

## VII. PREDATORY LENDING AND SERVICING

- A. “Predatory Lending” is a catch-all phrase used to describe a collection of abusive lending practices:
1. Loan Flipping—making a subsequent loan to refinance the original loan which results in no economic net benefit to the borrower.
  2. Excessive Fees—the charging of fees that bear no reasonable relationship to the services actually provided.
  3. Packing—the selling of additional products in a loan agreement.
  4. Lending without regard to the borrower’s ability to repay.
  5. “Bait and switch.”
- B. Evaluating an individual predatory lending claim: Does the overall transaction make sense for the consumer, based on his or her financial situation?
- Did the consumer consolidate high interest credit card debt to a loan with a lower interest rate?
  - Did the consumer take cash out at closing of the refinance to make critical home repairs she would otherwise have been unable to afford?
  - Did the consumer’s overall monthly debt payment amount increase or decrease?
  - Is the interest rate on the new home loan less or more than the interest rate on the old one? (This factor will also require a comparison of prevailing market interest rates at the time of each transaction.)
  - Did the consumer convert unsecured debt to secured debt, placing him at risk for losing his home?
  - Is the consumer monthly payment reasonable in light of her income and other debt obligations?
- C. Other key factors in evaluating an individual claim:
- Did the customer approach the lender about the refinance, or was it the other way around?

- Did the customer knowingly and willingly sign the loan documents? Were the loan papers signed under coercive circumstances, such as in the customer’s home? Were disinterested witnesses present?
  - In cases involving elderly borrowers, who many plaintiffs’ attorneys and legislators believe were at greater risk for lending abuses, one should also consider whether the borrower suffered from some condition, such as dementia, resulting in diminished capacity. Was a trusted family member involved in the decision to refinance? Does the transaction make sense for someone with a short life expectancy and a fixed income?
- D. Class certification may be difficult to obtain: Predatory lending claims potentially involve a number of individual issues that may make certification of a class difficult (although this will ultimately depend on the particular lender’s practices and how the predatory lending claim is pled). The factors listed above in Sections B and C all raise individual issues that can be used to argue non-common issues of fact predominate.
- E. Supreme courts are continuing to reject local predatory lending ordinances: The Supreme Court of California (*American Fin. Servs. Ass’n v. City of Oakland*, 34 Cal. 4th 1239, 23 Cal. Rptr. 3d 453, 104 P.3d 813 (2005) and the Supreme Court of New York have held that local predatory lending ordinances are preempted by state and/or federal law. (*Mayor of City of New York v. Council of City of New York*, 4 Misc. 3d 151, 780 N.Y.S.2d 266 (N.Y. Sup. Ct. 2004).) In late 2006, the Ohio Supreme Court reached the same result, *American Financial Services Assn. v. City of Cleveland*, 112 Ohio St.3d 170 (2006).
- F. “Predatory Servicing,” like predatory lending, is a catch-all phrase.
1. Predatory servicing cases often include one or more of the following types of allegations:
    - a. Imposing unwarranted and improper fees—often late fees when the loan was not late.
    - b. Failing to credit payments received in a timely fashion—allegedly so that late fees can be charged and borrowers placed in foreclosure.
    - c. Misapplying payments—allegedly for the benefit of the servicer.

- d. Prematurely referring the account to foreclosure and collections—despite legal and accounting errors allegedly made by the servicer.
  - e. Failing to timely respond and communicate with customers.
  - f. Finally, these practices are alleged to exist despite the servicer’s advertising and information that generally trumpets how the servicer is responsive and customer-oriented.
- G. Claims of predatory servicing have surfaced everywhere.
- 1. Testimony before Congress: See testimony of Maureen McGrath, National Advocacy Against Mortgage Servicing Fraud, before the House Subcom. on Capital Markets, Insurance & Gov’t Sponsored Enterprises (June 14, 2004), *available at* <<http://financialservices.house.gov/media/pdf/061404mm.pdf>>.
  - 2. Websites by class action counsel: See <<http://www.lieffcabraser.com/loan-servicing.htm>>
  - 3. Consumer “gripe” websites. Internet complaint sites feed potential plaintiffs to willing lawyers. See <<http://www.ripoffreport.com/reports/ripoff65970.htm>>, <[http://www.consumeraffairs.com/finance/finance\\_\\_companies.htm](http://www.consumeraffairs.com/finance/finance__companies.htm)>, <<http://community.lawyers.com/messageboards/>>, <<http://www.lawyersandsettlements.com>>, <<http://uspeakout.com/>>, <<http://www.edcombs.com/FSL5CS/Custom/TOCViolations.asp>>.
  - 4. State and federal regulatory agencies and prosecutors.
    - a. FBI, HUD Office of Inspector General, the FTC, state and local prosecutors cooperated in suing Fairbanks Capital Corporation in 2002-2003. (Settled \$55 million; see <<http://www.lieffcabraser.com/fairbanks.htm>>.) FTC action against Associates. (Settled FTC and follow-on class action, \$240 million; see <[http://consumeraffairs.com/news02/iti\\_settles.html](http://consumeraffairs.com/news02/iti_settles.html)>, <[www.ftc.gov/opa/2002/09/associates.htm](http://www.ftc.gov/opa/2002/09/associates.htm)>.) Suits against Household and Ameriquest by state attorneys general. (Household settled for \$484 million; see <<http://www.oag.state.tx.us/oagnews/release.php?id=158>>; Ameriquest settled for \$325 million; see <<http://www.oag.state.tx.us/consumer/lawsuits.php>>.)

