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DO CONFLICTS BETWEEN CLASS MEMBERS VITIATE CLASS ACTION SECURITIES FRAUD SUITS?

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Many commentators believe that the enhanced pleading requirements of the recently enacted Private Securities Litigation Reform Act[1] will reduce the number of private securities fraud suits.[2] However, a recent, but little noticed federal district court decision may also greatly affect litigation of securities fraud suits brought under Section 10(b) of the Securities & Exchange Act of 1934[3] and Rule 10b-5, promulgated thereunder by the Securities and Exchange Commission.[4] Plaintiffs in these cases typically

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[1] Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) [hereinafter PSLRA].

[2] *See Curbing Stock-Swindle Swindlers*, SACRAMENTO BEE, Dec. 9, 1995, at B6 (noting that provisions in PSLRA, such as requiring plaintiffs to post bond before suing, create "steep barrier[s] for small investors"); Mark Griffin, *Securities Litigation Bill is Reform in Name Only*, N.Y. TIMES, June 25, 1995, at § 3 p. 13 (stating that PSLRA "is more accurately described as securities litigation *repeal*"); Ed McCracken, *The New Threat to High-tech Firms*, S.F. CHRON., June 28, 1995, at A19 (quoting Senator John Kerry as stating that one purpose of PSLRA was to reduce number of "speculative suits based on no evidence of wrongdoing"); *Safe Harbor for Fraud*, SACRAMENTO BEE, July 13, 1995, at B6 (contending that Congress took "meat-ax to a problem that was better suited to a chisel").

[3] 15 U.S.C. § 78j(b) (1994). Section 10(b) of the Act makes it:

> unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange ... (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

[4] 17 C.F.R. § 240.10b-5 (1995). This regulation makes it:

> unlawful for any person, directly or indirectly, by the use of any means or

seek to have their cases certified as class actions under Federal Rule of Civil Procedure ("FRCP") 23(b)(3). Qualification as a "(b)(3)" class action requires the establishment of six elements: numerosity, commonality, typicality, adequacy of representation, predominance and superiority.[5] Until recently, courts had routinely found that securities cases satisfied these requirements and, accordingly, certified them as class actions.[6] However, in a lengthy and thoughtful opinion, the United States District Court for the Northern District of California, in *In re Seagate Technology II Securities Litigation*,[7] identified potential conflicts between class members which call into question the ability of securities fraud class actions to satisfy the typicality and adequacy of representation elements of FRCP 23(a) and FRCP 23(b)(3).[8]

The *Seagate II* court identified two situations in which con-

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> instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, ... (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of any security.

Id.

[5] FED. R. CIV. P. 23(a), (b)(3). For a detailed discussion of the requirements for class certification under FRCP 23(a), (b)(3), see *infra* notes 17-23 and accompanying text.

[6] *See, e.g.*, Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 122 F.R.D. 177, 179 (E.D. Pa. 1988) ("Securities actions are particularly suitable for class action treatment and any doubts should be resolved in favor of allowing a class action.") (citing Eisenberg v. Gagnon, 766 F.2d 770, 785 (3d Cir.), *cert. denied*, 474 U.S. 946 (1985)); Simon v. Westinghouse Elec. Corp., 73 F.R.D. 480, 487 (E.D. Pa. 1977) (stating that doubtful case should be resolved in favor of allowing class action); Herbst v. Able, 47 F.R.D. 11, 22 (S.D.N.Y. 1969) (explaining that one reason for allowing class actions is presumption that such actions are financially feasible for class), *order amended on other grounds*, 49 F.R.D. 286 (S.D.N.Y. 1970).

[7] 843 F. Supp. 1341 (N.D. Cal. 1994) [hereinafter *Seagate II*].

[8] *Id.* at 1359. In *Seagate II*, a class action was brought alleging that "the price of Seagate common stock was fraudulently inflated for a period of several months." *Id.* at 1344. During this time the defendants allegedly did not fully disclose the truth concerning the financial condition and business prospects of the corporation. *Id.* As a result, the trading price of the stock declined gradually rather than declining suddenly as usually occurs when a one-time full disclosure of fraud is released. *Id.* Pursuant to FRCP 23, plaintiffs sought certification of a class consisting of all persons who purchased shares during the period. *Id.*

Subsequently, summary judgment was granted for the defendants on the grounds that the alleged fraud was not actionable. *In re* Seagate Tech. II Sec. Litig., 1995 U.S. Dist. Lexis 2052, *31 (holding that there was no proof of fraud). The finding of no proof of securities fraud by the *Seagate II* court does not affect its reasoning concerning the certification of class actions in securities fraud cases, and it is this aspect of *Seagate II* that is the subject of this article.

flicts can arise. The first situation, identified as the "seller-purchaser conflict," arises when members of the proposed class both bought and sold the security at issue during the relevant period (such persons are called "seller-purchasers").[9] The second situation, identified as the "equity conflict," arises when members of the proposed class hold equity in the security's issuer at the time of the litigation (such persons are called "current holders").[10] For an actively traded security, it is virtually certain that both circumstances will be present to some extent: some class members will have both purchased and sold securities during the class period and some class members will be holding equity in the security's issuer while the case is being litigated.

The court's analysis in *Seagate II* demonstrates that securities cases in which the proposed class contains seller-purchasers or current holders cannot meet the requirements of FRCP 23(b)(3) and, therefore, should not be certified as class actions. The court, however, was unwilling to reach this conclusion and, instead, ordered an "evidentiary hearing" to determine the actual extent of the potential conflicts.[11] The *Seagate II* court did not describe the evidence that would be relevant in such a hearing and, because the plaintiffs elected to seek certification of a class that did not contain seller-purchasers rather than submit evidence about conflicts in the class initially proposed, no hearing was ever held.[12]

The proceedings in *Seagate II* can be interpreted in two ways. Under one interpretation, securities fraud cases could never be certified as class actions if the proposed class contained either seller-purchasers or current holders. Under the alternative interpretation, securities fraud cases could only be certified as class actions following an evidentiary hearing to determine the actual extent of potential conflicts. This article considers both interpretations. Section I explains why conflicts arise and

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[9] *Seagate II*, 843 F. Supp. at 1359.

[10] *Id.* at 1362.

[11] *Id.* at 1367. The *Seagate II* court concluded that:

> [b]ecause of the potential for conflicts created by the fraud-on-the-market theory and the out-of-pocket measure of damages, the adequacy of the representation cannot be ascertained without examining the composition of the class... . Accordingly, th[e] court has little choice but to resort to an evidentiary hearing on these issues.

Id.

[12] *In re* Seagate Tech. II Sec. Litig., 156 F.R.D. 229, 230-31 (N.D. Cal. 1994).

the reason these conflicts should prevent class certification. Section II considers and rejects the arguments and proposed procedures that courts have used to certify securities fraud cases as class actions despite the existence of class conflicts. Section III discusses the court's resolution of *Seagate II* and explains how readily available evidence could be used in an evidentiary hearing regarding the extent of class conflicts. Section IV concludes by discussing the implications of *Seagate II* on future securities fraud class actions.

I. HOW CLASS CONFLICTS ARISE IN SECURITIES FRAUD CASES

To understand the nature of the problems identified by the *Seagate II* court, it is necessary to briefly discuss the requirements for class certification and the method by which plaintiffs seek to satisfy these requirements in securities fraud cases.

A. The Requirements for Class Certification of a Securities Fraud Case

Plaintiffs who bring securities fraud cases under Section 10(b) of the Securities & Exchange Act of 1934 and Rule 10b-5 must establish that the defendants intentionally misrepresented, misstated or failed to disclose material facts upon which the plaintiffs relied, causing them injury.[13] In other words, the six elements of a securities fraud are the existence of a misstatement or omission, scienter, reliance, materiality, causation and damages.[14]

As noted above, there are also six requirements that plaintiffs must satisfy to obtain class certification: numerosity, commonality, typicality, adequacy of representation, predominance and superiority.[15] The first four requirements stem from FRCP 23(a) which provides that:

> One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will

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[13] *See* HERBERT NEWBERG & ALBA CONTE, NEWBERG ON CLASS ACTIONS § 22.48 at 22-190 (3d ed. 1992) [hereinafter NEWBERG].

[14] *See id.*

[15] *See* FED. R. CIV. P. 23(a), (b)(3).

fairly and adequately protect the interests of the class.[16]

In addition to these requirements, the plaintiffs must also satisfy one of the three parts of FRCP 23(b); almost all plaintiffs elect to bring securities class actions under subsection (3) of FRCP 23(b).[17] This section of the federal rules imposes two additional requirements: "that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy."[18]

Of the requirements for class certification, only the typicality and the adequacy of representation elements need further elucidation. In order to meet the typicality requirement of FRCP 23(a)(3), the interests of the representative plaintiffs must be aligned with those of the represented group. For typicality, the plaintiff's claims must arise from the same event or practice or course of conduct that gives rise to the claims of the other class members, and the plaintiff's claims must be based on the same legal theory.[19] In these circumstances, the plaintiff will advance the interests of the class members by advancing his or her own self-interest.[20] The adequacy of representation requirement is satisfied when "there is an absence of antagonism between the named plaintiff and the other class members" and "the absent class members can be assured of a vigorous prosecution by the named plaintiff and his counsel."[21]

Securities fraud cases typically satisfy the numerosity, commonality and superiority requirements of FRCP 23 with ease.[22] The numerosity requirement is usually satisfied in cases

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[16] FED. R. CIV. P. 23(a).

