

Second Circuit Clarifies Class Certification Requirements in Significant Securities Class Action Decision

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On July 7, 2017, the U.S. Court of Appeals for the Second Circuit offered significant guidance regarding the circuit's class certification requirements in *In re Petrobras Securities*, No. 16-1914. In addressing an issue of first impression, the Second Circuit underscored the need to consider the individualized nature of determining whether a plaintiff engaged in a "domestic" securities transaction under the U.S. Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010). The decision effectively creates an additional hurdle for plaintiffs seeking to certify a class of investors in nonexchange-traded securities.

In *In re Petrobras Securities*, the plaintiffs asserted violations of Section 10(b) of the Securities Exchange Act of 1934 against Brazilian petroleum company Petrobras and Sections 11, 12 and 15 of the Securities Act of 1933 against Petrobras and over a dozen underwriters of its bonds. The plaintiffs alleged that the defendants made various false or misleading statements and that, when the truth was revealed, the value of Petrobras securities declined. In February 2016, the district court certified two classes of investors who purchased Petrobras American depository shares or bonds in "domestic transactions" under *Morrison*.

Following the defendants' interlocutory appeal, the Second Circuit affirmed in part and vacated in part the district court's class certification order and remanded the case for further proceedings.

The Second Circuit agreed with defendants that the district court failed to adequately consider the need for individualized *Morrison* inquiries when it concluded that common classwide issues predominate over individual issues, as Rule 23(b)(3) requires. The Second Circuit reiterated that United States securities laws extend only to "transactions in securities listed on domestic exchanges" and "domestic transactions in other securities." To establish a "domestic transaction" in nonexchange-traded Petrobras bonds, each class member is required to show that title passed or "irrevocable liability" was incurred in the United States.

The Second Circuit indicated that, at least based on the record of the *Petrobras* case, determining whether putative class members engaged in a "domestic transaction" was an individualized inquiry. As the Second Circuit explained, "the potential for variation across putative class members — who sold them the relevant securities, how those transactions were effectuated, and what forms of documentation might be offered in support of domesticity — appears to generate a set of individualized inquiries." The district court had failed to consider "the ways in which evidence of domesticity might vary in nature or availability across the many permutations of transactions in Petrobras Securities," including transactions on the secondary market. On this basis, the Second Circuit vacated the class certification order and remanded the case for further class certification proceedings.

The Second Circuit, however, declined to overturn the certified class on the ground that no administratively feasible way exists to identify class members who purchased nonexchange-traded Petrobras bonds in a "domestic transaction" under *Morrison*. Instead, to satisfy the so-called "ascertainability requirement," lead plaintiffs need only prove that the "proposed class is defined using objective criteria that establish a membership with definite boundaries." The Second Circuit thus contributed to a split among the circuits on the contours of the "ascertainability requirement" — a split that may, in due course, be resolved by the Supreme Court.

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Separately, the Second Circuit upheld the district court's finding that Petrobras securities traded in an efficient market, made in the course of applying the "fraud on the market" reliance theory established in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

While declining to adopt a particular test for market efficiency, the Second Circuit held that the plaintiffs were not required to establish that the price of Petrobras securities increased in response to good news and decreased in response to bad news. Rather, it was sufficient to show that the price changed in response to significant events, regardless of the direction of the changes, and to offer "indirect" evidence of market efficiency, such as high trading volume, extensive analyst coverage and large market capitalization.