Legal Backgrounder

WLF Washington Legal Foundation

Advocate for freedom and justice®
2009 Massachusetts Avenue, NW
Washington, DC 20036
202.588.0302

Vol. 25 No. 20 May 21, 2010

CURTAILING CLASS ACTION ABUSE: HOW THREE DEVELOPMENTS CONVERGED TO REDUCE THE PRESSURE TO SETTLE

by

Trenton H. Norris and James F. Speyer

One of the rarest occurrences in the law is a class action trial. Some lawyers who specialize in class actions go their entire careers without trying one. This is because the pressure on a defendant company to settle a class action lawsuit that has made it past the pleading stage and the class certification stage is usually overwhelming — regardless of the merits of the underlying claims. When facing a trial involving a certified class, with aggregate damage claims that could seriously hurt or bankrupt the company, most chief executives and boards of directors will decide that settling for a percentage of the claimed damages is a more prudent course of action than betting the company on a favorable jury verdict. Just like some companies were deemed "too big to fail" during the 2008 financial crisis, these cases are, literally, "too big to try" -- except there is no government bailout for the companies forced to defend against them.

As a result, in class actions, the real battle is most often not over the merits of the claims, but whether the plaintiffs will be able to certify a class and thereby provoke a settlement. This battle comes down, in most cases, to whether plaintiffs can advance beyond two checkpoints our legal system has created to filter out lawsuits that are either facially meritless or inappropriate as class actions: the motion to dismiss and the motion for class certification. If a large lawsuit advances beyond the pleading stage, often "the threat of discovery expense will push cost-conscious defendants to settle even anemic cases." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 559 (2007). And if a lawsuit advances beyond the pleading stage *and* is certified as a class action, it may well "create unwarranted pressure to settle nonmeritorious claims." *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 162 (3rd Cir. 2001).

A legal system that forces companies to settle weak or meritless cases for large sums is unjust. It is also inefficient because it requires companies to allocate capital unproductively. That, in turn, puts American businesses at a competitive disadvantage vis-à-vis much of the world.

In recent years, three independent legal developments, from three separate sources, have converged to improve this state of affairs. While far from a perfect fix, these changes in the law have reduced the threat that abusive class action litigation poses for American businesses. This LEGAL BACKGROUNDER examines these changes, as well as current efforts to undo them.

Trenton H. Norris and **James F. Speyer** are partners with Arnold & Porter LLP. **Christopher S. Tarbell**, an associate with the firm, assisted in the preparation of this article.

Congress Diverts Large Class Actions from State Court to Federal Court. Traditionally, federal courts had diversity jurisdiction over a class action only if all of the class representatives were citizens of a different state than all of the defendants, and if the amount in controversy for each named plaintiff (and, in some circuits, each absent class member) exceeded $75,000. These rules resulted in most class actions being heard in state courts. For example, the vast majority of consumer class actions involve individual claims of less than $1,000. And even if the individual claims did exceed $75,000, a plaintiffs' lawyer could avoid removal to federal court simply by naming a defendant who is a citizen of the same state as a named plaintiff.

In 2005, Congress enacted the Class Action Fairness Act (CAFA). CAFA significantly expanded federal diversity jurisdiction over class actions. Under CAFA, federal courts (with some exceptions) now have jurisdiction over class actions so long as *any* class member is a citizen of a state different from *any* defendant, and the *total* amount in controversy exceeds $5 million. Thus, rather than complete diversity, only minimal diversity is now required; and there is no longer any minimum amount-in-controversy threshold that any individual class member must satisfy.

CAFA also loosened the procedural requirements for removal to federal court. Prior to CAFA, all defendants had to consent to removal, and only an out-of-state defendant could initiate removal. Now, *any* defendant can remove, and that defendant does not need to obtain the consent of any of the other defendants.

As one would expect, CAFA has diverted to federal court an enormous number of class actions that otherwise would have been heard in state court. According to a 2008 study by the Federal Judicial Center, the average number of consumer protection/fraud class actions filed in or removed to federal court per month post-CAFA is more than triple the pre-CAFA average.[1] The numbers are similar, although slightly less dramatic, for contracts and property damage class actions. Lee & Willging, at 11-12.

