Seventh Circuit Addresses Certification of Securities Class Actions in Wake of Recent Supreme Court Opinions

To succeed on a motion for class certification under Federal Rule of Civil Procedure 23(b)(3), a party must demonstrate that "questions of law or fact common to class members predominate over any questions affecting only individual members." *Halliburton Co. v. Erica P. John Fund, Inc. ("Halliburton II")*, 573 U.S. 258, 294 (2014) (quoting *Comcast Corp. v. Behrend*, 569 U.S. 27, 33 (2013)). Under *Basic Inc. v. Levinson*'s "fraud-on-the-market" theory, plaintiffs in securities fraud can demonstrate that the securities at issue traded in an efficient market, therefore entitling them to a class-wide presumption of reliance. 485 U.S. 224, 246-247 (1988).[1] Defendants can rebut the presumption by "sever[ing] the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff or his decision to trade at a fair market price." *Halliburton II*, 573 U.S. at 268. Evidence supporting or refuting the *Basic* presumption is often relevant to other closely-related merits issues in a securities fraud action, including materiality and loss causation, that the Supreme Court has instructed courts may not decide at the class certification stage. *Amgen Inc. v. Conn. Ret. Plans and Trust Funds*, 568 U.S. 455 (2013) ("*Amgen*"); *Erica P. John Fund, Inc. v. Halliburton Co. ("Halliburton I")*, 563 U.S. 804 (2011).

In *In re: Allstate Corporation Securities Litigation*, 2020 WL 4013360 (7th Cir. July 16, 2020),[2] the U.S. Court of Appeals for the Seventh Circuit vacated a district court's ruling on class certification because the district court failed to consider evidence of price impact to rebut the *Basic* presumption. The Court held that the district court erred in determining that the evidence was relevant only to merits questions. The opinion is likely to be relied upon by district courts attempting the challenging task of ruling on securities fraud class certification motions, while abiding by the Supreme Court's recent precedents of *Amgen*, *Halliburton I*, and *Halliburton II*.[3] Significantly, the Seventh Circuit also (1) affirmed the viability of the "inflation maintenance" theory (the theory that misrepresentations can have a price impact by preventing a previously-inflated stock price from falling) in the Seventh Circuit and (2) limited the use of "back-end price impact" evidence (evidence of the stock price's reaction or lack of reaction to the alleged corrective disclosures).

I. Background

In early 2013, Allstate Corporation announced a new growth strategy in its auto insurance business: softening its underwriting standards to attract more customers. With this announcement, Allstate acknowledged that new and potentially riskier customers might file more auto claims. Allstate's Chief Executive Officer, Thomas Wilson, said the company knew of the potential for increased claim filings, would monitor it, and would adjust its business practices accordingly.

On August 3, 2015, Allstate issued a press release reporting its financial results for the second quarter of 2015, disclosing the negative impact of its revised underwriting standards. *Carpenters Pension Trust Fund for N. Cal. v. Allstate Corp.*, 2018 WL 1071442, at *2 (N.D. Ill. Feb. 27, 2018). Allstate explained that the higher claim

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[1] The *Basic* presumption of reliance is based on the efficient market hypothesis, which reflects the notion that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.* at 246.

[2] Unless otherwise stated, all quotations in this memorandum are taken from this opinion.

[3] All three opinions provide guidance for district courts' consideration at the class certification stage of evidence rebutting the fraud-on-the-market presumption: *Halliburton I* held that district courts could not consider such evidence to decide loss causation; *Amgen* held that district courts could not consider such information to decide materiality; and *Halliburton II* held that district courts "must" consider such evidence if offered to show the absence of transaction causation, also known as price impact.

rates it had experienced for three quarters were fueled, at least in part, by the growth strategy and that the company would be "tightening some of [its] underwriting parameters." On August 4, 2015, Allstate's stock price dropped by more than ten percent.

Plaintiffs Carpenters Pension Trust Fund for Northern California and Carpenters Annuity Trust Fund for Northern California (together, "Carpenters") brought a putative class action under Sections10(b) and 20(a) of the Securities Exchange Act of 1934 against Allstate and two of its officers. *Carpenters Pension Trust Fund for N. Cal.*, 2018 WL 1071442, at *1. Carpenters alleged that, during the time between the 2013 growth strategy announcement and the August 2015 stock price drop, Allstate misled the market by misrepresenting that the increased claim frequency was due to factors other than the growth strategy, such as "higher-than-usual precipitation" and "miles driven." *Id.* at *2. Allstate contended, however, that those with an understanding of the insurance industry knew that relaxed underwriting standards can often lead to increases in claim frequency. *Id*. Allstate argued that the market understood the risks of Allstate's growth strategy, and that any increase in claim frequency was a "trade-off predictable both to the company and to the market." *Id*.