[17] NEWBERG, *supra* note 13, § 22.46 at 22-188 ("Securities class actions seeking primarily monetary damages for class members have been brought almost exclusively under the Rule 23(b)(3) category.").

[18] FED. R. CIV. P. 23(b)(3).

[19] *See Seagate II*, 843 F. Supp. at 1351 ("In essence, if the elements which the named plaintiff had to prove to prevail were substantially similar to those elements which the class members had to establish, typicality was satisfied.") (citations omitted); NEWBERG, *supra* note 13, § 22.19 at 22-86 ("If they are substantially the same as those needed to be proved by the class members to redress a wrong common to the class and the plaintiff, the representative's claim is typical.").

[20] NEWBERG, *supra* note 13, § 22.17 at 22-58, 22-59.

[21] *Seagate II*, 843 F. Supp. at 1346 (citing NEWBERG, *supra* note 13, § 22.24 at 22-102).

[22] *Id.* at 1351-52; *see also* NEWBERG, *supra* note 13, § 22.9 at 22-24, § 22.14 at 22-31, § 22.48 at 22-190, and § 22.60 at 22-252.

involving publicly traded securities because most corporations have hundreds or thousands of shareholders who reside in geographically diverse areas.[23] The commonality requirement is satisfied because, under most circumstances, three of the six elements of a securities claim raise common issues. The existence of a misstatement or omission and scienter are common issues because these elements concern activities of the defendants that may have adversely affected all class members.[24]

Another common question in securities fraud cases is materiality. Information is considered material if there exists a substantial likelihood that a *reasonable investor* would consider the information as significantly altering the total mix of information.[25] Since this inquiry relates to the behavior of a reasonable investor rather than any particular plaintiff, it is a common question. Further, the superiority requirement, in general, is easily satisfied because many potential class members will have small claims that would be uneconomic to pursue individually.[26] As discussed below, the remaining requirements of FRCP 23—predominance, typicality and adequacy of representation—are more problematic.

B. Predominance and the "Fraud-on-the-Market" Theory

FRCP 23(b)(3) requires that common issues predominate over any questions affecting only individual class members.[27] While three of the six elements of a securities fraud claim raise common issues (the existence of a misstatement or omission, scienter and materiality), the three remaining elements of a securities fraud claim—reliance, causation and damages—seem to raise individual issues because they are personal to the plaintiffs.[28] If these elements were viewed as individual issues, courts would have great difficulty in finding that common issues pre-

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[23] NEWBERG, *supra* note 13, § 22.9 at 22-24. *See also* Friedlander v. Barnes, 104 F.R.D. 417, 418 (S.D.N.Y. 1984) (noting that numerosity can be satisfied by "hundreds, or perhaps thousands, of people").

[24] *See* NEWBERG, *supra* note 13, § 22.15 at 22-36; *see also In re* Activision Sec. Litig., 621 F. Supp. 415, 428 (N.D. Cal. 1985) (finding that commonality requirement was met when plaintiffs alleged same material misrepresentation by each defendant).

[25] Basic Inc. v. Levinson, 485 U.S. 224, 240 (1988).

[26] *See Seagate II*, 843 F. Supp. at 1351-52; NEWBERG, *supra* note 13, § 22.61 at 22-260.

[27] FED. R. CIV. P. 23(b)(3).

[28] *Seagate II*, 843 F. Supp. at 1352.

dominate.[29]

Rather than have courts struggle with this difficult question, plaintiffs typically allege that the defendants' conduct was a "fraud-on-the-market" because the defective disclosures affected the market price of an issuer's securities.[30] For example, plaintiffs may allege that by releasing false positive information or failing to disclose negative information, an issuer caused its stock price to be "artificially inflated."[31] Under this theory, anyone who traded the issuer's stock in the open market would have been affected by the alleged fraud.[32]

Under the fraud-on-the-market theory, each of the three remaining elements of a securities fraud claim becomes a common issue or, at least, has common elements. This has been recognized most frequently with respect to the reliance element.[33] Un-

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[29] *Id.* Nevertheless, as the *Seagate II* court noted, many courts have certified securities fraud cases as class actions despite finding that three of the six elements of the claim raised individual issues. *Id.* (citations omitted). The *Seagate II* court criticized these holdings as being based on vague policy considerations instead of a relative evaluation of the weight of common and individual issues as is required by FRCP 23. *Id.* at 1352-53.

[30] "The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business." Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986) (citation omitted).

[31] *Seagate II*, 843 F. Supp. at 1357. While most securities fraud cases do concern buyers of common stock, securities fraud suits can be brought on behalf of sellers of common stock as well as buyers and sellers of other securities. The discussion in the text of buyers of common stock is for expositional convenience only; the issues discussed in the text would apply to other types of cases as well.

[32] Basic Inc. v. Levinson, 485 U.S. 224, 242 (1988).

[33] The prevailing view is that requiring individual plaintiffs to prove direct reliance upon a fraudulent misrepresentation by defendants does not comport with modern securities transactions. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 745-46 (1975). Justice Blackmun, writing for a plurality of four Justices in *Basic Inc.*, noted that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would ... prevent[] [plaintiffs] from proceeding with a class action, since individual issues then would ... overwhelm[] the common ones." *Basic Inc.*, 485 U.S. at 242. In order to overcome the conflict between requiring individual proof or permitting the certification of a class in a private action under Rule 10b-5 courts have emphasized the elements of materiality and causation. *See* Blackie v. Barrack, 524 F.2d 891, 895 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976). The resulting fraud-on-the-market theory affords the plaintiff class a presumption of actual reliance. *See, e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153 (1972) (noting in case "involving primarily a failure to disclose, proof positive of reliance is not a prerequisite to recovery"); Harris v. Union Elec. Co., 787 F.2d 355, 366 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986) (stating that when alleged fraudulent conduct primarily involves failure to disclose plaintiffs are not required to prove reliance).

der the fraud-on-the-market theory, purchasers need not show that they were aware of any specific false representation.[34] Instead, purchasers are said to have relied on the "integrity of the market," i.e., the "supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price."[35] Consequently, a plaintiff need not prove his own personal reliance on the particular misrepresentation; instead reliance is presumed.[36] By making reliance a common issue, the fraud-on-the-market theory shifts the balance in favor of a finding that common issues predominate.[37]

The impact of the fraud-on-the-market theory goes beyond reliance. Causation is also a common element because a defrauded investor's damages result from the affect of the alleged wrongdoing on the performance of his investment.[38] Additionally, the fraud-on-the-market theory is relevant to the question of materiality: presumably the price of a security will be affected by an alleged defective disclosure when "reasonable investors" believe that the defect is significant.[39] For this reason, a stock price will be "artificially inflated" by an alleged misstatement or

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[34] *Basic Inc.*, 485 U.S. at 243. The principal underlying the fraud-on-the-market theory is that even investors who do not directly rely upon the misstatement or omission will be defrauded by any public and material misstatement or omission regarding that company. *Id.*

[35] *Blackie*, 524 F.2d at 907. This theory is premised upon the assumption that, in the efficient open securities market, the market price of any particular stock is determined by all of the information regarding the company and its business that is made available to the investing public. *See Peil*, 806 F.2d at 1160-61. It logically follows, therefore, that any misleading statement regarding a company or its business will necessarily impact the price of the stock for that company as it is traded on the market. *Id.* at 1161; *see also* Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 439-46 (1984) (detailing development of fraud-on-the-market theory in federal court).

[36] *Basic Inc.*, 485 U.S. at 247; *see also* Schlanger v. Four-Phase Sys. Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982) (asking "Who would knowingly roll the dice in a crooked crap game?").

[37] *Basic Inc.*, 485 U.S. at 242.

[38] The private right of action that developed pursuant to Rule 10b-5 is rooted in the common law of deceit. *See* Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir.), *modified on other grounds*, 650 F.2d 815 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983); Moody v. Bache & Co., 570 F.2d 523, 527 (5th Cir. 1978) (noting implied cause of action under Rule 10b-5 is essentially tort claim). One of the elements of deceit is that the plaintiff's damages are caused by the fraudulent activity of the defendant. PROSSER & KEETON, THE LAW OF TORTS §§ 105-107 (5th ed. 1984).

[39] *See Peil*, 806 F.2d at 1160-61.

omission if and only if the alleged disclosure defect is material.

