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A New Standard For Class Certification

Friday, December 15, 2006 --- Last week, a panel of the United States Court of Appeals for the Second Circuit unanimously overturned a district court order granting class certification in six test cases of the more than three hundred consolidated cases in the In re: Initial Public Offering Securities Litigation, ___ F.3d ___, 2006 WL 3499937 (2d Cir. Dec. 5, 2006).

The business press understandably has emphasized the financial significance of the decision for the parties to the case, who were litigating claims alleged to involve billions of dollars.

But the Second Circuit's IPO decision has far broader legal significance, including in areas having nothing to do with securities litigation. The Second Circuit's decision comprehensively analyzed the class certification requirements of Federal Rule of Civil Procedure 23, clearly articulated a rigorous standard for class certification, and demolished the arguments typically made by plaintiffs in favor of a more lenient standard.

For many years, courts considering motions for class certification have confronted the issue of what showing is necessary to support class certification. Plaintiffs seeking class certification have, not surprisingly, argued that they need to make only the most minimal showing.

In doing so, they have relied on the language in the Supreme Court's 1974 decision in Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974), that a court considering a class certification motion may not "conduct a preliminary inquiry into the merits of a suit."

The district court, relying on this language, as well as language in the Second Circuit's decisions in Caridad v. Metro-North Commuter Railroad, 191 F.3d 283 (2d Cir. 1999), and In re Visa Check/MasterMoney Antitrust Litigation, 280 F.3d 124 (2d Cir. 2001), held that plaintiffs needed only to make "some showing" that they satisfied the requirements for class certification.

Moreover, the district court held that the "some showing" standard could be satisfied even by a controverted expert report, because under Eisen and Visa Check, it was inappropriate for a district court to weigh competing expert reports at the class certification stage. In the district court's view, all plaintiffs had to do at the class certification stage was "articulate a theory . . . that is not fatally flawed."

The Second Circuit rejected the "some showing" standard as inadequate to satisfy the requirements of Rule 23 and expressly disavowed any language

to the contrary in Caridad and Visa Check. 2006 WL 3499937 at *7, *13, *15. The Circuit Court held (id. at *1):

"(1) that a district judge may not certify a class without making a ruling that each Rule 23 requirement is met and that a lesser standard such as "some showing" for satisfying each requirement will not suffice,

"(2) that all of the evidence must be assessed as with any other threshold issues, [and]

"(3) that the fact that a Rule 23 requirement might overlap with an issue on the merits does not avoid the court's obligation to make a ruling as to whether the requirement is met, although such a circumstance might appropriately limit the scope of the court's inquiry at the class certification stage . . .."

Thus, a "district judge is to assess all of the relevant evidence admitted at the class certification stage and determine whether each Rule 23 requirement has been met, just as the judge would resolve a dispute about any other threshold prerequisite for continuing a lawsuit." Id. at *15.

In addition, even though a district judge "must be accorded considerable discretion to limit both discovery and the extent of the hearing on Rule 23 requirements," "the district judge must receive enough evidence, by affidavits, documents, or testimony, to be satisfied that each Rule 23 requirement has been met." Id.

In reaching its decision, the Second Circuit relied upon relevant Supreme Court precedent, decisions of other circuits, and the 2003 amendments to Rule 23. The Circuit Court observed that the "principal Supreme Court decision on determining Rule 23 requirements, General Telephone Co. of the Southwest v. Falcon [457 U.S. 147 (1982)]," had stated that a class action "'may only be certified if the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied.'" 2006 WL 3499937 at *7, quoting Falcon, 457 U.S. at 161 "'Actual, not presumed, conformance with Rule 23 remains . . . indispensable.'" Id. at *7, quoting Falcon, 457 U.S. at 161.

The Circuit Court also noted that the 2003 amendments to Rule 23 eliminated the concept of "provisional class certification" and that the Advisory Committee Notes state that a court that is not satisfied that the Rule 23 requirements have been met should deny class certification. Id. at *13.

The Circuit Court further noted that other circuits, including the Third, Fourth, Fifth, Seventh, Eighth, and Eleventh Circuits, have "generally supported an obligation of the district court to make a determination that the requirements of Rule 23 are met, and [have] not accepted a weak 'some showing' standard." Id. at *12.

The Court also carefully reviewed Eisen, and the circuit court case upon

which it relied, to show that the language quoted from Eisen "had nothing to do with determining the requirements for class certification." Id. at *8.

Rather, that language related to a "collateral issue" of who would bear the cost of class notice. Id. "With Eisen properly understood to preclude consideration of the merits only when a merits issue is unrelated to a Rule 23 requirement, there is no reason to lessen a district court's obligation to make a determination that every Rule 23 requirement is met before certifying a class just because of some or even full overlap of that requirement with a merits issue." Id. at *15.

Finally, the Second Circuit provided some guidance with respect to both the process by which the trial court should make class certification determinations and the impact of such determinations.

First, "[t]o avoid the risk that a rule 23 hearing will extend into a protracted mini-trial of substantial portions of the underlying litigation, a district court must be accorded considerable discretion to limit both discovery and the extent of the hearing on Rule 23 requirements." Id.

Second, "the determination as to a Rule 23 requirement is made only for purposes of class certification and is not binding on the trier of fact." Id. The second point regarding the limited binding effect of the class determination decision is, to some extent, a logical concomitant of the first point regarding the trial court's discretion to impose limits on the fact-finding process through which the class determination is made.

Nonetheless, prudent litigants will want to consider carefully their strategy and development of the record at the class certification stage, to minimize any risk of an adverse finding that may in the future undermine their case on the merits.

The ultimate long-term impact of the Second Circuit's IPO decision remains to be seen. Plaintiffs counsel still have the opportunity to seek rehearing en banc and/or to seek Supreme Court review.

For the present, however, and at a minimum, the decision underscores the obligation of district courts to conduct a rigorous evaluation of motions for class certification and to certify a class only after determining that each of the requirements of Rule 23 has been met.

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