Congress enacted CAFA to remedy what it saw as "class action abuses taking place in state courts."[2] This included the filing of large interstate class actions in "magnet" state courts, which have a reputation of being particularly hospitable to class actions. S. Rep. No. 109-14 at 22-23. Congress found that "some state court judges are less careful than their federal court counterparts about applying the procedural requirements that govern class actions," and that state court judges, with limited staff and enormous caseloads, are often "unable to give class action cases and settlements the attention they need." *Id.* at 14. Congress also saw CAFA as furthering the original purpose of diversity jurisdiction: to "protect citizens in one state from the injustice that might result if they were forced to litigate in out-of-state courts." *Id.* at 7-8. Before CAFA, a plaintiffs' lawyer could, for example, prevent removal of an action against a large out-of-state manufacturer simply by naming as an additional defendant a small local retailer that sold the manufacturer's goods. With its minimal diversity requirement, CAFA eliminates that possibility.

The Supreme Court Tightens Federal Pleading Requirements. For fifty years, federal judges who denied motions to dismiss -- thereby allowing the case to proceed beyond the initial pleading stage -- routinely justified their decisions by invoking the famous statement of the Supreme Court in the 1957 case of *Conley v. Gibson*: a complaint "should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." 355 U.S. 41, 45-46 (1957). Over the years, this "no set of facts" standard was often criticized as too lax. Read literally, as many courts did, it allowed a plaintiff to survive a motion to dismiss -- and begin to impose discovery costs on defendants -- with a collection of purely conclusory allegations, so long as those allegations left open the possibility that the plaintiff might be able to later come up with some set of facts to support his claim.

In 2007, in *Bell Atlantic Corp. v. Twombly*, the Supreme Court "retired" *Conley v. Gibson's* "no set of facts" language. In *Twombly*, the Supreme Court instituted a far more rigorous two-part test to determine whether a complaint adequately states a claim for relief. First, courts are only required to accept as true non-

---

[1]Emery G. Lee III & Thomas E. Willging, Fed. Judicial Ctr., *The Impact of the Class Action Fairness Act of 2005 on the Federal Courts: Fourth Interim Report to the Judicial Conference Advisory Committee of Civil Rules* 12 (2008), *available at* http://www.uscourts.gov/rules/Fourth%20Interim%20Report%20Class%20Action.pdf

[2]S. Rep. No. 109-14, at 27 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 3, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_reports&docid=f:sr014.109.pdf

conclusory allegations of *fact*: "[L]abels and conclusions, and a formulaic recitation of the elements of a cause of action[,] will not do." *Twombly*, 550 U.S. at 555. The *Twombly* Court applied this principle to hold that the bare assertion that defendants entered into a conspiracy to restrain trade was a legal conclusion that would not suffice to advance the case beyond the pleading stage. *See id.* at 556, 564. Second, the well-pleaded factual allegations must "plausibly suggest" entitlement to relief. *Id.* at 557; *see also id.* at 555. Factual allegations that only raise the possibility of, or are merely consistent with, misconduct, do not satisfy this standard. *See id.* at 557-58. The facts must show that the claim is not simply "conceivable," but "plausible." *Id.* at 570. The Court applied this principle to hold that well-pleaded factual allegations of parallel conduct are insufficient to allege an illegal antitrust conspiracy. Parallel conduct, although consistent with a conspiracy, is also consistent with a wide range of competitive business behavior. It therefore does not "plausibly suggest" conspiracy. *See id.* at 556-57, 565-69.

