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COUNTERCLAIMS AGAINST ABSENT CLASS MEMBERS IN CONSUMER CREDIT CLASS ACTIONS

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Lenders who are defendants in consumer credit class actions brought by borrowers alleging Truth in Lending violations may have a new way to fight back: counterclaims against absent class members for unpaid debts. This tactic could result in the court's denial of class certification. Admittedly, the authorities are mixed, with a strong line of cases where such counterclaims have been dismissed. The author discusses these cases and suggests reasons for their nonapplicability to the consumer credit field. He then analyzes another line of cases indicating judicial acceptance of this new form of counterattack by beleaguered lenders.

Remember the days when borrowers of funds wouldn't dream of suing their lenders? Remember what life was like before the Truth in Lending Act? [1] Twenty years ago it would have been laughable to conceive of a class action brought by all bank credit card holders against the bank arising out of the bank's extension of credit to those holders. Not so anymore. Indeed, as more and more credit regulations are imposed upon lenders and more and more disclosure requirements are forced upon financial institutions, lenders have become targets of litigation.[2]

However, there may be a new way to counterattack. Specifically, there is a new twist to federal class action litigation these days—defendants' counterclaims against absent class members. While, in general, courts have dismissed such counterclaims on motion, some counterclaims have survived motions

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1 15 U.S.C. §§ 1601 et seq. (1974).

2 See, e.g., Carter v. Public Fin. Corp., 73 F.R.D. 488 (N.D. Ala. 1977).

to dismiss. The significance of surviving a motion to dismiss should be readily apparent.

First, *prior* to class action certification, defendants could interpose a counterclaim and assert that, by reason of that counterclaim, class action certification should not be granted because the individual questions on the counterclaim predominate over the common, class questions.[3]

Second, *after* a class is declared, the existence of a counterclaim can have a strong deterrent effect upon possible claimants. For example, class members may be reluctant to file claims and subject themselves to the court's jurisdiction if they know that a claim may be asserted against them in excess of their own claim.

At first blush, one would assume that, by definition, *absent* class members, either before or after class certification, are not, as a matter of law, opposing parties against whom counterclaims can be asserted. Prior to certification, since there is no declared class, the prospective class members are just that—"prospective" participants in a litigation.

Even after certification, since a putative class member can "opt out" (and in fact many putative class members simply do not participate at all by reason of their failure to file claims), certification does not assure a class member's entrance into a suit.

Thus, defense counsel may think it is a futile gesture to interpose a counterclaim against absent class members since such a counterclaim would be stricken on motion. However, that is not necessarily the case. As described below, there is a lack of clear appellate authority and the lower court authorities are inconsistent. Therefore, attorneys should attempt to tailor their case's claims to the case law in support of their position.

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[3] See Weit v. Continental Ill. Nat'l Bank & Trust Co., 60 F.R.D. 5, 7-8 (N.D. Ill. 1973). (In antitrust class action by bank credit card holders against several banks, defendants opposed class certification on grounds that compulsory counterclaims against thousands of class members whose accounts had unpaid balances would render class action unmanageable. The district court held that the plaintiff class would not be rendered unmanageable since only class members who filed claims would become "parties" subject to counterclaims, which would consist solely of liquidated amounts owed by the parties on their delinquent accounts.)

This article will highlight the several views expressed in the leading cases, including those in which such counterclaims have withstood attack by motion.[4]

The Majority View—No Counterclaim

Following a strict reading of Federal Rule of Civil Procedure 13, the majority of the cases hold that an "absent" class member is just that—absent. Thus, a defendant cannot assert a counterclaim against any party other than the named plaintiffs.

The leading case is Judge Bauman's decision in *Donson Stores, Inc. v. American Bakeries Co.*,[5] dismissing counterclaims asserted against unspecified members of the plaintiff class in an antitrust action. That decision has been followed in most other reported cases on the point.[6]

Judge Bauman's decision in *Donson* rested upon the plain language of Rule 13, which provides that a counterclaim (whether compulsory or permissive) may be made only "against an opposing *party*."[7] Noting both the decisions holding that class members are not "parties" for discovery purposes and the

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[4] While plaintiffs could simply assert defenses to the counterclaim in their reply to it, a motion to dismiss the counterclaim would still be necessary to avoid the deleterious effect, described above, that the mere assertion of a counterclaim creates. Thus, even after the reply to the counterclaim is filed, plaintiffs should move to dismiss it. It is clear that plaintiffs, having raised the defenses in their reply to a defendant's counterclaims, preserve the right to "renew these defenses by motion" under Rule 12(b) of the Federal Rules of Civil Procedure. 2A *Moore's Federal Practice* ¶ 12.06 at 2245 (2d ed. 1979). See also Majerus v. Walk, 275 F. Supp. 952 (D. Minn. 1967); Albachten v. Corbett, 156 F. Supp. 863 (S.D. Cal. 1957); Watts-Wagner Co. v. General Motors Corp., 64 F. Supp. 506 (S.D.N.Y. 1945).