Even the damages issue has common elements under the fraud-on-the-market theory. Typically, plaintiffs use the "out-of-pocket loss" measure of damages in Rule 10b-5 litigation.[40] Under this measure, a defrauded buyer who holds stock until the end of the class period would claim as damages the amount of the "artificial inflation" on the date that he or she purchased the stock.[41] Traders who both buy and sell shares during the class period would claim as damages the difference between the inflation on the date of purchase and the inflation on the date of sale.[42] Thus, all investors who bought and sold shares on the same dates would have the same per share damage claim. The only individual issues with respect to damages are the dates and amounts of a particular investor's transactions. Hence, under the fraud-on-the-market theory, five of the six elements of a securities fraud claim are common and the remaining issue, damages, has common elements. For this reason, the fraud-on-the-market theory has been viewed as a procedural device that favors class certification by providing a method for class actions to satisfy the predominance requirement of FRCP 23(b)(3).[43] As will be discussed below, however, the fraud-on-the-market theory has other effects that call into question whether securities fraud cases can meet the typicality and adequacy of representation requirements for certification under FRCP 23(a).

C. Class Conflicts, Typicality and Adequacy of Representation

While the claims of different class members may well raise common questions, this need not imply that different class mem-

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[40] *Blackie*, 524 F.2d at 908.

[41] *Seagate II*, 843 F. Supp. at 1357.

[42] *See id.* Strictly speaking, the "out-of-pocket" loss accurately measures the economic loss attributable to an alleged fraud only in the special case where there are no intervening factors that affect a security's price. *See* Janine S. Hiller & Stephen P. Ferris, *Use of Economic Analysis in Fraud on the Market Cases*, 38 CLEV. ST. L. REV. 535, 551-56 (1990). In many circumstances, it may be important to take into account intervening causes when calculating damages. *See id.*

[43] *Seagate II*, 843 F. Supp. at 1357-58. "Because proof of the existence of a misstatement or omission, scienter, and price inflation all constitute questions of law and fact common to the class, virtually no individual questions remain, and the predominance prerequisite is easily satisfied." *Id.* at 1358 (footnote omitted); *see also* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 12 (1982) ("The fraud on the market theory can be viewed as a procedural device that favors plaintiffs because it allows a class to be certified by shifting the burden of proof on the reliance issue.").

bers want common answers to those questions. Instead, each class member wants to establish answers to the questions that maximizes his or her own welfare. The possibility that different class members will want different answers calls into question whether securities fraud cases can meet the typicality and adequacy of representation requirements for class certification under FRCP 23(a).

The *Seagate II* court noted that the fraud-on-the-market theory potentially gives rise to two kinds of conflicts among class members: the "seller-purchaser conflict" and the "equity conflict."[44] The seller-purchaser conflict arises whenever members of the proposed class both bought and sold the security at issue during the proposed class period (a person who first bought stock and then sold stock during the class period is known as an "in-and-out" and a person who first sold stock and then bought stock during the class period is known as an "out-and-in").[45] A seller-purchaser class member is both a beneficiary (as a result of his or her sales) and a victim (as a result of his or her purchases) of the alleged fraud. A seller-purchaser only has damages if the amount of his or her losses from purchasing at artificially inflated prices exceed the amount of his or her gains from selling at artificially inflated prices. Moreover, for a seller-purchaser class member, the smaller the inflation on his or her sale dates, the greater his or her damages.

These properties of a seller-purchaser class member's out-of-pocket loss can create conflicts with other class members. To maximize damages, the seller-purchaser class member would want the plaintiffs' counsel to establish that the stock price was substantially inflated on the dates when he or she purchased but was *not* inflated on the dates when he or she sold.[46] Obviously, proving this would not be in the interest of class members who

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[44] *Seagate II*, 843 F. Supp. at 1359, 1362.

[45] In/out plaintiffs benefit from maximizing the difference between the inflation at purchase and inflation at sale. *Seagate II*, 843 F. Supp. at 1359. The in/out plaintiff's interest, therefore, is in minimizing the degree of price inflation existing at the date of sale. *Id.* In contrast, a plaintiff buying on the day an in/out plaintiff sells has the opposite interest, i.e., to maximize the price inflation on that date. *Id.* Different plaintiffs have conflicting incentives in shaping the evidence. *Id.* The seller-purchaser conflict has been raised by defendants in numerous courts, usually to no avail. *Id.*; *see also Blackie*, 524 F.2d at 908 (explaining seller-purchaser conflict in detail); *Simon*, 73 F.R.D. at 484 (engaging in brief discussion of seller-purchaser conflict).

[46] *Seagate II*, 843 F. Supp. at 1359.

purchased stock on or near the sale dates; those class members would want to prove that the stock price was inflated on those dates to maximize their own damage claims.[47] Further, class members who purchased on other dates would not want to make the seller-purchaser plaintiffs' argument (that the stock price was substantially inflated on some days but not others) if it weakened their damage claim (which would require a finding that the stock price was substantially inflated on the dates of their own purchases).[48]

The second potential conflict identified by the *Seagate II* court, the equity conflict, arises whenever a class member holds stock while the litigation is pending and the issuer is a defendant.[49] This conflict arises because any damage award paid by the issuer will reduce the value of a current holder's shares (which are residual claims on the issuer's assets).[50] Thus, pay-

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[47] *See id.* Conflicts between seller-purchasers and purchasers (who did not sell) are not necessarily irreconcilable, because both a seller-purchaser and a purchaser who bought on the date of the seller-purchaser's sales could maintain damage claims as long as the average amount of inflation on the dates of the seller-purchaser's sales was *less than* the amount of inflation on the dates of his or her purchases. However, because a purchaser who bought on the days the seller-purchaser sold has no interest in showing that the amount of inflation was higher on the dates the seller-purchaser purchased, he or she may not want to allocate the resources of the class to demonstrate that this necessary condition holds. Thus, conflicts may occur even under these circumstances. *See Blackie*, 524 F.2d at 908-9.

[48] *See Seagate II*, 843 F. Supp. at 1359. Note that the seller-purchaser conflict arises when particular class members both bought and sold the relevant security. It does not matter whether sales preceded purchases or purchases preceded sales. When a particular class member's sales occur first, he or she will want to argue that the amount of inflation increased during the relevant period, to maximize his or her damages. Conversely, class members whose purchases occur first will want to argue that the amount of inflation decreased during the relevant period. *Id.*

[49] *Seagate II*, 843 F. Supp. at 1362. This form of conflict is likely to arise from the dual interests held by some members of the plaintiff class. *Id.* Specifically, those plaintiffs who still own shares of the relevant security at the date of the suit have divided loyalties. The current holders seek recovery for themselves, but as equity holders in the relevant issuer they also want to minimize the overall liability of the issuer. *Id.*; *see also Able*, 47 F.R.D. at 15 (noting defrauded stock holder "wears two hats").

[50] *Seagate II*, 843 F. Supp. at 1362. Defendants have had little success in preventing class certification on the basis of the "equity conflict." *See* Herbst v. Int'l Tel. & Tel. Corp., 495 F.2d 1308, 1314 (2d Cir. 1974). The idea embraced by the courts is that the defrauded shareholders personal interests far overshadow his interest as an equity holder. *See Able*, 47 F.R.D. at 15. Also, any potential class member whose current holdings are so large has the option to request to be excluded from the class. *Id.* Damage awards paid by defendants other than the issuer do not impose any costs on current holders, however, any indirect costs borne by issuers (such as legal fees, lost management time and costs associated with indemnity agreements) ad-

ment of an award to the class can only make a current holder better off if his or her share of the recovery exceeds his or her share of the costs.[51] A current holder's net benefit will depend on his or her share of the benefits and costs. The conflict with other class members arises because the current holder's net benefit is increased by maximizing his or her own recovery and minimizing the recovery of other class members (because the larger the aggregate recovery, the lower the value of his or her current stock holdings).[52] When the issuer will fund all or part of any recovery, a current holder would want the plaintiffs to establish that the stock price was inflated on the dates he or she purchased but not inflated on any other dates. Obviously, this would not be in the interest of class members who purchased on these other dates. Moreover, if a current holder's current holdings are sufficiently large, he or she may prefer that the litigation not occur at all because the expected cost of the litigation, resulting from a diminution in the value of the holder's shares, exceeds the expected benefit.[53]

When seller-purchaser or equity conflicts exist, securities fraud claims can not satisfy the adequacy of representation requirement of FRCP 23(a). As explained above, there must be an "absence of antagonism"[54] between the named plaintiff and other class members for the adequacy of representation requirement to

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versely affect current holders. *Int'l Tel. & Tel.*, 495 F.2d at 1314.

[51] The *Seagate II* court noted that the fact that the individual plaintiff is more interested in personal recovery than the overall welfare of the corporation only addresses the reason for that individual's participation in the class action. *Seagate II*, 843 F. Supp. at 1363. The court noted that this individual interest does not indicate that he would be agreeable to numerous other plaintiffs receiving damage awards at the expense of the corporation in which he possesses equity. *Id.*

Note also that because plaintiffs' counsel will receive a portion of any damage award as a contingency fee, the benefit to the class from litigation is less than the damage award.

[52] *Seagate II*, 843 F. Supp. at 1364. The plaintiff in such a situation will be indifferent as to whether the class members whose recovery he or she prevents are equity holders or non-equity holders. *Id.* In other words, the plaintiff's antagonism will not discriminate because "both equity holders and non-equity holders will find themselves opposed by this equity-holding plaintiff." *Id.*

[53] "[I]f, by chance, any class member currently has holdings of [the defendant issuer's] stock so large that he would prefer not to assert his claims for past losses, such a person ... always has the option under [FRCP] 23(c)(2) to request exclusion from the class." *Able*, 47 F.R.D. at 15.

