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Defeating Class Certification in Securities Fraud Actions

Kermit Roosevelt III

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Defeating Class Certification in Securities Fraud Actions

Kermit Roosevelt III*

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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 Rule 23(a) requirements of

* Assistant Professor, University of Pennsylvania Law School. The author thanks Timothy S. Bishop, Joo Hyang Kim, Nathaniel Persily, and Catherine Struve for their comments and assistance in the preparation of this Article. A previous version was presented at the 20th Annual Federal Securities Institute Conference on February 14, 2002, and benefited from the discussion at that session. As an associate with the Chicago office of Mayer, Brown, Rowe & Maw, the author participated in the representation of the defendants in *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154 (3d Cir. 2001), which is discussed *infra* Part IV. The views expressed in this Article do not necessarily reflect those of Mayer Brown.

1. *Gen. Tel. Co. v. Falcon*, 457 U.S. 147, 161 (1982).

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.”² The text of the Rule might seem to erect formidable barriers, but for years it has been received wisdom in the legal community that the degree of difficulty in getting a class certified depends in large part on the substantive theory of recovery.³ In particular, consensus holds that allegations of securities fraud are particularly suitable for class action treatment.⁴ *Basic v. Levinson*⁵ cut the individualized issue of reliance out of the Securities and Exchange Commission’s standard Rule 10b-5 cause of action,⁶ replacing it with the common issues of materiality and market efficiency, and the rest is history.⁷ In *Amchem Products, Inc. v. Windsor*,⁸ the Supreme Court notably failed to shake up this settled understanding, commenting that “[p]redominance is a test readily met in certain cases alleging

2. FED. R. CIV. P. 23(b)(3).

3. See U.S.C.S. RULES OF CIVIL PROCEDURE, Rule 23 note (1998) (History; Ancillary Laws and Directives) (outlining causes of action generally thought to sustain a class action and those thought to be less certifiable).

4. *Id.*

5. 485 U.S. 224 (1988).

6. 17 C.F.R. § 240.10b-5 (1987).

7. *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.” *Id.* 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. Am. 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 typically allows 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, Inc.*, 259 F.3d 154, 179-80 (3d Cir. 2001) (stating that investors who trade in a stock affected by fraudulent information are presumed injured in fraud-on-the-market cases, but plaintiffs in securities class actions can establish loss on a common basis only if the evidence indicates that each plaintiff suffered some loss).

8. 521 U.S. 591 (1997).

consumer or securities fraud.”⁹ Securities class actions now typically follow what one court has called an “all too familiar path”:¹⁰ motions practice and discovery “of massive proportions,”¹¹ followed by settlement on the eve of trial.¹²

How familiar is this pattern? A recent empirical survey of class actions in four federal districts over a two-year period found that a “(b)(3) class was certified in 94% to 100% of the securities cases”¹³ Such data have caused one commentator to opine that the securities class action is no longer best understood as a lawsuit at all.¹⁴ 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.”¹⁵

This Article is written in the conviction that 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 cases, class certification is not a foregone conclusion, and defense counsel would be well advised to oppose it vigorously. The purpose of this Article is to explore the situations in which such opposition has the best chance of success. Part II examines the easiest case for class certification. Part III discusses the ways in which allegations of securities fraud may depart from that paradigm case. Next, Part IV examines a recent decision of the Third Circuit that illustrates the correct approach to certification analysis. Finally, Part V sketches 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 Civil Procedure 23(f), which allows, at the circuit court’s discretion, immediate appeal of class certification

9. *Id.* at 625.

10. *In re Activision Sec. Litig.*, 723 F. Supp. 1373, 1374 (N.D. Cal. 1989).

11. *Id.*; see also 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) (noting that “securities complaints contained more frequent use of boilerplate allegations” than other Rule 23(b)(3) class action complaints surveyed).

12. *In re Activision Sec. Litig.*, 723 F. Supp. at 1374.

13. Willging et al., *supra* note 11, 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).

14. William B. Rubenstein, *A Transactional Model of Adjudication*, 89 GEO. L.J. 371, 372 (2001).

15. *Id.*

rulings.¹⁶ 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 settle if the class was certified, and the plaintiffs would give up if it was not.¹⁷ With appellate review unavailable, most of the development of the Rule 23(b)(3) standards took place at the district court level. Rule 23(f) has allowed 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."¹⁸ When the appellate consideration is over, the conventional wisdom on Rule 23(b)(3) certifications in securities fraud cases will likely have undergone substantial revision, with more rigorous analysis of the

16. FED. R. CIV. P. 23(f).

17. 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 because 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 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 that 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* FED. R. CIV. P. 23 advisory committee's note (1998) (stating that appeal is appropriate when "as a practical matter, the decision on certification is likely dispositive of the litigation"); *see also In re Sumitomo Copper Litig.*, 262 F.3d 134, 139 (2d Cir. 2001) ("[P]etitioners seeking leave to appeal pursuant to Rule 23(f) must demonstrate either (1) that the certification order will effectively terminate the litigation and there has been a substantial showing that the district court's decision is questionable, or (2) that the certification order implicates a legal question about which there is a compelling need for immediate resolution."); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 165 (3d Cir. 2001) (stating that the court should consider the following factors, among others, when deciding whether to grant appellate review of a certification order: (1) whether the order would have the effect of ending the case; (2) whether the ruling was erroneous; and (3) whether an appeal would facilitate the development of the law on class certification).

18. *Szabo v. Bridgeport Mach.*, 249 F.3d 672, 675 (7th Cir. 2001).

class certification factors becoming the norm and denial of certification in securities cases becoming more commonplace.¹⁹

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

The place to start is with the Supreme Court's aside in *Amchem*, which comes nearest to an authoritative pronouncement on the subject.²⁰ That dictum (the case before the Court was a mass tort) seems to neatly encapsulate the conventional wisdom.²¹ However, as the Court was careful to say, its observation applied only to *certain* securities fraud cases, and only to the predominance requirement.²²

Amchem certainly does not support the proposition that certification is appropriate for all securities fraud cases.²³ However, it would be folly to deny that *some* securities fraud allegations are easy cases for class certification. After *Basic*, there is one prime 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 a 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 who purchase the security on the open market after the misrepresentation and before the corrective disclosure bring suit.

19. See *id.* (holding that the cases did not correctly understand the applicable principles); see also James D. Weidner, *Rule 23(f) Appeals*, 1269 PLI/CORP. 717, 739 (2001) (arguing that because of its "propensity to hear Rule 23(f) appeals," the Seventh Circuit "[has] the potential to create a highly developed law on class actions, which other courts will then look to for guidance"). The same could now be said of the Third Circuit.