On March 26, 2019, the United States District Court for the Northern District of Illinois granted Carpenters' motion for class certification. *In re Allstate Corp. Sec. Litig.*, 2019 WL 1512268, at *2 (N.D. Ill. Mar. 26, 2019). Carpenters, in seeking class certification, invoked the *Basic* presumption of fraud-on-the-market to satisfy Rule 23(b)(3)'s predominance requirement. *In re: Allstate Corp. Sec. Litig.*, 2020 WL 4013360, at *2. To demonstrate *Basic* reliance, Carpenters offered evidence that Allstate's stock traded in an efficient market and argued that information defendants introduced into the market was presumed to be incorporated into Allstate's stock price. In response, Allstate offered an expert report opining that (1) there were no statistically-significant increases in Allstate's stock price following any of the alleged misrepresentations and (2) the information allegedly concealed was well known to the market and covered by analyst reports. Allstate argued that this evidence "sever[ed] the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, and his decision to trade at a fair market price" (quoting *Basic*, 485 U.S. at 248). While Allstate characterized the evidence as showing the absence of transaction causation, as permitted by *Halliburton II*, Carpenters claimed the evidence went toward a "truth-on-the-market" materiality defense, which *Amgen* prohibits at the class certification stage. The district deemed the dispute "merits based" and improper for consideration at class certification.

II. The Seventh Circuit's Opinion

The Seventh Circuit vacated the district court's class certification opinion, holding that the district court committed legal error by failing to consider Allstate's evidence on price impact, including its expert report. The Seventh Circuit explained that the district court had erred by embracing "*Amgen* at the expense of *Halliburton II* . . . rather than engaging in the messier but required process of simultaneously complying" with instructions from both cases. In its opinion, the Seventh Circuit also (1) provided guidance for harmonizing the three Supreme Court precedents *Halliburton I*, *Amgen*, and *Halliburton II*, (2) stated that evidence of price impact following a corrective disclosure may be considered at class certification only as indirect evidence of transaction causation, and (3) affirmed the inflation maintenance theory's viability in the circuit.

First, the Seventh Circuit articulated the "challenge" courts face in simultaneously following *Halliburton I*, *Amgen*, and *Halliburton II*: Rule 23(b)(3)'s predominance requirement requires courts to engage with a case's merits but without deciding the merits. In other words, district courts must walk a balance between "'*evaluating* evidence to determine whether a common question exists and predominates, *without weighing* that evidence to determine whether the class will ultimately prevail on the merits'" (quoting *Bell v. PNC Bank, N.A.*, 800 F.3d 360, 377 (7th Cir. 2015)). The Seventh Circuit also adopted the burden-shifting framework from the Second Circuit's opinion *Waggoner* v. *Barclays PLC*, 875 F.3d 79, 96–104 (2d Cir. 2017); specifically: (1) the plaintiff must make a prima facie showing sufficient to invoke the *Basic* presumption; and (2) the burdens of production and persuasion

by a preponderance of the evidence (when factoring in both parties' evidence) then shift to the defendant. *In re: Allstate Corp. Sec. Litig.*, 2020 WL 4013360, at *10.

To invoke the *Basic* presumption, plaintiffs must demonstrate the ability to use common evidence of reliance. The Seventh Circuit explained that Plaintiffs regularly do so with evidence that the market upon which the defendant's shares traded is efficient. Defendants can then, in turn, attempt to rebut the *Basic* presumption with evidence that plaintiff did not, in fact, rely on the market's integrity, or that the market was not, in fact, efficient.[4] Both inquiries focus on whether an "intervening cause disrupted the connection between a false statement and a trade relying on the assumption that the false statement was factored into the market price." As such, reliance evidence is inherently relevant to loss causation and materiality, consideration of which at class certification is prohibited by *Halliburton I* and *Amgen*, respectively. The Seventh Circuit explained that the inquiry must focus not on loss causation but on "transaction causation" (whether all purchasers can be said to have "relied on the integrity of the price set by the market") (quoting *Basic*, 485 U.S. at 226).

