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One Minute Memo™

Second Circuit Makes it More Difficult For Plaintiffs to Obtain Class Certification in Complex Cases

In a significant decision with potentially wide-ranging implications, on December 5, 2006 the Second Circuit, in *In re Initial Public Offering Securities Litigation*, No. 05-3349, significantly limited the ability of plaintiffs to certify class actions in large, complex cases, such as those involving securities fraud. Although the Second Circuit, answering a "surprisingly unsettled" question, described its decision as a "clarification" of the Court's previous holdings, the decision appears to mark a considerable shift in Second Circuit jurisprudence in favor of defendants.

The underlying action – which was perhaps the largest securities fraud litigation ever filed – arose out of thousands of class action lawsuits filed in 2001 against 55 of the nation's largest underwriters and hundreds of companies and their officers, in connection with a series of Initial Public Offerings (IPOs) conducted during the "stock market bubble" of the late 1990s. The complaints alleged a massive scheme to defraud the investing public in violation of federal securities laws. After consolidating the cases for pretrial purposes, Judge Scheindlin (S.D.N.Y.) chose six of the cases against the underwriter defendants as "focus" cases. She then certified all six classes, holding that the plaintiffs had met their burden of making "some showing" with respect each Rule 23 class certification requirements. The underwriter defendants appealed this ruling to the Second Circuit.

Reversing Judge Sheindlin's decision, the Second Circuit held that plaintiffs must actually establish each Rule 23 requirement – rather than merely making "some showing" of each – before a court will certify a class. Certification is a critical turning point in cases because once a class is certified, the financial risk to defendants often becomes too high to continue to litigate, and defendants have no choice but to settle. For example, emboldened by Judge Scheindlin's certification decision, plaintiffs' counsel indicated that it would settle for no less than $12.5 billion.

The Supreme Court has not directly addressed the issue of the required showing at the class certification stage. Rather, in somewhat conflicting decisions, the Supreme Court has required a "rigorous analysis" of the certification requirements, while cautioning courts to avoid addressing the merits of the underlying action. A majority of Circuits have interpreted this precedent as requiring an actual showing of each Rule 23 class certification requirement, even if that standard may require some inquiry into the merits of the case. For example, the Third, Fourth, Fifth, Seventh, Eighth, and Eleventh Circuits require more than merely "some showing" at the certification stage, and allow district courts to make factual and legal inquiries, even if such inquiries intrude upon the merits of the substantive claims.

Until its recent decision in the IPO cases, the Second Circuit had interpreted the Supreme Court's precedent as being quite restrictive at the class certification stage, and has allowed class certification based on as little as "some showing" of each Rule 23 requirement. The Second Circuit did not allow any inquiry into the merits of the substantive claims. This liberal approach to class certification, however, has now been abandoned in favor a "more extensive inquiry into whether Rule 23 requirements are met." In so doing, plaintiffs seeking class certification in the Second Circuit will now be required to present more of a showing than in the past as to each required element – numerosity, adequacy, commonality, typicality and superiority. Moreover, as to each of these elements, district courts will have more flexibility to evaluate the underlying facts, even if those facts overlap with the merits of the claim.

In addition to reversing a district court decision that had paved the way for potentially one of the largest securities class action settlements in history, the Second Circuit has significantly changed the landscape for class certification in complex securities cases. Given the volume of securities litigation in the Second Circuit, which encompasses the world's largest financial center, the decision promises to add another weapon in the defense bar's arsenal.

If you have any questions regarding the Second Circuit decision, please contact the Seyfarth Shaw attorney with whom you work or any of the Litigation attorneys on our website, www.seyfarth.com

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