Disposition of defendant's counterclaim by motion is also permitted by Rule 12(d) of the Federal Rules of Civil Procedure, which provides that a defense made in a pleading may be heard and determined on application before trial. 2A *Moore's Federal Practice, supra,* at 2244. See also Marcus v. Hinck, 2 F.R. Serv. 12d.121 (S.D.N.Y. 1939); Equitable Life Assurance Soc'y v. Saftlas, 35 F. Supp. 63 (E.D. Pa. 1940); Cooper v. Westchester County, 42 F. Supp. 1 (S.D.N.Y. 1941); Richardson v. North Am. Clay Co., 5 F.R. Serv. 12b.22 (S.D.N.Y. 1941). "And, of course these defenses can be raised by motion for judgment on the pleading pursuant to Rule 12(c)." 2A *Moore's Federal Practice, supra,* at 2344. See also Duarte v. Christie Scow Corp., 27 F. Supp. 894 (S.D.N.Y. 1939).

[5] 58 F.R.D. 485 (S.D.N.Y. 1973).

[6] *In re* Sugar Indus. Antitrust Litigation, 73 F.R.D. 322 (E.D. Pa. 1976); Hill v. A-T-O, Inc., [1975] CCH Trade Cases ¶ 60,235 (E.D.N.Y. 1975); Serpa v. Jolly King Restaurants, Inc., [1974-2] CCH Trade Cases ¶ 75,301 (S.D. Cal. 1974); see Dennis v. Saks & Co., 20 F.R. Serv. 2d 994 (S.D.N.Y. 1975); Turoff v. Union Oil Co., 61 F.R.D. 51 (N.D. Ohio 1973).

[7] R. Civ. 13 (emphasis added).

Second Circuit Court of Appeals' decision in *Korn v. Franchard*,[8] Judge Bauman concluded that

> Rule 23 contemplated an adversary contest involving only the representative members of the class, with all other members of the class being permitted passively to await the outcome of the principal suit. Therefore, in the absence of any reported decision holding that absent class members are parties for the purpose of this Rule 13, I hold that they are not. In reaching this decision, I note that in these cases the right to counterclaim is readily subject to abuse as a tactical device to encourage plaintiffs to opt out.[9]

If absent class members are not, as a matter of law, parties against whom counterclaims may be asserted under Rule 13 of the Federal Rules of Civil Procedure, then it is simply "icing on the cake" for the Second Circuit in *Van Gemert v. Boeing Co.*,[10] to hold, additionally, that the right to such counterclaim, if it existed, would be "subject to abuse as a tactical device to encourage plaintiffs to opt out."

The view of the U.S. District Court for the Southern District of New York in *Korn* was reinforced three years later, in *Dennis v. Saks & Co.*[11] In *Dennis*, an antitrust consumer class action by charge account customers against several department stores, the Southern District dismissed defendant Saks' counterclaims that an unknown number of unidentified class members "are in breach of their charge account agreement with Saks" and another department store defendant's claim that "some members of the class . . . owe Bergdorf [another defendant] various amounts for goods sold and delivered by Bergdorf at varying times." [12]

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[8] 456 F.2d 1206 (2d Cir. 1972).

[9] Donson Stores, Inc. v. American Bakeries Co., 58 F.R.D. 485, 489 (S.D.N.Y. 1973).

[10] 590 F.2d 433 (2d Cir. 1978), *aff'd* 441 U.S. 942 (1980).

[11] 20 F.R. Serv. 2d 994 (S.D.N.Y. 1975).

[12] Plaintiffs' Memorandum in Support of Motion to Dismiss Counterclaims Newly Asserted Against Absent Class Members by Defendants Saks and Bergdorf at 1, Dennis v. Saks, 20 F.R. Serv. 2d 994 (S.D.N.Y. 1975). See also Perry v. Beneficial Fin. Co. of New York, Inc., 81 F.R.D. 490 (W.D.N.Y. 1979), a recent Western District of New York consumer class action by borrowers against a lender. The Western District dismissed Beneficial's counterclaim against certain unnamed class members for alleged loan defaults while allowing the counterclaim asserted against the plaintiff individually.

The significance of the *Dennis* case is heightened by the U.S. Supreme Court's recent decision in *Reiter v. Sonotone Corp.*[13] upholding the right of consumers to file federal treble damage actions.[14]

In the wake of *Reiter*, increased consumer antitrust class actions can be expected, and no doubt defendants in such actions will attempt to circumvent the holdings in *Donson* and *Dennis*. Under those authorities, whether or not defendants like Saks could assert offsets against delinquent charge customers at the end of the case—if those customers came into court to file claims against the defendants—it is plain that they cannot assert blanket counterclaims against absent persons who may be behind in their payments.[15]

This view seems attractive, for even if such defendants identified the specific members of the class who were delinquent, many or most of them could no doubt have paid up by the time the case was over, and other members could have become delinquent in the interim.[16] For this reason, the courts have held that it would be particularly inappropriate to permit a general counterclaim, or any consideration of claims against class members in such cases, until the damage-distribution stage.