- b. Regulators' and prosecutors' efforts spawn private litigation. *See, e.g., Schlosser v. Fairbanks Capital Corp.*, 323 F.3d 534 (7th Cir. 2003).
    - c. Agencies and prosecutors use administrative or investigative subpoenas to gather evidence that may later be made available to private plaintiffs.
  - 5. Lawsuits—class action and individual claims.
- H. Class certification may be difficult to obtain: Like predatory lending suits, predatory servicing cases usually involved a number of individual issues, making certification difficult to obtain.
  - 1. *Chase Manhattan Mortgage Corp. v. Porcher*, 898 So. 2d 153, 157-58 (Fla. Dist. Ct. App. 2005) (reversing class certification in putative nationwide class action charging Chase delayed posting payments to impose improper late fees; individual evidence would be required to prove that a class member's payment was or was not late).
  - 2. *Ploog v. HomeSide Lending*, 2001 WL 1155288 (N.D. Ill. 2001) (class certification denied because of individual questions on claim loan servicer violated 12 U.S.C. § 2605(d) by failing to respond in a timely manner to qualified written requests).
  - 3. Because standard mortgage and deed of trust forms choose the law of the state in which the property is located, all 50 states' laws will be implicated in most nationwide class actions, further complicating certification. *See Washington Mutual Bank v. Superior Court*, 24 Cal. 4th 906 (2001).
- I. Downsides of Predatory Servicing Litigation:
  - 1. Expensive to defend
  - 2. Negative publicity
- J. Proactively Stemming the Litigation Tide.
  - 1. Refer unsatisfied customers to supervisors.
  - 2. Monitor public complaint websites and offer to fix customers' complaints.

## VIII. THE CONVERGENCE OF ALTERNATIVE MORTGAGE PRODUCTS, THE SUBPRIME MELTDOWN AND SUITABILITY

### A. The Advent of Alternative Mortgage Products

1. As housing prices reached unprecedented heights across the country, the mortgage industry expanded its use of nontraditional products, such as interest-only and payment option mortgages. According to a recent Federal Reserve Board survey, these products make up more than 1/3 of mortgage portfolios at 21.6% of the largest banks.
2. In 2006, interest-only mortgages accounted for 25% of the dollar volume of all originations, and option ARM mortgages accounted for 15% of all originations. Another source reports that about 27% of all mortgages made in 2006 were nontraditional.

### B. Nature of the Products

1. These products often provide little, if any, principal reduction, and in the case of payment option mortgages, can result in negative amortization. Coupled with declining real estate values, borrowers may own homes whose value is less than their loan balance. Further, when higher amortizing payments are required, they may not be able to afford higher monthly payment. Borrowers are stuck—they are unable to refinance the loan and may not even be able to sell for enough to pay off the mortgage.
2. Results include increased delinquencies, defaults, and foreclosures, as well as increased litigation.
3. Lawsuits have already begun. A federal court in Wisconsin recently granted summary judgment in favor of borrower with a nontraditional mortgage. *Andrews v. Chevy Chase Bank, FSB*, 2007 WL 112568 (E.D. Wis. 2007).
4. Regulators and legislatures are also getting involved.
  - a. Federal banking regulators issued an interagency Guidance in September 2006 for the purpose of “clarify[ing] how institutions can offer nontraditional mortgage products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume.” The agencies’ primary directive is that the consumer’s ability to repay the loan—and not just in its early years—must be considered and disclosed.

- b. The Senate Banking Committee conducted a hearing on February 7, 2007, on predatory lending practices. The hearing, led by Senator Dodd and entitled “Preserving the American Dream: Predatory Lending Practices and Home Foreclosures,” focused on nontraditional mortgages. Dodd pointed out that approximately 8 in 10 subprime loans today are 2/28 adjustable rate mortgages, mortgages whose monthly payments will spike up by as much as 30% to 50% or more in later years. He also pointed out that about \$600 billion in ARMs will reset this year.
- c. The California legislature is considering imposing guidelines for nontraditional loans.
- d. Other states have done so or are considering doing so. For example, Minnesota is considering banning altogether negative amortization loans.

C. The Subprime Meltdown

- 1. Eight weeks after the Senate Banking Committee’s February 7, 2007 hearing, the subprime mortgage market went into a tailspin.
  - a. Twenty subprime lenders have closed and are making no new loans.
  - b. Those lenders stock prices have gone into free fall.
  - c. Massive layoffs of employees are the norm.
  - d. Most notable is the New Century Bankruptcy following the commencement of an investigation by the Securities and Exchange Commission.
- 2. What happened?
  - a. Rising interests rates and the resetting of mortgage payments at substantially higher amounts with respect to alternative mortgage products, has given rise to an unprecedented delinquency and foreclosure rate.
    - i. The MBA has reported that 4.5% of subprime mortgages were in the foreclosure process by the end of the 4<sup>th</sup> quarter.
    - ii. At the same time 13.3% of all subprime borrowers were behind on their payments; the highest level since 2002.

- b. The effect of early payment defaults on subprime lenders.
  - i. To meet the requirements of their credit lines, subprime lenders must maintain a net worth or debt ratio at a certain level.
  - ii. The investment banks that extend the lines of credit also require the subprime lenders to buy back loans which are early payment defaults.
  - iii. The massive numbers of early payment defaults have resulted in the providers of credit (the investment banks) requiring the subprime lenders to repurchase equally massive numbers of bad loans, thereby lowering the amount of capital the lenders have to satisfy the net worth and debt ratio requirements.
  - iv. The investment banks wary of the liberal underwriting standards and the alternative mortgage products that have resulted in the defaults and seeing that the subprime lenders are failing to meet their capital requirements, have shut down credit lines.
  - v. With the buybacks and shrinking or non-existent credit lines the subprime lenders are simply out of cash with which to make loans.

D. Rising Delinquencies, Coupled With the Subprime Meltdown Equal Suitability.

- 1. With delinquencies and foreclosures rising, pressure is building in Congress for stricter standards for mortgage brokers and lenders under the nomenclature of "Suitability."
  - a. "Suitability," in essence, is that the selected loan must be the most appropriate available option given the circumstances and needs of a particular borrower.
  - b. Such a standard would require loan officers to determine an applicant's suitability for a particular loan based on certain criteria, for example:
    - i. Income, assets, employment and the likelihood that any of the three might change.

