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Outside Counsel

MUST RELIANCE BE PROVEN TO CERTIFY A CLASS?

By **Vincent R. Cappucci**

THE Private Securities Litigation Reform Act of 1995 [FN1], and particularly its provisions providing a safe harbor for forward looking statements, limitations on damages and the virtual elimination of joint and several liability, was intended by Congress to reduce the number of fraud cases filed under the federal securities laws.

President Clinton's concern that the Reform Act would prevent plaintiffs with meritorious claims from having their day in court prompted him to veto the bill. However, the Reform Act became effective on Dec. 22, 1995, when Congress voted to override the veto.

Since that time, there has been a dramatic increase in the number of common law fraud claims filed in state courts, [FN2] cases which prior to the passage of the Reform Act, would more likely have been venued in a federal forum.

For instance, more than 20 securities fraud cases have been filed this year in California state courts alone, a 500 percent increase from previous years. [FN3] The New York state courts, however, remain an unemployed forum for these claims although it is expected that plaintiffs' counsel will consider the state court alternative as a solution to the onerous provisions of the Reform Act.

Another potential aftermath of the Reform Act will be an increase in the amount of common law fraud claims filed in federal court in lieu of federal securities claims, assuming that an independent basis of federal jurisdiction, such as diversity of citizenship, exists.

As a result of plaintiffs jockeying to assert the state law claims, New York state and federal courts will be asked to certify common law securities fraud claims to proceed on a class basis.

Although common law fraud claims, at least under New York law, are substantively similar to claims under §10(b) of the Securities Exchange Act of 1934 and Rule 10b-

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5 promulgated thereunder, the differences between the two claims in the manner and timing in which a plaintiff is required to prove reliance - an element of both claims - raises issues as to whether both claims are equally suitable for class action treatment.

Both Fed. R. Civ. P. 23 (a)(2) and (B)(1)(3) and CPLR §901 require that questions relating to individual class members not predominate over common questions of law or fact. Considering that putative members in class actions often consist of many thousands of individuals, it is not hard to imagine that individual questions of reliance could predominate over questions that are common to the class.

The possibility of this occurring in a Rule 10b-5 case, however, was virtually eliminated by the U.S. Supreme Court in Basic Inc. v. Levinson [FN4] when it endorsed the "fraud on the market" theory.

The theory is founded on the premise that the price of a company's stock, if traded in an open and efficient market, is determined by all available material information about the company.

Because any public misrepresentation about an issuer would necessarily be reflected in the price of the stock, as long as a plaintiff relied on the integrity of the market, or the price of the security, it is not necessary that he prove that he directly relied on the alleged misrepresentation. [FN5]

The fraud on the market theory affords plaintiffs a presumption of reliance which is rebuttable by defendants only on a showing that "severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price." [FN6]

Because of the difficulties inherent in rebutting the presumption, individual issues of reliance do not defeat class certification in most federal securities fraud cases.

Because the issue of reliance in motions to certify Rule 10b-5 class actions is so easily disposed of with the assistance of the fraud on the market theory, one might assume that without the benefit of the theory, class certification would be denied.

This argument has been advanced by defendants numerous times in the context of common law fraud claims because, to date, no state has extended the fraud on the market doctrine to common law fraud claims.

In fact, following a 1993 decision by the California Supreme Court expressly rejecting the application of the theory to common law fraud claims, [FN7] many believed that the availability of class action treatment for such claims would be limited substantially, if not eliminated altogether. [FN8] That has not proven to be the case in New York.

'Cheyenne Software'

A recent decision in the Eastern District of New York, In re Cheyenne Software,

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Inc. Sec. Litig., [FN9] illustrates how the New York courts appear to welcome the state law fraud claim.

Defendants in that case opposed class certification by arguing that the fraud on the market theory was inapplicable to plaintiffs' common law fraud claim and, consequently, plaintiffs were required to prove individual reliance.

