SECOND CIRCUIT ISSUES RULING WITH MAJOR IMPLICATIONS ON SCOPE OF SECURITIES CLASS ACTIONS

The Second Circuit recently issued an important ruling, *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 2009 WL 2169197 (July 22, 2009), imposing additional limitations on the scope of securities class actions at the class certification stage. Addressing an issue of first impression at the appellate level in the aftermath of the Supreme Court's decision in *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005), the Second Circuit excluded in-and-out traders — those who sold their shares before the end of the class period — from the certified class because plaintiffs had failed to demonstrate loss causation (one of the required elements of a section 10(b) claim) by a preponderance of the evidence. The Second Circuit has thus reaffirmed both its broad authority to closely scrutinize a district court's class certification decision and the heavy burden on plaintiffs in securities class actions to introduce substantial evidence at the class certification stage.

Factual Background and the District Court's Decision

The litigation stemmed from a February 2000 initial public offering by Flag Telecom Holdings, Ltd. ("FLAG" or the "Company"), a broadband capacity provider. Plaintiffs alleged that the registration statement for FLAG's IPO contained a misstatement concerning the amount of broadband capacity that FLAG had "pre-sold" at the time of the IPO. Plaintiffs also claimed that, following the IPO, FLAG's public filings included a number of misrepresentations and omissions that painted a falsely optimistic view of the Company's prospects and the demand for its products. Plaintiffs alleged that the fraud was revealed to the market on February 13, 2002 when FLAG disclosed that 14% of the Company's revenues for the year ending December 31, 2001 resulted from "reciprocal transactions," or "swaps of telecommunications capacity between competitors." The district court noted that although such transactions may be entered into for legitimate reasons, they could also be used to defraud investors by creating "the impression that the company is selling capacity when it is merely unloading useless dark fiber on one of its networks in exchange for useless dark fiber on a competitor's network." After the February 13, 2002 disclosure, FLAG's stock price dropped only 37 cents.

Shareholders brought suit under both the Securities Act of 1933 and the Securities Exchange Act of 1934. Plaintiffs sought to have a class certified that included all persons or entities who purchased or otherwise acquired FLAG securities between February 16, 2000 and February 13, 2002, as well as all purchasers of FLAG common stock traceable to the Company's IPO on February 16, 2000. In opposing class certification, defendants argued, among other things, that in-and-out traders — investors that sold their shares before the February 13, 2002 corrective disclosure that, according to the Complaint, revealed the truth of defendants' fraud to the market — should be excluded from the class. Plaintiffs responded that in-and-out traders should remain in the class because some information regarding FLAG's alleged misrepresentations had "leaked" into the market prior to February 13, 2002 and that the disclosure of the leaked information resulted in a significantly larger stock price drop than the post-February 13 decline of 37 cents.

On September 5, 2007, the district court entered an order certifying a single class consisting of 1) purchasers of common stock traceable to FLAG's IPO that asserted claims under the '33 Act based on the allegedly misleading registration statement; and 2) investors that purchased FLAG common stock between March 6, 2000 and February 13, 2002 asserting certain claims (including under section 10(b) of the '34 Act) based on allegedly misleading statements made after the IPO regarding, among other things, the "reciprocal transactions." The district court included "in-and-out traders" within the second category, finding that it was "conceivable" that those investors could prove loss causation. In fact, the investor selected to represent the class (who is obligated under Rule 23(a) to be an adequate and typical representative for the class) was himself an in-and-out trader.

Defendants sought leave to appeal the district court's decision granting class certification under Rule 23(f), which provides federal appellate courts with the discretionary authority to review a class certification decision immediately. The Second Circuit granted the Rule 23(f) request, thereby allowing defendants to appeal the lower court's decision.

The Second Circuit's Decision

Before addressing the central question of whether in-and-out traders could properly be included in the certified class, the Second Circuit noted that defendants' argument with respect to in-and-out traders implicated both the typicality and the adequacy of representation requirements of Rule 23(a) and, more generally, the court's authority to define the class and the class claims, issues, or defenses pursuant to Rule 23(c)(1)(B). Given that the putative class representative himself was an in-and-out trader, the district court was thus required under Rule 23(a) to find "that he is both an adequate and typical representative of the class and not subject to any 'unique defenses which threaten to become the focus of the litigation.'"

The Second Circuit also resolved an important jurisdictional issue. Plaintiffs argued that the inclusion of in-and-out traders went solely to loss causation (a merits issue), and thus should not be considered on an interlocutory appeal under Rule 23(f). The Court rejected that argument, noting that in-and-out traders' ability to prove loss causation (especially in light of the status of the putative class representative) could not be "cleanly separated from class certification as to render the issue outside the scope of our Rule 23(f) review." Citing its landmark decision in *In re IPO Sec. Litig.*, 471 F.3d 23 (2d Cir. 2006), the Second Circuit noted that "lower courts have an 'obligation' to resolve factual disputes relevant to the Rule 23 requirements and to determine" whether plainitffs have proffered sufficient proof to satisfy those requirements "by a preponderance of the evidence." That obligation is "not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement." The Second Circuit determined that the lower court "abused its discretion" when it permitted in-and-out traders to remain in the class because the district court's "'conceivable' standard of proof does not satisfy the preponderance of the evidence standard set forth in *In re IPO* and its progeny."

The Second Circuit also found that plaintiffs had not provided "sufficient evidence" that the class representative or other in-and-out traders could prove loss causation and excluded all in-and-out traders from the class. The Court emphasized that in *Dura*, the Supreme Court held that plaintiffs alleging securities fraud under section 10(b) cannot rely solely on the allegation that they purchased securities at artificially inflated prices. Plaintiffs thus must demonstrate that a company's stock price declined after the truth (or "corrective disclosure") regarding the subject of a defendant's misrepresentation was revealed to the market and must disaggregate the loss caused by the disclosure of the truth correcting a particular misrepresentation from loss caused by disclosures of other information or other factors. The Court rejected plaintiffs' "leakage" argument and concluded that in-and-out traders could not meet their burden of establishing loss causation by a preponderance of the evidence. Noting that plaintiffs had previously alleged that FLAG's disclosures prior to February 13, 2002 were false, the Court commented that plainitffs "cannot have it both ways" and later argue that these disclosures "revealed the truth with respect to the specific misrepresentations alleged."[1]

Ramifications of the Second Circuit's Decision

The Second Circuit's decision reaffirms that plaintiffs must establish all of the Rule 23 requirements — even those that overlap with a merits issue (such as loss causation) — by a preponderance of the evidence at the class certification stage. Moreover, by excluding in-and-out traders from the class, the *Flag Telecom* decision appears to provide defendants with the ability to restrict the size of the class in a significant way and thereby limit potential damages at the class certification stage.

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If you have any questions concerning the *Flag Telecom* decision, or would like additional information, please contact Stephen W. Greiner (212-728-8224, sgreiner@willkie.com), Todd G. Cosenza (212-728-8677, tcosenza@willkie.com), or the Willkie Farr & Gallagher attorney with whom you regularly work.

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[1] On August 5, plaintiffs filed a petition with the Second Circuit requesting a rehearing of this appeal *en banc*. We will provide updates on any significant developments that impact the *Flag Telecom* decision.