[54] *See supra* note 21 and accompanying text (explaining that absence of antagonism will assure class members vigorous prosecution on behalf of class by named plaintiffs).

be fulfilled. When there are class conflicts, there is antagonism. This is most obvious when the proposed class representative is either a seller-purchaser or a current holder, because persons in either position have an incentive to reduce the damage claims of other class members.[55] However, conflicts will exist even when the proposed class representative neither sold stock during the class period nor currently holds stock, because such plaintiff's interests will diverge from those of proposed class members who either sold stock or currently hold stock.[56]

Both the seller-purchaser and equity conflicts would also prevent securities fraud cases from satisfying the typicality requirement of FRCP 23(a), because when there are class conflicts, class members' claims will not arise from the same course of conduct or the same legal theory.[57] Each class member will want to shape the evidence to maximize his or her own recovery and minimize the costs of obtaining a recovery.[58] These quantities will depend on the extent of the alleged artificial inflation at any point in time, the timing and magnitude of each class member's purchases and sales, and the extent of each class member's current holdings. Therefore, each class member might want to highlight the significance of some of the alleged misrepresentations and omissions and trivialize the importance of others. In addition, different class members may have different interests in presenting evidence as to when allegedly omitted information should have been disclosed.

D. "Partial Curative Disclosure" Cases

The plaintiffs in *Seagate II* originally sought certification of a class consisting of all persons, other than the defendants, who purchased Seagate stock during the period April 13, 1988 to October 7, 1988.[59] The plaintiffs alleged that even though Seagate

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[55] *See supra* notes 45-53 and accompanying text (explaining in detail conflicts caused by seller-purchasers and current holders).

[56] *Seagate II*, 843 F. Supp. at 1359.

[57] *Id.* at 1351. The *Seagate II* court reasoned that class conflicts should be dealt with under the "adequacy of representation" element, because "alignment of interest is not the test for typicality; it is the result." *Id.* at 1351 n.14 (citing NEWBERG, *supra* note 13, § 22.17 at 22-59). When there are class conflicts, however, the class representatives may want to pursue different claims than other class members, raising questions as to typicality as well as adequacy.

[58] *Seagate II*, 843 F. Supp. at 1358-59.

[59] *Id.* at 1344-45.

knew that it had been adversely affected by changing conditions in its principal line of business, "[i]nstead of fully disclosing 'the truth concerning its financial condition and business prospects,' ... starting with a press release on July 18, 1988, Seagate made a series of 'grudging admissions of certain adverse facts—no one of which was fully curative.'"[60] The *Seagate II* court reasoned that because the "inflation ribbon" decreases upon "partial curative disclosures" of the type described by the plaintiffs, such disclosures implied that persons who purchased prior to and sold after the disclosure would have significant damages, increasing the probability that the seller-purchaser conflicts in the proposed class would be severe.[61] Therefore, the *Seagate II* court concluded that courts should be most concerned with the seller-purchaser conflict in "a partial curative disclosure case" such as *Seagate II*, and did not determine whether class conflicts would be serious enough to preclude class certification in other types of cases.[62]

The court's reasoning in *Seagate II* is faulty in two respects. First, seller-purchaser conflicts do not arise from changes in the amount of "inflation" upon which everyone agrees, but from uncertainty about whether and how much the "inflation ribbon" has changed. If all plaintiffs agreed that the amount of inflation de-

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[60] *Id.* at 1344 (quoting Plaintiff's Second Consolidated Am. Compl. ¶ 53 at 30 and Plaintiff's Submission *re* Ending Date of Class Period, June 3, 1991, at 2).

[61] *Id.* at 1364. The *Seagate II* court explained that partial curative disclosure leads to a greater potential of in/out traders in the plaintiff class, and the damages suffered by these in/out traders will be more significant. *Id.* In the full disclosure cases some fluctuation in the level of price inflation during the class period is to be expected. *Id.* If there are no leakages or partial disclosures, the price of inflation will remain substantially constant. *Id.* The *Seagate II* court concluded that because the fluctuation in price inflation will be slight, the in/out plaintiffs are not likely to have suffered a great amount in damages. *Id.* On the other hand, a partially curative disclosure can be expected to decrease the level of price inflation only proportionately. *Id.* The issuance of a series of partial disclosures creates a "step effect" in the amount of price inflation, each disclosure partially ratchets down the amount of inflation. *Id.* The "steps" created by partial disclosures will increase the potential of in/out traders. *Id.* at 1365. In the one-time full disclosure case, not every individual that bought and sold in the relevant period will be entitled to recovery, as slight fluctuations that occur may mean that some plaintiffs sell at price inflation levels equal to or higher than that at which they bought. *Id.* With partial disclosures, however, *all* persons whose transactions branch across "steps" will be entitled to in/out damages. *Id.* Also, because of the periodic significant downward "steps" in the amount of price inflation (as opposed to the slight fluctuations associated with full disclosure, in/out damages will be greater. *Id.*

[62] *Seagate II*, 843 F. Supp. at 1365.

creased following some partial curative disclosure, then persons who bought before and sold after the disclosure would have a significant damage claim and persons who bought after the disclosure would have smaller damage claims: there would be no conflict. Conflicts arise when there are disagreements about the amount of inflation. These may occur because plaintiffs who bought before and sold after a disclosure would have an incentive to minimize the amount of inflation after the disclosure and persons who bought after the disclosure would want to maximize this amount (in effect disputing the claim that the disclosure was curative). The claims of subsequent purchasers, however, might not be credible in the face of a partial curative disclosure. For this reason, partial curative disclosures only increase conflicts if such disclosures result in greater uncertainty about the amount of inflation.

The second and more important defect in the *Seagate II* court's reasoning is that uncertainty about the amount of "inflation" can arise without any "partial curative disclosure." Class members may argue that the amount of "inflation" varies for other reasons such as additional misstatements made by the defendants during the class period, omitted information that the defendants discovered and should have disclosed during the class period, or as a result of information disclosed by third parties during the class period. The incentives for class members to make these arguments depends on the dates and amounts of their own transactions. For this reason, seller-purchaser conflicts may be severe in cases without any "partial curative disclosures."

II. PREVIOUS ATTEMPTS TO ADDRESS CLASS CONFLICTS

Many courts have certified securities claims as class actions even when defendants have raised the issues of seller-purchaser and equity conflicts.[63] In some cases, courts have argued that class conflicts cannot provide sufficient reason for denying certification.[64] In other cases, courts have argued that procedural

[63] *Id.* at 1359 (citations omitted); *see also Blackie*, 524 F.2d at 908 (holding seller-purchaser conflicts do not afford valid reason for refusing to certify class); Greene v. Emerson Ltd., 86 F.R.D. 47, 61 (S.D.N.Y. 1980) (rejecting arguments that equity conflicts and seller-purchaser conflicts should bar class certification).

[64] *See, e.g., Int'l Tel. & Tel.*, 495 F.2d at 1314 (concluding that any concern by plaintiffs that damage award could harm corporation was outweighed by their per-

solutions exist which can mitigate the problems created by class conflicts.[65] As recognized by the court in *Seagate II*, however, the reasoning provided by previous courts is questionable.

A. Should Class Conflicts Prevent Class Certification?

Many courts have asserted that class conflicts only concern the issue of damages and do not go "to the heart of the controversy."[66] Under this assumption, these courts conclude that class conflicts, no matter how severe, cannot preclude a finding of adequacy or typicality.[67] This rationale, however, is clearly incorrect because class conflicts concern the amount of alleged "artificial inflation" which, under the fraud-on-the-market theory, is relevant not only to the issue of damages, but also to the issues of reliance, materiality and causation.[68] Additionally, because the amount of inflation depends on which affirmative statements were misrepresentations and when disclosures should have been made, conflicts also arise concerning these issues.[69] Thus, class conflicts can affect five of the six elements of a securities claim.

Another reason courts have certified securities fraud cases as class actions despite class conflicts is the belief that the techniques of market analysis are too "sophisticated" to allow any class representative to distort the evidence as to the amount of price inflation for his or her own benefit.[70] This argument ignores the possibility that plaintiffs will shape the evidence as to the factual claims (regarding which affirmative statements were

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sonal interest in recovery).

[65] *See, e.g.*, *Able*, 47 F.R.D. at 15 (holding that any class member with large holdings always has option under FRCP 23(c)(2) to request exclusion from class).

[66] *Seagate II*, 843 F. Supp. at 1358 (citing *Blackie*, 524 F.2d at 909); *see also* Gates v. Dalton, 67 F.R.D. 621, 630 (E.D.N.Y. 1975) (noting that class conflict cannot exist unless conflict is "genuine" and goes to "the heart of the matter") (citations omitted); Redmond v. Commerce Trust Co., 144 F.2d 140, 151 (8th Cir. 1944) ("[A]ntagonism must be as to the subject matter of the suit.").

[67] *See, e.g.*, *Gates*, 67 F.R.D. at 632 ("[D]efendant's evidence of antagonism ... should be nothing short of clear and convincing.").