- ii. Recurring expenses and the impact they might have on the borrowers' ability to repay.
    - iii. The potential for higher future payments given the loan in question.
  - c. Consumer advocates consider "Suitability" the solution to the problems of "predatory lending," mortgage fraud and rising foreclosures.
  - d. By contrast, industry spokespersons have pointed out that "Suitability," which is borrowed from the securities industry (e.g. brokers are required to make suitability determinations when customers seek a specific trade or investment), constitute a radical and unwarranted departure from key principals of mortgage lending and an open invitation to litigation.
- 2. "Suitability Litigation"
  - a. Principals of Suitability that lead to lawsuits:
    - i. Historically the relationship between a borrower and a lender has been arms length.
    - ii. "Suitability" changes the nature of that relationship, making the lender the borrower's fiduciary (e.g. financial advisor).
    - iii. Loan underwriting is now based on objective, verifiable factors concerning a borrower's ability to repay.
    - iv. "Suitability" introduces subjective considerations (i.e., what is "most appropriate" for this borrower), thus creating a risk or perceived bias, discrimination and/or unfairness in lending decisions.
  - b. The First Wave: The New York Suitability Case. The suit claims that mortgages granted to two dozen elderly borrowers who cannot afford their payments are "legally void and unenforceable" because the lenders failed to consider repayment ability when granting the credit. The suit against Countrywide Home Loans Inc., IndyMac Bank, Homecomings Financial LLC, PHH Mortgage Corp., Washington Mutual Inc., and First National Bank of Long Island, seeks to stop collections and foreclosure proceedings during the pendency of the litigation. The suit

further contends that the lenders facilitated the overarching fraud scheme of Peter Dawson, the elderly borrowers' financial planner, who convinced the retirees to mortgage their homes so he could invest the proceeds. Dawson, in turn, siphoned off approximately \$1 million.

In comments to the American Banker, Jacob Zamansky, the plaintiff's lawyer, opined that "industry standards require mortgage lenders to 'know their customer' and consider the suitability of the borrower." He added that lenders are required "to engage in, and adopt, 'safe and sound' lending policies which prevent abusive or predatory loans to borrowers who lack the ability or means to repay."

Zamansky's blog carries a description of the suit and a copy of the affirmation in support of a preliminary injunction motion.

<http://www.zamansky.com/pdf/JHZ%20Affirmation.pdf> will get you the affirmation.

- c. Anticipated future cases.
  - i. Borrowers will raise suitability as defense to foreclosure actions.
  - ii. The foreclosure action itself will be "prima facie" evidence that the suitability standard was not met.
  - iii. Parties will debate the "proximate cause" of the default. Was the loan unsuitable in the first instance or is the default due to other causes, such as death, disability, divorce, job loss, etc.
  - iv. The disputes will be time consuming and costly to all involved.

## **IX. PREEMPTION DEVELOPMENTS**

### **A. OTS Preemption:**

- 1. *WFS Financial, Inc. v. Super. Ct. (de la Cruz)*, No. C051414, 2006 Cal. App. LEXIS 879 (June 15, 2006)
  - a. WFS originally sued a borrower after the proceeds from a sale of a repossessed car failed to cover the loan balance. The borrower asserted a class action cross-complaint alleging that the lender's pre-sale notice failed to comply with disclosure requirements under California's Rees

Levering Automobile Sales Finance Act (Cal. Civ. Code § 2983.2), and asserted an Unfair Competition Law (“UCL”) claim based on that violation. The plaintiff sought refunds to every borrower sued in a collection case by WFS for over four years.

- b. The trial court denied WFS’s demurrer, which argued that the cross-complaint was preempted by federal law and OTS. A Third District panel, however, granted WFS’s writ petition in a thorough, published 27-page opinion issued June 15. The Court of Appeal ordered the trial court to dismiss – without leave to amend – the cross-claim.
- c. The Court of Appeal found that the particular notice requirements imposed by the Rees-Levering Automobile Sales Finance Act do not apply to WFS because it operates exclusively under the preemptive federal regulations of the OTS. Citing U.S. Supreme Court authority, the court found that the OTS’s interpretation of its own regulation was definitive. This is the first California Court of Appeal decision to recognize this significant principle of regulatory construction in the context of banking preemption. In so doing, the court distinguished numerous troubling California appellate decisions addressing OTS preemption.
- d. Petition for review pending.

- 2. State law challenges to yield spread premiums dismissed: *Monroig v. Washington Mutual Bank*, 19 A.D.3d 563, 800 N.Y.S.2d 416 (N.Y. App. Div. 2005) (Homeowners Loan Act preempts state law claims against lender for paying broker a YSP); *Pearson v. Bank of America*; *Kleiman v. Washington Mutual Bank*
- 3. State law challenges to processing of prepay penalty dismissed: *Zorfas v. CitiMortgage, Inc.* (San Francisco Superior Court, Mar. 3, 2005)

B. OCC Preemption: Continued momentum, with a hiccup.

- 1. Gift Card Litigation: *SPGGC, Inc. v. Ayotte*, 2006 DNH 89; 2006 U.S. Dist. LEXIS 52823 (D.N.H. Aug. 1, 2006). In a major victory for the banking industry, a federal district court in New Hampshire has rejected the state’s efforts to regulate the terms of stored value gift cards issued by a national bank and federal savings association, but marketed and sold by a non-bank third party. According to the Court, a state’s attempt to impose restrictions upon a national banking product “stand[s] as an

obstacle to the fulfillment of Congressional policies and goals embodied in federal banking laws and the associated regulations implemented by both OTS and OCC” and is therefore preempted.

