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# APPEALS COURT REJECTS CLASS CERTIFICATION IN \$800 BILLION LAWSUIT

by

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The Hon. Jack B. Weinstein, in a massive, over five hundred page decision, certified a Brobdignagian plaintiff class – all persons in the United States who had purchased light cigarettes. *Schwab v. Philip Morris USA Inc.*, 449 F. Supp. 2d 992 (E.D.N.Y. 2006). The class encompassed tens of millions of people and sought damages estimated at some \$ 800 billion.

The plaintiffs had sought class certification for purchasers of “light” cigarettes for damages for mail and wire fraud under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1962. It was claimed that the defendants engaged in racketeering activity by implicitly representing that “light” cigarettes were healthier than regular cigarettes. There was a perception among consumers that light cigarettes containing lower tar and nicotine were healthier. Judge Weinstein citing his own decision in *Falise v. American Tobacco Co.*, 94 F.Supp.2d 316 (E.D.N.Y. 2000) found that the actions of the Defendants had “distorted the body of public knowledge” concerning light cigarettes. This theory is a variation on a “fraud on the market” claim seen in securities litigation. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). However, the facts of this claim, and the idiosyncrasies of consumer purchasing decisions, would ultimately lead to the U.S. Court of Appeals for the Second Circuit to reverse Judge Weinstein in *McLaughlin v. American Tobacco Company*, --- F.3d--- 2008 WL 878627 (CA2 NY). What was crucial for the Second Circuit and certainly patent in the record below was the fact that purchasers of consumer products buy for a variety of different reasons.

**History.** In 1967 the Federal Trade Commission (FTC) adopted the “Cambridge Filter Method” (also referred to as the “FTC Method”) for measuring tar and nicotine levels in cigarettes. Essentially, the tobacco manufacturers were barred by the FTC from making claims about tar and nicotine levels in their products unless based upon the FTC Method. *McLaughlin v. American Tobacco Company*, --- F.3d--- 2008 WL 878627 (CA2 NY) citing *Brown v. Brown & Williamson Tobacco Corp.*, 479 F.3d 383, 392 ( 5<sup>th</sup> Cir. 2007).

The FTC Method used a machine to “smoke” the cigarette and measured tar and nicotine output. While the FTC rule and methodology had the beauty and simplicity of a standardized test, the FTC Method did not realistically mimic how a person smoked. Smokers seeking to maintain nicotine levels while

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smoking light or low nicotine cigarettes would “compensate” or titrate by smoking differently. The compensation would take the form of more puffs per cigarette, taking the smoke deeper into the lungs, holding the smoke longer, consuming more cigarettes per day or simply covering air holes on the cigarette to get more smoke. Not all light smokers would compensate and not all light smokers who did compensate did so in the same manner.

In 2001, the National Cancer Institute published Monograph 13. The publication concluded that there was no convincing evidence that changes in cigarette design (including light cigarettes) had any impact upon disease burden for smokers. The tobacco manufacturers countered that the 2001 publication was little more than a summary of already available research.

**Threshold Issues.** The Second Circuit reviewed the grant of class certification by the court below on an abuse of discretion standard. *Moore v. Paine Webber, Inc.*, 306 F.3d 1257 (2d Cir. 2002). The class may not be certified unless each Rule 23 requirement is met and all evidence must be assessed as with any other threshold issue. The well known elements of a claim for class certification are: 1) numerosity, 2) commonality, 3) typicality and 4) adequacy of representation. Further, in this action, the requirements of Rule 23(b)(3) needed to be fulfilled: that questions of law or fact common to class members predominate over any questions affecting only individual members.

**The RICO Claim.** A plaintiff seeking damages under a civil RICO claim must show the injury to business or property occurred “by reason of” the defendant’s action. The violation must be the “but for” cause as well as proximate cause of the injury. “But for” causation is known as transaction causation or reliance. Proximate cause is referred to as “loss causation.” To prevail, the plaintiff needs to establish a RICO violation, injury to business or property, transaction causation and loss causation. *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763 (2d Cir. 1994). In the context of appellate review of class certification, the plaintiffs needed to establish that common questions predominated over individual issues of injury and causation.

**Causation and Reliance.** Proof of widespread and uniform misrepresentations was, according to the Second Circuit, only half of the equation. The plaintiffs needed to show that but for the misrepresentation the injured party would not have entered into the transaction. The court held that reliance is an individual issue not subject to general proof. Here the court recognized that an individual consumer purchasing light cigarettes may have been unaware of any misrepresentation, preferred the taste of this type of cigarette or chose this type of cigarette as an expression of personal style. The court distinguishes the “fraud on the market theory” advocated by the plaintiffs and the court below. While a fraud on the market may have impact on a discrete and efficient market like the New York Stock Exchange, the market for consumer goods does not behave in a similar fashion. Further, the inefficiency of the consumer market in light cigarettes is highlighted by the fact that both the sales and price of light cigarettes did not change with the dissemination of information that light cigarettes were not “healthier” than regular cigarettes.