Judge Allyne R. Ross disposed of defendants' argument, acknowledging a "longstanding rule adhered to in this Circuit permitting class certification of common law fraud claims in circumstances presented here [i.e., allegations that an issuer misrepresented its financial outlook resulting in an inflated stock price,] notwithstanding potential issues of individualized reliance." [FN10]

Judge Ross proceeded to certify the common law class claims, holding that even "assuming, without deciding, that individual reliance must be demonstrated for plaintiffs to succeed on a common law fraud claim, common questions, such as the existence and materiality of defendants' alleged misrepresentations, predominate and are common to the class." [FN11]

The longstanding rule referred to in Cheyenne was first enunciated by the Second Circuit in Green v. Wolf Corp. [FN12] 20 years prior to the Supreme Court's adoption of the fraud on the market theory in Basic v. Levinson.

Defendants in Green v. Wolf attempted to persuade the court that each person injured in a Rule 10b-5 case "must show that he personally relied on the misrepresentations in order to recover" and that "any common issues of misrepresentations do not predominate over the individual questions of reliance." [FN13]

The Second Circuit rejected this argument noting that, "[c]arried to its logical end, it would negate any attempted class action under Rule 10b-5, since ... reliance is an issue lurking in every 10b-5 action." [FN14] The court concluded that it saw "no sound reason why the trial court, if it determines individual reliance is an essential element of proof, cannot order separate trials on that particular issue, as on the question of damages, if necessary." [FN15]

New York Courts

Since Green v. Wolf was decided in 1968, federal and state courts in New York have routinely certified common law fraud claims as class actions, concluding that individual issues of reliance can be dealt with at a later stage. [FN16]

This reasoning bears a striking resemblance to the rebuttable presumption afforded plaintiffs under the fraud on the market theory in Rule 10b-5 litigation. In fact, without explicitly adopting the fraud on the market theory, New York courts have long recognized the existence of a presumption of reliance for common law fraud claims at the class certification stage.

The First Department in Weinberg v. Hertz Corp [FN17] was the first state court to speak in terms of a presumption, holding that "once it has been determined that the

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[mis]representations alleged are material and actionable, thus warranting certification, the issue of reliance may be presumed subject to proof as is required on the trial." [FN18]

Federal courts in New York have followed the First Department's lead in holding that "reliance may be presumed for purposes of class certification subject to such proof as is required on the trial." [FN19] Moreover, at least two cases in the Southern District have recognized that the presumption of reliance carries through the summary judgment stage as long as plaintiffs "come forward with clear and convincing evidence that at least one plaintiff relied on defendant's allegedly misleading statements." [FN20]

Thus, despite the fact that each member of a putative common law fraud class may be required to prove individualized reliance at some point in the litigation, New York plaintiffs should not hesitate to bring common law fraud cases as class actions. The cases should be certified and, assuming there is proof that at least one plaintiff directly relied on defendants' misrepresentation, summary judgment against the plaintiff class would not be easily awarded, at least on the issue of reliance.

Of course, absent New York's adoption of the fraud on the market theory for common law fraud claims, plaintiffs will ultimately be required to prove reliance before a judgment can be granted.

The manner and procedure in which individual reliance questions would be proven has not yet been articulated by our courts. Although most of the cases certifying classes of common law fraud claims state that "individual issues of plaintiffs' reliance can be adjudicated through the use of subclasses and separate trials if necessary," [FN21] there is no authority which gives satisfactory guidance on this issue.

Judicial economy obviously militates against requiring each class member to prove individual reliance in a separate trial. A preferred method would be to employ subclasses similar to those used in federal litigation and as permitted by CPLR §906(2), [FN22] so that reliance can be litigated for groups of class members who purchased or sold a security under similar circumstances (i.e., people who decided to buy a security after reading certain disclosures about the issuer in a widely disseminated publication). Issues of reliance by such subclasses would proceed during a second phase of a bifurcated trial.