2. *Nat’l City Bank of Indiana v. Turnbaugh*, 2006 U.S. App. LEXIS 20538 (4th Cir. Aug. 10, 2006)
  - a. Affirms grant of summary judgment in favor of National City Bank of Indiana and its Maryland-chartered mortgage subsidiaries, National City Mortgage Co. and First Franklin Financial Corp., in a suit by Charles W. Turnbaugh, commissioner of financial regulation at the state Department of Labor, Licensing and Regulation. On appeal, 39 other states and the District of Columbia signed on as amici in support of Maryland’s position.
  - b. Held Maryland cannot enforce a law that limits prepayment penalties on adjustable rate mortgages if the lender is an operating subsidiary of a national bank. National Banking Act and OCC regulations of the federal pre-empt the Maryland Mortgage Lender Law. “If state law applied to operating subsidiaries to a greater extent than it applied to their parent national banks, it would frustrate national banks’ right to conduct the ‘business of banking’ through operating subsidiaries.”
3. *Wachovia Bank, N.A. v. Burke*, 414 F.3d 305 (2d Cir. 2005). OCC’s operating subsidiary preemption regulations are valid and entitled to deference. However, they provide no basis for federal subject matter jurisdiction of challenge to state regulation; preemption defense must be presented in state court.
4. *Wells Fargo Bank, N.A. v. Boutris*, 419 F.3d 949 (9th Cir. 2005). California corporate regulator’s authority to order operating subsidiaries of banks to conduct audits to determine whether California law was violated is preempted by National Bank Act and pertinent federal regulations. Federal regulations also field-preempt California’s licensing authority over such entities.
5. *Wachovia Bank, N.A. v. Watters*: On April 17, 2007 the Supreme Court affirmed the Sixth Circuit’s decision in *Wachovia Bank, N.A. v. Watters*, 550 U.S. \_\_\_\_ (2007) finding that “Wachovia’s mortgage business, whether conducted by the Bank itself or through the Bank’s operating subsidiary is subject to the OCC’s superintendence, and not to the licensing, reporting and visitorial regimes of several states in which the subsidiary operates.” (Opinion Syllabus, p. 2.)

6. *Fuchs v. Wachovia Mortgage Corp.*, No. 17000-03, 2005 N.Y. Misc. LEXIS 2545 (N.Y. Sup. Ct. Nov. 15, 2005). Plaintiffs alleged that the mortgage lender's practice of charging for document preparation fees constituted the unlawful practice of law. The district court dismissed the claims, holding that state laws were preempted by the National Bank Act and OCC regulations.
7. HMDA Fight: *Office of Comptroller of the Currency v. Spitzer*, 396 F. Supp. 2d 383 (S.D.N.Y. 2005) (OCC preemption regulation is valid and precludes state attorney general from enforcing state's anti-discrimination law against national bank as parens patriae); *Clearing House Ass'n v. Spitzer*, 394 F. Supp. 2d 620 (S.D.N.Y. 2005) (same).
8. The Ninth Circuit found that the FCRA, as amended in 1996 and 2003, forbids states from enacting requirements or prohibitions concerning the exchange of information between affiliates. This decision holds that "information" for these purposes refers only to "information" that would otherwise constitute a credit report for FCRA purposes; namely, information bearing on a consumer's creditworthiness, credit standing, character, reputation, or mode of living which is to be used for purposes of determining eligibility for credit, insurance, or employment. To the extent California's Financial Information Privacy Act (Fin. Code §§ 4050-4060) regulates sharing of that type of information among affiliates, it is preempted. To the extent it regulates sharing of other types of information, it is not preempted. *American Bankers Ass'n v. Gould*, 412 F.3d 1081 (9th Cir. 2005)
9. But see *Smith v. Wells Fargo Bank*, 135 Cal. App. 4th 1463, 38 Cal. Rptr. 3d 653 (2006) (OCC regulations do not preempt a UCL "unlawful" claim based on failure to make disclosures about account charges, as required by OCC regulations or based on breach of account holder agreement).
10. *See also Kroske v. U.S. Bank Corp.*, 432 F.3d 976 (9th Cir. 2005) (National Bank Act does not preempt Age Discrimination in Employment Act or analogous state law).

C. DIDMCA Preemption:

1. *Wells Fargo Bank, N.A. v. Boutris*, 419 F.3d 949 (9th Cir. 2005).
2. *Sweeney v. Savings First Mortgage*, 388 Md. 319, 879 A.2d 1037 (2005) (DIDMCA preempts Maryland's Finder's Fee Law as finder's fees are "finance charges" for DIDMCA purposes;

however, DIDMCA protects only the lender, not the loan broker, so plaintiff can enforce the Finder's Fee Law against the broker).

3. *McCarthy v. Option One Mortgage Corp.*, 362 F.3d 1008 (7th Cir. 2004) (DIDMCA preempts state law barring prepayment penalty; substantial compliance with OTS regulations suffices to invoke preemption).
4. *U.S. Bank v. Clark*, 216 Ill. 2d 334, 837 N.E.2d 74 (2005)—Illinois Interest Act Case: Homeowners argued that creditors had violated the Act by imposing fees in excess of three percent on loans with interest rates of greater than eight percent. The trial court dismissed the claims, ruling that they had been preempted by the DIDMCA, 12 U.S.C. § 1735f-7a. The Illinois Supreme Court agreed, overruling *Fidelity Financial Services, Inc. v. Hicks*, 214 Ill. App. 3d 398 (1991) to the extent its interpretation of the Illinois statute allowed for a contrary finding. Instead, the court found that the limitation in 815 Ill. Comp. Stat. Ann. 205/4.1a (2004) on lender charges was implicitly repealed by the state legislature's 1981 amendment of 815 Ill. Comp. Stat. Ann. 205/4 (2004). Neither of the opt-out provisions in DIDMCA had been applied by the legislature as a 1992 amendment to § 4.1a did not act to readopt or revive the preempted interest and points limitation.
5. *Quicken Loans, Inc. v. Wood* (9th Cir. 2006) 449 F.3d 944. This case follows *Wells Fargo Bank v. Boutris* (9th Cir. 2005) 419 F.3d 949 in holding that DIDMCA does not preempt California's per diem interest statute (Civ. Code 2948.5), which forbids a lender from charging interest for more than a day before the deed of trust is recorded. It goes a step further, holding that the Alternative Mortgage Transaction Parity Act, 12 U.S.C. §§3801-06 does not preempt the per diem interest statute either.
6. *Silvas v. E\*Trade Mortg. Co.* (S.D. Cal. 2006) 421 F.Supp.2d 1315. This case held that OTS regulations preempt UCL claim based on TILA violation. The longer statute of limitations under the UCL is additional regulation that conflicts with OTS' preemption of entire field of lending, including fees and advertising.

D. OTS Preemption of Maryland County Local Ordinance:

1. OTS issued legal opinion on March 7, 2006, concluding that federal law preempts application to federal savings associations of recent amendments to the Code of Montgomery County, Maryland, addressing predatory lending.