20. *Amchem Products, Inc. v. Windsor*, 521 U.S. 591, 597 (1997).

21. *Id.* at 625 (stating that many mass tort cases would not satisfy the Rule 23 requirements because as the "Advisory Committee for the 1966 revision of Rule 23 . . . noted . . . 'mass accident' cases are likely to present 'significant questions, not only of damages but of liability and defenses of liability, . . . affecting the individuals in different ways'" (omission in original)).

22. *Id.*

23. *Id.* ("Predominance is a test readily met in *certain* cases alleging consumer or securities fraud or violations of the antitrust laws.") (emphasis added).

The requirements of Rule 23 fit those facts like a glove.²⁴ The plaintiffs are all in essentially the same position: they purchased securities whose market prices were inflated, to an identical extent, by a single misrepresentation (commonality). Each plaintiff, in an individual suit, would be seeking to prove facts that would entitle the others to recover (typicality and adequacy). The common issues would encompass almost all the elements of the Rule 10b-5 cause of action—materiality, scienter, causation, and injury, with materiality doing double-duty as reliance under *Basic*—and would predominate over whatever individual issues exist.²⁵ Finally, because small investors with little at stake might not be able to attract plaintiffs' lawyers if forced to proceed individually, the superiority of the class action form is evident.

However, 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 over the legal imagination is regrettable, because many securities fraud cases differ in crucial respects. They do not involve single misrepresentations or disclosures, and sometimes the representations do not relate to the underlying value of a security. They feature long time periods and ambiguous price movements, and the purchasers include large institutions as well as small investors. The following Part discusses the ways in which the facts of securities fraud cases may depart from the paradigm sketched above and the implications of those departures for the certification requirements.

III. PARADIGMS LOST: COMPLICATIONS

Actual allegations of securities fraud may differ from the paradigm case in several ways, complicating matters 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 essentially works by substituting a

24. See FED. R. CIV. P. 23 advisory committee's notes.

25. *Id.*

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 may be deemed to have relied on the misrepresentation.²⁶ It is important to realize, however, 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;²⁷ as the total mix of information changes over time, so too does the materiality analysis. Publicly-held corporations issue earnings statements and press releases; they 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 affects 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.²⁸

B. *Multiple Misrepresentations or Disclosures*

In particular, 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 between class members. Each plaintiff can maximize his recovery by showing that the price of the security was inflated when he purchased it, but not when he sold it.²⁹ 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

26. See, e.g., *Mottoros v. Abrams*, 524 F.Supp. 254, 258 (D.C. Ill. 1981).

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

28. See, e.g., *J.H. Cohn & Co. v. Am. Appraisal Assocs., Inc.*, 628 F.2d 994, 998 (7th Cir. 1980) (stating that 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) ("[T]he 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."), *aff'd*, 612 F.2d 799 (3d Cir. 1980).

29. See, e.g., *Greene v. Emersons Ltd.*, 86 F.R.D. 47, 61-62 (D.C.N.Y. 1980).

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.³⁰ 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.³¹

C. *Atypical or Nonpublic Misrepresentations*

In some cases, the misrepresentations on which plaintiffs base their Rule 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.³² 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.³³

30. See, e.g., *Ziemack v. Centel Corp.*, 163 F.R.D. 530, 540-42 (N.D. Ill. 1995) (discussing conflict between securities fraud class members who bought and sold at different times); *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1358-62 (N.D. Cal. 1994) (examining conflicts in litigation between those that bought and sold on different days and those that still hold some of the relevant securities); *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 482-85 (W.D. Mich. 1994) (discussing “the conflict between sellers and purchasers of the subclass periods”). See generally David J. Ross, *Do Conflicts Between Class Members Vitiolate Class Action Securities Fraud Suits?*, 70 ST. JOHN’S L. REV. 209 (1996) (discussing both “seller-purchaser conflict” and “equity conflict”).

31. See, e.g., *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1358-59 (N.D. Cal. 1999) (stating that because antagonism over price inflation, for example, implicates the damages, reliance, materiality, and proximate cause elements, it is “heart of the suit”).

32. See *West v. Prudential Sec., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002) (holding that fraud-on-the-market doctrine and its presumption of reliance upon misstatements were inapplicable in a securities fraud class action against securities brokerage firm for stockbroker’s allegedly false statements to several clients that a particular corporation was certain to be acquired at premium in near future).

33. 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, Inc.*, 259 F.3d 154, 179-80 (3d Cir. 2001). See also, e.g., *Prudential*, 282 F.3d at 938 (refusing to allow plaintiffs to invoke fraud-on-the-

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.³⁴ That may once have been an apt description of securities fraud cases; in 1950, institutional investors held only 7.2% of outstanding equities.³⁵ However, by 1997 that proportion had increased to 46.7%.³⁶ Many, if not most, securities fraud cases now count large institutions, with large holdings of the stock at issue, among the potential plaintiffs—institutions such as mutual funds, pension funds, hedge funds, and large corporations with the resources and economic incentives to pursue individual claims.³⁷

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

market based on nonpublic misrepresentations); *In re LifeUSA Holding Inc.*, 242 F.3d 136, 144-45 (3d Cir. 2001) (finding no predominance in fraud case based on numerous non-uniform “sales pitches” for annuity contracts); *Baum v. Great W. Cities, Inc.*, of N.M., 703 F.2d 1197, 1210 (10th Cir. 1983) (affirming the district court’s ruling not to certify the case as a class action because individual issues of reliance and limitations might prevent common issues from predominating); *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 482 F.2d 880, 882 (5th Cir. 1973) (stating that a class should not be certified when individual problems predominate over questions of law and fact common to all).

34. Harry Kalven, Jr. & Maurice Rosenfield, *The Contemporary Function of the Class Suit*, 8 U. CHI. L. REV. 684, 684 (1941).

