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Deutsche Bank Victory May Have Far-Reaching Consequences

Law360, New York (January 23, 2014, 1:36 AM ET) -- A unit of Deutsche Bank recently won dismissal of a suit brought by mortgage bond investors after a New York state appeals court determined the claims for loan repurchase and indemnity were subject to a six-year statute of limitations that began to run when the loans were originally contributed to the securitization trust.

The decision — reached in Ace Securities Corp. v. DB Structured Products Inc. — may ultimately limit new suits by investors who allege that their claims do not accrue — and that therefore the statute of limitations does not begin to run — until the claim is discovered or the seller of the loan refuses to repurchase it or provide indemnification.

The Ace decision is also likely to affect the loan loss methodologies used by participants in the residential mortgage market, contractual negotiations between buyers and sellers in the market, and the perceived riskiness of those market participants by potential investors and acquirers.

Background

Since 2007, loan sellers and securitizers have been subject to a significant wave of lawsuits brought by owners of loans or securities claiming repurchase or indemnification for faulty loan underwriting and other breaches of representations and warranties found in the underlying loan purchase and sale agreements.

In almost all cases, the common practice for owners facing losses stemming from loans or mortgage-backed securities has been to wait for loans to become delinquent. Once the loans entered into delinquency, their owners would then start searching for violations of representations and warranties that appeared in the original purchase agreement with respect to those loans.

Any such violations would subsequently be used as a basis for demanding that the loans be repurchased from the owner by the seller or the securitizer. A seller’s refusal to repurchase would then lead the owner to seek judicial recourse, which would be available if the statute of limitations for the assertion of claims had not expired.

Owners seeking recourse have generally taken the position that the statute of limitations for claims assertion should not begin to run until either they discovered the violation or until their demand to repurchase an offending loan was not satisfied.

Interpretations of New York state law, and its statute of limitations regarding contractual disputes, are crucially important, given that most causes of action involving claims arising out of activity within the residential mortgage-backed security market are filed in New York and are subject to that state's law.

The Ace Decision

In Ace, two plaintiffs sought judicial recourse from DB Structured Products Inc., alleging that DB had breached representations and warranties with respect to a pool of mortgage loans that were governed by two agreements — a mortgage loan purchase agreement and a pooling and servicing agreement.

The plaintiffs filed suit on March 28, 2012, which was also the sixth anniversary of the date the deal closed. The suit was filed only 49 days after the plaintiffs notified DB of the alleged breach. Importantly, the contract at issue provided DB with both (1) a 60-day period during which it was permitted to cure any alleged breach and (2) a 90-day period during which it instead could repurchase any loans causing the breach.

Both periods were to commence following the loans' owners informing the sellers of the alleged breach by written notice, which in this instance occurred on Feb. 8, 2012. Thus, filing suit on March 28 conceivably cut short the window that DB was contractually afforded to cure or repurchase.

In May 2013, the court of first review held that the statute of limitations under New York state law began to run when DB failed to cure or repurchase defective mortgage loans from the pool of loans that had been sold to the investors. The breach, the court held, was DB's failure to comply with a demand to cure or repurchase and not any appearance of falsity in the representations and warranties as of the closing date of the contract.

The court noted that had the parties contemplated limiting repurchase demands to a six-year period following the date of the contracts, they could have expressly placed such a provision in the contracts. Instead, absent any such provision, the plaintiffs had a right to expect continuing performance from DB, and each time DB failed to perform under the contract, it committed an independent breach of the contracts at issue.

The court therefore held that the statute of limitations would begin to run only after DB failed to comply with the plaintiffs' cure or repurchase request. Such a holding would be favorable to loan owners and would serve as precedent for the position that the statute of limitations could extend well beyond six years following the date of a contract's closing.

A four-judge appellate panel in December unanimously reversed the lower court's May decision and ruled instead that the statute of limitations began to run when the sale or securitization was first closed. This holding was consistent with a 2003 decision in Structured Mortgage Trust 1997-2 v. Daiwa Finance Corp., which held that the six-year statute of limitations under applicable New York state law begins "when the wrong is committed, and not when the plaintiff discovers it."

Because the Ace plaintiffs did not file notice with DB early enough to accommodate the cure and repurchase periods (i.e., 90 days prior to March 28, 2012), the earliest they could seek judicial recourse would be a date that would fall after the expiration of the statute of limitations. Thus, the four-judge panel held that the lower court erred and dismissed the action. The Ace plaintiffs have indicated that they plan to appeal.

Additional Consequences

If the appellate court's decision is upheld, it will likely limit similar actions because many of the securitizations or loan sale transactions having the "most toxic" loans closed more than six years ago (i.e., prior to 2008). While the owners of the loans or the securities may now have to be more vigilant about searching for breached representations and warranties, they will have to balance this vigilance against the possibility that removing loans from a securitization could create other consequences or issues.

Included among those issues is the resulting burden placed on trustees and owners themselves as those owners seek out loan-level information to evaluate whether individual loans have violated a specific representation or warranty. Additionally, parties reviewing loan-level information are required to comply with applicable privacy laws, an additional administrative burden and risk involved in reviewing files and documentation associated with loans.

As a result, sellers and securitizers may begin to see the end of the stream of claims and challenges with respect to their older loan origination activities.

The impact of the Ace decision could have other far-reaching consequences. For example, we expect that many sellers and securitizers may attempt to reconsider or perhaps modify their loan loss-reserve calculations and methodologies to take into account the limitation or elimination of liability related to pre-2008 loan origination activities, particularly in situations in which the loans were sold on a "whole-loan" servicing released basis, given that such calculations and methodologies take into account the prospects of litigation and its resultant costs.

In addition, for companies with extended histories of loan origination activities, the decision may help moderate the perceived risks associated with these legacy loan origination activities for potential investors and buyers of such companies.

Given that the perceived creditworthiness and quality of the loans originated before 2008 is less than those originated after that time, any cap on the likelihood of losses stemming from that period will eliminate much of the riskier aspects of a company's potential exposure.

Moreover, the decision could affect the degree to which sellers attempt to insert language in new contracts seeking to limit their exposure for claims stemming from violations of representations and warranties. In March 2013, market observers took note of contractual provisions in a JPMorgan RMBS transaction limiting the company's liability for violations of certain representations and warranties to only five years.

While the loans at issue were of high quality (low loan-to-value ratio loans and borrowers with high credit scores), observers noted the possibility that such provisions could find their way into other purchase agreements. The Ace decision could shape the perceived necessity or scope of such provisions.

Finally, decisions regarding New York state law in this area could affect the government-sponsored enterprises (GSEs) in at least two ways.

First, they may influence market-leading guides, as both the Fannie Mae Selling Guide and the Freddie Mac Single-Family Seller/Servicer Guide guides are governed by New York state law. The decisions may also impact negotiations by the GSEs involving repurchase settlements with large market participants as well as the negotiations by independent originators that had been fearing the potential impact of those settlements.

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