2. On the same day, Maryland state court issued a restraining order barring Montgomery County from enforcing its mortgage anti-discrimination measure. *American Fin. Servs. Ass'n v. Montgomery County*, No. 269105-V (Md. Cir. Ct. Mar. 7, 2006).
- E. California State Law Preemption of Local Ordinance. California's state anti-predatory lending statute, Fin. Code § 4970 *et seq.*, impliedly preempts the entire field of regulation of predatory practices in home loans, excluding all local governmental entities from adopting ordinances in that field. See *American Fin. Servs. Ass'n v. City of Oakland*, 34 Cal. 4th 1239, 23 Cal. Rptr. 3d 453, 104 P.3d 813 (2005).

## **X. WAGE AND HOUR LITIGATION**

- A. Explosion of Fair Labor Standards Act claims on behalf of loan officers and others.
1. *Olivo v. GMAC Mortgage Corp.*, 374 F. Supp. 2d 545, 549-50 (E.D. Mich. 2004) holds that GMAC's loan officers are exempt from FLSA overtime pay requirements as "outside salesmen."
  2. *Belton v. Premium Mortgage, Inc.*, 2006 WL 561489 (W.D. Mo. 2006) (holding loan officers were not exempt as "outside salesmen.").
  3. Dept. of Labor, Employment Standard Administration March 31, 2006 letter to National Association of Mortgage Brokers, interprets regulations to allow treatment of outside loan sales representatives as exempt outside salesmen.
  4. Settlements in wage and hour litigation involving loan/account personnel.
    - a. *Butler v. Countrywide Home Loans, Inc.*, No. BC 268250, (California Superior Court, Los Angeles County).
    - b. *Cox v. Downey Sav. & Loan Ass'n*, No. BC 318964, (California Superior Court, Los Angeles County).
    - c. Bank of America settlement.
  5. On May 31, 2006, the U.S. Dept. of Labor sent out a clarifying letter about loan officers wherein it stated that "employees of finance companies who obtain and solicit mortgages may be exempt outside sales employees if they are 'customarily and regularly engaged away from their employer's place of business in obtaining mortgages from brokers and individuals.'"

- B. Increased Litigation Under State Wage and Hour Laws.
1. California's Sue-Your-Boss Law. Cal. Lab. Code § 2698 *et seq.*
  2. State law exemptions may differ in scope and definition from FLSA exemptions. *See, e.g., Ramirez v. Yosemite Water Co., Inc.*, 20 Cal. 4th 785 (1999).
  3. State law may impose additional wage and hour requirements. *See, e.g.,* Cal. Lab. Code § 512; Cal. Code Regulations, tit. 8, § 11040(11), (12) (meal and rest breaks).
  4. Potential for corporate officers to be held personally liable under some state laws. *See, e.g.,* Cal. Lab. Code § 558.
- C. Joint FLSA/State Law Wage and Hour Cases Pose Unique Class Action Problems.
1. The Portal-to-Portal Act amended the FLSA in 1947 to lessen employer liability by requiring, among other things, opt-in classes. Each plaintiff must affirmatively consent in writing to litigation on his or her behalf. 29 U.S.C. § 216(b).
    - a. FLSA class certification generally follows a two-step procedure. *See, e.g., Epps v. Oak Street Mortgage, LLC*, 2006 WL 1460273 (M.D.Fla. 2006); *Stanfield v. First NLC Financial Servs., Inc.*, 2006 WL 3190527 (N.D.Cal. Nov. 1, 2006), citing *Leuthold v. Destination America, Inc.*, 224 F.R.D. 462, 466 (N.D. Cal. 2004).
    - b. First step: Early in litigation plaintiff moves for conditional certification and notice to class members of right and need to opt in. At this stage, the plaintiff need only make a minimal showing by allegation (and, perhaps, some evidence) that plaintiff and class members are "similarly situated" in being "victims of a single decision, policy or plan." The burden is light, and typically the class is conditionally certified. *Scott v. Heartland Home Finance, Inc.*, 2006 WL 1209813 (N.D.Ga. 2006) (granting conditional class certification to class of loan officers); *Stanfield*, 2006 WL 3190527 at \*2 (granting conditional class certification to class of loan officers, loan processors and account managers), citing *Leuthold*, 224 F.R.D. at 467; *Davis v. Novastar Mortgage, Inc.*, 408 F. Supp. 2d 811, 815 (W.D. Mo. 2005).
    - c. Second step: After discovery, the employer may move to decertify the class. At this stage, the court determines

propriety and scope of class, considering (i) disparate factual and employment settings of individual employees, (ii) various defenses available to employer as to individual employees, and (iii) fairness and procedural considerations. *Leuthold*, 224 F.R.D. at 467; *Epps*, 2006 WL 1460273 at \*3 (denying defendant's motion to decertify class of loan officers).

- d. Typically, the opt-in rate for FLSA actions is 15-30% of the certified class, although the rate may be higher in union-backed suits. See Matthew Lampe & E. Michael Rossman, *Procedural Approaches for Countering the Dual-Filed FLSA Collective Action and State-Law Wage Class Action*, 20 Lab. Law. 311, 313 (2005).
2. State law claims are subject to normal opt-out class action procedure under Federal Rule of Civil Procedure 23(b)(3). Opt-out rates are typically low. Plaintiffs therefore often combine state law claims with FLSA claims to obtain the benefits of both: FLSA liquidated damages and attorney fees with an opt-out class for the state law claims.
  3. Employer counter-strategies begin with removal of the case to federal court, see *Breuer v. Jim's Concrete of Brevard, Inc.*, 58 U.S. 691 (2003), followed by:
    - a. A motion to dismiss non-opt-in class members on the ground that the court lacks supplemental jurisdiction over them. See *Bartelson v. Winnebago Indus., Inc.*, 219 F.R.D. 629 (N.D. Iowa 2003). The downside to this strategy is that the dismissed employees may refile in state court.
    - b. A motion to dismiss non-opt-in class members on the ground that the court should exercise its discretion to decline supplemental jurisdiction over them because state law claims predominate or there are other compelling reasons to decline jurisdiction. 28 U.S.C. § 1367(c); *De Asencio v. Tyson Foods, Inc.*, 342 F.3d 301 (3d Cir. 2003). Same downside: dismissed employees may refile in state court.
    - c. An opposition to Rule 23 class certification on the ground that:
      - i. Rule 23(a)'s numerosity requirement cannot be met since joinder of all class members is possible using the FLSA opt-in procedure. See, e.g., *Thiebes v.*

*Wal-Mart Stores, Inc.*, 2002 WL 479840 (D. Or. 2002).