35. NEW YORK STOCK EXCHANGE, 2001 FACT BOOK 61-62, available at http://www.nyse.com/pdfs/2001_factbook_06.pdf.

36. *Id.*

37. See Dan Cordtz, *Private Attorney General*, PALM BEACH DAILY BUS. REV., Sept. 10, 2001, at 8 (stating that institutional investors like pension funds are increasingly taking the lead in securities class action certifications); see also Paul Elias, *Locals Lose Out in McKesson Case*, SAN FRANCISCO RECORDER, Dec. 30, 1999, at 1 (noting the choice of the New York State Common Retirement Fund to serve as lead plaintiff in stock fraud suit); Michael A. Riccardi, *Judge Calls for Competitive Bids to Hire Securities Counsel*, Legal Intelligencer, Aug. 5, 1998, at 1 (reporting four large pension funds selection to be co-lead plaintiffs in a securities fraud class action).

individual investor, and differing sophistication may destroy commonality on several Rule 10b-5 issues. The materiality analysis depends on the sophistication of a plaintiff,³⁸ as does the assessment of reasonable reliance³⁹ and the application of the Securities Act's tolling provision.⁴⁰ The presence of institutional investors within the plaintiff class will prevent resolution of these issues by common proof and undermine 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.⁴¹ 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.⁴² However, to say that a short seller relies on the integrity of the market price is a stretch; traders short-sell 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 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.⁴³

38. See *Straub v. Vaisman & Co.*, 540 F.2d 591, 596-98 (3d Cir. 1976) (finding 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").

39. See *Brown v. E.F. Hutton*, 991 F.2d 1020, 1032 (2d Cir. 1993) (stating that when an investor acts recklessly there is not justifiable reliance).

40. Securities Act of 1933 § 13, 15 U.S.C. § 77m (1994 & West Supp. 2002). See *Romano v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 834 F.2d 523, 528 (5th Cir. 1987) (acknowledging that the two-year statute of limitations does not begin to run until "the aggrieved party has either actual knowledge of the violation or notice of facts which, in the exercise of due diligence, would have led to actual knowledge thereof").

41. See BLACK'S LAW DICTIONARY 1379 (6th ed. 1990) (defining "short sale").

42. See *Sullivan & Long, Inc. v. Scattered Corp.*, 47 F.3d 857, 859 (7th Cir. 1995) (defining a "short sale" to be a "sale at a price fixed now for delivery later").

43. See *Ganesh v. Computer Learning Ctrs., Inc.*, 183 F.R.D. 487, 490 (E.D. Va. 1998) ("Short-sellers arguably lack standing to avail themselves of the securities laws, both because they effectively sold their stock before they purchased it and because, unlike the traditional investor who hopes to profit from the company's good fortune, they seek to gain from the company's decline.").

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. This makes it more likely, from the Rule 23(b)(3) perspective, that individual issues will be found to predominate.⁴⁴ However, it has additional legal significance, especially in the 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 adjudication of the controversy," and the rule explicitly instructs courts to consider "the difficulties likely to be encountered in the management of a class action."⁴⁵ These difficulties are seldom faced because of the frequency with which securities fraud class actions are settled before trial. However, the fact that a case is likely to be settled if a class is certified⁴⁶ 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*.⁴⁷

Consequently, 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 stated, "[I]t cannot be lightly overlooked that as a class gets larger it may transform a litigation into a gigantic burden on the

44. FED. R. CIV. P. 23(b)(3).

45. *Id.*

46. *See supra* note 17. That a large class has substantial in terrorem potential is not an unmitigated good for plaintiffs. Federal courts 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 a 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.").

47. *See Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 620 (1997) ("Confronted with a request for settlement-only class certification, a district court need not inquire whether the case, if tried, would present intractable management problems."). Moreover, the more coercive the certification, the greater the likelihood of Rule 23(f) review. FED. R. CIV. P. 23 advisory committee's note (1998).

Court's resources beyond its capacity to manage or effectively control."⁴⁸ For very large classes, the demands of an actual trial can approach the absurd. In one case, the court estimated that actual trial of individual damage claims would require "well over one hundred years."⁴⁹ At that point, the class action can no longer be called a superior form of resolution, and the case becomes what the Supreme Court has described as a "Frankenstein monster posing as a class action."⁵⁰

F. *Non-10b-5 Claims*

While the general proscription of Rule 10b-5 dominates the popular imagination, securities fraud plaintiffs may also bring suit under other sections of the Act, notably Sections 11 and 12(a)(2).⁵¹ In addition to the complications discussed above, these sections present their own difficulties for a plaintiff seeking class certification.

Section 11 imposes liability on certain enumerated parties for misstatements or omissions in registration statements.⁵² It requires plaintiffs to make two showings that frequently cannot be achieved with common proof. First, while there is currently a split of authority over whether its cause of action extends to plaintiffs who purchased in the secondary market rather than in an initial public offering,⁵³ it is agreed that plaintiffs must in any case be able to show that the stock they purchased was issued pursuant to the allegedly

48. *In re Hotel Tel. Charges*, 500 F.2d 86, 91 (9th Cir. 1974) (quoting *Morris v. Burchard*, 51 F.R.D. 530, 535 (S.D.N.Y. 1971)).

49. *Galloway v. Am. Brands, Inc.*, 81 F.R.D. 580, 586 (E.D.N.C. 1978). The claims in *Galloway* were antitrust claims, but similar principles govern securities fraud cases. *See, e.g.*, *Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 725 (11th Cir. 1987) (finding that a large class was appropriate in a securities fraud action only because the common questions predominated need for individual treatments). Also, damage is an element of the 10b-5 cause of action, just as it is with the Sherman Act. *In re Visa Check/MasterMoney Antitrust Litig.*, 192 F.R.D. 68, 81-88 (E.D.N.Y. 2000).

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

51. Securities Act of 1933 §§ 11, 12(a)(2), 15 U.S.C. 77k, 77l(a)(2) (1994 & West Supp. 2002).

52. 15 U.S.C. § 77k.

53. *Compare* *WRT Energy Sec. Litig.*, 1997 Fed. Sec. L. Rep. (CCH) ¶ 99,560 (S.D.N.Y. 1997) (allowing suit only by initial public offering purchasers), *with* *Joseph v. Wiles*, 223 F.3d 1155, 1161 (10th Cir. 2000) (allowing suit by aftermarket purchasers).

defective registration statement.⁵⁴ Second, while Section 11 does not generally require a plaintiff to show reliance, it does impose a reliance requirement on any plaintiff who purchases the security after the issuer has made available an earnings statement covering a period of twelve months after the registration statement.⁵⁵

Section 12(a)(2) allows purchasers of securities sold on the basis of a false or misleading prospectus, or false or misleading oral statements, to sue their sellers.⁵⁶ It applies only to purchasers in initial public offerings.⁵⁷ Section 12(a)(2), like Section 11, grants defendants affirmative defenses that may require individual analysis.⁵⁸ First, both sections allow defendants to avoid or reduce liability by showing that all or part of the decline in the value of a security is due to factors other than the alleged misrepresentation or omission.⁵⁹ Second, both sections preclude recovery by any person who actually knew of the alleged misrepresentation at the time of purchase.⁶⁰ Finally, both sections are subject to the general Section 13 limitations period, which may require individualized assessments of diligence.⁶¹ In addition, the equitable basis of the Section 12(a)(2) rescission remedy has led courts to impose a promptness requirement akin to a laches defense.⁶² However, the "class action format is not suitable for the individualized treatment required for the exercise of equitable powers."⁶³

G. *Atypical Lead Plaintiffs*

Defeating certification by showing the atypicality of a named plaintiff is usually only a temporary victory, as the class may just

54. See *Barnes v. Osofsky*, 373 F.2d 269, 271-73 (2d Cir. 1967) (approving an action maintained only by one who purchased the securities directly subject to the registration statement).