[68] *Seagate II*, 843 F. Supp. at 1357-58.

[69] *See id.* at 1356 (recognizing that false positive statements or omissions of negative fact result in artificial price inflation whereas false negative statements or omissions of positive fact cause artificial price deflation).

[70] *See id.* at 1360 (finding that argument that analysis is too difficult to manipulate "interesting"); *In re* LTV Sec. Litig., 88 F.R.D. 134, 149 (N.D. Tex. 1980) ("[A]vailable techniques of proof such as econometric modeling are sufficiently demanding of internal consistency as to reduce the opportunity for such manipulation of data.").

misrepresentations and when disclosures should have been made) that determine the amount of price inflation. In addition, there is the possibility that some plaintiffs may use incorrect techniques of market analysis when it is in their interest to do so. Thus, the existence of precise techniques for analyzing the affect of any alleged misstatement is not sufficient to alleviate class conflicts.

Finally, some courts have suggested that class conflicts are not important because all plaintiffs have an interest in cooperating with each other so as to avoid collective defeat.[71] But, as the *Seagate II* court noted, "if the in/out trader cooperates with those persons who purchased on the date that he sold, his recovery is necessarily diminished, perhaps even eliminated."[72] Similarly, if a current holder cooperates with persons who purchased on dates other than his or her purchase date, he or she may be worse off than if there was a collective defeat.[73] Thus, there is good reason to doubt that cooperation is in every class members' interest. Moreover, courts advancing this argument have never explained the mechanism by which numerous, geographically disparate class members could cooperate to resolve disputes.[74]

B. Proposed Procedural Remedies

Many courts have recognized the issue of class conflicts, but have asserted that procedural devices exist which sufficiently mitigate the problem.[75] These assertions are also questionable. One oft-proposed solution is "subclassing," which involves divid-

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[71] *See Seagate II*, 843 F. Supp. at 1361 (recognizing but dismissing this argument).

[72] *Id.* The *Seagate II* court's conclusion is too strong for the reasons stated *supra*, note 47 (explaining that in/out traders will not always be harmed by cooperating with other plaintiffs).

[73] *See id.* at 1363 (noting that current holder would not want "hundreds or thousands of other plaintiffs receiving damage awards at the expense of the company in which he possesses equity").

[74] Courts have certified classes under the assumption of cooperation without any discussion of how, logistically, this cooperation occurs. *See, e.g., LTV Sec.*, 88 F.R.D. at 148 (rejecting argument that in/out conflicts should bar class certification); Blackie v. Barrack, 524 F.2d 891, 909-10 (9th Cir. 1975) (holding that common interests of plaintiffs outweigh conflicts).

[75] *See Blackie*, 524 F.2d at 909 (recognizing problem of possible conflict but proposing devices such as fashioned remedies and subclassing to relieve problem); Gates v. Dalton, 67 F.R.D. 621, 632 (E.D.N.Y. 1975) (allowing for an opposing group to alter class through subclassing or "other modifications of the class action order").

ing the class into subclasses based on the dates of transactions.[76] The purported benefit of having subclasses is that conflicts within the class can be eliminated by grouping class members with similar interests.[77] However, to avoid conflicts within subclasses there would need to be a separate subclass for each possible combination of purchase and sale dates (assuming that the amount of inflation was required to be constant on any particular date).[78] In a class period of many days, the number of subclasses would be far too large to be workable. In addition, subclasses only identify subsets of the proposed class that have common interests; the use of subclasses can not eliminate the conflicts of interest that exist between members of different subclasses. Properly understood, the use of subclasses is merely a method of accounting for class conflicts; subclasses do nothing to mitigate these conflicts.[79] Not surprisingly, none of the courts which have suggested the use of subclasses for the purpose of alleviating class conflicts has actually implemented this procedure.[80]

Courts have also asserted that the ability of class members to opt out of the class somehow protects class members from conflicts.[81] A particular plaintiff, however, cannot cause a class representative to pursue the particular plaintiff's interests by opting out of the class. Moreover, particular plaintiffs would have to evaluate the case before determining whether to opt out. For most investors the costs of such an evaluation would be prohibitive and would greatly increase the costs of class actions.

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[76] *See Seagate II*, 843 F. Supp. at 1361 (citing *Blackie*, 524 F.2d at 911; Koenig v. Smith, 88 F.R.D. 604, 609 (E.D.N.Y. 1980)).

[77] *See Blackie*, 524 F.2d at 911 (noting that judge will be able to assure fairness by creating subclasses if necessary); *LTV Sec.*, 88 F.R.D. at 149 ("[S]ubclassing has the potential to cure any such problems."); *see also* Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1346 (9th Cir. 1976) (noting that class conflicts may require creation of subclasses, but do not necessarily bar class actions); Deborah L. Rhode, *Class Conflicts in Class Actions*, 34 STAN. L. REV. 1183, 1221-23 (1982) (describing subclassing as one solution to deal with conflicts).

[78] *See Seagate II*, 843 F. Supp. at 1362 ("[F]or each day of the class period, two subclasses would be needed: one for all plaintiffs who purchased shares on that day ... and another for all in/out plaintiffs who sold shares on that day.").

[79] *See* Rhode, *supra* note 77, at 1223-32 (describing problems with subclassing such as bias, timing, manageability, and expense).

[80] *Seagate II*, 843 F. Supp. at 1361 (stating that "[n]one of the reported cases has attempted to implement subclasses").

[81] *See, e.g.*, *Green*, 541 F.2d at 1339 (recognizing right under FRCP 23(c)(2) and (c)(3) to "opt out and not be bound by the judgment").

In short, this "solution" runs counter to the entire theory of class actions, which are supposed to provide a mechanism to allow for the aggregation of claims to economize on costs.

III. MEASURING THE EXTENT OF POTENTIAL CLASS CONFLICTS

As noted above, the plaintiffs in *Seagate II* originally sought certification of a class consisting of all persons, other than the defendants, who purchased Seagate stock during the period April 13, 1988 to October 7, 1988.[82] After the *Seagate II* court ruled that an "evidentiary hearing" would be required to determine the potential for conflicts created by the fraud-on-the-market theory,[83] the plaintiffs elected to seek certification of a narrower class consisting of persons who purchased shares of Seagate common stock prior to July 18, 1988 and did not sell any shares of Seagate common stock during the same period.[84] In *Seagate II*, the court stated that the new class avoided the "seller-purchaser" conflict, but failed to address the remaining equity conflicts.[85] Despite the possibility of such conflicts, the court certified the proposed narrower class without either requiring an evidentiary hearing or providing any additional analysis of the requirements of the FRCP.[86]

The court's resolution of *Seagate II* is inadequate because it agreed to certify a class that included current holders even though the court's analysis implied that, due to possible equity conflicts, proposed classes which contain current holders cannot fulfill the "adequacy of representation" requirement of FRCP 23(a).[87] The *Seagate II* court could have resolved the equity conflict problem in the same way that it resolved the seller-purchaser conflict problem—by refusing to certify a class which

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[82] *See Seagate II*, 843 F. Supp. at 1344-45 (noting that another judge had earlier ordered certification in four subclasses: "period 1) April 13, 1988 to July 19, 1988; 2) July 20, 1988 to August 7, 1988; 3) August 8, 1988 to September 24, 1988; [and] 4) September 25, 1988 to October 7, 1988").

[83] *Id.* at 1365-66.

[84] *Seagate II*, 156 F.R.D. at 230.

[85] *Id.* at 231 (recognizing that determination of equity conflict would be difficult).

[86] *Id.* (noting lack of information from either party to make determination as to equity conflict and trend of courts to allow such actions despite possible class conflicts because of policy to afford legal recourse in securities fraud cases).

[87] *Seagate II*, 843 F. Supp. at 1362-64 (explaining equity conflict and dismissing arguments that suggest adequacy of representation still exists despite equity conflict).

contained current holders.[88] A class that excluded any purchasers during the class period who continued to hold shares as of the date of the litigation, in addition to purchasers who sold shares during the class period, would have been certifiable.[89] The court's resolution of *Seagate II* is also inadequate because it did not describe the evidence that would have been relevant in an evidentiary hearing as to the extent of class conflicts.[90] *Seagate II* leaves unanswered important questions about how the extent of class conflicts can be measured, what data can be used, what the data would show and how this evidence would be used to evaluate whether proposed classes satisfied the requirements for class certification.[91] The remainder of this article addresses these questions.

A. Measuring the Extent of Class Conflicts

As previously noted, the seller-purchaser conflict arises when members of the proposed class both sold and purchased the subject security during the proposed class period.[92] Obviously, the greater the ratio of sales to purchases for any particular class member, the greater his or her conflict with class members who purchased shares on the dates he or she sold.[93] This makes the ratio of sales to purchases of individual class members (the "sell-purchase ratio") a natural measure of the extent of the seller-purchaser conflict. The potential for conflict is especially severe when the sell-purchase ratio exceeds one. In this case, a class member can benefit from litigating only by demonstrating

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[88] Although the *Seagate II* court recognized that the seller-purchaser conflict would be so severe "that a class action would become utterly unworkable," the court never stated that it would refuse to certify that class. *Id.* at 1362. The plaintiffs, however, modified the scope of the class certification to remove such conflicts. *Seagate II*, 156 F.R.D. at 230.

