ACE in the Hole: Developments Since ACE Securities in Residential Mortgage-Backed Securities Litigation

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Introduction

The 2007–2008 economic crisis, spurred in part by widescale defaults on subprime mortgage loans, led investors, monoline insurers, and others with interests in residential mortgage-backed securities ("RMBSs") to sue various parties to the securitizations, including the original lenders behind the loans and the sponsors of the securities, to recover portions of their losses on nonperforming securitized loans. The investors and insurers have alleged that the lenders and sponsors breached contractual representations and warranties they made concerning the underwriting characteristics and quality of the securitized loans. Some of these claims are still being litigated, and a few new lawsuits are still being filed, notwithstanding that the relevant statutes of limitations on such claims have now expired, for the most part. In its landmark decision in *ACE Securities Corp. v. DB Structured Products, Inc.*, the New York Court of Appeals held that, under New York law, which applies to most RMBSs, claims generally accrue at the time when lenders and sponsors give the representations and warranties. In practice, this places the accrual date for the claims at the time of securitization at the latest, usually a few months after loan origination.

To the extent that ACE applies, most RMBS claims arising out of pre-recession securities should be time-barred by statutes of limitations, which are usually six years or less. ACE did not resolve all statute of limitations questions in the RMBS arena. This survey will discuss the various statute of limitations issues that are still being litigated post-ACE and other developments of interest in RMBS litigation that are not related to limitations issues.

Current RMBS Statute of Limitations Issues

Limitations Questions for Indemnity Claims

Due to the number of parties involved in RMBS transactions, suits by one group of parties arising out of the resolution of disputes among another group of parties have become commonplace. In one variant of suits arising out of suits, some plaintiffs base their RMBS claims not just on the alleged contractual breach of representations and warranties but also on contractual indemnification provisions, which, they argue, entitle them to recover separately the losses they suffered in paying off insurers and investors in other RMBS suits. The reason for adding a separate indemnity claim is that if the right to indemnity is triggered only by incurring an actual loss, the plaintiffs can theoretically extend the statute of limitations well beyond the limitations period for the underlying breach because the loss, not the original breach, would be the triggering event.

The question is whether the plaintiff's loss occurs when an investor recovers on a claim against the plaintiff or whether the right of indemnity is merely an additional remedy for the underlying breach. In *Lehman Bros. Holdings v. Universal American Mortgage Co.*, the U.S. Court of Appeals for the Tenth Circuit reached the latter conclusion. The court "base[d] accrual of the cause of action on the date of [the defendant's] breach of contract rather than the date of [the plaintiff's] payment to a third party."

In Lehman Brothers, the plaintiff alleged that it was forced to make payments to investors and insurers as a result of the original defendant lender's breaches of representations and warranties given to the plaintiff sponsor. The court held that, under New York law, contractual indemnity was but one of many remedies for a breach of contract, and thus, it was functionally no different for statute of limitations purposes from the repurchase claims that were held time-barred in ACE. The court distinguished between two types of indemnity. It found that indemnity claims by a plaintiff against a defendant, where both owe a duty to a third party, are "legitimate" indemnity claims and are new, separate claims for statute of limitations purposes and accrue when the loss occurs. However, indemnity claims by a plaintiff against a defendant based only on the defendant's alleged breach of a contractual duty owed to the plaintiff, where the defendant owes no duty to a third party, are no different from breach of contract claims in which the plaintiff's payments to the third party are the contract damages, and therefore, the ordinary contractual statute of limitations applies, and the claims accrue at breach, not at the time of payment.

The Lehman Brothers court relied on general indemnity principles and New York law, so its ruling has general applicability to RMBS claims based on contractual indemnity. Indeed, at least one court has cited the case for this proposition, but it allowed the action to proceed because the parties had entered into a tolling agreement for indemnity claims.