- ii. Rule 23(b)(3)'s superiority requirement cannot be met. Those employees who want to participate can do so by opting in. Class members may be confused by being asked to opt in and opt out at the same time. *Muecke v. A-Reliable Auto Parts & Wreckers, Inc.*, 2002 WL 1359411 (N.D. Ill. 2002); *Leuthold v. Destination America, Inc.*, 224 F.R.D. 462, 470 (N.D. Cal. 2004); *but see Breeden v. Benchmark Lending Group, Inc.*, 229 F.R.D. 623, 628-31 (N.D. Cal. 2005) (certifying Rule 23 class solely on issue of whether loan officers were properly classified as exempt employees).
- iii. In cases alleging misclassification of a class of employees as exempt from overtime laws, Rule 23(b)(3)'s predominance of common questions requirement is not met because individualized inquiries into each putative class member's daily work activities is necessary. *See, e.g., Dunbar v. Albertson's, Inc.*, 141 Cal.App.4th 1422 (2006)(denying certification of class of store managers); *Walsh v. Ikon Office Solutions, Inc.*, \_ Cal.App.4th \_ (No. A113172, as modified 3/28/07)(decertifying class of account managers).
- iv. If Rule 23 class certification is denied in the federal suit, does that ruling prevent class certification in a later-filed state-court, state-law-only claim on behalf of the same employee class? Surprisingly, the answer may be "yes." *See In re Bridgestone/Firestone, Inc. Tires Prod. Liab. Litig.*, 333 F.3d 763, 766-67 (7th Cir. 2003).

D. A California wrinkle: Prosecution of FLSA violations as unfair business practices under California's Unfair Competition Law ("UCL"), Cal. Bus. & Prof. Code, § 17200.

- 1. The UCL prohibits "unlawful" business practices—i.e., any business practice that violates some other law, such as the FLSA.

2. Advantages to UCL add-on claim:
  - a. Statute of Limitations.
    - i. The FLSA provides for a two-year limitations period unless the violation is willful, in which case a three-year period applies. 29 U.S.C. § 255(a).
    - ii. The UCL provides for a four-year limitations period. Cal. Bus. & Prof. Code § 17208. The longer period for which unpaid wages may be recovered under the UCL is so favorable to employees that plaintiff's lawyers who neglect to include a UCL claim may be committing malpractice. *See Janik v. Rudy, Exelrod & Zieff*, 119 Cal.App.4th 930, 943 (2004)(reversing dismissal of malpractice lawsuit; plaintiffs' attorneys had duty to consider and communicate to plaintiffs advantages and disadvantages of seeking to add UCL cause of action to overtime class action).
    - iii. *Bahramipour v. Citigroup Global Markets, Inc.*, 2006 WL 449132, at \*3-4 (N.D. Cal. 2006), holds that FLSA does not preempt UCL add-on claim or its longer limitations period. *Accord Barnett v. Washington Mut. Bank*, 2004 WL 2011462 (N.D. Cal. 2004).
  - b. Opt-out Class.
    - i. The FLSA allows only opt-in classes. 29 U.S.C. § 216(b).
    - ii. A regular Rule 23 opt-out class may be certified for a UCL claim.
    - iii. Cases holding that the FLSA does not bar opt-out class certification of UCL claims predicated on FLSA violations: *Harris v. Investor's Business Daily, Inc.*, 138 Cal. App. 4th 29, 2006 Cal. App. LEXIS 447 (Mar. 29, 2006; No. B178428); *Bahramipour*, 2006 WL 449132, at \*4-5; *Takacs v. A.G. Edwards & Sons, Inc.*, 444 F.Supp.2d 1100, 1118 (S.D.Cal. 2006); *Tomlinson v. IndyMac Bank, F.S.B.*, 359 F. Supp. 2d 898, 901 (C.D. Cal. 2005); *Barnett*, 2004 WL 2011462, at \*6-7; *Kelly v. SBC*,

*Inc.*, 1998 U.S. Dist. LEXIS 18643, at \*38 (N.D. Cal. 1998).

iv. Also, the California Supreme Court has granted review of *Mills v. Superior Court* (2006) 135 Cal.App.4th 1547, which had held that Labor Code § 226.7(b)'s imposition of liability for an additional hour's pay when the employer fails to allow mandated meal and rest time is a statutory penalty and so not enforceable through 17200 and not subject to additional penalties for delay in payment of wages. Briefing in *Mills* was deferred pending the decision in *Murphy v. Kenneth Cole Productions, Inc.*, No. S140308 (April 16, 2007), in which the Supreme Court held that the additional hour's pay is "wages," not a "statutory penalty" for statute of limitations purposes. The *Murphy* holding is likely to be applied in *Mills*, which would mean employees may file a UCL suit for relief under Labor Code § 226.7(b) and take advantage of the UCL's 4-year statute of limitations.

3. Disadvantage of the UCL add-on claim: limited relief.

a. In a private UCL action, the plaintiff may recover only an injunction and restitution of money "which may have been acquired by means of such unfair competition." Damages and penalties are not recoverable in a UCL action. Cal. Bus. & Prof. Code § 17203; *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal. 4th 1134, 1144, 131 Cal. Rptr. 2d 29, 63 P.3d 937 (2003).

b. Restitution, however, allows the plaintiff to recover money in which he or she has a vested interest, even if the money was never in his or her possession. Earned but unpaid wages, in particular, can be the subject of restitution under this rationale. *Cortez v. Purolator Air Filtration Prods. Co.*, 23 Cal. 4th 163, 178, 96 Cal. Rptr. 2d 518, 999 P.2d 706 (2000).

c. What sums are subject to restitution in a UCL add-on claim?

i. Liquidated damages under the FLSA are not "penalties" but are not recoverable in a UCL add-on claim because they are awarded in addition to the amount of unpaid wages. *Tomlinson v. IndyMac*

*Bank, F.S.B.*, 359 F. Supp. 2d 891, 897 (C.D. Cal. 2005).