55. 15 U.S.C. § 77k.

56. 15 U.S.C. § 77l(a)(2).

57. See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 582-84 (1995) (stating that claims may only arise out of initial sale offerings and not private sale agreements).

58. 15 U.S.C. § 77l(b).

59. See 15 U.S.C. §§ 77k(e), 77l(b).

60. 15 U.S.C. § 77l(a)(2).

61. 15 U.S.C. § 77m (1994 & West Supp. 2002).

62. See, e.g., *Westinghouse Elec. Corp. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212, 221 (S.D.N.Y. 1993) ("[P]laintiffs must make a prompt demand for rescission in order to . . . obtain . . . damages under § 12(2).").

63. *McDonald v. Pension Plan of NYSA-ILA Pension Trust Fund*, 153 F. Supp. 2d 268, 298-99 (S.D.N.Y. 2001).

return with another representative.⁶⁴ Nonetheless, it is worth considering, because a typicality challenge may fare well against "professional plaintiffs." A plaintiff who has purchased stock simply to bring a lawsuit demonstrably did not rely on the integrity of the market price and thus is subject to a defense not applicable to the rest of the class, a disqualifying atypicality.⁶⁵

IV. APPLICATIONS: *NEWTON V. MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.*⁶⁶

In *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* ("*Newton II*"), the Third Circuit encountered a putative class action that differed significantly from the paradigm case.⁶⁷ 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, 1996.⁶⁸ The defendants were the broker-dealers who had executed the plaintiffs' orders. 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).⁶⁹ Failure to disclose the alleged breach of duty leveraged the common law tort into a Rule 10b-5 claim.⁷⁰

64. See, e.g., *Alinda v. Penton Media, Inc.*, 143 F. Supp. 2d 363, 365 (S.D.N.T. 2001) (stating that Congress did not intend to "preclude intervention and certification of non-leading plaintiffs when previously appointed lead plaintiffs have been disqualified").

65. See *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 508 (9th Cir. 1992) ("[C]lass certification should not be granted if 'there is a danger that absent class members will suffer if their representative is preoccupied with defenses unique to it.'") (quoting *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176, 180 (2d Cir. 1990)).

66. 259 F.3d 154 (3d Cir. 2001) ("*Newton II*").

67. *Id.* at 162.

68. *Id.* at 169.

69. *Id.* at 162. 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 en banc*, *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 135 F.3d 266, 272 (3d Cir. 1998) ("*Newton I*").

70. See *In re Merrill Lynch Sec. Litig.*, 911 F. Supp. at 768 ("[T]he Federal securities statutes were modeled after the common law actions of fraud and deceit.").

The defendants initially prevailed before the district court on the theory that the duty of best execution was not sufficiently well-defined during the class period for the plaintiffs to establish either materiality or scienter.⁷¹ A divided panel of the Third Circuit affirmed, but the court en banc reversed, holding that when better prices were reasonably available, 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 Rule 10b-5 violation.⁷²

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 enough to support certification under Rule 23(b)(3)? Judge Debevoise answered in the negative and the plaintiffs appealed.⁷³

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.⁷⁴ Not so, the defendants replied: Determining whether a better price was available for any particular trade, and whether that plaintiff would have wanted a broker-dealer to spend the time to look for it, 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.⁷⁵

The facts of *Newton* parted company with the paradigm case on one 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.⁷⁶ The Third Circuit began its analysis with this observation⁷⁷ and went on to

71. See *Newton II*, 259 F.3d at 171.

72. See *id.* (discussing en banc holding).

73. *Id.*

74. See *id.* ("[Plaintiffs] claim this 'common scheme' provides a uniform course of unlawful conduct well-suited for adjudication as a class action.").

75. See *id.* at 172 (detailing defendants' argument against class certification).

76. See *Newton II*, 259 F.3d at 173.

77. See *id.* ("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.").

demonstrate how one divergence from the paradigm may be enough to bar certification.⁷⁸

The defendants argued that each of the elements of a 10b-5 cause of action would require individualized analysis.⁷⁹ 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."⁸⁰ 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.⁸¹ As a consolation prize, the court gave the plaintiffs a rebuttable presumption of reliance under *Affiliated Ute Citizens of Utah v. United States*,⁸² 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.⁸³ The *Affiliated Ute* presumption is a poor substitute for fraud-on-the-market, however, since the defendant's ability to rebut on a plaintiff-by-plaintiff basis tends to shift reliance out of the "common" column and into the "individual."⁸⁴ With respect to the fact of injury, the unavailability of the fraud-on-the-market theory likewise prevented plaintiffs from

78. See *id.* at 182-83 (discussing the commonality requirement for class certification).

79. *Newton v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 135 F.3d 266, 269 (3d Cir. 1998) ("*Newton I*").

80. *Id.* 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 questionable. The form the alleged breach took was automatic NBBO execution, and some investors (those who anticipated a rapid price increase) presumably would have preferred the speed of that execution to the delay required to scour the Internet for alternate sources of liquidity. *Newton II*, 259 F.3d at 176-78. Moreover, some of the plaintiffs were sophisticated institutional investors who were quite aware of both the defendants' practice of NBBO execution and the existence of alternatives. *Id.*

81. *Newton II*, 259 F.3d at 175-76.

82. 406 U.S. 128 (1970).

