NY High Court Brings Finality To RMBS Repurchase Claims

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Law360, New York (June 16, 2015, 5:50 PM ET) -- On June 11, 2015, New York's Court of Appeals unanimously affirmed the Appellate Division, First Department's decision in Ace Securities Corp. v. DB Structured Products Inc. and held that New York's six-year statute of limitations for breach of contract claims begins to run on the date that the residential mortgage-backed security (RMBS) defendant's contractual representations and warranties were first made, not on the date of its refusal to comply with the parties' agreed-upon remedy provision.

"Finality, Certainty and Predictability"

In a highly anticipated opinion, the court reaffirmed New York's emphasis on the "objectives of finality, certainty and predictability that New York's contract law endorses." Among the key aspects of the decision was the court's conclusion that a defendant's failure to comply with a contractual remedy provision is "not a separate and continuing promise of future performance" sufficient to defer accrual of the statute of limitations for breach of contract claims.

The court stressed that "[a]lthough parties may contractually agree to undertake a separate obligation, the breach of which does not arise until some future date, the repurchase obligation undertaken by [the defendant] does not fit this description." The court recognized that the representations at issue involved "certain facts about the loans' characteristics as of" the date of the contract — "not a promise of the loans' future performance" — and that "loans may default 10 or 20 years after they have been issued for reasons entirely unrelated to the sponsor's representations and warranties."

The court also concluded that "[t]he Trust suffered a legal wrong at the moment [the defendant] allegedly breached the representations and warranties." Because the defendant's obligation to repurchase was only a remedy for underlying breaches of representations, and not a substantive element of any breach claim, the court reasoned that the remedial obligation was "a procedural prerequisite to suit" that did not delay accrual of the limitations period.

"Day 1 Breaches"

The court's decision was well reasoned. Indeed, the defendant's representations and warranties were either true or false on the first day of the transaction — i.e., the date that they were made. As a result, any alleged breaches could only occur on day 1, and the statute of limitations for breach of contract must expire six years from that date.

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.

Significantly, at oral argument, the trustee had no answer to the most critical question raised by the court — namely, 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 on the loan application and later discovered to be false. 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.

Rather than provide concrete examples of breaches that could occur after closing, the trustee emphasized that RMBS investors had no duty to conduct due diligence on the loans at issue and thus could not have discovered the breaches on day 1. But this argument is, in essence, an attempt to import a "discovery rule" into New York's statute of limitations. As the court's decision makes clear, 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 also 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. Indeed, in any breach of contract case, the parties understand that there is a risk that they will not discover any breach until more than six years after the date of contract. By focusing on the investors' inability to discover potentially breaching loans, the trustee framed its position before the court as contrary to long-standing New York law regarding statute of limitations accrual.

Preventing Open-Ended or Subjective Liability

The court's decision reinforces New York's commitment to promoting certainty, predictability and finality in contractual matters by strictly applying the statute of limitations. Indeed, a contrary ruling would have twisted an agreed-upon remedy clause into a liability-enhancing provision, exposing RMBS defendants to nearly open-ended liability predicated on the plaintiff's unilateral decision regarding when to make demand for repurchase.

The court's application of a bright-line statute of limitations protects defendants' reasonable expectations; at the same time, parties may bargain for additional contractual language giving rise to a separate and continuing obligation to repurchase. Such language — if sufficiently explicit — could protect investors for the life of the loans.

As the court recognized, "even though the result may at times be harsh and manifestly unfair, ... a contrary rule would be entirely dependent on the subjective equitable variations of different Judges and courts instead of the objective, reliable, predictable and relatively definitive rules that have long governed this aspect of commercial repose." Definitive rules like those endorsed by the court can only help future commercial actors to reliably and efficiently structure their private affairs.

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