- ii. Waiting time penalties under California Labor Code section 203 are penalties and not recoverable in a UCL action. *Tomlinson*, 359 F. Supp. 2d at 895.
  - iii. Extra hour's pay, Cal. Lab. Code § 226.7(b), for violation of rest and meal break laws is earned wage and is recoverable in a UCL action. *Tomlinson*, 359 F. Supp. 2d at 896. (Decision will likely be followed by California Supreme Court, assuming its ruling in *Mills v. Superior Court*, *supra*, follows its *Murphy v. Kenneth Cole Productions*, *supra*, decision.)
4. Is this a California-only wrinkle?
- a. Other states' deceptive trade practice laws forbid "unfair" business practices. *E.g.*, Conn. Gen. Stat. Ann. § 42-110a, *et seq.*; Fla. Stat. Ann. § 501.201, *et seq.*; Mass. Gen. Law. Ann. ch. 93A.
  - b. Practices that violate laws other than the FTC Act have been held to be "unfair" practices prohibited by the FTC Act, 15 U.S.C. § 45(a). *See, e.g., F.T.C. v. Indiana Federation of Dentists*, 476 U.S. 447, 106 S. Ct. 2009, 90 L. Ed. 2d 445 (1986) (antitrust law violation).

## **XI. CLASS ACTION DEVELOPMENTS**

- A. Supreme Court Clarifies Federal Jurisdiction in Class Actions. In an important ruling for defendants in class action cases, the United States Supreme Court has confirmed that so long as the claim of any named plaintiff in a class action case exceeds \$75,000, a case may be removed to federal court on diversity grounds, provided that no member of the class is a citizen of the same state as the defendant. The Court pointed out that the recently enacted Class Action Fairness Act had no bearing on its decision, since many proposed exercises of supplemental jurisdiction might not fall within the purview of the Act. *Exxon Mobil Corp. v. Allapattah Servs., Inc.*, 125 S. Ct. 2611 (2005).
- B. "Captive" Entities No Longer Permitted as Representatives. Following federal authorities, a California Court of Appeal recently held that plaintiff's counsel should be disqualified in a case where the class representative had significant economic ties to the firm. *Apple Computer v. Superior Court*, 126 Cal. App. 4th 1253 (2005).

C. An inadequate class representative can obtain discovery to find a replacement, even prior to certification. An attorney recently brought a putative class action against Best Buy challenging its “restocking fee.” Following *Apple Computer, Inc. v. Superior Court*, 126 Cal. App. 4th 1253 (2005), the trial court found that the attorney could not be both the class counsel and the class representative. The court, however, granted the attorney’s request to conduct precertification discovery to find a replacement class representative. Defendant Best Buy was then ordered to send notice to the putative class members to “solicit” the replacement. *Best Buy Stores v. Superior Court*, 137 Cal. App. 4th 772 (2006).

D. Class Action Fairness Act (“CAFA”)

1. What is CAFA?

- a. Amends Existing Diversity Statute (28 U.S.C. § 1332)
- b. Creates Special Removal Procedures for Class Actions (28 U.S.C. § 1453)
- c. Adds Scrutiny of Coupon Settlements (28 U.S.C. § 1712)
- d. Settlements Require Notice to Government Officials (28 U.S.C. § 1715)

2. Federal Jurisdictional requirements

a. Basic Requirements for Class Actions

i. Amount in Controversy—\$5 million.

- (a) Class actions are defined generally as cases that are proposed to be certified pursuant to Fed. R. Civ. P. 23 or an analogous state provision. CAFA also applies, with slightly different requirements, to “mass actions,” which would include cases such as nationwide mass tort claims that are not appropriate for traditional class certification.
- (b) Under CAFA, the value of claims of putative class members may be aggregated to reach the threshold, but interest and costs do not count. 12 U.S.C. § 1332(c)(6). Courts have held that CAFA, by permitting aggregation of damages, also undermines the reasoning of case law prohibiting aggregation of attorneys’ fees or valuation

of injunctive relief from defendant's perspective. *See Berry v. Am. Express Publ'g*, 381 F. Supp. 2d 1118, 1123 (C.D. Cal. 2005) (injunction); *Yeroushalmi v. Blockbuster Inc.*, 2005 U.S. Dist. LEXIS 39331, at \*16 (C.D. Cal. July 11, 2005) (fees).

- (c) Courts are in conflict over who bears the burden of proof. *Compare, e.g., Brill v. Countrywide Home Loans, Inc.*, 427 F.3d 446, 448 (7th Cir. 2005) (rejecting argument that CAFA places burden of proof on party seeking remand); *Adams v. Insurance Co. of N. Am.*, Civ. No. 2:05-2507, 2006 WL 897945 (S.D. W. Va. Mar. 30, 2006) (same), *with Berry v. American Express Publishing Corp.*, 381 F. Supp. 2d 1118 (C.D. Cal. 2005) (CAFA shifted traditional burden of proof); *Natale v. Pfizer, Inc.*, 379 F. Supp. 2d 161 (D. Mass.), *affirmed on other grounds*, 424 F.3d 43, 2005 U.S. App. LEXIS 19912 (1st Cir. Sept. 16, 2005) (same).

ii. Minimal Diversity

- (a) Diversity for purposes of CAFA exists where any class member is a citizen of a different state from any defendant, or where the litigation involves claims between a foreign state or citizen of a foreign state, on the one hand, and a citizen of a U.S. state, on the other hand. *See* 28 U.S.C. § 1332(d)(2).

iii. Exceptions

- (a) CAFA includes exceptions to the basic jurisdictional rule designed to avoid allowing all local or predominantly in-state class actions into federal court.
- (b) A federal court “*may...decline*” jurisdiction over cases in which more than one-third, but less than two-thirds, of the class are citizens

of forum state and the primary defendants are citizens of the forum state.