83. See *Newton II*, 259 F.3d at 174-75 (discussing the "most reasonable placement of the burden of proof of reliance").

84. See *id.* at 176-80 (discussing the possible unavailability of a presumption of reliance). In *Newton II*, that rebuttal would 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.

establishing this element via common proof.⁸⁵ 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.⁸⁶ These requirements obviously raised individualized questions.⁸⁷

With fact of injury requiring a trade-by-trade analysis and reliance subject to plaintiff-by-plaintiff rebuttal,⁸⁸ the court found that individual issues predominated, plaintiffs' invocation of the *Amchem* dictum notwithstanding.⁸⁹ The need to "[e]xamin[e] millions of trades to ascertain whether or not there was injury . . . overwhelmed common questions"⁹⁰

The plaintiffs proposed to "gloss over this requirement" by developing a statistical formula that would calculate aggregate damages and then allocate them among class members.⁹¹ Such a suggestion, the court observed, would allow the plaintiffs to substitute a statistical calculation of damages for the proof of individual injury that the Rule 10b-5 cause of action requires.⁹² That suggestion would allow plaintiffs to dispense with proof of one element of their claim, a substantive alteration of rights forbidden by the Rules Enabling Act.⁹³

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.⁹⁴ Trial of the proposed class would require examination of "hundreds of millions of transactions executed over several years"; it would simply be unmanageable, indeed flatly impossible, without a lot of impermissible shortcuts.⁹⁵

85. *Id.* at 179-80.

86. *Id.* at 178.

87. *See id.* at 177-81.

88. *Newton II*, 259 F.3d at 181.

89. *See id.* at 189 (noting plaintiffs' citation of *Amchem*).

90. *Id.* at 187.

91. *Id.* at 187-88.

92. *See id.* at 187-90 (asserting that damage calculations do not exempt plaintiff from proving injury).

93. *See* 28 U.S.C. § 2072 (2000) (stating that rules "shall not abridge, enlarge or modify any substantive right").

94. *See Newton II*, 259 F.3d at 192 ("[E]stablishing proof of plaintiffs' injuries and litigating the defenses available to defendants would present insurmountable manageability problems for the district court.").

95. *See id.* at 191-92.

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 a common course of conduct depends on characteristics of the individual plaintiff or the individual transaction, the mere fact of common conduct is not enough.⁹⁶ 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.⁹⁷ *Newton II*'s superiority analysis shows that as a proposed class grows larger, it becomes more vulnerable to manageability challenges.⁹⁸ Even if injury could have been presumed, the task of calculating damages for each plaintiff "would require hundreds of millions of individual assessments,"⁹⁹ something no court could do.¹⁰⁰ Even a single individualized inquiry may thus be enough to bring down a truly massive class; as the Fourth Circuit has put it, "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

96. See *id.* at 189 (observing "the huge number of important individualized issues" that overwhelm any common questions).

97. *Id.* at 189-90 (noting similarity to mass tort cases).

98. See *id.* at 192 (explaining that the superiority requirement casts "serious doubt" on the manageability of certifying the class for trial).

99. *Newton II*, 259 F.3d at 192.

100. Bifurcating the trial into a liability phase and a damages phase is often suggested as a solution to the problem of calculating damages. See, e.g., *Pac. Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 58 (1991). Bifurcation can raise serious constitutional issues, however, because liability and damages issues often intertwine. See, e.g., *In re Lower Lake Erie Iron Ore Antitrust Litig.*, 998 F.2d 1114, 1182 (stating that "Seventh Amendment problems are inherent when separate juries determine facts of damage and amount of damages"). Therefore, the Seventh Amendment, which forbids one jury from reviewing another's conclusions, is implicated. See, e.g., *Castano v. American Tobacco Co.*, 84 F.3d 734, 750-51 (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 Litig.*, 998 F.2d 1144, 1184 (3d Cir. 1993) (reversing damages verdict handed down following a bifurcated antitrust trial because the jury may have reconsidered fact of injury in determining amount of damages).

the damage aspect of [the] case predominate,' and render the case unmanageable as a class action."¹⁰¹

Newton II also provides a useful reminder that plaintiffs cannot make it past the certification stage merely by invoking the authority of an expert.¹⁰² To overcome the difficulties inherent in examining each and every trade to determine whether individual plaintiffs suffered injury, the plaintiffs offered their expert's assertion that "a reliable measure of damages can be developed in this case based on the application of well-established statistical techniques."¹⁰³ The Third Circuit correctly refused to accept the offer: the proposed statistical proof would not have proved that each plaintiff had in fact suffered an actual injury, and what the plaintiffs proposed was essentially to overcome the predominance problem by eliding an element of the Rule 10b-5 cause of action.¹⁰⁴

From one perspective, the Third Circuit's treatment of the proffered statistical analysis is easily recognizable as conventional Rule 23(b) predominance analysis. The defendants claimed that the fact of injury would require individualized analysis, and the plaintiffs failed to establish that they could demonstrate injury by common proof.¹⁰⁵ From another perspective, however, it appears to venture into the merits of the case. The plaintiffs offered expert testimony to prove both fact and amount of damages, and the court held that testimony insufficient.¹⁰⁶ Yet it is one of the most familiar aphorisms of class action law that "nothing in either the language or the history of Rule 23 . . . gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action."¹⁰⁷

The fact that an analysis of plaintiffs' ability to satisfy the demands of Rule 23(b)(3) with expert testimony may resemble an inquiry into the merits of the case has caused courts some difficulty.

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

102. See *Newton II*, 259 F.3d at 182 (listing requirements for certification).

103. *Id.* at 188 n.33.

104. See *id.* at 187-90.

105. *Id.* at 188-89.

106. *Id.* at 188.

107. *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177 (1974).

In its *In re Visa Check/Mastermoney Antitrust Litigation*¹⁰⁸ opinion, the Second Circuit, over a strong dissent, invoked the *Eisen v. Carlisle & Jacquelin*¹⁰⁹ principle in support of a very limited role for courts in assessing expert testimony at the certification stage: “a district court may not weigh conflicting expert evidence or engage in ‘statistical dueling’ of experts.”¹¹⁰ This statement is correct in a certain limited sense. A court should not refuse to certify a class simply because it believes that the plaintiffs will not be able to make good on the factual allegations in their complaint, and to this extent merits questions are irrelevant to the certification decision.¹¹¹ However, it is simply not true that a district court is *barred* from weighing evidence or assessing competing testimony when doing so is necessary to a Rule 23 analysis.¹¹² What *Eisen* forbids is a “preliminary inquiry into the merits,” not the resolution of a merits issue in the course of a certification decision.¹¹³ The *In re Visa Check/Mastermoney* court may have confused these two concepts. As Judge Jacobs pointed out in his dissent, the challenged expert testimony related to the measure of damages, and the determination of which measure of damages should apply was “critical to the class certification motion” because one of the candidates created “intractable conflict” between class members.¹¹⁴

Like the *Newton II* court, the Seventh Circuit recently recognized that the analysis prescribed by Rule 23 must be scrupulously performed, even if it overlaps with the merits. In *West v. Prudential Securities, Inc.*,¹¹⁵ it refused to allow certification based on uncritical acceptance of an expert’s testimony, holding that such deferential treatment “amounts to a delegation of judicial power to the plaintiffs, who can obtain class certification just by hiring a competent expert.”¹¹⁶ The *Prudential* plaintiffs sought to use the fraud-on-the-market theory to allow all purchasers of a particular stock to recover for alleged misstatements that were made by a single broker to a small number of clients, and never publicly

108. 280 F.3d 124 (2d Cir. 2001).

