. Cohn & Co. v. American Appraisal Assocs, Inc.*, 628 F.2d 994, 999 (7th Cir. 1980); see also, *e.g.*, *Hanon v. Dataproducts Corp.*, 976 F.2d 497 (9th Cir. 1992) (affirming denial of certification in securities case on typicality grounds because named plaintiff was subject to unique defenses);

B. Adequacy

An adequacy challenge usually asserts that the interests of class members are antagonistic. There are two sorts of pervasive conflicts in securities fraud class actions that may threaten the "undivided loyalties to absent class members" that "basic due process requires."[54] First, there is seller-purchaser conflict: class members all want to argue that the price was inflated when they purchased, but not when they sold. Since a class member will almost always have another class member as his counterparty in a trade of class securities, there is inevitable conflict. In order to increase his own recovery, each class member will have an incentive to minimize the harm suffered by counterparty class members. The effect of such conflict can be quite substantial, and it increases as class periods lengthen. In its most extreme form it will present the spectacle of a named plaintiff arguing that other class members are entitled to no recovery at all, something that should give any court pause.[55] Seller-purchaser conflict has prevented certification in some cases,[56] but we feel it has yet to be given its full due.

Second, there is arguably an "equity" conflict, which occurs when some class members still hold stock. These members will want to reduce the recovery of other class members since recovery against the corporation reduces the value of their stock holdings. Equity conflict has thus far not posed much of an obstacle to class certification.[57]

Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 903 F.2d 176 (2d Cir. 1990) (same); *Warren v. Reserve Fund, Inc.*, 728 F.2d 741 (5th Cir. 1984) (same); *In re Razorfish, Inc. Securities Litigation*, 2001 WL 476504 (S.D.N.Y. 2001) (same).

[54] *Broussard v. Meineke Discount Muffler Shops, Inc.*, 155 F.3d 331, 338 (4th Cir. 1998).

[55] See, *e.g*, *In re Cendant Corp. Litig.*, — F.3d —, — n.8 (3d Cir. 2001) (recognizing that proof stock price was still inflated when class members sold stock shows those members "would have no damages"); *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (same).

[56] For respectful treatments, see, *e.g.*, *Ziemack v. Centel Corp.*, 163 F.R.D. 530, 540-542 (N.D. Ill. 1995); *In re Seagate Technology II Securities Litig.*, 843 F.Supp. 1341, 1358-1362 (N.D. Cal. 1994); *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 482-485 (W.D. Mich. 1994); *The Centurions v. Ferruzzi Trading Int'l*, 1994 WL 114860 (N.D. Ill. 1993); *Desimone v. Industrial Bio-Test Laboratories. Inc.*, 80 F.R.D. 112, 113 (S.D.N.Y. 1978); *In re Warner Communications Sec. Litig.*, 618 F.Supp. 735, 744 (S.D.N.Y. 1985); *Weisberg v. APL Corp.*, 76 F.R.D. 233, 239-40 (E.D.N.Y. 1977); *Feldman v. Lifton*, 64 F.R.D. 539, 549 (S.D.N.Y. 1974); *Robinson v. Penn Central Co.*, 58 F.R.D. 436, 443 (S.D.N.Y. 1973).

[57] Beyond the cases cited in the preceding note, some of which also discuss equity conflict, perhaps the best treatment is *Ruggiero v. American Bioculture, Inc.*, 56 F.R.D. 93 (S.D.N.Y. 1972).

C. Predominance

Plaintiffs seeking to establish materiality, reliance, loss causation, and fact of injury by common proof rely critically on the fraud-on-the-market theory. They also rely on it reflexively, invoking the theory in some cases in which it is not applicable, and it is important to be ready to contest the assertion of a fraud on the market. Demonstrating that the market at issue is not efficient is one way to do this.[58] Another is demonstrating that the security's price failed to react in a manner consistent with a fraud-on-the-market case, either not rising on the misrepresentations or not falling on the subsequent disclosure of the truth. Lack of appropriate price movement can preclude reliance on the fraud-on-the-market theory, or simply reduce recovery to zero.[59] Without a fraud on the market, the individualized issue of reliance by itself is usually sufficient to defeat certification.[60]

It is important also to recognize the limitations of the fraud-on-the-market theory. The theory essentially consolidates the disparate plaintiffs into a single group—the market—and uses that measure of aggregate response as a substitute for individual proof. If the misrepresentations moved the market price up, they were material; if the subsequent disclosure of the truth moved the price down, plaintiffs were injured. But the commonality thus created exists for particular moments only, and the investors comprising the market are an ever-changing assemblage. Investors do not all buy and sell simultaneously, and the fraud-on-the-market theory does not create commonality between investors trading at different times. An extended class period, the existence of multiple misrepresentations or corrective disclosures, and the mix of other information affecting price may all prevent plaintiffs from establishing materiality or reliance by common proof even if they can use the fraud-on-the-market theory.[61]

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[58] See, *e.g.*, *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988), *vacated on other grounds sub nom. Fryar v. Abell*, 492 U.S. 914 (1989). More broadly, the efficient market hypothesis itself has come under fire recently as the growing school of "behavioral law and economics" seeks sacred cows to tip over. See generally Paul A. Ferrillo & Michael K. Rappaport, Sunbeam *Warms Market Efficiency Arguments*, N. Y. L. J. at 8 (Oct. 24, 2001).