Moreover, if the named plaintiffs in such a class action are not behind in any payments, defendants may not be able to plead a counterclaim against the class as a whole or against any subclass. Arguably, this would be inappropriate because of the individual nature of claims against delinquent customers and because the named plaintiffs (who are not alleged to be delin-

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[13] 442 U.S. 330 (1979).

[14] *Reiter* involved a putative class action on behalf of all persons in the United States who purchased hearing aids manufactured by five corporate defendants. The complaint contained allegations that defendants "committed a variety of antitrust violations, including vertical and horizontal price fixing." *Id.* at 335. The Court held "that a consumer deprived of money by reason of allegedly anticompetitive conduct is injured in his 'property' within the meaning of § 4" (*Id.* at 344), and is therefore a party entitled to seek damages under § 4 of the Clayton Act, 15 U.S.C. § 15. That such a remedy was particularly significant for consumers in a class action context was specifically alluded to by the Court. Reiter v. Sonotone Corp., note 13 *supra*, at 344 n.7.

[15] See Weit v. Continental Ill. Nat'l Bank & Trust Co., note 3 *supra*, at 5; Hermann v. Atlantic Richfield Co., 72 F.R.D. 182 (W.D. Pa. 1976).

[16] But see Rollins v. Sears, Roebuck & Co., 71 F.R.D. 540 (E.D. La. 1976).

quent) would not be proper representatives of any such class or subclass.

Clearly, *Donson* and its offspring have continued vitality and are authorities that defendants will have difficulty in distinguishing when faced with motions to dismiss their counterclaims against absent class members—particularly in consumer antitrust class actions. Yet, what about consumer credit class actions?

Another View: The Discretionary Approach—The Defense Strikes Back

In light of the above authorities, one would assume that, at least as far as the Southern District of New York was concerned, it is well settled that absent class members are not "opposing parties" against whom counterclaims may be asserted. However, two years after *Dennis*, a different view was expressed by the same court.[17]

In *National Super Spuds, Inc. v. New York Mercantile Exchange*,[18] the court held that there was no statutory preclusion of the assertion of counterclaims against absent class members, but that such assertion was a matter for the court's "discretion." *National Super Spuds* was a purported class action on behalf of all persons holding "long" positions in May 1976 potato futures contracts charging defendants with various forms of unlawful market manipulation. One defendant filed a counterclaim, solely against absent and mostly unnamed class members, charging a conspiracy to "squeeze" the relevant futures and cash markets. Plaintiffs, relying on *Donson Stores*, moved to dismiss the counterclaim on the ground that absent class members were not "opposing parties" within Federal Rule of Civil Procedure 13.[19]

The court denied the motion to dismiss the counterclaim and specifically held that absent class members are "opposing

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[17] *Id.*
[18] 75 F.R.D. 40 (S.D.N.Y. 1977).
[19] *Id.* at 41-42.

parties" for purposes of counterclaims within the meaning of Rule 13.[20]

Acknowledging that *Donson Stores* had expressed a different position on the definition of "opposing parties," the court noted that

> numerous other cases . . . while not addressing the precise question, have intimated . . . [support for] the propriety of counterclaims against absent class members. *See, e.g., Cotchett v. Avis Rent A Car Sys., Inc.*, 56 F.R.D. 549 (S.D.N.Y. 1972); *Berkman v. Sinclair Oil Corp.*, 59 F.R.D. 602 (N.D. Ill. 1973); *Rodriguez v. Family Publications Serv., Inc.*, 57 F.R.D. 189 (C.D. Cal. 1972).[21]

After analyzing the considerations surrounding the assertion of counterclaims against absent class members in the context of the rules governing class action litigation, the court concluded that "no prejudice will result from our decision to allow these counterclaims to stand." [22] On the other hand, the court pointed out the considerable potential prejudice to defendants that could result from the opposite conclusion:

> Furthermore, a rule that counterclaims may not be asserted against class members raises the danger that such a claim may never be asserted, if the claim in fact "arises out of the transaction or occurrence that is the subject matter" of a class member's claim and must, therefore, be asserted in the original action as a compulsory counterclaim under Rule 13(a).[23]

Accordingly, the court concluded that "since the rules provide sufficient flexibility to deal with such matters within the context of each case, we cannot agree with the wooden application of a rule that class members are never 'opposing parties' for counterclaim purposes." [24]