In contrast, in the litigation filed by creditors and investors in the units of the former Residential Funding Company, the plaintiffs sued the original lenders of the loans as successors to RFC, a bankrupt securitization sponsor, seeking, among other things, contractual indemnification from the lenders for settlements that the sponsor entered into with investors and insurers. The settlements occurred during the sponsor's bankruptcy proceedings from May 2012 to December 2013. The plaintiffs argued that their indemnification claims arose only when the settlements were finalized in December 2013, at the time at which the bankrupt RFC became liable to the investors and insurers. Several trial courts have applied Minnesota law and sided with the plaintiffs in rulings on motions to dismiss. As one of these courts put it, "[u]nlike in New York, Minnesota law expressly requires final and actual liability to trigger indemnification." However, in the Minnesota Supreme Court case that the trial court cited to support the quotation, the issue was the proper accrual date of the claims under a statutory or common-law indemnity and not the contractual indemnity being pursued by RFC. Moreover, the Minnesota courts did not have the benefit of the Tenth Circuit's Lehman Brothers ruling when considering the issue in ruling on motions to dismiss.

Contract Provisions Designed to Circumvent Limitations Periods

Another question is whether statutes of limitations apply if the parties contract for a different period in which to bring claims. New York and Delaware courts have reached different results on the question. In one notable post-ACE New York case, *Bank of New York Mellon v. WMC Mortgage, LLC*, the court held, citing ACE, that the claims accrued at the time of sale even if the parties expressly contracted for a later accrual date. The parties there designated the first demand for repurchase as the accrual date of any claim in the following provision:

> Any cause of action against the Seller or the Servicer, as applicable, relating to or arising out of the breach of any representations and warranties . . . shall accrue upon (i) discovery of such breach by the Purchaser or notice thereof by the Seller or the Servicer to Purchaser, (ii) failure by the Seller or the Servicer, as applicable, to cure such breach, repurchase such Mortgage Loan as specified above, substitute a Substitute Mortgage Loan for such Mortgage Loan as specified above and/or indemnify the Purchaser, and (iii) demand upon the Seller or the Servicer, as applicable, by the Purchaser for compliance with the terms of this Agreement.

Based on this contractual language, the plaintiff argued "that even though ACE held that put-back claims accrue at closing, the holding in ACE was a default rule that is applicable only when RMBS contracts are silent on accrual." The plaintiff argued that its contract was "not silent, and expressly provides a specific accrual date," so "that accrual date must govern for statute of limitations purposes."

The WMC Mortgage court rejected the plaintiff's argument in its entirety, comparing the accrual-setting provision to the demand-first requirement in the contract at issue in ACE: "Though ACE did not involve an accrual provision, the substance of the pre-suit demand process in the [contract] is substantively similar to the contracts in ACE and, indeed, is substantially similar to the typical governing contracts in put-back actions." On this basis, the court stated that it "cannot hold that the repurchase protocol in [the contract] is a substantive condition precedent without contravening ACE."

However, a Delaware court reached a contrary decision based on its reading of Delaware law in *Bear Stearns Mortgage Funding Trust 2006-SL1 v. EMC Mortgage LLC*. The accrual provision at issue there expressly provided that claims accrued only upon the buyer's demand to cure and the seller's failure to comply. The court therefore treated the date of the seller's failure to cure as the date on which the buyer's cause of action for breach of contract accrued, applying the contractual provision, and reached that result on two independent bases. First, the court stated: "Delaware law treats an accrual provision as a condition precedent to the running of the statute of limitations." Since a condition precedent to suit had not been triggered, no accrual occurred. Second, the court noted that the Delaware legislature had amended the Delaware statute of limitations to provide that parties may contract for their own statute of limitations for disputes over $100,000, with a maximum limitations period of twenty years. The court applied the statute to the dispute at hand, even though the statute was enacted more than seven years after the parties had entered into the securitization contract, by deeming the statute of limitations a procedural matter, so that legislative amendments were presumptively retroactive.

