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Schleicher v. Wendt Impact: The Seventh Circuit Splits with the Fifth Circuit on Class Certification Requirements

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In *Schleicher v. Wendt*,[1] the Seventh Circuit considered the extent to which a plaintiff must establish loss causation and materiality before a class can be certified in an action arising under § 10(b) and Rule 10b-5 promulgated thereunder.[2] In holding that a plaintiff does not have to prove these elements during certification proceedings, the court reaffirmed the fraud-on-the-market theory of reliance and rejected the Fifth Circuit's requirement that a plaintiff in a securities class action prove loss causation and materiality in order to certify a class.

In *Schleicher*, the defendants argued, based in part on Fifth Circuit precedent (*see Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[3]), that in order for plaintiffs to recover using the fraud-on-the-market theory, they must prove that the defendants' statement or omission materially affected the market price of the security.

Schleicher involved a Rule 10b-5 class action against the senior executives of Conseco, Inc., a financial-services holding company. The plaintiffs alleged that the defendants made materially false and misleading statements and omissions about Conseco's operations and financial condition. In certifying a class, the district court concluded that, among other things, the plaintiffs had

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shown, under the fraud-on-the-market theory, "common issues will predominate over individual issues with respect to the reliance element of the securities fraud claims."[4] The district court also rejected the defendants' assertion that the plaintiffs were required to prove loss causation in order to benefit from the presumption of reliance afforded by the fraud-on-the-market theory.[5] The defendants appealed.

In an opinion written by Chief Judge Frank Easterbrook, the Seventh Circuit disagreed, holding that plaintiffs need not prove loss causation before a court may certify a securities class action under Rule 23 of the Federal Rules of Civil Procedure.[6] In so holding, the Seventh Circuit explicitly rejected the Fifth Circuit's decision in *Oscar Private Equity*.

[T]he Seventh Circuit [held] that plaintiffs need not prove loss causation before a court may certify a securities class action under Rule 23 of the Federal Rules of Civil Procedure.

The Seventh Circuit also criticized other circuit courts for requiring plaintiffs to establish materiality and falsity as a condition to class certification, which the court considered a misreading of the Supreme Court's decision in *Basic Inc. v. Levinson*.[7] According to the *Schleicher* court, materiality and falsity are "issues on the merits," which should not be resolved at the class certification stage.[8]

In *Basic*, the Supreme Court held that reliance may be presumed if the company's stock is traded on an efficient market. As Judge Easterbrook explained, the theory is based on the notion that "the price of a well-followed and frequently traded stock reflects the public information available about a company."[9] Thus, if a company's stock trades in an efficient market, plaintiffs can rely on the presumption of reliance provided by the fraud-on-the-market theory for class certification purposes.[10]

According to Judge Easterbrook, however, the Fifth Circuit departed from the plain meaning of *Basic*.[11] In *Oscar Private Equity*, the court "insist[ed]" that plaintiffs prove loss causation before a class may be certified to counteract the "enabl[ing]" impact the fraud-on-the-market doctrine has on the certification of a securities class.[12] According to the Fifth Circuit, such a requirement was necessary in order to "accord this signal event [*i.e.*, class certification] of the case its due."[13] As a result, the Fifth Circuit held that "to trigger the presumption [of reliance] plaintiffs must demonstrate that... the cause of the decline in price is due to the revelation of the truth and not the release of the unrelated negative information."[14]

The requirement set forth in *Oscar Private Equity* has been reinforced repeatedly by the Fifth Circuit. In 2009, for example, the Fifth Circuit decided a number of cases (*e.g.*, *Alaska Electrical Pension Fund v. Flowserve Corp.*,[15] and *Fener v. Operating Engineers Construction Industry & Miscellaneous Pension Fund (Local 66)*[16]) in which the court reaffirmed that:

> **[t]o establish loss causation, a plaintiff must prove (1) that the negative 'truthful' information causing the decrease in price [was] related to an allegedly false, non-confirmatory positive statement made earlier and (2) that it is more probable than not that it was this negative statement, and not other unrelated negative statements, that caused a significant amount of the decline.[17]**

In *Fener*, the most recent of these cases, the Fifth Circuit left no doubt that "[p]laintiffs still must prove loss causation through the same rigorous process that we established in *Oscar*."[18]

