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RECENT CHALLENGES TO CLASS CERTIFICATION IN SECURITIES FRAUD CLASS ACTIONS

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INTRODUCTION

In recent years, defendants in federal securities fraud class actions have shifted their focus to new challenges at the class certification stage. One creative argument to emerge from the defense bar is premised on the doctrine of standing, namely whether the owners of "artificial shares" (created in the context of short sale transactions) constitute "purchasers" for purposes of the federal securities laws. This argument was advanced in In re Polymedica Corp. Sec. Litig., 224 F.R.D. 27 (D. Mass. 2004), appeal docketed, No. 05-1220 (1st Cir. Feb. 15, 2005), and most recently in In re Reliant Sec. Litig., No. 02-1810, slip op. (S.D. Tex. Feb. 23, 2005), both of which are reviewed and critiqued in this article. While in Polymedica and Reliant, the district courts ultimately dismissed the defendants' "artificial shares" arguments and certified the classes, the viability of this argument remains alive, given that the U.S. Court of Appeals for the First Circuit agreed to hear oral argument on May 4, 2005 in In re Polymedica Corp. Sec. Litig. Similarly, defendants in In re Reliant have filed a petition for leave of appeal under the Federal Rule of Civil Procedure 23(f).

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Another novel argument at the class certification stage involves a challenge made to "market efficiency," primarily arising out of the market bubble of the 1990's. This argument was argued and refuted in In re Xcelera.com Sec. Litig., No. 00-CV-11649, slip op. (D. Mass. Sept. 30, 2004), but remains subject to additional review on appeal to the U.S. Court of Appeals for the First Circuit. In re Xcelera.com Sec. Litig., appeal docketed, No. 04-8022 (1st Cir. Feb. 15, 2005).

I. Unsuccessful Challenges to Class Certification Based Upon an "Artificial Shares" Argument

In In re Polymedica Corp. Sec. Litig., 224 F.R.D. 27 (D. Mass. 2004), defendants challenged class certification by arguing that certain class members lacked standing as a result of "artificial shares" in the market which were created by short-sale transactions. Id. In a short-sale transaction, "(1) a short seller borrows stock and sells it to an investor; and (2) the short seller purchases stock to return the stock she borrowed (she "covers" her short)." Id. at 44. As advanced by defendants, "[t]he effect of the short sale 'borrowing' transaction is the creation of an 'artificial' share. As a result of the lending transaction, there are more punitive owners of the stock than actual shares issued and outstanding." Defendants Polymedica Corporation and Liberty Medical Supply Inc.'s Opposition to Lead Plaintiffs' Motion for Class Certification at 18, In re Polymedica Corp., 224 F.R.D. 27 (D Mass. 2004) (No. Civ. A 00-12426-REK). Accordingly, the Polymedica defendants maintained that "it is the brokerage firm customer (the shareholder whose stock was "lent") who has the 'artificial share,' by virtue of the fact that she has lost certain rights in the stock." In re Polymedica Corp., 224 F.R.D. at 45. "As a result, [defendants] contend, those proposed class members who had 'artificial shares' will need

to be distinguished from those who did not. [Thereby] creat[ing] overwhelming individualized questions" precluding class certification. Id.

The Polymedica court, in defining the scope of standing in federal securities class actions, noted that "[s]tanding in a securities fraud case such as this one is limited simply to 'purchasers or sellers of securities.'" Id. (quoting In re Oxford Health Plans, Inc. Secs. Litig., 199 F.R.D. 119, 122 (S.D.N.Y. 2001)). The Polymedica court concluded that defendants' argument regarding artificial shares was "wholly without merit," stating that "[t]hose proposed class members who had 'artificial shares' were nevertheless purchasers in the strictest sense of the word. They are not, in any way, the 'bystanders' that should be excluded from bringing suit." Id. at 45 (citing Haber v. Kobrin, No. 82 Civ. 3715, 1983 WL 1332, at *3 (S.D.N.Y. June 3, 1983)). Further dismissing defendants' "ownership" argument and concluding that no separation of the proposed class members was necessary, the court stated, "[s]tanding in a securities fraud case is not contingent on the rights a person has in a security." In re Polymedica Corp., 224 F.R.D. at 45.

The Polymedica defendants petitioned for leave to appeal under the Federal Rules of Civil Procedure 23(f) and the First Circuit agreed to consider: (1) did the district court err in crafting a novel, unrecognized test for market efficiency under the fraud-on-the-market doctrine articulated by Basic Inc. v. Levinson, 485 U.S. 224 (1988); and (2) did the district court err by certifying a class based on the mere hope and expectation that a plan could be developed to ascertain class membership, rather than requiring plaintiff to propose a reasonable plan as a prerequisite to certification. Polymedica (D. Mass.) (Def.'s Pet., Docket No. 04-8019 at 3-4).