[59] See, *e.g.*, *Nathanson v. Zonagen, Inc.*, 267 F.3d 400, 413 (5th Cir. 2001) ("It is clear that a fraud-on-the-market theory may not be the basis for recovery in respect to an alleged misrepresentation which does *not* affect the market price of the security in question"); *Harris Trust & Sav. Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987) ("If, for example, a firm reveals that an earlier public statement was mistaken, but the price of the securities does not move in response, the investors suffer no damages").

[60] See, *e.g.*, *Castano*, 84 F.3d at 745 ("[A] fraud class action cannot be certified when individual reliance will be an issue").

[61] See, *e.g.*, *J.H. Cohn & Co. v. American Appraisal Assocs, Inc.*, 628 F.2d 994, 998 (7th Cir. 1980) (an early purchaser "would face a different question of proof on the materiality issue" than one who purchased "after a great deal more information . . . was available"); *Gelman v. Westinghouse Corp.*,

Loss causation and fact of injury throw the theory's limitations into even sharper relief. Not only can plaintiffs who bought and sold at different times not rely on common proof to show that the market price was inflated as a result of defendant's misrepresentations when they purchased and not when they sold; they do not even have common aims. Instead, the class members are pitted against other class members, each trying to establish contradictory theories about when inflation existed, when it dissipated, and what caused it. Beyond the adequacy issues thus presented, this sort of individualized analysis can be tremendously complex.

Nor does fraud on the market necessarily even allow plaintiffs to establish reliance by common proof. Reliance, after all, "is not enough by itself; that reliance must be justifiable, or reasonable."[62] Because reasonableness depends on the characteristics of an investor and the other information available to him, fraud on the market may not even create commonality for plaintiffs purchasing at the same time.[63] Fraud on the market, in short, is no panacea for the class action proponent.

D. Superiority

The superiority determination frequently comes down to the question of whether trial of the contemplated[64] class action would be manageable. Manageability, in turn, is in large part a function of two variables: the number of class members or transactions that must be examined, and the complexity of the analysis that must be performed for each. As classes grow larger, the number of required determinations can climb into the millions, and even routine inquiries can create insuperable manageability problems. If calculating a class member's damages requires fifteen

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73 F.R.D. 60, 68 (W.D. Pa. 1976), *aff'd* 612 F.2d 799 (3d Cir. 1980) ("the question of materiality as it pertains to the claim of a shareholder who sold stock in May or June is vastly different from the question as it pertains to claims stemming from sales in November or December).

[62] *Harsco Corp. v. Segui*, 91 F.3d 337, 342 (2d Cir. 1996).

[63] In particular, sophisticated investors are held to higher standards with regard to reasonable reliance. See *In re Livent, Inc. Noteholders Sec. Litig.*, 2001 WL 740673 (S.D.N.Y. 2001); see generally *Brown v. E.F. Hutton*, 991 F.2d 1020, 1032 (2d Cir. 1993) (discussing reasonableness standards). A similar requirement has been imposed in some cases with respect to materiality. See *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3d Cir. 1976) (no materiality when a plaintiff acting with "due care" should have known the relevant facts, taking into account plaintiff's "sophistication" and "access to relevant information").

[64] We say "contemplated" because the district court must consider the possibility, even if it is clear that certification will, as a practical matter, lead to settlement and not trial. See *Amchem*, 512 U.S. at 619; cf. *Kline v. Coldwell, Banker & Co.*, 508 F.2d 226, 238 (9th Cir. 1974) (Duniway, J., concurring) ("I doubt that plaintiffs' counsel expect the immense and unmanageable case that they seek to create to be tried. What they seek will become . . . an overwhelmingly costly and potent engine for settlements, whether just or unjust").

VI. CONCLUSION

Rule 23(f) has ushered in a new era of appellate court involvement in certification decisions. The next few years will see rapid development of class certification law. The increased availability of appellate review gives defense counsel greater opportunity to oppose reflexive class certification in securities fraud cases, and we believe that opportunity should be embraced. The cases are on the way; 407 federal securities fraud class actions were filed in 2001, an all-time record and nearly double 2000's total of 216.[69] When the dust settles, we believe it will turn out that certification of securities fraud class actions is far from a foregone conclusion.

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the case unmanageable as a class action"); *Abrams v. Interco, Inc.*, 719 F.2d 23 (2d Cir. 1983) (affirming denial of certification in antitrust case on manageability grounds because of the individualized nature of the necessary determinations regarding damages and other issues); *Continental Orthopedic Appliances, Inc. v. Health Insurance Plan of Greater New York, Inc.*, 198 F.R.D. 41 (E.D.N.Y. 2000) (denying certification in antitrust case in part because amount of damages was not susceptible to common proof using a formula or economic model)

[69] See Jonathan D. Glater, *Flood of Lawsuits Puts Underwriters in Cross Hairs*, The New York Times B4 (December 2, 2001).