

**SECOND CIRCUIT ISSUES IMPORTANT DECISION ON CLASS CERTIFICATION  
IN MBS-RELATED LITIGATION**

Earlier this week, the Second Circuit issued a decision that will impact the scope of class actions in mortgage backed securities-related litigation. In *N.J. Carpenters Health Fund v. RALI Series 2006-Q01 Trust*, No. 11-1683 & 11-1684 (2d Cir. 2012), the court affirmed a district court decision denying certification to two proposed classes of investors in 74 offerings of mortgage-backed securities made between March 2006 and October 2007. Class certification was denied because questions about the investors' knowledge of supposed misstatements in the registration statements for the offerings were held to predominate over generalized liability issues. This decision will encourage lower courts to consider class certification carefully in MBS-related litigation and will prompt challenges to certification, particularly where the proposed class includes financial institutions with varying levels of knowledge about MBS and MBS markets.

**The District Court Opinion**

The district court opinion addressed class certification motions in two related cases brought by pension funds. Both cases asserted negligence-based securities claims, alleging that defendants, issuers and underwriters of MBS, made materially misleading omissions and misstatements in offering documents in violation of sections 11, 12(a)(2) and 15 of the Securities Act of 1933. Like many other class actions related to MBS, plaintiffs claimed that — contrary to defendants' descriptions in the offering documents — the mortgage originators systematically disregarded the underwriting guidelines. As a result, plaintiffs alleged that their investments were much riskier than what was portrayed in the offering documents.

Defendants opposed class certification because, among other things, issues of each investor's knowledge would predominate over general issues of liability and a class action would not be a superior means of resolving the investors' dispute for that reason. More specifically, while plaintiffs' claims were negligence-based, defendants pointed out that section 11 creates an affirmative defense precluding liability where a plaintiff knew that the offering documents contained untruths. Defendants argued that individualized questions about each plaintiff's knowledge would predominate because the classes proposed by plaintiffs were comprised of sophisticated financial institutions, each of which would have had different levels of knowledge about the extent to which underwriting guidelines could be relied upon at different times over the class period.

The district court denied class certification on both predominance and superiority grounds. With respect to predominance, the court explained that “[w]here a defendant shows that broad knowledge of the alleged wrongful conduct existed ‘throughout the community of market participants . . . this widespread knowledge [] would precipitate individual inquiries as to the knowledge of each member of the class,’ and defeat the predominance of common issues.” *N.J. Carpenters Health Fund v. Residential Capital, LLC*, 272 F.R.D. 160, 168 (S.D.N.Y. 2011)

(quoting *In re Initial Pub. Offering Sec. Litig.*, 471 F.3d 24, 44 (2d Cir. 2006)). Applying that standard, the court found that individual issues of knowledge would predominate based on certain facts including that plaintiffs were sophisticated investors steeped in the MBS market; one of plaintiffs' investment advisors met regularly with loan originators and knew that certain loans were issued that did not conform with underwriting guidelines; some purported class members were themselves defendants in other mortgage-crisis related litigation involving similar allegations (indeed, some class members like Freddie Mac and Fannie Mae were involved in the structuring of the offerings at issue and the selection of the underlying loans); and class members purchased at different times, some purchasing after information about loan defaults and analyst downgrades became available. With respect to superiority, the district court found that the need for individual inquiries about knowledge meant that a class action was not a superior method for resolving the dispute, as did the fact that plaintiffs had both the incentive and the financial resources to pursue their claims individually.

### **The Second Circuit Decision**

In a summary order, the Second Circuit affirmed the district court's denial of class certification. The court first noted that plaintiffs as the party seeking class certification bear the burden of demonstrating (by a preponderance of the evidence) that each of Rule 23's requirements is met. The court explained that the issue at the certification stage was not the "merits" question — whether defendants have satisfied their affirmative defense under section 11 concerning the purchaser's actual knowledge of the specific untruth or omission in the registration statement — "but the [class] certification question of whether common liability issues predominate over individual knowledge defenses." Noting the partial and "limited" record before the lower court, the Second Circuit found no basis to conclude that the district court abused its discretion in ruling that individualized issues would predominate and that the "knowledge defenses would require extensive individual proceedings," particularly in light of the "cumbersome class definitions" (including 74 separate offerings) put forward by plaintiffs and the fact that investors that purchased at different times in the class period would have had available varying degrees of public information.<sup>1</sup>

In reaching this conclusion, the Second Circuit also rejected plaintiffs' claim that denying class certification would have a draconian impact on other MBS litigation. The court identified three other decisions in the Southern District of New York that had granted class certification in MBS actions, noted that class certification is always based on a case-by-case inquiry, and found that "both grants and denials of class certification in MBS litigation may fall within the range of a district court's discretion."

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<sup>1</sup> The court specifically noted that its decision addressed only plaintiffs' failure to satisfy the predominance requirement and did not reach (because it did not have to) plaintiffs' argument that the district court erred in its ruling on the superiority requirement.

## Conclusion

The Second Circuit's decision demonstrates the potential for a purchaser's individual knowledge to complicate (if not defeat) class certification in MBS litigations asserting section 11 claims. Given the deference afforded to the lower court's findings and the decision's express acknowledgement that other courts in the district have certified classes based on different offerings and circumstances, the decision does not provide sweeping guidelines for MBS-related cases. But it provides leeway for district courts to consider class certification carefully and offers an example to defendants of how differences among class members can be presented to courts to challenge certification.

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