



## CORPORATE AND SECURITIES LITIGATION

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### *Challenges to the Scope of Class Certification*

Most securities fraud cases involve allegations that false statements were made to inflate the price of a company's stock. A case pending in the U.S. District Court for the Northern District of Illinois presents the flip side of this situation, where allegedly misleading statements were made to keep the price low in anticipation of a merger.

On July 17, 2007, U.S. District Judge Robert W. Gettleman certified a shareholder class in *Levie v. Sears Roebuck & Co.*<sup>1</sup> Judge Gettleman's decision raises interesting issues about the length of a certified class period, as well as the persons included in any class certified.

#### The 'Sears' Facts

As alleged by the Sears plaintiff, in early September 2004, the beginning of the class period, Sears presented a "strategy update" to investors and analysts concerning a prior agreement with Kmart to purchase or lease stores, but failed to disclose that it was engaged in merger talks with Kmart. In the following weeks, Sears made other statements to the effect that it intended to follow its previously announced business plan to continue operating independently. Sears also announced a net loss of \$61 million for the third quarter of 2004 and told investors that they should lower their expectations for the fourth quarter. The stock price dropped. The complaint alleges that, during this same time period, Sears was in the middle of negotiating a deal by which Kmart would acquire a controlling interest in Sears. If this news reached investors, it was expected that Sears' stock price would rise and threaten to make Sears too expensive to acquire. During the third quarter of 2004, Sears also re-purchased millions of its own shares for what the plaintiff called a "rock bottom" average price of about \$36. When the deal with Kmart was announced in mid-November 2004, the end of the class period, Sears stock price rose to about \$53 per share. After Judge Gettleman denied Sears' motion to dismiss, the plaintiff moved for certification of a "seller class" consisting of all investors who sold



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their shares during the period Sears allegedly had failed to disclose the merger talks.

#### The Duration of the Class Period

Among other challenges to certification, Sears challenged the proposed class period, submitting documentary evidence and sworn statements demonstrating that merger talks only began in late October and arguing that plaintiff's allegation that discussions began in early September was factually unsupported in the complaint. Arguing that the class period could only begin with the first purportedly misleading statement after merger talks commenced, Sears contended that the class period was at most seven trading days beginning with the complaint's first factually supported allegation concerning merger discussions. The court declined to consider Sears' evidence on class-period duration, holding that factual inquiries on a motion for class certification were limited to those required to determine if certification was appropriate under Rule 23, i.e., numerosity, commonality, typicality and class representation, and that the court could not look beyond the pleadings to evaluate the contested class period.<sup>2</sup>

Sears is a reminder that, even where outright dismissal is not possible on a motion to dismiss, defendants must challenge each alleged false statement, requiring plaintiffs to demonstrate, and pressing the court to review, the factual basis for the alleged falsity of each statement as well as each defendant's knowledge of the falsity of each statement as demanded by the heightened pleading requirements of the PSLRA. (15 USC §78u-4(b))<sup>3</sup> In this manner, a defendant can sometimes narrow the class period which a plaintiff may later seek to certify.

In *Sears*, the court did not undertake such an analysis in deciding the motion to dismiss. Judge Gettleman found that the claim arose from a duty to disclose merger negotiations, if they were occurring and were material, in order to make the statements issued not false or misleading, and did not arise from any independent duty to disclose those negotiations. Despite that finding, the court held only that whether merger negotiations were material was a fact issue for the jury. The court appears not to have addressed whether an adequate factual basis existed for plaintiff's allegations of early merger discussions, even though those allegations formed the sole basis for the court's decision that plaintiff's complaint sufficiently pleaded that Sears public statements may have been misleading or false, including those made early in the class period. 2007 WL 2039534\* n.3. Then, on the class certification motion, the court found any such inquiry off limits, as a factual inquiry unrelated to Rule 23.

Particularly where a court finds that some of the alleged false statements in a complaint do meet the particularity and scienter requirements of the PSLRA, judges may need to be reminded that the PSLRA nonetheless requires that each and every alleged false statement be analyzed separately as well as that faithful compliance with that exercise could be important for a possible later certification motion.

In instances where courts do not review each alleged false or misleading statement on a dismissal motion, and this failure has a later impact on the scope of the class certified, it might be useful to point out the policy considerations at issue in an effort to have the court address the matter on the certification motion. Although it is certainly correct that Rule 23 does not permit a merits review at the class certification stage absent a relevance to one of the four Rule 23 factors, the same policy reasons that support the Rule 23 merits inquiry also support a careful analysis of any time period certified. In the real world of securities litigation, class certification drastically raises the stakes and creates the likelihood of in terrorem settlements.

As the U.S. Court of Appeals for the Seventh Circuit observed in *Szabo v. Bridgeport Machines, Inc.*, a case relied upon by Judge Gettleman, "[T]he class certification turns a \$200,000 dispute...into a \$200 million dispute." Judicial scrutiny is called for "not only because of the

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