[89] Alternatively, the *Seagate II* court could have refused to certify the proposed class unless plaintiffs dropped the issuer, Seagate, as a defendant. If the issuer is not a defendant and will not pay any damage award, then there is no equity conflict because the value of a current holder's shares will not be affected by the litigation.

[90] *Seagate II*, 843 F. Supp. at 1365-66 (ordering evidentiary hearing and instructing that plaintiffs prove "extent and severity of class conflicts" and establish nature of "damages ... suffered by the various class members").

[91] *See id.*

[92] *See Seagate II*, 156 F.R.D. at 230-31 (eliminating need for evidentiary hearing because scope of class had been modified by plaintiffs' counsel).

[93] *See Seagate II*, 843 F. Supp. at 1359 ("[T]he in/out plaintiff's interest lies in minimizing the degree of inflation existing at the date of sale. A retention plaintiff buying on that date ... has an exactly opposite interest ... .").

that the average amount of inflation on his or her purchase dates exceeds the average amount of inflation on his or her sale dates by a greater percentage than the percentage amount by which the class member's sales exceed his or her purchases.[94] Additionally, as with any seller-purchaser, the lower the amount of inflation on his or her sale dates, the greater his or her claimed damages.[95]

The equity conflict arises when members of the proposed class (i.e., persons who purchased shares during the class period) hold stock currently.[96] As an analog to the sell-purchase ratio, one might consider the ratio of shares currently held to shares purchased during the class period as a measure of the extent of equity conflict. This measure, however, would be inadequate for two reasons. First, while the equity conflict arises when a class member holds shares currently, the extent of the conflict depends on how large his share holdings are relative to the total amount of shares outstanding; the larger the total amount of shares outstanding, the smaller the conflict (because when there are more shares outstanding, a greater share of the costs of the litigation will be borne by others). Similarly, the benefit a class member receives from any recovery depends not only on how many shares he or she purchased during the class period, but on how many shares were purchased by others (who may share in any recovery); the larger the number of shares purchased during the class period by others, the smaller the benefit. Thus, a better measure of the equity conflict is the ratio of the ownership percentage (N/O, where N is the number of shares currently held and O is the number of shares currently outstanding) to the ratio of the purchase percentage (P/V, where P is the number of shares purchased by the current holder during the class period and V is the number of shares purchased by all class members during the class period). The greater the equity ratio, the greater the equity conflict.[97] Particular attention should be paid

[94] *Id.* ("[I]n/out plaintiffs benefit from maximizing the difference between inflation at purchase and inflation at sale.").

[95] *Id.* (explaining effect of inflation on seller-purchaser conflict).

[96] *See generally supra* notes 49-53 and accompanying text (defining "equity" conflicts, explaining why and when they occur, and describing their effect on class actions).

[97] Formally, suppose a company with O shares outstanding were to pay a total damage award of some amount, D. The per share cost of such an award to current holders would be D/O. If a current holder owns N shares, his or her share of the

to current holders whose equity ratios exceed one. For the most part litigating *harms* such current holders, because the costs the litigation would impose on them will exceed the benefits they would expect to obtain from the litigation.[98]

In summary, "seller-purchaser conflicts" arise whenever a class member both bought and sold stock during the class period and "equity conflicts" arise whenever a class member holds stock while the litigation is pending. The extent of the "seller-purchaser conflict" for any class member depends on the "sell-purchase ratio" as defined above. The extent of the "equity conflict" for any class member depends on the "equity ratio" as defined above. For each class member, these ratios are a function of the number of shares he or she purchased during the class period, the number of shares he or she sold during the class period and the number of shares he or she holds while the litigation is pending.

B. Data Requirements

In a typical case, the information necessary to calculate "sell-purchase" and "equity" ratios for every member of a proposed class is not publicly available and could not be ascertained without extensive discovery (such as a proof of claim procedure).[99] Publicly available information, however, can be used to

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cost would be $N*D/O$. The current holder would only want to engage in litigation if his or her expected recovery exceeded this amount. To determine whether this condition holds, assume that V shares were purchased during the class period *and* that each share purchased would receive an equal pro-rata amount of any recovery (an assumption which is discussed in note 101 *infra*). Under these circumstances, each class member would receive D/V per share. A current holder who purchased P shares during the class period would receive $P*D/V$. The net benefit that a current holder would receive from litigating is $D*[P/V - N/O]$. This amount is positive only if the quantity in brackets is positive or, equivalently, if the quantity $[N*V/(O*P)]$ (which is the "equity ratio") is less than 1.0. For simplicity, this model assumes that the issuer pays the entire damage award, the issuer has no other costs associated with the litigation, and plaintiffs' counsel receives no contingency fee. While the model contains several simplifying assumptions, nothing is lost, however, because in a more general model, a plaintiff's willingness to litigate would still be inversely related to the equity ratio.

[98] The only exceptions would be those current holders with equity ratios less than one that have reason to expect a greater than average per share recovery as compared to other class members. The necessary "equity premium" can be calculated by subtracting 1.0 from the reciprocal of the equity ratio. Even if the equity premium were sufficiently large, however, such current holders would have severe equity conflicts because they would want to minimize the aggregate recovery in order to reduce the costs the litigation imposes on them.

[99] *See Seagate II*, 843 F. Supp. at 1362 (indicating that information regarding

obtain some measure of the extent of these conflicts of interest. In particular, certain types of institutions must submit quarterly reports of their securities holdings to the Securities and Exchange Commission on Form 13F.[100] The information contained in such filings is compiled by various data vendors. By examining sequential filings, one can determine the net number of shares bought or sold by any particular institution during a specific quarter[101] and the number of shares currently held by the institution. This information can then be used to assess the extent of the seller-purchaser and current holder conflicts.

C. Application to Seagate II

Seagate II provides an illustrative example. On March 31, 1988, institutions reported holdings of approximately 24,000,000 shares of Seagate common stock, approximately 49% of Seagate's then outstanding shares.[102] Thus, institutions represented a substantial fraction of Seagate shareholders. Table 1 reports data necessary to assess seller-purchaser conflicts—the number of shares purchased, the number of shares sold, and the "sell-purchase ratio."[103] The table shows that eighty-seven institutions purchased shares during the relevant period, accounting for total purchases of 28,048,851 shares.[104] Of these institutions, twelve sold no shares during the period.[105] Collectively these

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conflicts would need to be determined for *"each transaction"*) (emphasis in original).

[100] *See* 15 U.S.C. § 78m(f)(1) (1994) (requiring disclosure by institutional investment managers as to large securities holdings); 15 U.S.C. § 78l (1994) (requiring Form 13-F to be filed).

[101] For example, if institution XYZ held 10,000 shares at the end of quarter one and 20,000 shares at the end of quarter two, then institution XYZ had net purchases of 10,000 shares during quarter two.

[102] *See infra* app. A, tbl. 1 (Compilation of 13-F Forms by CDA Investment Technologies, Inc.).

[103] The institutional holdings data is available on a quarterly basis only. The data shown is for the period from April 1, 1988 to September 30, 1988, a period which closely approximates the class period in *Seagate II*. *See infra* app. A, tbl. 1. It is not possible to identify offsetting purchases and sales of the same quantity of shares that occur within a quarter using this data. For example, an institution whose holdings increased by 10,000 shares during a quarter may have purchased 20,000 shares and sold 10,000 shares. For this reason, the calculations of the sell-purchase ratio in table 1 are biased *downwards* and understate the potential class conflicts. *See id.*

[104] *See id.*

[105] *See id.* (Avatar Investors Assoc., Brown Bros. Harriman & Co., Capital Research & Mgmt., Chemical Banking Corp., Cigna Corp., Fidelity Mgmt. & Res. Corp., Hancock J. Spec. Equities, Keystone Custodian FDS, Killen Group Inc., Kingdon Capital Mgmt., NCM Capital Mgmt. Group Inc., and Norwest BK Minne-

twelve institutions, which had no seller-purchaser conflict, accounted for 9.6% of the total institutional share purchases.[106] The remaining institutions each sold some shares and, therefore, would have had seller-purchaser conflicts with other class members.[107] Many of these conflicts would not have been severe. However, forty institutions, which collectively accounted for 26.8% of the total institutional share purchases, would have had particularly severe seller-purchaser conflicts because they sold more shares during the period than they purchased during the period.[108]

Table 2 reports data necessary to assess equity conflicts in the proposed class—the number of shares of Seagate common stock held on December 31, 1993 (the quarter ending immediately prior to the date of the *Seagate II* decision) by institutions that purchased Seagate stock during the proposed class period.[109] For each institution, table 2 reports the number of shares purchased during the class period, the number of shares held on December 31, 1993 and the "equity ratio."[110] The table shows that of the eighty-seven institutions that bought shares during the class period, only six did not hold Seagate stock on December 31, 1993.[111] Collectively these institutions, which had no equity

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sota NA).

