

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term 2005

Argued: June 6, 2006

Decided: December 5, 2006)

Docket No. 05-3349-cv

In Re: INITIAL PUBLIC OFFERING SECURITIES
LITIGATION

JOHN G. MILES, SASWATA BASU, MICHAEL HUFF, SEAN
ROONEY, KRIKOR KASBARIAN, STATHIS PAPPAS, JAMES
COLLINS, DIANE COLLINS, JOSEPH ZHEN, ZITTO
INVESTMENTS, J. CHRIS ROWE, VASANTHAKUMAR
GANGAIAH, FREDERICK HENDERSON, BARRY LEMBERG,
ANITA BUDICH, SPIROS GIANOS, MARY JANE GIANOS,
and HARALD ZAGODA,
Plaintiffs-Appellees,

v.

MERRILL LYNCH & CO., INC., GOLDMAN, SACHS & CO.,
MERRILL LYNCH, PIERCE, FENNER & SMITH INC.,
CREDIT SUISSE FIRST BOSTON LLC, ROBERTSON STEPHENS,
INC., MORGAN STANLEY & CO., INC., BEAR STEARNS &
CO., INC., THE BEAR STEARNS COMPANIES, INC.,
J.P. MORGAN SECURITIES INC., DEUTSCHE BANK
SECURITIES, INC. (f/k/a Deutsche Banc Alex. Brown,
Inc., DB Alex. Brown LLC, and BT Alex. Brown
Inc.), LEHMAN BROTHERS, INC., SG COWEN SECURITIES,
CORP. (n/k/a SG Cowen & Co., LLC), RBC DAIN
RAUSCHER, INC. (f/k/a Dain Rauscher, Inc.) and
PRUDENTIAL SECURITIES, INC.,
Defendants-Appellants.

Before: NEWMAN, SOTOMAYOR, and HALL, Circuit Judges.

Appeal from the October 13, 2004, order of the United States

District Court for the Southern District of New York (Shira A. Scheindlin, District Judge), granting a motion for class certifications in six focus cases out of 310 consolidated class actions, which themselves were consolidations of thousands of separate class actions alleging securities law violations in connection with initial public offerings.

Vacated and remanded.

Gandolfo V. DiBlasi, New York, N.Y. (John L. Hardiman, Penny Shane, David M.J. Rein, Richard J.L. Lomuscio, Taleah E. Jennings, Sullivan & Cromwell LLP, New York, N.Y., on the brief), for Defendant-Appellant Goldman, Sachs & Co.; Andrew B. Clubok, Richard A. Cordray, Brant W. Bishop, Kirkland & Ellis LLP, Wash., D.C., on the brief, for Defendant-Appellant Morgan Stanley & Co. Inc.; Randy Mastro, Robert Serio, Mark Holton, Gibson, Dunn & Crutcher LLP, New York, N.Y., on the brief, for Defendants-Appellants Bear, Stearns & Co. and The Bear Stearns Companies, Inc.; Robert B. McCaw, Louis R. Cohen, Fraser L. Hunter, Jr., Mark M. Oh, David S. Lesser, Wilmer Cutler Pickering Hale and Dorr LLP, New York, N.Y., on the brief, for Defendant-Appellant Credit Suisse First Boston LLC.; Andrew J. Frackman, Brendan J. Dowd, Matthew J. Merrick, O'Melveny & Myers LLP, New York, N.Y., on the brief, for Defendant-Appellant Robertson Stephens, Inc.; Barry R. Ostrager, David W. Ichel, Joseph M. McLaughlin, Simpson Thacher & Bartlett LLP, on the brief, for Defendant-Appellant J.P. Morgan Securities Inc.; Stephen M.