Another recent case evaluating the "artificial shares" argument is In re Reliant Sec. Litig., No. 02-1810 (S.D. Tex. Feb. 23, 2005). This litigation resulted from defendants' false reporting of at least $7.9 billion in revenue over a three-year period, which made Reliant Energy and Reliant Resources (collectively "Reliant") appear to be far more successful than they were. In re Reliant Sec. Litig., No. 02-1810, slip op. at 3 (S.D. Tex. Feb. 23, 2005). Plaintiffs brought suit against the Reliant defendants and the underwriters of Reliant Resources' April 30, 2001 initial public offering (the "IPO") alleging violations of Sections 11 and 15 of the 1933 Act. Id. All of these claims were based upon alleged misrepresentations or omissions relating to so called "round-trip" energy trades, whereby Reliant simultaneously bought and sold electricity and natural gas from other energy traders in the same amount and for the same price. Id. at 2-3. Upon public disclosure that Reliant engaged in "round-trip" energy trading and disclosing that it had inflated its revenues, Reliant's share price plummeted. In re Reliant Sec. Litig., No. 02-1810 (S.D. Tex.) (Pl.'s Memo., Docket 108, at 4); *See also* Memorandum and Order Certifying Class, Docket No. 143, at 3 (S.D. Tex. Feb. 23, 2005).

In In re Reliant Sec. Litig., defendants' challenge to class certification mimicked the "artificial shares" argument forwarded by defendants in In re Polymedica Corp., 224 F.R.D. 27 (D. Mass. 2004). The Reliant defendants premised their "artificial share" argument on the proposition that "[w]hen one investor lends a share that another investor later purchases from a short seller, both of these persons, the lender and the subsequent investor, cannot 'own' the same share at the same time." In re Reliant Sec. Litig., No. 02-1810 (S.D. Tex. Feb. 23, 2005) (Memorandum and Order Certifying Class, Docket No. 143, at 18). Defendants argued that given the shortcomings of the current trading

regime, as it pertains to the holding and documentation of securities' ownership, "it is impossible to resolve the conflict arising between the two by determining which of the two investors holds a real – as opposed to an artificial – share." Id. at 19; In re Reliant Sec. Litig., No. 02-1810 (S.D. Tex.) (Def.'s Opp., Docket No. 113, at 10). Defendants further argued, "because Plaintiffs cannot show that these class members' claims are based upon the ownership of *real* (rather than artificial) shares, they cannot prove that they hold 'securities,' as that term is defined in the Securities Act of 1933." In re Reliant Sec. Litig., No. 02-1810 (S.D. Tex. Feb. 23, 2005) (Memorandum and Order Certifying Class, Docket 143, at 20); (Def.'s Opp., Docket No. 113, at 13) (emphasis added). Consequently, distinguishing owners of "artificial shares" from other members of the class would create "overwhelming individualized questions" making treatment as a class action inappropriate. Id. (Memorandum and Order Certifying Class, Docket No. 143, at 20).

Premising its decision to grant Plaintiffs' Motion For Class Certification, in large part, on "one of the Federal judiciary's luminaries, Senior United States District Judge Robert E. Keeton, in In re Polymedica Corp.," the Reliant court chiseled away at defendants' "ownership" argument explaining that "the Supreme Court has noted that the statutory definition of 'security' was intended to 'encompass virtually any instrument that might be sold as an investment,' and that the securities laws were designed to 'regulate investments, in whatever form they are made and by whatever name they are called.'" In re Reliant Sec. Litig., No. 02-1810, slip op. at 20, 22 (S.D. Tex. Feb. 23, 2005) (Memorandum and Order Certifying Class, Docket No. 143, at 20) (quoting Reves v. Ernst & Young, 494 U.S. 56, 61 (1990)). The Reliant court was not persuaded by

defendants' argument that "the original purchaser who lawfully 'acquir[ed] such security,' see Section 11, as now bereft of 'real' shares and left only with 'artificial shares,' untraceable to the registration statement." Id. (Memorandum and Order Certifying Class, Docket No. 143, at 22-23). Rather, the Court explained, "[t]his is not what the statute provides and no court has so held. It is the fact that one was a *purchaser* of the security that gives him standing under Section 11." Id. at 23 (emphasis added) (citing In re Polymedica Corp., 224 F.R.D. at 45).

With regard to defendants' argument concerning the colossal effort required to identify those who held "real" shares of the security, as opposed to "artificial shares," the court noted, "[s]hort sales of securities have been made throughout these 30 years or so and, as defendants' counsel conceded in oral argument, defendants anticipated an after market following their registration … [and] [t]here is nothing about the short sales in Reliant Resources shares that has been shown to raise major individual issues that would predominate over issues common to the class." In re Reliant Sec. Litig., No. 02-1810, slip op. at 23 (S.D. Tex. Feb. 23, 2005). In conclusion, the Reliant court stated, "[i]n sum, the court is not persuaded by Defendants' theory that real purchasers of real shares traceable to the registration statement are unwittingly rendered mere holders of artificial shares for which they have no recourse under the Securities Act, and that sorting out those who are holders of 'artificial shares' will raise individual questions that predominate over the major common issues in this case." Id. at 23-24. Plaintiffs' motion for class certification was granted.

