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Guest Post: ACE Securities – Will There Be a New Wave of RMBS Repurchase Litigation?

By Kevin LaCroix on May 1, 2015

On April 30, 2015, the New York Court of Appeals heard oral argument in a mortgage-backed securities-related case in which the court must consider when the statute of limitations begins to run for claims of breach of contractual representations and warranties. The range of possible outcomes of the case include an interpretation of the statute of limitations that could lead to a new wave of RMBS repurchase litigation that otherwise would be time-barred. In the following guest post, Robert Fumerton and Alexander Drylewski of the Skadden, Arps, Slate Meagher & Flom law firm discuss the oral argument and consider the possible implications. A version of this post previously was published as a Skadden client alert.

I would like to thank Robert and Alexander for their willingness to publish their article as a guest post on this site. I welcome guest posts from responsible authors on topics of interest to readers of this blog. Please contact me directly if you would like to submit a guest post. Here is Robert and Alexander's guest post.

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On Thursday, April 30, the New York Court of Appeals heard oral argument in *ACE Securities Corp. v. DB Structured Products, Inc.*, a closely-watched case that will have far-reaching implications for residential mortgage-backed securities (RMBS) repurchase litigation and potentially beyond. While it is impossible to predict with certainty how the Court will ultimately rule when it issues its decision (which likely will be later this year), the key points raised by the Court during oral argument suggest that it may be leaning towards a ruling that accords with New York's long-held goals of promoting finality and predictability in commercial business affairs.

The critical question in *ACE* is when the statute of limitations begins to run for claims of breach of contractual representations and warranties. Defendant DB had argued – and the New York Appellate Division, First Department, held – that the six-year limitations period begins to run on the date that the representations and warranties were breached (*i.e.*, on the date that they were first made). The trustee, on the other hand, argued that the limitations period does not begin to run until the plaintiff demands that the defendant cure or repurchase the allegedly breaching loans pursuant to the contract's remedy provision and the defendant refuses to comply. Because the vast majority of RMBS transactions that are the subject of repurchase litigation closed in 2007 or earlier, any new repurchase actions would be time-barred by New York's six-year statute of limitations if that limitations period began to run upon closing. If, however, the Court of Appeals holds that the limitations period does not begin to run until a defendant refuses to comply with plaintiff's repurchase demand, we could expect to see a new wave of RMBS repurchase litigation that otherwise would be time-barred.

Breaches Occurred At Closing

During Thursday's oral argument, much of the discussion focused on whether the alleged breaches of representations and warranties occurred on Day 1 of the RMBS transaction (*i.e.*, upon closing), or whether they could occur at some later point in time. DB argued that the representations and warranties were either true or false on the date they were made. As a result, any alleged breaches could only occur on Day 1 of the transaction and the statute of limitations for breach of contract must expire six years from that date. Indeed, RMBS representations and warranties typically relate to the characteristics of the mortgage loans, including the loan-to-value ratios and occupancy status of the underlying properties, as well as whether the loans complied with the applicable originator underwriting guidelines. These are static characteristics that cannot be altered or change in the future.

Many of the Court's questions centered around this issue. Significantly, the trustee had no answer to the most critical question raised by the Court – *i.e.*, whether it could provide any example of a breach of representation or warranty that could occur after the transaction closed. The only specific example that the trustee offered was a situation where the borrower's employment status was misstated. But this is precisely the type of representation that is either true or false on Day 1 – a borrower's employment status at the time of closing cannot later "become" false through subsequent events.

The trustee also argued, in vague terms, that the materiality of any breaches of representations and warranties may not become known until some time after closing. In support of this position, the trustee emphasized that RMBS investors had no duty to conduct due diligence on the loans at issue. But this argument is, in essence, an attempt to import a "discovery rule" into New York's statute of limitations. New York case law is well-settled that the limitations period for breach of contract claims begins to run on the date of breach regardless of whether or when the plaintiff may have discovered the breach. This principle is further reflected in N.Y. CPLR 206(a), which states that where a demand is necessary in order to institute a breach of contract suit, "the time within which the action must be commenced shall be computed from the time when the right to make the demand is complete" – not the time when demand is actually made. By focusing on the investors' inability to discover potentially breaching loans, the trustee framed its position as contrary to long-standing New York law regarding statute of limitations accrual.

Separate Breach or Remedy?

The trustee repeatedly emphasized during oral argument that its claims were not for breach of representations and warranties, but for the failure to repurchase the breaching loans. A defendant's obligation to repurchase breaching loans, however, is an agreed-upon contractual *remedy* for breaches of representations and warranties – not an independent promise. Put another way, any dispute over whether a defendant should repurchase a breaching loan is really nothing more than a dispute over whether that loan in fact breaches the defendant's representations and warranties in the first place.

In light of this, the Court of Appeals' decision could have consequences that go well beyond the world of RMBS litigation. It is commonplace for parties to include in their contracts exclusive remedy provisions similar to the cure-or-repurchase provision at issue in *ACE*. Parties generally agree to such provisions as a way of limiting the potential liability of a party making representations and warranties in the event that any representations or warranties turn out to be untrue. A ruling by the Court of Appeals that these remedy provisions can trigger a new, independent limitations period would run contrary to the parties' intent to *limit* liability, and could result in parties to such provisions facing *increased* liability through an indefinite statute of limitations.

Policy Considerations

One of the well-established goals of New York's statute of limitations jurisprudence is to promote certainty and predictability in commercial business affairs, as evidenced by New York courts' rejection of the "discovery rule" for breach of contract claims. Indeed, Chief Judge Lippman appeared to recognize this important consideration during the oral argument in *ACE*. Delaying accrual of the statute of limitations until a time when the plaintiff discovers the breach could lead to open-ended potential liability and raise concerns regarding the degradation of sources of proof.

Despite these concerns, the trustee argued that RMBS plaintiffs should have the unilateral right to determine when the statute of limitations begins to run simply by deciding when to demand repurchase. The mortgage loans underlying most RMBS transactions, however, have 30- or 40-year terms. If the Court of Appeals were to rule that the statute of limitations does not begin to run until repurchase is demanded and refused, RMBS defendants could potentially face liability for decades after the transactions closed. Such a regime is antithetical to the certainty and predictability for which New York jurisprudence strives.

In response to these policy considerations, the trustee argued that the inability to demand repurchase throughout the life of the underlying loans would negatively affect investors' willingness to purchase RMBS. But in 2007, RMBS investors were presumably aware that under New York law, the statute of limitations begins to run on the

date of breach without regard to their discovery. If the parties had wanted to ensure protection for the life of the loans they could have drafted contractual language giving rise to a continuing obligation by DB to repurchase the loans.

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The issues raised by the Court of Appeals during oral argument suggest that it is keenly focused on New York's longstanding jurisprudence regarding accrual and its goals of finality and predictability. In light of those goals, as well numerous other legal and policy considerations, the Court of Appeals should hold that New York's six-year statute of limitations for breach of contract claims begins to run on the date that the contractual representations and warranties were first made, not on the date of a defendant's refusal to comply with the parties' agreed-upon remedy provision.

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