Shapiro, Timothy S. Bishop, Joshua D. Yount, Mayer, Brown, Rowe & Maw LLP, Chicago, Ill., on the brief for Defendants-Appellants Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith Inc.; Mark Holland, Robert G. Houck, Clifford Chance US LLP, New York, N.Y., on the brief, for Defendants-Appellants Merrill Lynch & Co., Inc. and Merrill Lynch, Pierce, Fenner & Smith Inc.; Moses Silverman, Philip Barber, Paul, Weiss, Rifkind, Wharton & Garrison LLP, New York, on the brief, for Defendant-Appellant Lehman Brothers Inc.; A. Robert Pietrzak, Joel M. Mitnick, Maria D. Meléndez, Sidley Austin Brown & Wood LLP, New York, N.Y., on the brief, for Defendant-Appellant Deutsche Bank Securities Inc. (f/k/a Deutsche Banc Alex. Brown Inc., DB Alex. Brown LLC and BT Alex. Brown Inc.); Jay B. Kasner, Scott D. Musoff, Skadden, Arps, Slate, Meagher & Flom LLP, New York, N.Y., on the brief, for Defendant-Appellant SG Cowen Securities Corp. (n/k/a SG Cowen & Co., LLC); Stewart D. Aaron, Arnold & Porter LLP, New York, N.Y., on the brief, for Defendant-Appellant RBC Dain Rauscher, Inc. (f/k/a Dain Rauscher, Inc.); Stephen L. Ratner, Sarah S. Gold, Proskauer Rose LLP, New York, N.Y., on the brief, for Defendant-Appellant Prudential Securities Inc.

Robert A. Wallner, New York, N.Y. (Melvyn I. Weiss, David A.P. Brower, Ariana J. Tadler, Peter G. Safirstein, Christian P. Siebott, Ann M. Lipton, Milberg Weiss Bershad & Schulman LLP, New York, N.Y.; Stanley D. Bernstein, Robert J. Berg, Rebecca M. Katz, Felecia L. Stern, Danielle Mazzini-Daly, Bernstein Liebhard & Lifshitz, LLP, New York, N.Y.; Richard

S. Schiffrin, David Kessler, Schiffrin & Barroway, LLP, Radnor, Penn.; Daniel W. Krasner, Fred Taylor Isquith, Thomas H. Burt, Wolf Haldenstein Adler Freeman & Herz LLP, New York, N.Y.; Jules Brody, Aaron Brody, Stull Stull & Brody, New York, N.Y.; Howard Sirota, Rachell Sirota, Saul Roffe, Sirota & Sirota LLP, New York, N.Y., on the brief), for Plaintiffs-Appellees.

(Robin S. Conrad, Nat'l Chamber Litigation Center, Wash. D.C.; Gary A. Orseck, Roy T. Englert, Jr., Alan E. Untereiner, Robbins, Russell, Englert, Orseck & Untereiner, Wash., D.C., for amicus curiae Chamber of Commerce of the United States of America in support of Defendants-Appellants.)

(Bernard Sorkin, Scarsdale, N.Y.; Theodore M. Shaw, Jacqueline A. Berrien, Norman J. Chachkin, Robert H. Stroup, NAACP Legal Defense and Educational Fund, Inc., New York, N.Y. for amicus curiae NAACP Legal Defense and Educational Fund, Inc. in support of Plaintiffs-Appellees.)

JON O. NEWMAN, Circuit Judge.

This appeal primarily concerns the issue, surprisingly unsettled in this Circuit, as to what standards govern a district judge in adjudicating a motion for class certification under Rule 23 of the Federal Rules of Civil Procedure. Comprehended within this broad issue are subsidiary issues such as whether a definitive ruling must be made that each Rule 23 requirement has been met or whether only

some showing of a requirement suffices, whether all of the evidence at the class certification stage is to be assessed or whether a class plaintiff's evidence, if not fatally flawed, suffices, and whether the standards for determination of a Rule 23 requirement are lessened when a Rule 23 requirement overlaps with an aspect of the merits of the proposed class action. Finally, the appeal presents the question whether granting a motion for class certification in the pending litigation exceeded the District Court's discretion.

These issues arise on an appeal by Defendants-Appellants Merrill Lynch & Co. and others ("the underwriters") from the October 13, 2004, order of the District Court for the Southern District of New York (Shira A. Scheindlin, District Judge) granting in part Plaintiffs-Appellees' motion for class certification in six securities fraud class actions. The six actions were selected by the District Court as "focus cases" out of 310 consolidated class actions, which themselves were consolidations of thousands of separate class actions. All of the lawsuits, including the six at issue on this appeal, involve claims of fraud on the part of several of the nation's largest underwriters in connection with a series of initial public offerings ("IPOs").

We conclude (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 issue, (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, and (4) that the cases pending on this appeal may not be certified as class actions. We therefore vacate the class certifications and remand for further proceedings.