In 2009, the Supreme Court followed up *Twombly* with its decision in *Ashcroft v. Iqbal*, an unlawful discrimination lawsuit brought by a Pakistani citizen against government officials in the wake of the September 11, 2001 attacks. *Iqbal* reinforced -- some say strengthened -- *Twombly's* pleading requirements. Among other things, *Iqbal* advised courts to begin the motion-to-dismiss analysis by carefully separating out conclusory allegations that are not entitled to be assumed true from factual allegations that are so entitled, in order to determine whether the well-pleaded factual allegations alone plausibly suggest wrongdoing. *Ashcroft v. Iqbal*, 556 U.S. __, 129 S. Ct. 1937, 1949-50 (2009). In undertaking this analysis, the Court held that allegations that Attorney General John Ashcroft was the "principal architect" of the discriminatory policy and FBI Director Robert Mueller was "instrumental" in adopting it, as well as the allegation that Ashcroft and Mueller "knew of" and "condoned" the policy, were "conclusory and not entitled to be assumed true." *Id.* at 1951 (internal quotations omitted). Over the dissent of Justice Souter -- who believed that such allegations were not conclusory (and who authored *Twombly*) -- the Court, in a 5-4 decision, held that the complaint did not state a claim. *See id.* at 1954.

Although it is difficult to gauge the precise impact of *Twombly* and *Iqbal*, it is not unreasonable to assume that a fair number of lawsuits that would have survived a motion to dismiss before these rulings will not survive now. Moreover, *Twombly* and *Iqbal* may well discourage plaintiffs' lawyers from filing some lawsuits at all -- an important effect, yet hard to measure.

Circuit Courts of Appeals Tighten Federal Class Certification Standards. In the class certification context, the 1974 Supreme Court case of *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), plays the same role that *Conley v. Gibson* did in the pleading context. That is, for over 30 years federal judges who granted motions for class certification routinely justified their decisions by invoking the famous statement of the Supreme Court in *Eisen*: "We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action." *Id.* at 177.

This language led many courts to apply a lenient standard to certification motions. For example, some courts felt bound to accept as true the allegations of the complaint regarding its appropriateness as a class action -- even if the defendant submitted evidence proving otherwise. *See In re Hydrogen Peroxide Antitrust Litig.* (*In re Hydrogen Peroxide*), 552 F.3d 305, 318 n.18 (3rd Cir. 2008). Some courts held that plaintiffs needed only to make a minimal showing -- variously characterized as "some showing" or a "threshold showing" -- that the requirements for a class action had been met, rather than actually *proving* that they satisfied all of the class action requirements. *See id.* at 321; *In re Initial Pub. Offerings Sec. Litig.* (*In re IPO*), 471 F.3d 24, 32, 35 & n.5 (2nd Cir. 2006), *reh'g denied*, 483 F.3d 70 (2nd Cir. 2007). And some courts credited expert testimony submitted by plaintiffs and refused to consider expert testimony submitted by the defendants on the ground that it was inappropriate to weigh conflicting expert evidence (or indeed any evidence) at the class certification stage. *See In re Hydrogen Peroxide*, 552 F.3d at 322, 325; *see also In re IPO*, 471 F.3d at 31, 35. These courts adopted this permissive standard despite the Supreme Court's instruction in another case that courts should conduct a "rigorous analysis" of whether the proposed class could satisfy the class action requirements of Rule 23. *Gen. Tel. Co. of Southwest v. Falcon*, 457 U.S. 147, 161 (1982).

The trend in federal courts towards more rigorous class certification standards mirrors the trend in pleading requirements, except here it is federal appellate courts that are leading the charge. These courts obviously did not *officially* "retire" the *Eisen* language, in the way the Supreme Court "retired" the *Conley v. Gibson* language. But a number of influential circuit courts have *effectively* retired the *Eisen* language, by holding that this language was never intended to inhibit a thorough examination of whether plaintiffs have satisfied each of the Rule 23 requirements. These courts -- most notably the Second Circuit in *In re IPO* and the Third Circuit in *In re Hydrogen Peroxide* -- noted that the *Eisen* statement "was made in a case in which the district judge's merits inquiry had nothing to do with determining the requirements for class certification" and that, properly understood, the statement does not bar a preliminary inquiry into the merits if such an inquiry is necessary to decide whether each of the class action requirements under Rule 23 has been met. *See In re IPO*, 471 F.3d at 33-34, 41. In other words, "*Eisen* is best understood to preclude only a merits inquiry that is not necessary to determine a Rule 23 requirement." *In re Hydrogen Peroxide*, 552 F.3d at 317.