109. 417 U.S. 156 (1974).

110. *In re Visa Check/Mastermoney*, 280 F.3d at 135.

111. *Eisen*, 417 U.S. at 177.

112. *Id.*; *West v. Prudential Sec., Inc.*, 282 F.3d 935, 938 (7th Cir. 2002).

113. *Eisen*, 417 U.S. at 177.

114. *In re Visa Check/Mastermoney*, 280 F.3d at 155, 158 (Jacobs, J., dissenting).

115. *West v. Prudential Sec., Inc.*, 282 F.3d 935 (7th Cir. 2002)

116. *Id.* at 938.

disseminated.¹¹⁷ A “reputable financial economist” provided expert support for the plaintiffs’ theory, and the district court certified the class.¹¹⁸ The Seventh Circuit reversed,¹¹⁹ holding that the application of the fraud-on-the-market theory to nonpublic misrepresentations was a significant extension, and the fact that plaintiffs produced competent expert testimony as some support for their theory was not enough to satisfy the demands of Rule 23.¹²⁰ Engaging in an independent review of the record, Judge Easterbrook held that the plaintiffs had failed to demonstrate that nonpublic information affected the price of the stock at issue, a fatal defect.¹²¹

Like *Newton II*, *Prudential* is, from one perspective, a conventional certification decision. The plaintiffs failed to show that they could establish causation by common proof.¹²² Of course, Judge Easterbrook’s decision on that point was bound up with the merits; the plaintiffs failed because their evidence did not demonstrate causation *at all*, even though their expert opined that it did.¹²³ *Prudential* and *Newton II* correctly recognize that plaintiffs cannot insulate a certification motion from scrutiny by wrapping it in expert testimony.¹²⁴ Critical evaluation of an expert’s opinion as to what conclusions the evidence supports will frequently bring courts close upon the merits, but it is no more than Rule 23 demands.¹²⁵ An expert who testifies, for example, that every plaintiff has suffered injury is in effect testifying that injury may be established by common proof. However, the decision as to whether the elements of a claim are susceptible to common proof is for the judge and may not be handed off to experts. “A district judge may not,” as Judge Easterbrook held, “duck hard questions by observing that each side has some support, or that considerations relevant to class certification also may affect the decision on the merits. Tough

117. *Id.* at 936-37.

118. *Id.* at 938.

119. *Id.* at 940.

120. *Prudential*, 282 F.3d at 937.

121. *Id.* at 938-39.

122. *Id.* at 938.

123. *Id.*

124. *Id.*; *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 191 (3d Cir. 2001) (“*Newton II*”).

125. *See, e.g., Weisfeld v. Sun Chemical Corp.*, 210 F.R.D. 136, 143-44 (D.N.J. 2002) (concluding that plaintiff’s expert witness could only show that the antitrust injury impacted the class members and did not fulfill the requirement of common proof, thereby failing to meet the requirements of Rule 23).

questions must be faced and squarely decided, if necessary by holding evidentiary hearings and choosing between competing perspectives."¹²⁶ Rule 23 demands a rigorous analysis, and expert testimony is no substitute for judicial decision-making.

V. ARGUMENTS AND AUTHORITY

The previous Parts have given an abstract description of difficulties for securities fraud class action plaintiffs and have examined a case study. This Part aims to offer resources for defendants. Following are the most powerful arguments against certification and citations to the most useful cases in support of those arguments. The arguments and citations are grouped according to the requirements of Rule 23.

A. *Typicality*

A named plaintiff will fail to satisfy the typicality requirement if he himself has no claim.¹²⁷ In *Baffa v. Donaldson, Lufkin & Jenrette Securities Corp.*,¹²⁸ for example, the Second

126. *Prudential*, 282 F.3d at 938. One way of putting this is to say that class certification is not summary judgment. A plaintiff can survive a summary judgment motion merely by demonstrating contested issues of fact; the judge must deny the motion even if he is skeptical about the plaintiff's ability ultimately to prove his case. See *Szabo v. Bridgeport Machs., Inc.*, 249 F.3d 672, 675-76 (7th Cir. 2001) (noting that a decision to certify under Rule 23 does not involve accepting the plaintiffs' assertions as true, but that instead a judge must make whatever factual or legal inquiries are necessary to allow the class action to proceed). However, Rule 23 forbids agnosticism; it does not allow class certification in the face of doubt as to whether the plaintiffs have made the required showing. FED. R. CIV. P. 23(b)(3) (explaining that the court must find that "the questions of law or fact predominate over any questions affecting only individual members" before a class action will be maintained). Hence, is it not enough (as the *In re Visa Check/Mastermoney* court apparently believed) for plaintiffs to show "'a reasonable probability of establishing' [their] claims by common proof"? *In re Visa Check/Mastermoney Antitrust Litig.*, 280 F.3d 124, 135 (2d Cir. 2001) (quoting *In re Sumitomo Copper Litig.*, 182 F.R.D. 85, 91 (S.D.N.Y. 1998)). The court must face the issue and decide whether common proof is possible.

127. See FED. R. CIV. P. 23(a)(3) (discussing that one or more members of a class may sue or be sued on behalf of all only if "the claims or defenses of the representative parties are typical of the claims and defenses of the class").

128. 222 F.3d 52 (2d Cir. 2000).

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."¹²⁹ Such plaintiffs apparently present themselves with some frequency.¹³⁰ 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, "The 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."¹³¹

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."¹³² 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. Because a class member will almost always have another class member as his counterparty in a

129. *Id.* at 58-59.

130. See, e.g., *E. Tex. Motor Freight Sys., Inc. v. Rodriguez*, 431 U.S. 395, 403-04 (1977) (holding that plaintiff had not suffered employment discrimination); *Franze v. Equitable Assurance*, 296 F.3d 1250, 1251 (11th Cir. 2002) (holding that plaintiff's claim was time-barred); *McClain v. S.C. Nat'l Bank*, 105 F.3d 898, 903 (4th Cir. 1997) (stating that plaintiff had not paid allegedly illegal loan insurance charges); *Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63, 69 (8th Cir. 1980) (discussing the fact that, in securities fraud case, plaintiffs did not rely on alleged misrepresentations); *In re Am. Bank Note Holographics, Inc. Sec. Litig.*, 93 F. Supp. 2d 424, 435 (S.D.N.Y. 2000) (stating that aftermarket purchasers could not represent Securities Act § 12(a)(2) class).