Use of Placeholder Litigation to Avoid Limitations Problems

Courts usually allow RMBS claims to survive motions to dismiss even if the plaintiffs do not identify the specific loans at issue. A plaintiff facing a statute of limitations deadline may be permitted to simply file a placeholder complaint and then take discovery to identify the breaching loans based on a recent ruling. Following in the footsteps of one of the Nomura rulings, one of the few RMBS cases to go to trial in recent years, the court in *Mastr Adjustable Rate Mortgages Trust 2006-OA2 v. UBS Real Estate Securities Inc.* held that plaintiffs may pursue claims on loans not alleged to have been in breach when the complaint was first filed. The plaintiff filed suit alleging specific breaches as to a discrete group of loans as summarized in pre-litigation correspondence between the parties. Thereafter, years after the case was filed, the plaintiff's expert report identified breaches in loans not referenced in that correspondence or the complaint but on which discovery had been taken. The court reached its holding notwithstanding the fact that the contract at issue required a pre-suit demand and an opportunity to cure that had never been given with respect to some of the later-added loans.

Suits May Be Revivable if Pre-Suit Demands Were Not Exhausted

In *U.S. Bank N.A. v. DLJ Mortgage Capital, Inc.*, a New York trial court dismissed a repurchase suit without prejudice because the pre-suit demand process required by the contract had not yet been exhausted. However, the court also held that the statute of limitations may not bar a future claim pursued after exhausting the demand process and after the expiration of the statute of limitations due to the savings provision in the New York Civil Practice Rules. The court held that "this action was timely commenced by the Trustee's filing . . . before the statute of limitations expired, and [the action] was not rendered untimely commenced by the Trustee's failure to satisfy the repurchase demand condition precedent prior to" commencing the action or the statute of limitations expiring.

Extended Statute of Limitations for Government Plaintiffs

Statute of limitations provisions specific to government entities may apply to toll or extend the state law statute of limitations that would otherwise apply. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 provides the Federal Deposit Insurance Corporation with a six-year statute of limitations to bring repurchase claims. The FIRREA also deems claims to have accrued on the later of the dates on which they would normally accrue under state law or the date the FDIC is appointed as conservator or receiver.

The extended FIRREA statute of limitations has allowed the FDIC to bring claims in its role as receiver for failed entities such as AmTrust Bank, a purchaser of mortgage loans, based on pre-recession loan sales. The FDIC was appointed receiver of AmTrust on December 4, 2009, rendering potentially timely suits brought through the end of 2015. The FDIC has pursued several such suits.

The Federal Housing Finance Administration, the conservator of Fannie Mae and Freddie Mac, benefits from a similar provision, rendering claims "brought by" the FHFA to accrue on the later of the state law dates of accrual or the appointment of the FHFA as conservator. The Second Circuit has interpreted the provision narrowly, however, to encompass only claims actively prosecuted by the FHFA and has held as time-barred claims pursued by a nongovernmental plaintiff even if FHFA technically commenced the suit.

Other Current Issues in RMBS Litigation

While statute of limitations issues dominate the RMBS litigation landscape, there are other topics of note in RMBS litigation. These include alleged breaches of trustees' duties to vigorously enforce the rights of the trust against securitization sponsors, standing to sue for breaches of contract among the many parties in complex securitization transactions, and government litigation and pre-suit settlements involving RMBS.

Suits Against Trustees for Mismanagement of RMBS Trusts

Numerous RMBS investors have sued the trustees of RMBS trusts alleging that the trustees failed to pursue breach of contract claims against securitization sponsors adequately and diligently, when such claims were still timely. Some of the investors' claims survive motions to dismiss. As a rule, claims by investors against trustees sounding in breach of contract have fared better than those sounding in tort. This is due in part to the fact that a trustee's duties are usually limited by federal statute to those expressly stated in the trust indenture.

Three recent cases provide illustrative examples. In *Royal Park Investments SA/NV v. HSBC Bank USA, N.A.*, the court denied the trustee's motion to dismiss as to most of the breach of contract claims (some were held time-barred), but dismissed negligence claims, and in a separate ruling, dismissed a count for breach of the covenant of good faith as duplicative of the breach of contract claims.