Background

Throughout 2001, thousands of investors filed class actions against 55 underwriters, 310 issuers, and hundreds of individual officers of the issuing companies, alleging that the Defendants had engaged in a scheme to defraud the investing public in violation of federal securities laws. The Assignment Committee of the Southern District of New York transferred all these suits to Judge Scheindlin for pretrial coordination. Judge Scheindlin consolidated the thousands of cases by issuer, resulting in 310 consolidated actions.

The complaints, as amended, consist of a set of "Master

Allegations" applicable to all 310 consolidated actions and a "Class Action Complaint" specific to each of the 310 issuers. The Master Allegations describe three fraudulent devices used by the underwriters. First, they allege that the underwriters conditioned allocations of shares at the offer price on agreements to purchase shares in the aftermarket (the "Tie-in Agreements"). Second, they allege that the underwriters also required customers who received allocations of shares at the offer price to pay three forms of "Undisclosed Compensation" to the underwriters: (1) paying inflated brokerage commissions, (2) paying commissions on churned transactions in unrelated securities, and (3) purchasing other unwanted securities from the underwriters. Third, the Plaintiffs allege that the underwriters used their analysts in several improper ways: (1) setting unrealistic price targets, (2) promising a "hot" analyst to an issuer in exchange for underwriting the IPO, (3) tying analyst compensation to performance of the investment banking division, (4) allowing analysts to own shares of stocks they were touting, and (5) failing to disclose these conflicts of interest. The Master Allegations also allege that the underwriters facilitated receipt of quick profits by insiders of the issuer and that the issuers (also Defendants) "participated in and benefitted from" the underwriters' misconduct.

The Master Allegations detail the specific activities of each underwriter. These allegations include reports of the tie-in arrangements, undisclosed compensation, and analyst manipulation.

The issuers in the six focus cases involved in the pending appeal are Corvis Corp., Engage Technologies, Inc., FirePond, Inc., iXL Enterprises, Inc., Sycamore Networks, Inc., and VA Software Corp. All six complaints include the following six claims:

* claims under section 11 of the Securities Act, 15 U.S.C. § 77k, against the issuer, individual officers, and underwriters for untrue material statements of fact or material omissions from the registration statement, specifically the tie-in agreements and the undisclosed compensation;

* claims under section 15 of the Securities Act, 15 U.S.C. § 77o, against individual officers for derivative liability for an issuer's violation of section 11;

* claims under section 10(b) of the Securities and Exchange Act of 1934 ("the Exchange Act"), 15 U.S.C. § 78j, and Rule 10b-5, 17 C.F.R. § 240.10b-5, against the underwriters for deceptive and manipulative practices in connection with an IPO, specifically the tie-in agreements and the undisclosed compensation;

* claims under section 10(b) of the Exchange Act and Rule 10b-5

against the underwriters for materially false or misleading or material omissions from the registration statement/prospectus, specifically concealment of the tie-in agreements, undisclosed compensation, and analyst conflicts of interest;

* claims under section 10(b) of the Exchange Act and Rule 10b-5 against issuers and individual officers for materially false or misleading or material omissions, specifically concealment of the underwriters' wrongdoing; and

* claims under section 20(a) of the Exchange Act, 15 U.S.C. § 78t, against individual officers for derivative liability for an issuer's violation of Rule 10b-5.

Two of the complaints, those concerning iXL Enterprises, Inc. and Sycamore Networks, Inc., also included three additional claims related to secondary offerings that occurred with stocks of those issuers:

* claims under section 11 of the Securities Act against the issuer, individual officers, and underwriters for untrue material statements of fact or material omissions from the registration statement for the secondary offering, specifically the tie-in agreements and the undisclosed compensation;

* claims under section 15 of the Securities Act against individual officers for derivative liability for an issuer's violation

of section 11 in connection with the secondary offering; and

* claims under section 10(b) of the Exchange Act and Rule 10b-5 against the underwriters for deceptive and manipulative practices in connection with the secondary offering, specifically the requirement that allocants in the IPO agree to purchase shares in the secondary offering.