- (c) A federal court “*shall...decline*” jurisdiction over cases in which more than two-thirds of the class are citizens of forum state and either (i) one defendant is a citizen of the forum state against whom significant relief is sought, or (ii) the primary defendant is a citizen of the forum state.

iv. Removal Timing

- (a) 30-day limit applies
- (b) 1-year rule does not apply

v. What cases may be removed to federal court under CAFA?

- (a) CAFA applies to “any civil action commenced on or after the date of the enactment of this Act [Feb. 18, 2005].”
- (b) Courts have largely settled the meaning of “commenced” as the date of commencement in state court. See *Bush v. Cheaptickets, Inc.*, 425 F.3d 683, 689 (9th Cir. 2005); *Natale v. Pfizer, Inc.*, 424 F.3d 43, 44 (1st Cir. 2005); *Plubell v. Merck & Co.*, 434 F.3d 1070, 1071-72 (8th Cir. 2006); *Pritchett v. Office Depot, Inc.*, 420 F.3d 1090 (10th Cir. 2005); *Knudsen v. Liberty Mut. Ins. Co.*, 411 F.3d 805 (7th Cir. 2005).
- (c) Courts have, however, held that even in a case that commenced in state court prior to February 18, 2005, a subsequently filed amended complaint that does not relate back for statute of limitation purposes might provide a basis for removal under CAFA. *Knudsen v. Liberty Mut. Ins. Co.*, 435 F.3d 755, 757 (7th Cir. 2006) (vacating remand order where removal was appropriate based on amended claims seeking relief for conduct not at issue in initial complaint).

- (d) In addition, complaints adding new defendants may reopen the window of removal for the entire case. *See Braud v. Transp. Serv. Co.*, No. 06-30088, 2006 U.S. App. LEXIS 8496 (5th Cir. Apr. 6, 2006).
- (e) A dramatic expansion of the class period may make the complaint removable where, under applicable law, the amendment would not relate back for limitations purposes. *Senterfitt v. SunTrust Mortgage, Inc.*, 385 F. Supp. 2d 1377 (S.D. Ga. 2005).
- (f) Some conflict exists over whether relation back should be determined by federal or state law. *Compare, e.g., Lee v. CitiMortgage, Inc.*, No. 4:05CV1216, 2005 U.S. Dist. LEXIS 22571, at \*7 (E.D. Mo. Oct. 5, 2005) (relation back under Fed. R. Civ. P. 15), *with Schorsch*, 417 F.3d at 749 (relation back is to be decided under state law); *see also Schillinger*, 425 F.3d at 335 (deferring resolution of whether federal or state law should determine the type of commencement that is necessary for federal removal under CAFA).

vi. Miscellaneous

- (a) Removing defendants do not need consent of all defendants.
- (b) An in-state defendant may remove.
- (c) Any ruling, including subject matter jurisdiction remands, “may” be reviewed on appeal.

3. Settlements

a. Judicial Scrutiny of Coupon Settlements

- i. CAFA’s settlement provisions apply to class actions in federal court, regardless of whether removed based on CAFA. *See* 28 U.S.C. § 1711 (definitions of “proposed settlement” and “class action” under CAFA).

- ii. If the proposed settlement provides for coupons to be given to class members, CAFA imposes several requirements in calculating the attorneys' fees. If the attorneys' fees are awarded on a contingent fee basis, the attorneys' fees must be based on the value to class members of the coupons that are redeemed. 28 U.S.C. § 1712(a). The court may look to expert testimony on the value of the coupons. 28 U.S.C. § 1712(d). Otherwise, the attorneys' fees must be based on the amount of time class counsel reasonably expended working on the action. 28 U.S.C. § 1712(b).
  - iii. If the proposed settlement provides for coupons in addition to equitable relief, the portion of the fees based on recovery of the coupons should be based on the value to the class members of those coupons, and the other portion of the fees should be based on reasonable time expended. 28 U.S.C. § 1712(c).
  - iv. The court can approve a settlement in which class members would be awarded coupons only after a hearing to determine whether, and a written finding that, the class settlement is fair, reasonable, and adequate. The court may require that a portion of the value of unclaimed coupons be given to charity or the government.
- b. Geographic Discrimination
- i. The settlement may not provide greater sums to some class members over others solely on the basis that the former are located closer to the venue of the action, or on some other geographic basis.
- c. Notification of Government Officials, Regulators
- i. Within 10 days after a proposed settlement agreement is filed with the court that would be binding on class members, a notice must be served upon any "appropriate Federal official" *and* "appropriate state official" for the state in which any class members reside. *See* 28 U.S.C. § 1715(b), (c).
    - (a) The appropriate Federal official is generally the Attorney General of the United States;

however, in the case of financial institutions, the “appropriate” official would be the federal regulators with oversight responsibility for the defendant.

- (b) The appropriate State official will generally be the regulator with oversight responsibility of the defendant, or that licenses or authorizes the defendant to conduct business in the state.
- ii. The notice to Federal and State officials must include:
- (a) A copy of the complaint and amended complaints;
  - (b) Notice of any scheduled judicial hearing;
  - (c) Any proposed or final notification to class members of their right (or lack of right) to opt out and of the proposed settlement;
  - (d) Any proposed or final settlement binding on some or all class members;
  - (e) Any settlement or other agreement contemporaneously made between class counsel and defendant’s counsel;
  - (f) Any final judgment or notice of dismissal;
  - (g) If feasible, the names of class members residing in the particular state and the estimated proportionate share of the claims of those class members to the entire settlement, or if not feasible, a reasonable estimate thereof; and
  - (h) Any written judicial opinion relating to the class notification, class settlement, contemporaneous settlement agreements, or final judgment or notice of dismissal. *See* 28 U.S.C. § 1715(b).
- iii. Final approval of the settlement can only issue once 90 days have passed since these items are served. *See* 28 U.S.C. § 1715(d).

4. Implications
  - a. In-state Defendants
    - i. More California clients sued in California? New York, Texas, Florida, etc.
  - b. Class Certification
    - i. Determination of primary defendants, “significant basis” test, and even class composition, could begin to intrude on merits and theories of case.