In re IPO and *In re Hydrogen Peroxide*, along with pioneering cases from other circuits, have ushered in a new era in class certification.[3] Plaintiffs now have to *prove*, by a preponderance of the evidence, that they satisfy all of the Rule 23 requirements, and they can no longer rely on the allegations of their complaints or a perfunctory evidentiary showing. *See In re Hydrogen Peroxide*, 552 F.3d at 307, 320. Courts must now examine *all* of the evidence bearing on certification, including expert testimony and other evidence submitted by defendants. *See id.* at 307, 323-25; *see also In re IPO*, 471 F.3d at 41-42. And, if there are factual disputes, or disputes between the expert witnesses, courts *must* resolve them before deciding whether to certify a class. *See, e.g., In re Hydrogen Peroxide*, 552 F.3d at 323; *In re IPO*, 471 F.3d at 41-42.

The Plaintiffs' Bar Fights Back. The plaintiffs' bar has been creative and forceful in its efforts to circumvent or resist these trends. They have, for example, avoided the "minimal diversity" rule of CAFA by choosing not to sue potential defendants that are not diverse. In one class action brought on behalf of California consumers, plaintiffs alleged a price-fixing conspiracy among the world's largest chocolate manufacturers, but, to remain in state court, they sued only the one chocolate manufacturer that was a California citizen. *See Clark v. Nestlé USA, Inc*., No. CGC-10-496175 (S.F. Super. Ct. Jan. 21, 2010 (filed)). While this ensures a state court forum for the case, it also deprives plaintiffs of potential sources of funding for any settlement or judgment -- thereby indicating just how important it is to at least some plaintiffs' lawyers to avoid federal court.

The plaintiffs' bar has also sought help from Congress. Senator Arlen Specter has introduced a bill that would legislatively overrule *Twombly* and *Iqbal* and reinstate the *Conley v. Gibson* pleading standard. *See* Notice Pleading Restoration Act of 2009, S. 1504, 111th Cong. § 2 (2009). The bill remains in committee, and its prospects for passage are unclear.

Conclusion. CAFA funnels large class actions to federal courts. Once in federal court, *Twombly* and *Iqbal* impose a finer filter at the motion-to-dismiss stage. And if a lawsuit proceeds beyond the pleading stage, *In re IPO* and *In re Hydrogen Peroxide* and their brethren impose stricter standards for class certification. Taken together, these independent developments will operate to limit the number of class actions that proceed to the expensive stage of discovery and that are ultimately certified, thereby relieving at least some of the settlement pressure faced by American businesses. Although the plaintiffs' bar has tried to blunt the impact of these changes, its efforts have -- to date -- been only minimally successful.

Notably, these developments will cull the herd only of its weakest members. A lawsuit based on facts that plausibly suggest wrongdoing will, as always, survive a motion to dismiss. And a class action supported by a factual record showing that it is legitimately appropriate for class treatment will also survive this increased scrutiny. The cases that will not survive are those that are facially meritless or inappropriate for class treatment, and they will be culled out at an earlier stage of the litigation, thus "secur[ing] the just, speedy, and inexpensive determination" of purported class actions. FED. R. CIV. P. 1.

---

[3] *See, e.g., Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007); *Gariety v. Grant Thorton, LLP*, 368 F.3d 356 (4th Cir. 2004); *Szabo v. Bridgeport Machs., Inc.*, 249 F.3d 672 (7th Cir. 2001). And just last month the Ninth Circuit adopted the *In re IPO* approach. *Dukes v. Wal-Mart Stores, Inc.*, __ F.3d __, Nos. 04-16688, 04-16720, 2010 WL 1644259 (9th Cir. Apr. 26, 2010) (en banc).