Motions to Dismiss. In February 2003, Judge Scheindlin ruled on the Defendants' motions to dismiss. In re IPO Securities Litigation, 241 F. Supp. 2d 281 (S.D.N.Y. 2003). Judge Scheindlin denied the Defendants' motions except with respect to two sets of claims: the section 11 and section 15 claims of Plaintiffs who had sold their shares above the offering price, and some of the Rule 10b-5 claims against issuers and individual officers. Id. at 296-97. Judge Scheindlin granted the Plaintiffs leave to re-plead the latter claims. Id. at 399.

In December 2003, Judge Scheindlin denied the Underwriter Defendants' renewed motion to dismiss. In re IPO Securities Litigation, 297 F. Supp. 2d 668 (S.D.N.Y. 2003). Judge Scheindlin held that the Plaintiffs' allegations of loss causation were sufficient when they alleged that the Defendants had manipulated the market. She also held that it was fair to infer dissipation of the

inflated price over time in a manipulation case, notwithstanding the Second Circuit's intervening decision in Emergent Capital Investment Management, LLC v. Stonepath Group, Inc., 343 F.3d 189 (2d Cir. 2003) (holding that, in a material misstatement or omission securities fraud action, plaintiffs must allege a price correction to adequately plead loss causation). 297 F. Supp. 2d at 674-75.

Class Certification. In October 2004, Judge Scheindlin issued an order granting in part and denying in part the Plaintiffs' motions for class certification in the six focus cases. In re IPO Securities Litigation ("IPO Dist. Ct."), 227 F.R.D. 65 (S.D.N.Y. 2004). For each focus case, Judge Scheindlin defined the class as follows:

The Class consists of all persons and entities that purchased or otherwise acquired the securities of [Specific Issuer] during the Class Period and were damaged thereby. Excluded from the Class are:

(1) Defendants herein, each of their respective parents, subsidiaries, and successors, and each of their respective directors, officers and legal counsel during the Class Period, and each such person's legal representatives, heirs, and assigns, members of each such person's immediate family, and any entity in which such person had a controlling interest during the Class Period;

(2) all persons and entities that, with respect to [Specific Issuer's] initial public offering: (a) received an allocation, (b) placed orders to purchase shares of that issuer's securities in the aftermarket within four weeks of the effective date of the offering, (c) paid any undisclosed compensation to the allocating

underwriter(s), and (d) made a net profit (exclusive of commissions and other transaction costs), realized or unrealized, in connection with all of such person's or entity's combined transactions in [Specific Issuer's] securities during the Class Period; and

(3) all persons and entities who satisfy all of the requirements of subparagraph (2) with respect to any of the 309 initial public offerings that are the subject of these coordinated actions, if that offering occurred prior to [Specific Issuer's] offering.

Id. at 102.

Of particular pertinence to this appeal, Judge Scheindlin explicitly considered the issue of the standard of proof that the Plaintiffs must meet to obtain class certification. She noted that the Supreme Court has been silent on the question of what showing plaintiffs must make in support of their motion for class certification. The only parameters established by the Supreme Court in this regard, she further noted, were that a court must conduct a "rigorous analysis" in which it "may be necessary for the court to probe behind the pleadings," General Telephone Co. of the Southwest v. Falcon, 457 U.S. 147, 160-61 (1982), but the court cannot "conduct a preliminary inquiry into the merits of a suit," Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974). IPO (Dist. Ct.), 227 F.R.D. at 90-91. Judge Scheindlin noted recent decisions by the Fourth and Seventh Circuits that suggested that the plaintiffs must establish the

requirements of Rule 23 by a preponderance of the evidence, even if resolving those issues requires a "preliminary inquiry into the merits," Szabo v. Bridgeport Machines, Inc., 249 F.3d 672, 676 (7th Cir. 2001), or an "overlap with issues on the merits," Gariety v. Grant Thornton, LLP, 368 F.3d 356, 366 (4th Cir. 2004). See IPO (Dist. Ct.), 227 F.R.D. at 91-92.

Judge Scheindlin concluded that applying the preponderance standard was inappropriate where those elements were "enmeshed" with the merits, because, as Eisen cautioned, 417 U.S. at 178, that standard would prejudice a defendant. Instead, she adopted a "some showing" standard, which she derived from this Court's opinions in Caridad v. Metro-North Commuter Railroad, 191 F.3d 283, 292 (2d Cir. 1999), and In re Visa Check/MasterMoney Antitrust Litigation ("Visa Check"), 280 F.3d 124, 134-35 (2d Cir. 2001). Judge Scheindlin concluded:

In order to pass muster, plaintiffs -- who have the burden of proof at class certification -- must make "*some showing*." That showing may take the form of, for example, expert opinions, evidence (by document, affidavit, live testimony, or otherwise), or the uncontested allegations of the complaint.