Second, the Seventh Circuit limited the purposes for which defendants may use back-end price impact evidence at the class certification stage, stating that: "the Supreme Court has held that the relevant temporal focus upon class certification is at the time of purchase" (citing *Halliburton I*, 563 U.S. at 812). Allstate had offered evidence that the stock price had not dropped as a result of the alleged corrective disclosures. The Seventh Circuit held that such evidence, and any evidence of the stock behavior following the initial alleged misstatements, is relevant at class certification *only* to the extent it helps "the district court determine the information impounded into the price at the time of the *initial* transaction" (emphasis added). Along the same lines, Allstate was not permitted to introduce a truth-on-the-market defense at the class certification stage. The Seventh Circuit instructed that, on remand, the district court should consider Allstate's evidence "with regard to 'ex post price distortion,' or '[w]hether the stock price responds when the [alleged] fraud is revealed to the market,' only as backward-looking, indirect evidence of the core question here – 'ex ante price distortion' as a constituent part of transaction causation, or 'whether stock price [is] distorted at the time that the plaintiff trades'" (quoting Jill E. Fisch, *The Future of Price Distortion in Federal Securities Fraud Litigation*, 10 Duke J. Const. L. & Pub. Pol'y 87, 94 (2015)).

Third, the Seventh Circuit affirmed the viability of the inflation maintenance theory in the circuit. Under this theory, in lieu of needing to show that defendant's alleged misrepresentation *raised* the stock price, a plaintiff need only show that "'the defendants' false statements caused the stock price to *remain* higher than it would have been had the statements been truthful,' even if the price itself does not change by a single cent" (quoting *Glickenhaus & Co. v. Household Intern., Inc.*, 787 F.3d 408, 419 (7th Cir. 2015) (emphasis added)). Consequently, Allstate's evidence that the stock price did not react to Allstate's allegedly false statements did "not resolve the legal issue of price impact."

III. Potential Implications

Going forward, defendants litigating in the Seventh Circuit will face additional restrictions on how they may use back-end price impact evidence to rebut the *Basic* presumption. In this regard, the Seventh Circuit's opinion is more restrictive than recent opinions in the Second Circuit that permit defendants to rebut the *Basic* presumption by showing, "by a preponderance of the evidence, that the entire price decline on the corrective-

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[4] *See also id*. ("*Basic* also allows defendants to show that their alleged misrepresentations did not actually affect the market price in two ways that are difficult to distinguish from the merits of the plaintiff's claims. First, if the 'market makers were privy to the truth' about information allegedly concealed, or second, if 'news of [the allegedly concealed truth] credibly entered the market and dissipated the effects of the misstatement,' the causal connection between the alleged fraud and the market price would be broken.'") (quoting *Basic*, 485 U.S. at 248-249).

disclosure dates was due to something other than its alleged misstatements."[5] Defendants attempting to do so in the Seventh Circuit, on the other hand, may now use back-end price impact evidence only to show lack of inflation on the front end.

The opinion also could have a meaningful impact on discovery management at the class certification stage. Given "the significant and growing overlap between the evidence at stake at the certification and merits stages," the Court observed that "district courts may well choose not to bifurcate discovery at all in putative fraud-on-the-market securities class actions." As the evidence discussed in the opinion focused on public statements and economic data, however, it remains to be seen whether district courts will open up full discovery before class certification motions.

Finally, the opinion illustrates the growing complexity of an area of the law that "require[s] a district court to split some very fine hairs." As courts and litigants struggle to apply numerous precedents, it is very likely that we will hear more in this area from the Supreme Court or the other circuits.

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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 in it, please do not hesitate to call or email Joel Kurtzberg at 212.701.3120 or jkurtzberg@cahill.com; Lauren Perlgut at 212.701.3558 or lperlgut@cahill.com; or Jason Rozbruch at 212.701.3750 or jrozbruch@cahill.com; or email publications@cahill.com.

[5] *Arkansas Teacher Ret. Sys.* v. *Goldman Sachs Grp., Inc.*, 955 F.3d 254, 270 (2d Cir. 2020)*; see also Strougo v. Barclays PLC*, 312 F.R.D. 307, 326 (S.D.N.Y. 2016) ("Defendants also attempt to prove lack of price impact by reference to the price change on the corrective disclosure date. To succeed, defendants must prove to a preponderance of the evidence that the price drop on the corrective disclosure date was not due to the alleged fraud."), *aff'd*, *Waggoner*, 875 F.3d 79; *In re Chicago Bridge & Iron Company N.V. Securities Litigation*, 2020 WL 1329354 (S.D.N.Y. Mar. 23, 2020) ("[A] defendant can rebut the *Basic* presumption with evidence that the alleged misrepresentation was not associated with 'negative price stock-returns,' *i.e.*, there was no statistically negative, 'back-end' impact on stock following a corrective disclosure") (citation omitted). At least one court in the Sixth Circuit also has considered back-end evidence in rebutting the presumption. *See Ohio Pub. Employees Ret. Sys.* v. *Fed. Home Loan Mortg. Corp.*, 2018 WL 3861840, at *13, *18 (N.D. Ohio Aug. 14, 2018).

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