In *Schleicher*, the Seventh Circuit rejected the Fifth Circuit's rationale and holding in *Oscar Private Equity*. In affirming the district court's ruling (Chief Judge David F. Hamilton, Southern District of Indiana) that the plaintiffs need not establish loss causation as a prerequisite to class certification, Judge Easterbrook explained that if the defendants operated in an efficient market, under *Basic*, investors "can use the fraud-on-the-

market doctrine as a replacement for person-specific proof of reliance and causation."[19]

Judge Easterbrook criticized the Fifth Circuit for using *Basic* as an entitlement for "each court of appeals to set up its own criteria for certification of securities class actions or to 'tighten' Rule 23's requirements."[20] According to Judge Easterbrook, by using this justification, the Fifth Circuit created its own interpretation of Rule 23 to effect a policy result, one that would "make certification impossible in many securities suits."[21] Such a result, Judge Easterbrook concluded, "contradicts the decision, made in 1966, to separate class certification from the decision on the merits."[22]

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Turning to the case before the court, Judge Easterbrook concluded that the investors could rely on the fraud-on-the-market doctrine because Conseco stock had all the indicia of an efficient market: it was a large corporation, listed on the New York Stock Exchange, followed by analysts and included in the Standard & Poor's 500 Index. In light of these facts, the Seventh Court affirmed the district court's finding that the market for the Conseco's shares was efficient, therefore allowing the plaintiffs to benefit from the fraud-on-the-market presumption.

For class certification purposes, this presumption was enough.

NOTES

1. *Schleicher v. Wendt*, 2010 WL 3271964 (7th Cir. 2010) (*Schleicher II*).
2. The Securities Exchange Act of 1934 § 10(b), 15 U.S.C.A. § 78(j)(b); and Rule 10b-5, 17 C.F.R. § 240.10b-5, respectively.
3. *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007) (rejected by, Lapin v. Goldman Sachs & Co., 254 F.R.D. 168, Fed. Sec. L. Rep. (CCH) P 94842 (S.D. N.Y. 2008)) and (rejected by, In re Red Hat, Inc. Securities Litigation, 261 F.R.D. 83 (E.D. N.C. 2009)) and (disapproved of by, Schleicher v. Wendt, 2010 WL 3271964 (7th Cir. 2010)).
4. *Schleicher v. Wendt*, 2009 WL 761157 at *10 (S.D. Ind. 2009), aff'd, 2010 WL 3271964 (7th Cir. 2010) (*Schleicher I*).
5. *Schleicher I*, 2009 WL 761157 at *11–*12.
6. Fed. R. Civ. P. 23(b)(3).
7. *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194, Fed. Sec. L. Rep. (CCH) P 93645, 24 Fed. R. Evid. Serv. 961, 10 Fed. R. Serv. 3d 308 (1988).
8. *Schleicher II*, 2010 WL 3271964 at *7.
9. *Schleicher II*, 2010 WL 3271964 at *1.
10. *Schleicher II*, 2010 WL 3271964.
11. As Judge Easterbrook noted, *Oscar Private Equity* "represents a go-it-alone strategy." *Schleicher II*, 2010 WL 3271964 at *7.
12. *Oscar*, 487 F.3d at 262.
13. *Oscar*, 487 F.3d at 266.
14. *Oscar*, 487 F.3d at 265 (citation omitted).
15. *Alaska Elec. Pension Fund v. Flowserve Corp.*, 572 F.3d 221, Fed. Sec. L. Rep. (CCH) P 95255 (5th Cir. 2009).
16. *Fener v. Operating Engineers Const. Industry and Miscellaneous Pension Fund (LOCAL 66)*, 579 F.3d 401, Fed. Sec. L. Rep. (CCH) P 95315 (5th Cir. 2009).
17. *Alaska Elec. Pension Fund*, 572 F.3d at 228 (citation omitted).
18. *Fener*, 579 F.3d at 410.
19. *Schleicher II*, 2010 WL 3271964 at *2.
20. *Schleicher II*, 2010 WL 3271964 at *6.
21. *Schleicher II*, 2010 WL 3271964.
22. *Schleicher II*, 2010 WL 3271964.