[106] *See id.* These twelve institutions collectively purchased 2,682,320 out of total purchases of 28,048,851.

[107] *See supra* notes 47-48 and accompanying text (explaining seller-purchaser conflict).

[108] *See infra* app. A, tbl. 1. These forty institutions purchased 7,527,352 out of a total purchase of 28,048,851.

[109] *See infra* app. B, tbl. 2.

[110] *See id.* Information about both the number of shares outstanding and the number of shares purchased by proposed class members is required to calculate the equity ratio. Seagate had 70.8 million shares outstanding as of December 31, 1988. The reported volume of trading in Seagate stock from April 1, 1988 to September 30, 1988 was 123,970,911 shares. This figure represents the aggregate number of purchases as well as the aggregate number of sales. However, many of these purchases were made by market makers—intermediaries who quickly sold their stock to third parties. Such persons are unlikely to be able to assert viable claims. The calculations in table 2 assume that half of the reported volume is attributable to the activities of such intermediaries. *See id.* For discussions of the effect of intermediaries on reported volume, see Fischel & Ross, *The Use of Trading Models To Estimate Aggregate Damages in Securities Fraud Litigation: A Proposal For Change*, *in* SECURITIES CLASS ACTIONS: ABUSES AND REMEDIES, 136 (National Legal Center for the Public Interest 1994); Kenneth R. Cone & James E. Laurence, *How Accurate are Estimates of Aggregate Damages in Securities Fraud Cases?*, 49 BUS. LAW. 505, 512 (1994).

[111] *See infra* app. B, tbl. 2 (Batterymarch Finl. Mgmt., Chubb Corp., Harris

conflict, accounted for only 2.2% of the total institutional share purchases.[112] The remaining institutions each held some shares and, therefore, would have had equity conflicts with other class members.[113] Although many of these conflicts would not have been severe, thirty of the eighty-seven institutions, which collectively accounted for 7.7% of the total institutional share purchases, have equity ratios that exceed one, indicating severe equity conflicts.[114]

The data shows that the *Seagate II* court's concerns about the initial proposed class in *Seagate II* were well-founded—a substantial fraction of the proposed class would have had severe conflicts of both types.[115] Ultimately, the *Seagate II* court certified a narrower class consisting only of persons who purchased shares of Seagate common stock during the period from April 13, 1988 to July 18, 1988 and did not sell any shares during the same period.[116] By definition, this narrower class has no seller-purchaser conflicts,[117] but equity conflicts would remain.[118] The institutional holding data shows that fifty-three institutions bought shares during the shorter proposed class period.[119] Of these institutions only three did not hold Seagate stock on December 31, 1993.[120] Collectively, these institutions, which have no equity conflict, accounted for only 1.4% of the total institutional share purchases. The remaining institutions each held some shares and, therefore, would have had equity conflicts with other class members. Also, twenty-one of the fifty-three institu-

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Bankcorp Inc., Jacobs Levy Equity Mgmt., Lincoln Nat'l Corp., and Norwest Bank Iowa NA).

[112] *See id.* These six collectively purchased 611,169 out of a total purchase of 28,048,851.

[113] *See supra* notes 49-53 and accompanying text (discussing equity conflicts).

[114] *See infra* app. B, tbl. 2. These thirty institutions collectively purchased 2,151,559 shares out of a total purchase of 28,048,851.

[115] *See supra* notes 109-114 and accompanying text (indicating that 26.8 percent of purchased shares had significant seller-purchaser conflicts and 7.7 percent of purchased shares had significant equity conflicts).

[116] *Seagate II*, 156 F.R.D. at 231.

[117] *Id.*

[118] *See id.* ("[S]till left unaddressed is the possibility of 'equity' conflicts in the class.").

[119] *See infra* app. A, tbl. 1. As discussed in note 103, the institutional holdings data is available on a quarterly basis. The figures reported in the text are for purchasers during the period from April 1, 1988 to June 30, 1988, a period which closely approximates the revised proposed class period in *Seagate II*.

[120] *See infra* apps. A & B, tbls. 1 & 2 (Chubb Corp., Harris Bankcorp. Inc., and Lincoln Nat'l Corp.).

tions, which collectively accounted for 6.1% of the total institutional share purchases, have equity ratios that exceed one, indicating severe equity conflicts.

IV. CONCLUSION

Seagate II may radically change litigation of securities fraud cases because the potential conflicts between class members identified by the court in *Seagate II* demonstrate that proposed classes which include seller-purchasers or current holders do not satisfy the typicality and adequacy of representation elements of FRCP 23(b)(3) and, therefore, should not be certified as class actions. The *Seagate II* court was apparently uncomfortable with this implication of its analysis and did not find that classes which include sellers or current holders are automatically unsuitable for certification. Instead, the court suggested that an evidentiary hearing regarding the extent of the potential conflicts would be required before certification could occur. This article provides a rigorous framework for evaluating the extent of potential conflicts and demonstrates how readily available data can be used for this purpose in such evidentiary hearings. It remains for the courts to determine under what circumstances classes can be certified after properly measuring these conflicts.

APPENDIX A

TABLE 1
INSTITUTIONAL PURCHASES AND SALES OF SEAGATE TECHNOLOGY, INC. COMMON STOCK APRIL 1, 1988-SEPTEMBER 30, 1988

Institution	Purchases	Sales	Ratio
ALGER FRED MANAGEMENT	5,595,000	4,961,800	0.89
ALLSTATE LIFE INSURANCE	733,000	108,000	0.25
ALPHA SOURCE ASSET MGMT	3,100	5,564,850	1795.11
AMERICAN GENERAL CORP	100	19,500	195.00
AMERICAN NATL B&T/CHICAG	209,300	262,000	1.25
AVATAR INVESTORS ASSOC.	85,000	0	0.00
BEA ASSOCIATES INC.	715,800	500	0.00
BANK OF BOSTON CORP	185,000	220,450	1.19
BATTERYMARCH FINL MGMT	237,969	34,635	0.15
BENTLEY CAPITAL MGMT INC	269,200	279,000	1.04
BESSEMER TRUST CO N.A.	232,700	199,669	0.86
BRINSON PARTNERS INC	265,000	266,000	1.00
BROWN BRTHRS HARRIMAN&CO	14,300	0	0.00
CMB INVESTMENT COUNSELOR	117,700	2,100	0.02
CS FIRST BOSTON INC.	376,000	140,700	0.37
CAPITAL GUARDIAN TRUST	250,000	237,700	0.95
CAPITAL RESEARCH & MGMT	13,500	0	0.00
CHASE MANHATTAN CORP	151,000	213,250	1.41
CHEMICAL BANKING CORP.	306,500	0	0.00
CHUBB CORPORATION	212,000	424,650	2.00
CIGNA CORPORATION	469,550	0	0.00
CITICORP	23,350	75,200	3.22
COLLEGE RETIRE EQUITIES	1,085,100	1,135,000	1.05
CONNOR CLARK & CO. LTD.	145,000	221,100	1.52
DARCY & CO INC	212,270	22,616	0.11
DAWSON-SAMBERG CAP MGMT	50,000	50,000	1.00
DIMENSIONAL FUND ADVS.	40,100	57,000	1.42
EAGLE ASSET MGMT. INC	54,200	19,240	0.35
EQUITABLE COMPANIES INC	91,000	33,000	0.36
ESSEX INVESTMENT MGMT CO	79,000	75,800	0.96
FARMERS GROUP INC	13,000	180,763	13.90
FIDELITY MGMT & RES CORP	184,600	0	0.00
FIRST CHICAGO CORP	114,000	245,000	2.15
FIRST INTERSTATE BANCORP	150,800	175,000	1.16
FIRST PACIFIC ADVISORS	48,400	317,037	6.55
FLORIDA ST BOARD/ADMIN.	527,300	536,942	1.02
FREMONT INVMNT ADVISORS	459,900	391,000	0.85
GRANTHAM MAYO VAN OTTER	159,000	159,000	1.00
GREAT WEST LIFE ASSUR CO	31,998	22,000	0.69
GRUBER & MCBAINE CAP MGT	131,200	343,800	2.62
HSBC HOLDINGS PLC	144,900	147,000	1.01
HANCOCK J SPEC EQUITIES	445,100	0	0.00