Bifurcated trials and the isolation of separate issues for class action treatment follow the legislative intent of CPLR §906 which, in part, provides that when appropriate, "an action may be brought or maintained as a class action with respect to particular issues." The availability of birfurcation reinforces the prudence of extending the reliance presumption afforded common law fraud claims at the class certification stage, through trial. Indeed we await further jurisprudence as the New York courts adjudicate more common law fraud class claims brought under state law as a result of the federal securities law reform.

FN1. Pub. L. No. 104-67, 109 Stat. 737 (Dec. 22, 1995) (Reform Act).

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FN2. See e.g., Mike France, "Bye, Fraud Suits, Hello, Fraud Suits," Bus. Wk., Jun. 24, 1996, at 127-28.

FN3. Id.

FN4. 485 U.S. 224 (1988).

FN5. Banque Arabe et Int'l D'Investissement v. Maryland Nat'l Bank, 850 F. Supp. 1199, 1220-22 (S.D.N.Y. 1994), aff'd, 57 F.3d 146 (2d Cir. 1995) (citing Basic).

FN6. Basic v. Levinson, 485 U.S. at 248.

FN7. Mirkin v. Wasserman, 858 P.2d 568 (1993).

FN8. See e.g., Dennis J. Block and Jonathan M. Hoff, Proving Reliance in Common Law Fraud Cases, N.Y.L.J., Oct. 21, 1993 at 5 (col. 1).

FN9. 94-CV-2771 (ARR) (E.D.N.Y. Apr. 16, 1996).

FN10. Id. Order at 12.

FN11. Id.

FN12. 406 F.2d 291 (2d Cir. 1968).

FN13. 406 F.2d at 301.

FN14. Id.

FN15. Id.

FN16. See e.g., In re College Bound Consol. Litig., No. 93 Civ. 2348, 1994 WL 236163 at *3 (S.D.N.Y. May 31, 1994); Werner v. Satterlee, Stephens, Burke & Burke, 797 F. Supp. 1196, 1216 (S.D.N.Y. 1992); In re Crazy Eddie Sec. Litig, 135 F.R.D. 39, 41 (E.D.N.Y. 1991); In re Energy Systems Equip. Leasing Sec. Litig., 642 F. Supp. 718, 752 (E.D.N.Y. 1986); In re Saxon Sec. Litig., No. 82 Civ. 3103, 1984 WL 2399 at *4 (S.D.N.Y. Feb. 23, 1984); Pruitt v. Rockefeller Center Prop., Inc., 167 A.D.2d 14, 574, NYS2d 672, 676 (1st Dept. 1991); Weinberg v. Hertz Corp., 116 A.D.2d 1, 499 NYS2d 693, 696 (1st Dept. 1986), aff'd, 69 NY2d 979 (1987); Stellema v. Vantage Press, Inc., 109 A.D.2d 423, 492, NYS2d 390, 393 (1st Dept. 1985); Brandon v. Chefetz, 106 A.D.2d 162, 485, NYS2d 55, 59 (1st Dept. 1985). But see Katz v. NVF Co., 100 A.D.2d 470, 473 NYS2d 786, 789 (1st Dept. 1984).

FN17. 116 A.D.2d 1, 499 NYS2d 693, 696 (1st Dept. 1986), aff'd, 69 NY2d 979 (1987).

FN18. 499 NYS2d at 696.

FN19. Cheyenne, Order at 11 (citing In re Crazy Eddie Sec. Litig., 802 F. Supp. 804, 812 (E.D.N.Y. 1992).

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FN20. Kenavan v. Empire Blue Cross and Blue Shield, No. 91 Civ. 2393, 1993 WL 128012 at *4 (S.D.N.Y. Apr. 19, 1993); Crazy Eddie, 802 F. Supp. at 812.

FN21. See e.g., In re Crazy Eddie Sec. Litig., 135 F.R.D. 39, 41 (E.D.N.Y. 1991).

FN22. CPLR §906(2) provides that "a class may be divided into subclasses and each subclass treated as a class."

Vincent R. Cappucci is a member of Bernstein Litowitz Berger & Grossmann LLP. Lisa K. Buckser, an associate with the firm, assisted in the preparation of this article.

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