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February 23, 2007

LITIGATION ALERT

SECOND CIRCUIT REQUIRES HEIGHTENED STANDARD OF PROOF FOR CLASS CERTIFICATION EVEN IF MERITS ISSUES ARE INVOLVED

In a decision that will make it more difficult to obtain class certification in federal court, the 2nd Circuit recently vacated a district court's grant of class certification. In its December 5, 2006, ruling in *In re IPO Securities Litigation*[1] — six securities fraud suits alleging claims against underwriters, issuers and individual officers involved in initial public offerings of dot-com companies — the 2nd Circuit held that the district court had applied an erroneously low standard of proof by requiring plaintiffs to make only "some showing" that they had satisfied Rule 23's certification requirements. Because the certification issues were "enmeshed" with the merits, the district court had declined to apply the more stringent "preponderance of the evidence" standard to avoid making any determination of the merits.

The 2nd Circuit held that the district court must resolve all factual issues relevant to Rule 23 certification, even if those issues overlap with or are identical to merits issues. Applying this standard, the 2nd Circuit concluded that certification was improper because the litigation was "bristling with individual questions."

BACKGROUND

The U.S. Supreme Court has held that a district court must conduct a "rigorous analysis" to ensure that Rule 23's certification prerequisites have been satisfied.[2] However, in *Eisen v. Carlisle & Jacquelin* (1974),[3] the Court cautioned: "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." The *Eisen* Court observed that a preliminary determination of the merits during class certification may prejudice a defendant by coloring the subsequent proceedings. These statements have caused some courts to be wary of resolving factual issues related to class certification when they overlap with merits issues. The result: courts simply accepted allegations on such "overlap" issues as true or applied relaxed standards of proof, such as the district court's "some showing" standard. This made it relatively easy to certify class actions.

[1] 471 F.3d 24 (2d Cir. 2006).
[2] *General Telephone Co. of the Southwest v. Falcon*, 457 U.S. 147, 161 (1982).
[3] 417 U.S. 156 (1974).

In *In re IPO Securities Litigation*, the 2nd Circuit explained that these courts had misread *Eisen* because *Eisen* precluded consideration of the merits only when the merits issue is unrelated to a Rule 23 certification requirement. Therefore, the 2nd Circuit held, the district court could not abdicate its duty to conduct a "rigorous analysis" of certification merely because of an "overlap" between a certification issue and a merits issue. The 4th and 7th Circuits have similarly required a rigorous assessment of "overlap" issues at the class certification stage.[4]

The 2nd Circuit emphasized that its holding would not prejudice defendants because the trial court's preliminary determination of any "overlap" issues would not be binding on the trier of facts and analogized class certification findings to factual determinations involving preliminary injunctions, which do not bind the ultimate factfinder. Further, the 2nd Circuit highlighted the district court's discretion to limit the scope of discovery and the extent of any hearing to avoid turning a class certification motion into a mini-trial on the merits.

CONCLUSION

Although the 2nd Circuit issued its ruling in the context of a securities fraud class action, its holding is applicable to class actions generally. By requiring plaintiffs to prove each class certification requirement by a preponderance of the evidence, the 2nd Circuit's decision will make it more difficult to obtain class certification in federal court.

CONTACT INFORMATION

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[4] *Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004); *Szabo v. Bridgeport Machines, Inc.*, 249 F.3d 672 (7th Cir. 2001).