II. Challenges to Class Certification Based Upon a "Market Inefficiency" Argument

Another challenge to class certification advanced by defendants is that the market within which a company's stock trades is not an efficient market and therefore class certification is inappropriate. For example, in In re Xcelera.com Sec. Litig., No. 00-CV-11649, slip op. (D. Mass. Sept. 30, 2004) a securities class action alleging violations of Sections 10(b) and 20(a) of the Exchange Act and SEC Rule 10b-5, the alleged violations pertained to a 50%-50% joint venture agreement between Xcelera and Kahanberget Holding Ltd. and its subsidiary, JAM Investments Ltd. ("Kahnberget/JAM"), to acquire equal shares in Mirror Image Internet through a Private Placement Agreement. Id. at 1-2. In early April 1999, defendants announced through a press release that Xcelera had acquired a majority position in Mirror Image Internet, but failed to disclose the contribution of Kahnberget/JAM. Id. By failing to disclose Kahnberget/JAM's capital contribution, plaintiffs argue that Xcelera's share price during the class period was inflated. Id. It was not until August 9, 2000, when defendants publicly disclosed their liability to Kahnberget/JAM, that the dilution of Xcelera common stock became known, causing it to fall from $14 per share on August 8 to $11.75 per share the following day. Id.

In challenging class certification, the Xcelera defendants argued "in essence, that Xcelera was trading in a bubble that rivaled the Dutch tulip mania of the 1630s" (Id. at 4) and that "[b]ecause plaintiffs allege that defendants perpetuated a 'fraud on the market,' the lack of an efficient market would negate any presumption of reliance that would satisfy the 'commonality' and 'typicality' requirements of Federal Rule of Civil

Procedure 23(a)(2) & (3) as well as the requirement of Rule 23(b)(3) that 'questions of law or fact common to the members of the class predominate over any questions affecting only individual members.'" Id. at 2 (citing Basic, Inc. v. Levinson, 485 U.S. 224, 247 (1988)). With regard to the appropriate standard of review, defendants "urge[d] a 'close look' and 'rigorous analysis' of market efficiency," In re Xcelera.com Sec. Litig., No. 00-CV-11649, slip op. at 4 (D. Mass. Sept. 30, 2004) (citing Gariety v. Grant Thornton, LLP, 368 F.3d 356, 365 (4th Cir. 2004), to which plaintiffs responded that "[c]lass certification is not an appropriate stage at which to begin to address the merits of the lawsuit." In re Xcelera.com Sec. Litig., No. 00-CV-11649, slip op. at 4 (D. Mass. Sept. 30, 2004) (quoting Priest v. Zayre Corp., 118 F.R.D. 552, 554 (D. Mass. 1988).

Following a two-day evidentiary hearing on the issue of market efficiency, the court evaluated the factual assertions of defendants' and plaintiffs' experts using the reasoning laid out in Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989). Judge Zobel concluded that regardless of which standard the court applied – ignoring the merits or taking a close look at the merits – "the result would be the same," thereby entitling plaintiffs to the presumption of reliance. In re Xcelera.com Sec. Litig., No. 00-CV-11649, slip op. at 5 (D. Mass. Sept. 30, 2004).

Cammer set forth five factors that could give rise to an inference of an efficient market: (1) the stocks trading volume; (2) the number of analysts following and reporting on the stock; (3) the existence of market makers and arbitrageurs who could react quickly to company news; (4) eligibility to file an S-3 Registration statement; and (5) empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in stock price. Cammer, 711 F.

Supp. at 1286-1287. In concluding that an efficient market for the stock existed, Judge Zobel stated, "I credit plaintiff's expert analysis that the stock's trading volume was high; Xcelera received the attention of press and analysts as well as the participation of sophisticated investors; there were no undue limits to arbitrage, and that the stock price did respond to information." In re Xcelera.com Sec. Litig., No. 00-CV-11649, slip op. at 5 (D. Mass. Sept. 30, 2004).

The U.S. Court of Appeals for the First Circuit granted defendants' petition for leave to appeal under Federal Rule of Civil Procedure 23(f) and scheduled May 4, 2005 for oral argument. In granting the petition, the First Circuit agreed to consider two questions: "(1) Did the district court err in adopting a definition of market efficiency that excludes the requirement that the stock price accurately or rationally reflect all publicly available information; and (2) Did the district court err in applying certain factors from the analysis in Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989) to determine market efficiency?" In re Xcelera.com Sec. Litig., No. 00-CV-11649 (Def.'s Pet., Docket No. 04-8022 at 3-4).

IV. Conclusion

Defense counsel have unearthed an arsenal of new and creative arguments to defeat class certification in federal securities fraud class actions, two of which have been highlighted above. Although such novel arguments against class certification have been rejected at the district court level, uncertainty remains given the pendency of such issues before two separate courts of appeal. In any event, the trend indicates a new focus for defendants in addressing class actions.