While *National Super Spuds* is a more recent pronouncement from the Southern District on the issue, by its own terms, it, supposedly, is not inconsistent with *Donson*. Specifically, the court distinguished *Donson* and *Dennis* because they were

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[20] *Id.* at 42.
[21] *Id.* at 43.
[22] *Id.* at 44.
[23] *Id.* at 45.
[24] *Id.*

"antitrust cases involving thousands or millions of class members." [25]

Thus, the court held, "Antitrust cases involving thousands or millions of class members, many of whom had delinquent accounts or other liabilities subject to counterclaim [citations omitted] . . . are inapposite here. . . ." [26]

That may be a distinction without a difference, since there are now two cases in the Southern District, one holding, and one not holding that absent class members are "opposing parties" within the meaning of Rule 13 of the Federal Rules of Civil Procedure.

Why did the court conclude that the other cases "are inapposite here"? Since the issue, although rarely raised, has been litigated primarily in the Southern District, a close reading of the second circuit's opinions should be made by the practitioner. In this regard, it may be that the "majority view" (i.e., no right to counterclaim) expressed by the lower courts is the one that the Second Circuit, if squarely faced with the issue, would adopt. In dictum, the Second Circuit has cited, with approval, the proposition advanced by *Donson.*

Specifically, in *Van Gemert v. Boeing Co.*,[27] the Second Circuit noted:

> Absentees are not considered parties against whom counterclaims under Fed. R. Civ. P. 13 may be asserted, because "the right to counterclaim is readily subject to abuse as a tactical device to encourage plaintiffs to opt out." *See, e.g., Donson Stores, Inc. v. American Bakeries Co.,* 58 F.R.D. 485, 489 (S.D.N.Y. 1973).

Outside the Second Circuit, there are at least three Truth in Lending cases in which the courts have determined that the counterclaims were permissible and, indeed, compulsory, thus rendering the class "unmanageable." Accordingly, class certification was denied. These cases, although expressing the minority view, are of heightened interest to bankers and other institutional lenders coping with class actions under the Truth in Lending laws.

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[25] *Id.* at 44.
[26] *Id.*
[27] See Van Gemert v. Boeing Co., note 10 *supra*, at 440 n.15.

The Financiers Finesse a Counterclaim and the Class Collapses

In *Rollins v. Sears, Roebuck & Co.*,[28] plaintiff's motion to dismiss defendant's counterclaims against class members for delinquent charge accounts in a Truth in Lending Act class action was denied. As all class members were identified, *Donson* was held to be inapposite, the defendant's counterclaim was deemed proper, and, because of the counterclaim, class certification was denied.

The following year two more district courts denied class certification because compulsory counterclaims rendered the class action unmanageable and inferior to individual lawsuits.

Carter v. Public Finance Corp.[29] was an action under the Truth in Lending Act. The district court, in denying class certification, held that because eighty-five of the 383 potential class members were in default on their finance contracts with defendant, defendant would be compelled to counterclaim as to each of these class members or lose its rights under the contract. Thus, the multiplicity of counterclaims would create difficulty in the management of a class action. Moreover, a class action would be inferior to individual lawsuits since there would be a substantial interest on the part of class members to individually control their cases because of these counterclaims.

George v. Beneficial Finance Co. of Dallas[30] was also an action under the Truth in Lending Act. The district court, denying class action status citing *Carter*, stated:

> Some courts have concluded that a counterclaim is not compulsory if it would not have an independent jurisdictional base. That reasoning is not supported by the language or purpose of Rule 13(a). Compelling the assertion in one suit of all claims arising from common transactions serves the goal of conserving the resources of the courts and the litigants (efficiency) by resolving multiple disputes with a single presentation of facts.[31]

The *George* court criticized the decision of the district court

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[28] See Rollins v. Sears, Roebuck & Co., note 16 *supra*.
[29] 73 F.R.D. 488 (N.D. Ala. 1977).
[30] 81 F.R.D. 4 (N.D. Tex. 1977).
[31] *Id.* at 6.

in *Weit*,[32] stating that the holding that class members do not become "opposing parties" within the meaning of Rule 13(a) until they file claims at the recovery phase of the litigation only postpones the decision as to manageability of the suit as a class action. The *George* court stated:

> Nothing is gained from allowing the suit to proceed as a class action knowing full well that the "damage phase" of the case would be totally unmanageable. The result, even with this view of "opposing parties" is several hundred note suits before one federal court; and these suits not only would not have been in the federal forum but for the class certification but more importantly might never have been filed at all.[33]

Conclusion

Since clear appellate authority is lacking, and the authorities are inconsistent, defense counsel will no doubt seriously consider the filing of counterclaims in consumer credit class actions.

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[32] See Weit v. Continental Ill. Bank & Trust Co., 60 F.R.D. 5, 7-8 (N.D. Ill. 1975).

[33] Note 30 *supra*, at 7.