Legal Updates & News

Legal Updates

Ahead of the Summons

March 2007

Related Practices:

- Financial Services Law
- Financial Services Litigation
- Litigation

Class Actions Reconsidered?

The Second Circuit dropped a Fizzie® in the punchbowl in December when it decided *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2007), a securities class action case. It reversed class certification in six "focus cases" from 310 consolidated class actions. The opinion is likely to affect more than those consolidated cases. Why? Because in granting class certification, the district judge applied a commonly used standard, namely, that plaintiffs need only make "some showing" of each of the FRCP 23 elements for certification. The Second Circuit said no. Class certification requires "making determinations that each of the Rule 23 requirements has been met," and a court considering class certification must "resolve[] factual disputes relevant to each Rule 23 requirement." 471 F.3d at 41.

To reach this result, the Second Circuit had to distinguish *Eisen v. Carlisle and Jacquelin*, which cautioned against courts conducting "a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action." The Second Circuit, however, said that a court's duty to resolve factual issues in class certification cannot be avoided "just because" the dispute in the context of the class certification "is identical to the issue of the merits." *Id*. at 42. *Eisen* should properly be understood "to preclude consideration of the merits only when a merits issue is unrelated to a Rule 23 requirement." *Id*. at 41.

Applying this principle, the Second Circuit then reached five "conclusions" to guide trial court behavior in making decisions on class certification: (i) "[A] district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met"; (ii) Such determinations can be made only if the judge resolves relevant "factual disputes" and "finds whatever underlying facts are relevant to a particular Rule 23 requirement have been established"; (iii) This obligation "is not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement"; but (iv) "A district judge should not assess any aspect of the merits unrelated to a Rule 23 requirement"; and (v) A judge has "ample discretion to circumscribe both the extent of discovery concerning Rule 23 requirements and the extent of a hearing to determine whether such requirements are met." *Id*.

Practice Tip: Class certification is often outcome-determinative. So, poking into the merits at the class certification stage is often in a defendant's interest.

Subprime Sturm Und Drang

Sharpen your knives. The subprime mortgage market, which has helped fuel the economy and put 2 million families into homes over the last five years, is under attack.

In March, the Federal Financial Institution Regulatory Agencies (OCC, FRB, FDIC, OTS, and NCUA) issued for comment a proposed "Statement on Subprime Mortgage Lending." It is intended to enlarge upon the September 2006 "Interagency Guidance on Nontraditional Mortgage Product Risks," which was limited to the risks posed by "Interest-Only Mortgages" and "Payment Option ARMs." The new Statement applies the same principles more broadly to subprime ARM products. In particular, an institution's analysis of a borrower's repayment capacity should include an evaluation

of the borrower's ability to repay the debt by its final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.

The market has responded with turbulence. Market jitters caused risk premiums on the bonds of the major Wall Street financial investors to widen substantially in March, ditto the credit-default swaps (these measure the cost of credit protection). Originations of subprime mortgages are expected to decline 30-35% this year from 2006, when they comprised $600 billion, or about one-fifth of the total mortgage market. Delinquencies are also expected to soar on the once-popular "2/28" loans—these carry fixed rates for two years and then reset to a rate that floats with the market—as some borrowers' monthly payments jump 50% or more. It didn't help things that, in early March, New Century Financial Corp. announced it is the subject of a criminal investigation by the U.S. Attorney into its accounting and securities trading.

The new Statement will be open for comment for 60 days.

For further information, contact Joe Gabai at jgabai@mofo.com.

Made in Japan

Consumer class actions may soon be coming to Japan. The Japanese Consumer Contract Act ("CCA") was amended in May 2006 (effective June 2007) to provide for a limited class action-type mechanism for consumer litigation. The CCA as originally enacted provides consumers with relief from unconscionable contract terms. Specifically, the CCA sets forth conditions under which a consumer may avoid contractual obligations and under which certain limitations of liability are unenforceable. However, only consumers who suffer direct injury have standing to seek injunctive relief. The 2006 amendments, add a mechanism to permit consumer group litigation (*shouhisha dantaisoshou*) by which certain consumer groups accredited by the Prime Minister of Japan also have standing to seek injunctive relief to protect consumers from violations of the CCA.

For more information, contact Daniel Levison at dlevison@mofo.com.

Fireside Chat

In January, the California Supreme Court heard oral argument in a potentially important class action case that snuck under everyone's radar. The case is called *Fireside Bank v. Superior Court*, No. S139171, and it involves the issue of "one-way intervention." By that rule, a trial court in a class action case must first decide class certification before issuing a decision on the merits. This is to protect the due process right of defendants and is universally followed. Except it wasn't followed in the trial court below, yet the Court of Appeal said that didn't matter.

Without this rule, plaintiffs can "game" the system. In a case that might otherwise qualify as a class action, plaintiffs could instead bring several individual actions, each in a different court, lose all but one, then from that single victory amend the complaint to assert the claim on behalf of a class of claimants. The hapless defendant, guilty of nothing more than assuming that only a small amount of money was at stake, could find itself having to defend a class action that it has already "lost"—despite winning every case except that one.

It is at one's own peril that outcomes can be predicted from oral argument, but it seemed to our observers that the Supreme Court wasn't quite ready to jettison the rule. Watch this space. We should have a ruling by late March.

For more information, contact Will Stern at wstern@mofo.com.