131. *J.H. Cohn & Co. v. Am. Appraisal Assocs., Inc.*, 628 F.2d 994, 999 (7th Cir. 1980); see also *Hanon v. Dataproducts Corp.*, 976 F.2d 497, 508 (9th Cir. 1992) (affirming denial of certification in securities case on typicality grounds because named plaintiff was subject to unique defenses); *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176, 180 (2d Cir. 1990) (denying a motion for class certification because class representative subject to unique defenses); *Warren v. Reserve Fund, Inc.*, 728 F.2d 741, 747 (5th Cir. 1984) (holding that sophisticated investor not a suitable class representative as subject to peculiar defense); *In re Razorfish, Inc. Sec. Litig.*, 143 F. Supp. 2d 304, 309 (S.D.N.Y. 2001) (holding that shareholder did not meet typicality requirement and was not "most adequate" plaintiff).

132. *Broussard v. Meineke Disc. Muffler Shops, Inc.*, 155 F.3d 331, 338 (4th Cir. 1998).

trade of class securities, there is inevitable conflict as, in order to increase his own recovery, each class member will have an incentive to minimize the harm suffered by counterparty class members.¹³³ 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.¹³⁴ Seller-purchaser conflict has prevented certification in some cases,¹³⁵ but it has yet to be given its full due.

Second, there is arguably an "equity" conflict that occurs when some class members still hold stock. These members will want to reduce the recovery of other class members because recovery against the corporation reduces the value of their stock holdings.¹³⁶

133. See, e.g., *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (exemplifying the conflict between class members).

134. See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 228 n.8 (3d Cir. 2001) (recognizing that proof that stock price was still inflated when class members sold stock shows those members "would have no damages"); *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997) (noting that when a stock price is still inflated, plaintiffs have not suffered any damages).

135. See, e.g., *Ziemack v. Centel Corp.*, 163 F.R.D. 530, 540-542 (N.D. Ill. 1995) (requiring plaintiffs to submit briefs on the issue of class representation due to conflicts in liability and damages); *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1359-62 (N.D. Cal. 1994) (finding a class action unworkable because the reconciliation of conflicts would require too many class representatives); *Ballan v. Upjohn Co.*, 159 F.R.D. 473, 482-85 (W.D. Mich. 1994) (finding the plaintiff failed to meet the minimum standard of lack of antagonism between his interest and those of the class); *Centurions v. Ferruzzi Trading Int'l, S.A.*, No. 89 C 7009, 1994 WL 114860, at *13 (N.D. Ill. Jan. 7, 1993) (stating that plaintiffs did not show they were adequate representatives of proposed class as they were in conflicting positions in the market when they traded defendant's stock); *Desimone v. Indus. Bio-Test Labs., Inc.*, 80 F.R.D. 112, 113 (S.D.N.Y. 1978) (denying class certification in part due to the possibility that the plaintiff's claims were antagonistic to those of other class members); *Weisberg v. APL Corp.*, 76 F.R.D. 233, 239-40 (E.D.N.Y. 1977) (stating that plaintiff could only represent stockholders who exchanged shares during certain time periods); *Feldman v. Lifton*, 64 F.R.D. 539, 549 (S.D.N.Y. 1974) (explaining that investors who purchased early in the ten-year period and those who bought later have interests that are antagonistic); *Robinson v. Penn Cent. Co.*, 58 F.R.D. 436, 443 (S.D.N.Y. 1973) (stating that plaintiff may not adequately represent class because he seeks to represent all purchasers of common stock but may not have purchased from a named defendant).

136. See *In re Mut. Sav. Bank Sec. Litig.*, 166 F.R.D. 377, 383-85 (E.D. Mich. 1996) (discussing the conflict between "sellers" and "holders").

Equity conflict has thus far not posed much of an obstacle to class certification.¹³⁷

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.¹³⁸ 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. One way to do this is by demonstrating that the market at issue is not efficient.¹³⁹ Another way is by 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.¹⁴⁰ Lack of appropriate price movement can preclude reliance on the fraud-on-the-market theory, or simply reduce recovery to zero.¹⁴¹ Without a fraud on the market, the individualized issue of reliance by itself is usually sufficient to defeat certification.¹⁴²

137. Beyond the cases cited in note 135, *supra*, some of which also discuss equity conflict, perhaps the best treatment is *Ruggiero v. Am. Bioculture, Inc.*, 56 F.R.D. 93, 95 (S.D.N.Y. 1972).

138. *See, e.g., In re Honeywell Int'l. Inc., Sec. Litig., Civ. No. 00-3605 (DRD)*, 2002 WL 31525571, at *6 (D.N.J. Nov. 14, 2002) (discussing class certification and ability to take advantage of fraud-on-the-market theory).

139. *See, e.g., Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1122 (5th Cir. 1988) (recognizing a market efficiency defense is available against a fraud-on-the-market claim), *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., Oct. 24, 2001, at 8 (questioning the truth of the presumption that investors behave rationally).

140. *See, e.g., Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 414-15 (5th Cir. 2001) (noting that the information in question did not affect stock price).

141. *See, e.g., id.* at 414 ("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.").

142. *See, e.g., Castano v. Am. Tobacco Corp.*, 84 F.3d 734, 745 (5th Cir. 1996) ("[A] fraud class action cannot be certified when individual reliance will be an issue.").

It is also important 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.¹⁴³ 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.¹⁴⁴ However, 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.¹⁴⁵ An extended class period and the existence of multiple misrepresentations or corrective disclosures may prevent plaintiffs from establishing materiality or reliance by common proof even if they can use the fraud-on-the-market theory.¹⁴⁶

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, but they also do not even have common aims.¹⁴⁷ 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.¹⁴⁸ 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,

143. See, e.g., *In re Firstplus Fin. Group, Inc., Sec. Litig.*, No. Civ.A.3:98-CV-2551-M, 2002 WL 31415951, at *11 (N.D. Tex. Oct 28, 2002) (noting individual class members' reliance is not necessary).

144. See, e.g., *Peil v. Speiser*, 806 F.2d 1154, 1161 (3d Cir. 1986) (stating that where plaintiffs prove material misrepresentations and an open and developed market, the court will presume that misrepresentation increased the value and induced purchase).

145. See, e.g., *In re CINAR Corp. Sec. Litig.*, 186 F. Supp. 2d 279, 299 (E.D.N.Y. 2002) (noting "the unavailability of the fraud-on-the-market theory to create commonality").