The Second Circuit in *McLaughlin* states that it would not go as far as the Fifth Circuit and state that “a fraud class can not be certified when individual reliance will be an issue.” *Castano v. Am. Tobacco Co.*, 84 F.3d 734 (5<sup>th</sup> Cir. 1996). If we accept the proposition that consumers make purchasing decisions for a host of different reasons, the *McLaughlin* case establishes the difficulties that plaintiffs face when seeking class certification under RICO for consumer products. Lastly, the court alluded to the fact that some consumers were aware that light cigarettes were not in fact healthier. There could be no reliance on the Defendants’ misrepresentations if the consumers did not rely on them in purchasing the light cigarettes. In sum, the predominance of common questions under Rule 23 was not met on the reliance issue.

**Loss Causation.** Two facts were crucial for the Second Circuit in finding that the issue of loss causation was not susceptible to generalized proof. There was no change in the price of, or demand for, light cigarettes after the publication of Monograph 13. The Monograph is posited with revealing that light cigarettes are no healthier than regular cigarettes. The second salient factor is that a variety of factors can be envisioned for a consumer's decision to purchase light cigarettes. Which plaintiffs relied on the misrepresentation, in whole, in part or not at all bespeaks an individual inquiry and is not readily amenable to class wide proof.

**Injury.** The court found that the plaintiffs' theories of injury were a) generally not plausible as a matter of law, b) would lead to an impermissible fluid recovery and c) would, in the case of out-of-pocket damages, require individualized proof defeating class wide issues. The court held that out-of-pocket losses would need to be proven on an individual basis. Purchasers who would have continued smoking regular cigarettes had no loss as the price for the two items was the same. Purchasers who would have quit smoking could recover for the price of light cigarettes purchased. Those who would have continued to smoke but in greater moderation could recover some lesser amount.

**Loss of Value.** The loss of value damages claim purports to measure the difference between the price plaintiffs paid for lights and the price they would have paid but for the misrepresentation by the defendants. This is a benefit of the bargain argument that is unavailable in a RICO action. Damages under RICO require proof of a "concrete financial loss." As stated by the court, to establish a loss we are asked to calculate the price differential between a light cigarette and a presumably healthier cigarette that doesn't exist. RICO damages are available only for injury to business or property not for expectations. This damage theory was held to be entirely speculative.

**Price Impact.** The second damages theory rejected by the appellate court was price impact. The theory proposes that the defendants would need to reduce the price of light cigarettes to account for a decrease in demand following dissemination of information that light cigarettes are not healthier than regular cigarettes. The proof would consist of a multiple regression analysis based upon a hypothetical. This theory is belied by the fact that the publication of Monograph 13 has had no demonstrated effect on the market. Damaging to plaintiffs' claims was an admission by plaintiffs' expert that any number of extrinsic variables impact upon the price of cigarettes for consumers.

**Calculation of Damages and Fluid Recovery.** The methodology proposed by the lower court for damage calculations evokes in part the Red Queen's dicta "Sentence first – verdict afterwards." The defendants' aggregate liability would be determined in a single class wide adjudication and paid into a class fund. Next, the individual plaintiffs would collect using a proof of claim procedure. Third, any residue of the fund would be distributed for the benefit of the class under *cy pres* or "other doctrines." The Second Circuit reminds us that the "fluid recovery" has been forbidden in this circuit since *Eisen v. Carlisle & Jacquelin*, 479 F.2d 1005 (2d Cir. 1973). The damages calculation would be based an estimate of the percentage of the members of the class defrauded and in turn would be based upon an estimate regarding the average loss. The court rejected compelling Defendants to pay into a damages fund based upon an estimate of an estimate as offensive to the Rules Enabling Act and the Due Process Clause. When a fluid recovery is used to permit the mass aggregation of claims, the defendant's ability to challenge the allegations of individual plaintiffs is lost, violating the right to due process. Rough estimates of gross damages were found to alter the defendants' substantive rights.

**Statute of limitations.** The statute of limitations for a civil RICO claim is four years. The lawsuit was filed in May 2004. The district court found that some members of the proposed class were aware, long before the year 2000, that light cigarettes were no healthier than regular cigarettes. Some of the proposed class representatives were aware of compensation and its risks before May 2000.

The Second Circuit court found that a substantial number of the proposed class members were on

notice before the class period. The court acknowledged that the presence of individualized defenses does not *per se* destroy class certification. Significantly, Plaintiffs' counsel had filed lawsuits making similar allegations prior to the year 2000. The Second Circuit found that determining how many class members claims were time barred could not be determined in any class wide collective fashion and was yet another reason for reversing class certification.

**Conclusion.** This case contains valuable lessons for class action counsel defending or proposing class certification under RICO for a consumer product. The case is unique in that the price and demand for the consumer product was apparently unaffected by, as Judge Weinstein put it, the widespread distortion of the "body of public knowledge" by the defendants concerning the product. The price and demand for the product was also unaffected by the "revelation," if you will, that there had been widespread misrepresentation regarding the product.

The theme of compensation loomed large in *McLaughlin v. American Tobacco*. The plaintiffs sought class certification and compensation of \$800 billion. One of the reasons that light cigarettes were not in fact "healthier" was that smokers would "compensate" or titrate when smoking lower tar/lower nicotine cigarettes. The third iteration of the compensation theme was the problem of how to calculate plaintiffs' injury and damages when light and regular cigarettes were sold for the same price. In the end, the insufficient predominance of common issues on injury, reliance, damages, causation and the statute of limitations defense were ultimately fatal to this class certification.