However, in *Royal Park Investments SA/NV v. Deutsche Bank Nat'l Trust Co.*, the court denied the trustee bank's motion to dismiss breach of trust claims based on a conflict of interest theory. The plaintiffs alleged that the defendant bank was also involved in other securitizations, as seller or sponsor, and "that this created a conflict because Defendant feared that requiring a Seller to substitute or repurchase loans would cause those Sellers to retaliate by forcing Defendant to substitute or repurchase loans it had sold." Thus, the plaintiffs alleged that the trustee bank ignored breaches in the trust at issue in the lawsuit to influence other, nonparty trustees to similarly ignore the defendant trustee bank's breaching loans in securitizations where it was acting as the seller or sponsor of the loans. The Royal Park court found that "this allegation is sufficient to 'allow [ ] the court to draw the reasonable inference' of a conflict of interest and adequately allege breach of trust."

Likewise, in *Blackrock Core Bond Portfolio v. U.S. Bank N.A.*, the court sustained a breach of contract claim that alleged that the trust failed to adequately address loan deficiencies the trust indenture required. The plaintiff advanced the same conflict-of-interest theory—that survived a motion to dismiss a breach of trust claim in Commerzbank—in support of claims for breach of fiduciary duty and "extra-contractual" duties. While the Blackrock court held that the trustee's duty might well spring from the common law rather than from the contract, the plaintiff was limited to contractual remedies, so it dismissed such claims as barred by the economic loss doctrine.

Courts have also allowed claims to proceed against trustees related to servicing problems that the trustees allegedly failed to pursue against loan servicers despite having the right to do so. In one such case, *Phoenix Light SF Ltd. v. Deutsche Bank National Trust Co.*, the court held that the plaintiff sufficiently pleaded that the trustee "was aware that the servicers and sponsors of the Trusts were engaging in robo-signing, attempted to cover-up massive deficiencies in the documents in the Trusts and breached prudent servicing standards."

Standing to Sue

Due to the number of parties involved and the complexity of the contracts on which RMBS vehicles are based,63 the issue of who has standing to bring particular types of repurchase claims is sometimes the subject of litigation. In *National Credit Union Administrative Board v. U.S. Bank N.A.*, for example, after an unusually close review of pooling and servicing agreements in which the seller transferred "all right, title and interest" to the trust, the court held that the term "all" included the seller's right to pursue claims against the trustee for master servicing failures, including lax enforcement of representations and warranties against original lenders. The plaintiff, a liquidating agent acting on behalf of numerous credit unions, was held to lack standing to pursue claims against the trustee because it sold "all right, title and interest" in the loans to another entity, even though the other entity stated that it had no objection to the agent pursuing the claims.

More commonly, courts decline to rule conclusively on the standing issue at the pleadings stage in RMBS cases. In *Phoenix Light SF Ltd. v. U.S. Bank N.A.*, for example, the court held that it was "necessary" for the non-trustee plaintiffs to be assigned the trustee's right to sue loan sellers for breach of representations and warranties in order to have standing to sue because the transactional documents made it clear that "all right, title and interest" had been transferred to the trustee in the securitization process. Similarly, in the RFC litigation, some courts, ruling on motions to dismiss, held that the question of whether the plaintiffs "can, in fact, enforce those Agreements [in light of the 'all right, title and interest language'], or whether [plaintiffs have] assigned away [their] rights to do so, goes to the merits of the claims and is not an issue of standing." Left unresolved by the judges presiding over the various RFC actions was whether, on summary judgment, the court may conclude that such right, title, and interest was in fact maintained by plaintiff after it transferred its master servicing rights.

Government Involvement in RMBS Litigation

As noted in the previous Survey, the federal government's RMBS Working Group has been actively investigating and bringing cases that allege violations of state and federal laws. Since the beginning of 2015, two additional lenders have settled RMBS claims with the U.S. Department of Justice ("DOJ") for billions of dollars. Two other major lenders disclosed in 2016 that they were in negotiations with the DOJ to settle RMBS claims.