146. See, e.g., cases cited *supra* note 28.

147. See, e.g., *Seidman v. Am. Mobile Sys., Inc.*, 157 F.R.D. 354, 360 (E.D. Pa. 1994) (noting the questions for which plaintiffs could rely on common proof).

148. See, e.g., *id.*

“is not enough by itself; that reliance must be justifiable, or reasonable.”¹⁴⁹ 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.¹⁵⁰ 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 class action would be manageable.¹⁵¹ 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.¹⁵² 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 minutes, for example (an optimistic estimate in most securities fraud cases, given the need to quantify inflation and show a causal link to the defendant's misrepresentations), and there are twenty million trades during the class period, a court working eight hours a day for five days a week will be done in slightly over 2,403 years.

149. *Harsco Corp. v. Segui*, 91 F.3d 337, 342 (2d Cir. 1996) (quoting *Harrison v. Dean Witter Reynolds, Inc.*, 77 F.3d 609, 618 (7th Cir. 1996)).

150. In particular, sophisticated investors are held to higher standards with regard to reasonable reliance. See *In re Livent, Inc. Noteholders Sec. Litig.*, 151 F. Supp. 2d 371, 439 (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) (finding 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”).

151. “Contemplated” recognizes that 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 Prods., Inc. v. Windsor*, 521 U.S. 591, 600 (1997) (stating that “a class action may be certified for settlement purposes only, [but] Rule 23(a)'s requirements must be satisfied . . .”); 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 the compulsion of settlements, whether just or unjust.”).

152. See, e.g., *Upshaw v. Ga. Catalog Sales, Inc.*, 206 F.R.D. 694, 696 (M.D. Ga. 2002) (describing manageability and its interaction with superiority).

Recognizing the problems with multi-thousand-year proceedings, plaintiffs typically seek to simplify things by using two devices: bifurcating trials into liability and damages phases,¹⁵³ and using statistical methods to calculate damages.¹⁵⁴ The first can be opposed on the theory that liability and damages issues will overlap and bifurcation would amount to allowing one jury's factual findings to be reexamined by another in violation of the Seventh Amendment.¹⁵⁵ In particular, since fact of injury is an element of the Rule 10b-5 cause of action, a finding of liability implies a finding of injury.¹⁵⁶ Allowing a second jury to determine the amount of damages raises the possibility that the amount could be zero, an obvious conflict. Additionally, unless some provision is made for a more efficient calculation of damages, bifurcation does not solve the problem of overwhelming the court's resources.¹⁵⁷

Statistical calculation of damages is permissible in some circumstances, as when it is used to determine the appropriate awards to plaintiffs whose injuries have already been established.¹⁵⁸ However, it cannot be used to eliminate the need to prove fact of injury on an individual basis, at least not where fact of injury is an element of the cause of action.¹⁵⁹ Consequently, plaintiffs will need

153. See, e.g., *In re Visa Check/MasterMoney Antitrust Litig.*, 280 F.3d 124, 141 (2d Cir. 2001) (discussing bifurcation as a management tool for addressing damages in a class action).

154. See, e.g., *In re Domestic Air Transp. Antitrust Litig.*, 137 F.R.D. 677, 690 (N.D. Ga. 1991) (finding class action manageable because of the use of statistical analysis to calculate damages for class members); *Windham v. Amer. Brands, Inc.*, 565 F.2d 59, 68 (4th Cir. 1977) (stating that individual damage claims do not present a manageability problem if they are amenable to formula calculation).

155. See *Allison v. Citgo Petroleum Corp.*, 151 F.3d 402, 423 n.21 (5th Cir. 1998); *In re Rhone-Poulenc Rorer Inc.*, 51 F.3d 1293 (7th Cir. 1995) (granting mandamus petition seeking decertification in HIV/hemophiliac case based in part on concerns about the bifurcation plan adopted by the district court).

156. See, e.g., *Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. 1981) (listing elements of cause of action under Rule 10(b)(5)), *rev'd on other grounds*, 459 U.S. 375 (1983).

157. See *Windham v. Am. Brands, Inc.*, 565 F.2d 59, 72 (4th Cir. 1977) ("Whether dealt with in a unitary trial or in a severed trial, the problem of proof of the individual claims and of the essential elements of individual injury and damage will remain and severance could only postpone the difficulty of such proof.").

158. See *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 188 (3d Cir. 2001).

159. See, e.g., *Broussard v. Meineke Disc. Muffler Shops, Inc.*, 155 F.3d 331, 343 (4th Cir. 1998) (holding that the average loss of individual plaintiffs was not

to prove non-zero damages without resorting to statistical methods, and the ability to employ statistics in a subsequent calculation may do little to alleviate manageability problems.¹⁶⁰

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 this opportunity should be embraced. The cases are on the way; 407 federal securities fraud class actions have been filed so far this year, an all-time record and nearly double last year's total of 216.¹⁶¹ When the dust settles, it may turn out that certification of securities fraud class actions is no longer a foregone conclusion.

sufficient to certify class and that the actual losses of individual plaintiffs, which varied substantially, must be determined); *In re Fibreboard Co.*, 893 F.2d 706, 712 (5th Cir. 1990) (denying certification of 2990 asbestos plaintiffs where type of harm suffered varied substantially, making statistical calculation of the average damages suffered impermissible); *Sterling v. Velsicol Chem. Corp.*, 855 F.2d 1188, 1201-13 (6th Cir. 1988) (holding that damages attributed to injuries unsupported by insufficient medical testimony needed to be recalculated); *Windham v. Am. Brands, Inc.*, 565 F.2d 59, 70-72 (4th Cir. 1977) (denying class certification where, among other things, claims would require individual proof at trial); *Kline v. Coldwell, Banker & Co.*, 508 F.2d 226, 233-34 (9th Cir. 1974) (establishing that proof of injury is an essential element of damages); *In re Hotel Tel. Charges*, 500 F.2d 86, 90 (9th Cir. 1974) (stating that it is improper to bypass individual damage calculations).

160. In some cases, however, an inability to calculate damages mechanically will provide a sufficient ground to refuse certification. *See, e.g., Windham*, 565 F.2d at 68 (“[W]here 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.”); *Abrams v. Interco, Inc.*, 719 F.2d 23, 33-34 (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); *Cont’l Orthopedic Appliances, Inc. v. Health Ins. Plan of Greater N.Y., Inc.*, 198 F.R.D. 41, 47 (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).

161. *See* Jonathan D. Glater, *Flood of Lawsuits Puts Underwriters in Cross Hairs*, N.Y. TIMES, Dec. 2, 2001, at BU4.