Institution	Purchases	Sales	Ratio
HARRIS BANKCORP INC.	30,000	25,000	0.83
HUSIC CAPITAL MGMT.	67,500	173,000	2.56
IBM CREDIT INVT MGMT	28,800	30,000	1.04
IBM RETIREMENT PLAN	1,777,000	1,236,000	0.70
INTEGRA FINANCIAL CORP.	28,000	54,500	1.95
INVESTMENT COUNSELORS INC	117,700	120,000	1.02
INVESTMENT COUNSELORS/MD	571,000	558,200	0.98
INVESTMENT RESEARCH CO.	30,800	1,685,800	54.73
JACOBS LEVY EQUITY MGMT	97,000	64,000	0.66
KENTUCKY TEACHERS RETRM	72,566	7,000	0.10
KEYSTONE CUSTODIAN FDS	176,000	0	0.00
KEYSTONE INVESTMENT MGMT	85,000	85,000	1.00
KILLEN GROUP INC	479,200	0	0.00
KINGDON CAPITAL MGMT	270,320	0	0.00
LASALLE NATL TRUST N.A.	118,134	173,961	1.47
LINCOLN NATL CORP	10,000	32,000	3.20
LYNCH & MAYER INC	651,215	500,800	0.77
MCKEE C S & CO INC	33,500	99,000	2.96
MCMORGAN & COMPANY	7,761	200	0.03
MELLON BANK CORPORATION	10,500	48,000	4.57
MERCANTILE BANC/MISSOURI	231,000	31,000	0.13
MONTAG & CALDWELL	19,000	20,000	1.05
MORGAN J P & CO INC	10,000	54,200	5.42
MORGAN STANLEY GROUP INC	129,600	18,100	0.14
MU-CANA INVT COUNSELLING	901,500	108,000	0.12
NCM CAPITAL MGMT GRP INC	32,200	0	0.00
NATIONAL CITY BK/KENTCKY	599,100	793,700	1.32
NATIONSBANK CORPORATION	35,000	14,883	0.43
NEW YORK ST TEACHERS RET	53,610	311,000	5.80
NICHOLAS-APPLEGATE CAP.	357,600	208,000	0.58
NIPPON LIFE INSURANCE CO	1,248	212,000	169.87
NORTHERN TRUST CORP	552,100	30,200	0.05
NORWEST BANK IOWA N A	24,200	75,047	3.10
NORWEST BK MINNESOTA N A	206,600	0	0.00
NUMERIC INVESTORS L P	116,600	10,000	0.09
ONE VALLEY BANK N.A.	40,000	48,000	1.20
OPPENHEIMER MGMT. CORP.	1,806,500	137,000	0.08
PACIFIC MUTUAL LIFE INS	965,650	592,935	0.61
PANAGORA ASSET MGMT INC	562,210	565,000	1.00
PHOENIX HOME LIFE MUTUAL	191,800	202,000	1.05
PRUDENTIAL INS CO/AMER	28,000	123,000	4.39
PRUDENTIAL SECS. INC.	10,000	10,000	1.00
RUSSELL FRANK CO INC	46,000	46,000	1.00
SCHWAB CHARLES INVT MGMT	1,389,700	1,492,000	1.07
SEARS INVESTMENT MGMT	445,700	526,000	1.18
TOTAL	28,048,851	27,733,828	

Source: Calculated from institutional holdings reported on Form 13-F as compiled by CDA Investment Technologies, Inc.

APPENDIX B

TABLE 2
CLASS PERIOD PURCHASES OF SEAGATE TECHNOLOGY, INC. COMMON STOCK COMPARED TO DECEMBER 31, 1993 HOLDINGS OF INSTITUTIONS

Institution	Purchases	Holdings 12/31/93	Equity Ratio
ALGER FRED MANAGEMENT	5,595,000	762,800	0.12
ALLSTATE LIFE INSURANCE	733,000	108,400	0.13
ALPHA SOURCE ASSET MGMT	3,100	25,900	7.32
AMERICAN GENERAL CORP	100	46,365	406.12
AMERICAN NATL B&T/CHICAG	209,300	126,800	0.53
AVATAR INVESTORS ASSOC.	85,000	10,700	0.11
BEA ASSOCIATES INC.	715,800	274,300	0.34
BANK OF BOSTON CORP	185,000	25,000	0.12
BATTERYMARCH FINL MGMT	237,969	0	0.00
BENTLEY CAPITAL MGMT INC	269,200	194,000	0.63
BESSEMER TRUST CO N.A.	232,700	15,000	0.06
BRINSON PARTNERS INC	265,000	969,800	3.21
BROWN BRTHRS HARRIMAN&CO	14,300	10,000	0.61
CMB INVESTMENT COUNSELOR	117,700	247,027	1.84
CS FIRST BOSTON INC.	376,000	9,300	0.02
CAPITAL GUARDIAN TRUST	250,000	552,900	1.94
CAPITAL RESEARCH & MGMT	13,500	1,550,000	100.57
CHASE MANHATTAN CORP	151,000	124,700	0.72
CHEMICAL BANKING CORP.	306,500	79,100	0.23
CHUBB CORPORATION	212,000	0	0.00
CIGNA CORPORATION	469,550	103,142	0.19
CITICORP	23,350	170,800	6.41
COLLEGE RETIRE EQUITIES	1,085,100	568,100	0.46
CONNOR CLARK & CO. LTD.	145,000	843,800	5.10
DARCY & CO INC	212,270	5,000	0.02
DAWSON-SAMBERG CAP MGMT	50,000	214,700	3.76
DIMENSIONAL FUND ADVS.	40,100	32,000	0.70
EAGLE ASSET MGMT. INC	54,200	26,000	0.42
EQUITABLE COMPANIES INC	91,000	120,300	1.16
ESSEX INVESTMENT MGMT CO	79,000	388,500	4.31
FARMERS GROUP INC	13,000	290,000	19.54
FIDELITY MGMT & RES CORP	184,600	6,830,700	32.41
FIRST CHICAGO CORP	114,000	189,200	1.45
FIRST INTERSTATE BANCORP	150,800	245,400	1.43
FIRST PACIFIC ADVISORS	48,400	1,120,000	20.27
FLORIDA ST BOARD/ADMIN.	527,300	140,000	0.23
FREMONT INVMNT ADVISORS	459,900	27,600	0.05
GRANTHAM MAYO VAN OTTER	159,000	180,000	0.99
GREAT WEST LIFE ASSUR CO	31,998	10,300	0.28
GRUBER & MCBAINE CAP MGT	131,200	20,000	0.13
HSBC HOLDINGS PLC	144,900	2,800	0.02
HANCOCK J SPEC EQUITIES	445,100	300,000	0.59

Institution	Purchases	Holdings 12/31/93	Equity Ratio
HARRIS BANKCORP INC.	30,000	0	0.00
HUSIC CAPITAL MGMT.	67,500	781,500	10.14
IBM CREDIT INVT MGMT	28,800	19,000	0.58
IBM RETIREMENT PLAN	1,777,000	165,900	0.08
INTEGRA FINANCIAL CORP.	28,000	38,350	1.20
INVESTMENT COUNSELORS INC	117,700	440,700	3.28
INVESTMENT COUNSELORS/MD	571,000	517,350	0.79
INVESTMENT RESEARCH CO.	30,800	10,700	0.30
JACOBS LEVY EQUITY MGMT	97,000	0	0.00
KENTUCKY TEACHERS RETRM	72,566	38,500	0.46
KEYSTONE CUSTODIAN FDS	176,000	200,000	1.00
KEYSTONE INVESTMENT MGMT	85,000	676,350	6.97
KILLEN GROUP INC	479,200	216,600	0.40
KINGDON CAPITAL MGMT	270,320	100,000	0.32
LASALLE NATL TRUST N.A.	118,134	20,500	0.15
LINCOLN NATL CORP	10,000	0	0.00
LYNCH & MAYER INC	651,215	81,200	0.11
MCKEE C S & CO INC	33,500	481,000	12.58
MCMORGAN & COMPANY	7,761	579,100	65.36
MELLON BANK CORPORATION	10,500	1,627,755	135.79
MERCANTILE BANC/MISSOURI	231,000	2,000	0.01
MONTAG & CALDWELL	19,000	1,694,306	78.11
MORGAN J P & CO INC	10,000	10,800	0.95
MORGAN STANLEY GROUP INC	129,600	37,647	0.25
MU-CANA INVT COUNSELLING	901,500	467,004	0.45
NCM CAPITAL MGMT GRP INC	32,200	296,750	8.07
NATIONAL CITY BK/KENTCKY	599,100	14,000	0.02
NATIONSBANK CORPORATION	35,000	17,260	0.43
NEW YORK ST TEACHERS RET	53,610	53,400	0.87
NICHOLAS-APPLEGATE CAP.	357,600	184,200	0.45
NIPPON LIFE INSURANCE CO	1,248	8,700	6.11
NORTHERN TRUST CORP	552,100	21,900	0.03
NORWEST BANK IOWA N A	24,200	0	0.00
NORWEST BK MINNESOTA N A	206,600	64,700	0.27
NUMERIC INVESTORS L P	116,600	303,000	2.28
ONE VALLEY BANK N.A.	40,000	1,600	0.04
OPPENHEIMER MGMT. CORP.	1,806,500	945,000	0.46
PACIFIC MUTUAL LIFE INS	965,650	285,500	0.26
PANAGORA ASSET MGMT INC	562,210	67,800	0.11
PHOENIX HOME LIFE MUTUAL	191,800	150,000	0.69
PRUDENTIAL INS CO/AMER	28,000	142,400	4.45
PRUDENTIAL SECS. INC.	10,000	112,938	9.89
RUSSELL FRANK CO INC	46,000	126,800	2.41
SCHWAB CHARLES INVT MGMT	1,389,700	9,400	0.01
SEARS INVESTMENT MGMT	445,700	19,000	0.04
TOTAL	28,048,851	27,991,044	

Source: Calculated from institutional holdings reported on Form 13-F as compiled by CDA Investment Technologies, Inc.