

The Second Circuit Weighs In On Challenges To Class Certification In MBS-Related Litigation

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The Second Circuit recently 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*, Nos. 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's Decision

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 applicable underwriting guidelines. Plaintiffs alleged that their investments had been much riskier than what was portrayed in the offering documents as a result.

Defendants opposed class certification arguing, among other things, that issues regarding each investor's knowledge would predominate over general issues of liability and that a class action would not be a superior means of resolving the investors' dispute for that reason. More specifically, although 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



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extent to which underwriting guidelines could be relied upon at different times over the class period. Defendants also argued "that certain purchasers had knowledge that the loan originators were 'loosening and lowering' underwriting guidelines." *N.J. Carpenters Health Fund v. Residential Capital, LLC*, 272 F.R.D. 160, 168 (S.D.N.Y. 2011).

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." *Id.* (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 because, among other things, 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; and 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 structuring the offerings at issue and selecting the underlying loans). Additionally, class members purchased at different times, some purchasing as more information about loan defaults and analyst downgrades became publicly available. The district court explained that "[t]his information cast increasing levels of doubt on whether the loans comprising mortgage backed securities were originated in conformity with appropriate guidelines and risk analyses." *Id.* at 169-70.

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. Specifically, the district court noted that the purpose of class treatment – to bundle common claims that are too small to pursue individually in a single action – "is not served where, as here, the proposed class consists of large, institutional and sophisticated investors with the financial resources and incentive to pursue their own claims." *Id.* at 170. Moreover, the

class members had competing interests given the presence of "hedge funds and mutual funds, which were deeply involved in and profited from residential mortgage backed securities and other structured finance products." *Id.* at 171.

Related District Court Decisions

Before the Second Circuit decided *N.J. Carpenters*, three other Southern District of New York decisions granted plaintiffs' motion to certify classes involving MBS offerings. See *Pub. Emps. Ret. Sys. of Miss. v. Goldman Sachs Grp., Inc.*, No. 09-Civ-1110(HB), 2012 U.S. Dist. LEXIS 13548 (S.D.N.Y. Feb. 3, 2012) (Baer, J.); *Pub. Emps. Ret. Sys. of Miss. v. Merrill Lynch & Co.*, 277 F.R.D. 97 (S.D.N.Y. 2011) (Rakoff, J.); *N.J. Carpenters Health Fund v. DLJ Mortg. Capital, Inc.*, No. 08-Civ-5653 (PAC), 2011 U.S. Dist. LEXIS 92597 (S.D.N.Y. Aug. 16, 2011) (Crotty, J.). As to the Rule 23(b)(3) requirements of predominance and superiority, all three cases distinguished the district court's decision in *N.J. Carpenters Health Fund v. Residential Capital, LLC*, noting that those cases lacked, for example, specific evidence of class members' knowledge of the alleged misstatements or evidence of some class members' involvement in selecting the loans for the offerings. See, e.g., *Goldman Sachs Grp.*, 2012 U.S. Dist. LEXIS 13548, at *19-21; *Merrill Lynch & Co.*, 277 F.R.D. at 117; *DLJ Mortg. Capital, Inc.*, 2011 U.S. Dist. LEXIS 92597, at *20-23 & n.1.

In addition, the district court in *Merrill Lynch* found that general statements from a plaintiff's investment advisor about the degradation of underwriting standards did not demonstrate that individualized issues of knowledge predominated because "this broad indictment of the housing market as a whole does not suggest that [the investment advisor] had knowledge of the conduct alleged in this case." *Merrill Lynch & Co.*, 277 F.R.D. at 118. And, as the court in *DLJ Mortgage Capital* explained, "the fact that some of the potential class members are sophisticated financial institutions cannot, in itself, defeat class certification." *DLJ Mortg. Capital*, 2011 U.S. Dist. LEXIS 92597, at *20-23 n.1. In finding superiority satisfied, the three cases focused on the small amounts at stake for some class members, the minimal pending litigation related to these offerings, the Southern District of New York's expertise with securities laws, and the judges' familiarity with the cases before them. See, e.g., *Goldman Sachs Grp.*, 2012 U.S. Dist. LEXIS 13548, at *34-35; *Merrill Lynch & Co.*, 277 F.R.D. at 120-21; *DLJ Mortg. Capital*, 2011 U.S. Dist. LEXIS 92597, at *29.

Given the seemingly divergent rulings on the propriety of class certification in MBS-related litigation, attorneys and securities professionals eagerly awaited the Second Circuit's decision in *N.J. Carpenters Health Fund v. RALI Series 2006-Q01 Trust*.

The Second Circuit Decision

In *N.J. Carpenters Health Fund v.*

RALI Series 2006-Q01 Trust, the Second Circuit affirmed (in a summary order) 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." From that starting point, the Second Circuit found no basis to conclude that the district court abused its discretion in ruling that individualized issues would predominate. The court further explained 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 purchasing at different times in the class period would have had available varying degrees of public information. 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.

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 the three other decisions in the Southern District of New York (discussed above) 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." Thus, plaintiffs' efforts to dramatize the nature and consequences of the district court's ruling overreach the facts.

Conclusion

The Second Circuit's decision in *N.J. Carpenters Health Fund v. RALI Series 2006-Q01 Trust* 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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