

Second Circuit Clarifies Burden of Proof and Efficient Market Requirements in Denying Class Action Certification

On October 14, 2008, the United States Court of Appeals for the Second Circuit clarified what it acknowledged to be “some confusion” in its prior decisions, holding that the preponderance of the evidence standard applies to proof that the requirements for class action certification under Rule 23 of the Federal Rules of Civil Procedure are met.¹ In so doing, the Court of Appeals also made clear that in order to invoke the fraud-on-the-market presumption of reliance recognized in *Basic v. Levinson*, 485 U.S. 224 (1998), the proponent of the presumption must establish that the securities at issue traded in an “efficient” market.

I. Facts and Procedural History

According to its Complaint, Plaintiff Teamsters Local 445 Freight Division Pension Fund (“Teamsters”) purchased certificates (the “Certificates”) issued by Bombardier Capital Mortgage Securitization Corporation, a wholly owned subsidiary of Bombardier, Inc., for a total investment of \$234,826. These Certificates were sold in seven separate offerings between 1998 and 2001, and were each secured by a pool of mobile home loan contracts and mortgages.

In February 2005, Teamsters sued, alleging securities fraud under Section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 promulgated thereunder. Teamsters alleged that senior management had “disregarded underwriting standards, regularly underwrote loans to borrowers who were not creditworthy, and purchased large quantities of facially defective and deficient mobile home loans.”² Teamsters alleged that irresponsible underwriting practices resulted in escalating delinquency rates.

In February 2006, Teamsters moved for class action certification pursuant to Rule 23(b)(3) of the Federal Rules of Civil Procedure, proposing that the class be defined as all open market purchasers of the Certificates between February 7, 2000 and February 7, 2005. Because individual class member proof of reliance would render class action certification inappropriate, Teamsters sought to rely on the fraud-on-the-market presumption of reliance recognized by the United States Supreme Court in *Basic v. Levinson*, 485 U.S. 224 (1998).

The district court (Scheidlin, J.) applied a preponderance of the evidence standard in denying class action certification, finding that the fraud-on-the-market presumption of reliance was not available because the Certificates did not trade in an “efficient” market -- *i.e.*, a market that was “open and developed enough so that it quickly incorporate[d] material information into the price of the security.”³ In so holding, the district court relied upon a 19 year old decision in which this firm was involved.⁴

The district court applied the five factor analysis set forth in *Cammer*,⁵ concluding that Teamsters had failed to meet its burden of proving by a preponderance of the evidence that the Certificates traded in an efficient

¹ *Teamsters Local 445 Freight Division Pension Fund v. Bombardier, Inc.*, No. 06-3794-cv (2d Cir. Oct. 14, 2008).

² *Id.* at 4.

³ *Id.* at 5.

⁴ *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989).

⁵ *Cammer* identified the following five factors as ones to be considered in ascertaining whether a given security trades in an “efficient” market: (1) the average weekly trading volume of the Certificates, (2) the number of securities analysts following and reporting on the Certificates, (3) the extent to which market makers traded in the Certificates, (4) the issuer’s ability to file an SEC registration Form S-3, and (5) the demonstration of a cause and effect relationship between unexpected, material disclosures and changes in the Certificates’ prices. *Cammer*, 711 F. Supp. at 1286-1287.

market. Because the fraud-on-the-market presumption of reliance was not available, class action certification was denied.⁶ Plaintiffs were granted an interlocutory appeal.

II. Second Circuit's Decision

The Court of Appeals began its analysis by acknowledging that its prior decisions “[had] been less than clear” as to what evidentiary standard applied to class action certifications.⁷ The court conceded that some confusion was warranted, but emphatically declared “[t]oday, we dispel any remaining confusion and hold that the preponderance of the evidence standard applies to evidence proffered to establish Rule 23’s requirements.”⁸

After establishing the applicable standard of proof, the court analyzed the issue of market efficiency to determine whether the district court made clearly erroneous factual findings. The circuit court focused on the three *Cammer* factors the district court found failed to show an efficient market: (1) that analysts did not cover or report on the Certificates, (2) that there were no firms making a market in the Certificates, and (3) that the empirical data did not demonstrate a casual relationship between unexpected, material information and the Certificates’ prices.⁹

The Court of Appeals found no error in the district court’s rejection of testimony from Teamster’s expert that 44 analysts reported on Bombardier, Inc. during the proposed class period because the Certificates were not Bombardier securities.

Next, the Court of Appeals determined that firms were not making a market in the Certificates. According to the SEC, a “market maker” is defined as:

“a dealer who, with respect to a particular security, (i) regularly publishes bona fide, competitive bid and offer quotations in a recognized interdealer quotation system; or (ii) furnishes bona fide competitive bid and offer quotations on request; and (iii) is ready, willing and able to effect transactions in reasonable quantities at his quoted prices with other brokers and dealers.”
17 C.F.R. § 240.15c3-1[c]8 (2006).

Teamsters argued that the lead underwriter of the Certificates acted as a market maker because the securitization transactions were analogous to equity IPOs. Additionally, the bond trader for Teamster’s investment advisor testified that he could have obtained a quote from a broker-dealer during the class period. The district court concluded, and the Court of Appeals agreed, that this evidence failed to establish that firms were making a market in the Certificates.

The Court of Appeals completed its analysis with the most important of the *Cammer* factors: whether the Certificates’ prices reacted immediately to news of unexpected corporate events. This factor has been regarded as “the essence of an efficient market and the foundation for the fraud on the market theory.”¹⁰ Teamsters’ expert offered an event study to show an association between the fluctuations in the Certificates’ prices and the release of unanticipated, material information into the marketplace. The district court rejected the study on two grounds:

⁶ *Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc.*, 2006 WL 2161887 (S.D.N.Y. Aug. 1, 2006).

⁷ *Teamsters*, No. 06-3794-cv, slip op. at 10, quoting *In re IPO*, 471 F.3d 24, 32 (2d Cir. 2006).

⁸ *Id.* at 11. In so ruling, the Court of Appeals rejected plaintiff’s argument that the binary standard used in *Heerwagen v. Clear Channel Communications*, 435 F.3d 219 (2d Cir. 2006), should apply. The *Heerwagen* standard had a lower burden of proof for issues “identical to the merits,” requiring only “some showing” rather than by a preponderance of the evidence.

⁹ This appears to be the first time the Second Circuit has utilized the factors identified in *Cammer v. Bloom* to analyze the issue of market efficiency.

¹⁰ *Teamsters*, No. 06-3794-cv, slip op. at 20, quoting *Cammer v. Bloom*, 711 F. Supp. 1264, 1287 (D.N.J. 1989).

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(1) the study relied on Bloomberg prices which already assume market efficiency, and (2) the news used in the study reported solely on the financial status of Bombardier, Inc. and not on its mortgage division.

The Court of Appeals disagreed with the district court on its first ground for rejection. However, it found that this error was not material. The Court of Appeals agreed with the second ground for rejection, reasoning that Teamsters had failed to sufficiently connect the financial troubles of Bombardier, Inc. with the mobile home loans or contracts forming the collateral for the Certificates.

III. Significance of the Decision

This decision clarifies any remaining confusion as to what standard applies to plaintiffs' burden of proving satisfaction of the elements of Rule 23 for class action certification. The Court of Appeals reaffirmed its holding in *In re Initial Public Offerings Securities Litigation*, 471 F.3d 24 (2d Cir. 2006), that a single unified standard -- the preponderance of the evidence standard -- applies to all evidence offered to prove market efficiency. To assess market efficiency, the Court of Appeals looked to the factors first identified in *Cammer v. Bloom*.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.