IPO (Dist. Ct.), 227 F.R.D. at 93.

Judge Scheindlin then analyzed whether, under the "some showing" standard, the Plaintiffs had met the Rule 23 requirements. As to

commonality, she found numerous common factual issues for the class, and noted that, apart from individual calculation of damages, all other individual issues "will arise because of issues *defendants* choose to raise." Id. at 94. Even these issues, she concluded, would have common questions, such as whether a certain publication put the Plaintiffs on inquiry notice of the scheme. As to typicality, Judge Scheindlin dispensed with the Defendants' principal argument--that some class representatives were inappropriate due to their involvement in the scheme--by altering the class definition to exclude such persons. Judge Scheindlin also found that the class representatives would adequately represent the class. Defendants did not contest that the putative classes were so numerous as to render joinder impracticable.

The implied requirement of ascertainability implicated Judge Scheindlin's revised class definition. The Plaintiffs had conceded that any persons who knowingly participated in the market manipulation would be barred from recovery. Viewing three components of the market manipulation scheme as "necessary," Judge Scheindlin created subparagraph (2) of the class definition, quoted above, which excluded Plaintiffs that had (1) received an allocation, (2) purchased additional shares within four weeks of the IPO, (3) paid undisclosed

compensation, and (4) profited with respect to any of the 310 IPOs. The Defendants argued that determining which Plaintiffs had participated "would be a massive undertaking." Judge Scheindlin acknowledged that ascertainment would not be easy, but that the class definition was "objectively determinable," id. at 104, which satisfied the ascertainability criterion.

The Defendants raised four arguments relating to Rule 23(b)(3)'s requirement that common questions predominate over individual ones. First, they argued that individual questions surrounding transaction causation, or reliance, predominated because the fraud-on-the-market presumption of reliance, recognized in Basic Inc. v. Levinson, 485 U.S. 224, 245-47 (1988), could not apply for lack of an efficient market. Judge Scheindlin rejected this argument, ruling that the Plaintiffs had made "some showing" of market efficiency, IPO (Dist. Ct.), 227 F.R.D. at 107, and that knowledge of the Defendants' scheme from publications presented a common question rather than individual ones, id. at 110. Second, the Defendants argued that the Plaintiffs' expert report did not establish loss causation. Judge Scheindlin concluded that weighing the competing expert reports was inappropriate and, citing Visa Check, that the Plaintiffs had "satisfied their burden at this stage to articulate a theory of loss causation that is

not fatally flawed.” Id. at 115. Third, Judge Scheindlin accepted the Plaintiffs’ contention that they could prove damages class-wide by proposing a formula for the measure of damages over time. Id. at 116-17. Fourth, as to the Plaintiffs’ section 11 claims, Judge Scheindlin agreed with the Defendants that once untraceable shares¹ entered the market, the individual questions of whether an investor could trace his shares to the IPO would predominate, and so she ended the class periods with respect to these claims at the time when unregistered shares became tradeable. Id. at 118-19, 120.

Finally, Judge Scheindlin concluded that class adjudication was “clearly superior to any other form of adjudication,” id. at 122, and granted the Plaintiffs’ motion for class certification, subject to the modified definition and the limit on class period for section 11 claims set forth above, id.

Partial Settlement. In February 2005, Judge Scheindlin approved a settlement between the Plaintiff classes and the issuer and the

¹To prevail on a section 11 claim for a misleading registration statement, a plaintiff must be able to “trace” his or her shares to the defective registration statement. See DeMaria v. Andersen, 318 F.3d 170, 178 (2d Cir. 2003). As Judge Scheindlin observed, “Tracing may be established either through proof of a direct chain of title from the original offering to the [plaintiff] . . . or through proof that the [plaintiff] bought her shares in a market containing only shares issued pursuant to the allegedly defective registration statement.” IPO (Dist. Ct.), 227 F.R.D. at 117-18.