APL-2014-00156
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Court of Appeals

of the

State of New York

ACE SECURITIES CORP., HOME EQUITY LOAN TRUST, SERIES 2006-SL2, by HSBC Bank USA, National Association, solely in its capacity as Trustee pursuant to a Pooling and Servicing Agreement, dated as of March 1, 2006,

Plaintiff-Appellant,

– against –

DB STRUCTURED PRODUCTS, INC.,

Defendant-Respondent.

BRIEF OF LNR PARTNERS, LLC, CWCAPITAL ASSET MANAGEMENT LLC, AND C-III ASSET MANAGEMENT LLC AS *AMICI CURIAE* IN SUPPORT OF PLAINTIFF-APPELLANT'S APPEAL TO THE NEW YORK STATE COURT OF APPEALS

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Dated: March 13, 2015

COURT OF APPEALS
STATE OF NEW YORK
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APL-2014-00156

Plaintiff-Appellant,

-v-

DB STRUCTURED PRODUCTS, INC.,

Defendant-Respondent.

---X

CORPORATE DISCLOSURE STATEMENT

Pursuant to 22 N.Y.C.R.R. § 500.1(f), the undersigned counsel for *amicus curiae* LNR Partners, LLC ("LNR"), certifies that LNR Partners, LLC's ultimate parent corporation is Starwood Property Trust, Inc. ("SPT"). LNR Partners, LLC is also affiliated with SPT Management, LLC ("SPT Management"), which is the external manager of SPT. SPT Management is an affiliate of Starwood Capital Group. LNR has no subsidiaries.

Dated: March 13, 2015

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CORPORATE DISCLOSURE STATEMENT

Pursuant to 22 N.Y.C.R.R. § 500.1(f), the undersigned counsel for *amicus curiae* CWCapital Asset Management LLC ("CWCAM") certifies that CWCapital Asset Management LLC's parent corporation is CW Financial Services LLC which is owned by CWFS Holdings LLC which in turn is owned by CW Financial Services Holdings LLC. CW Financial Services Holdings LLC is owned by Galaxy Acquisitions LLC. CWCAM's affiliates are CWCapital Investments LLC, CompassRock Real Estate LLC, Convergent Risk Insurance Agency LLC, CWFS Insight LLC., CWFS-Reds LLC, CWCapital Commercial Funding Corp., ACGS 2004 LLC, and CWMarkets LLC. CWCAM has no subsidiaries.

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CORPORATE DISCLOSURE STATEMENT

Pursuant to 22 N.Y.C.R.R. § 500.1(f), the undersigned counsel for *amicus curiae* C-III Asset Management LLC certifies that C-III Asset Management LLC is a wholly-owned subsidiary of C-III Capital Partners LLC, which is a wholly-owned subsidiary of Island Capital Group LLC. C-III Asset Management LLC is also affiliated with C-III Realty Services LLC, C-III Commercial Mortgage LLC, New America Network Inc., C-III Investment Management LLC, Zodiac Title Services LLC and US Residential Group LLC. C-III Asset Management LLC has no subsidiaries.

Dated: March 13, 2015 VENABLE LLP

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STATEMENT OF INTEREST OF *AMICI CURIAE*

LNR Partners, LLC ("LNR"), CWCapital Asset Management LLC ("CWCAM"), and C-III Asset Management LLC ("C-III") respectfully submit this brief as *amici curiae* in support of Plaintiff-Appellant ACE Securities Corp. Home Loan Trust, Series 2006-SL2 ("ACE") in its appeal from an order of the Appellate Division, First Department, dismissing ACE's breach of contract claims involving certain residential mortgage-backed securities ("RMBS") transactions.

LNR, CWCAM, and C-III are the three largest commercial mortgage-backed securities special servicers in the country and collectively are responsible for servicing approximately 80% of all U.S. commercial mortgage-backed securities ("CMBS") trusts. They accordingly pursue the vast majority of CMBS repurchase claims that have arisen in the CMBS industry, the commercial-mortgage equivalents of the RMBS repurchase claims at issue in this case.

LNR is the largest commercial mortgage special servicer in the United States. It is the named special servicer on 28% (by balance) of all CMBS assets and 33% (by balance) of all CMBS special servicer/real estate-owned assets. In 2014, LNR was the special servicer on 152 CMBS trusts representing 10,354 loans with an outstanding principal balance of $135.8 billion. LNR is a market leader in real estate finance, asset management and property development, with a foundation in real estate. It has been focused on development and management of real estate since 1969 and began investing in non-performing loan pools in 1991 and in non-investment grade CMBS assets in 1993. Since its inception, LNR has successfully resolved over $57.8 billion in distressed loans.

CWCAM is a commercial real estate-related investment services firm that includes special servicing, asset management, investment management, property management, consulting, insurance, and risk management and technology solutions. It has $123 billion in CMBS loans currently under its management, including a portfolio of $5.9 billion in collateral principal investments. Since the real estate market crash commenced in 2007, CWCAM has successfully resolved $43 billion in troubled real estate loans.

C-III provides primary and special loan servicing for third-party portfolio owners, CMBS trusts, collateralized debt obligations ("CDOs"), government agencies, and various corporate affiliates. As of December 31, 2014, it is the named special servicer on over $106 billion in commercial real estate loans within 123 CMBS and CDO trusts and is the primary servicer for a portfolio of approximately $16 billion in performing loans. Its parent entity, C-III Capital Partners LLC, is a national leader in real estate services and investment management.

As the three leading CMBS special servicers, *amici* have a significant interest in explaining to the Court the legal and policy implications of the First

Department's decision. Although the decision addresses an RMBS securitization, it is being applied to breach claims relating to CMBS securitizations by many courts, both at the federal and state level. *Amici* thus have a compelling interest in the outcome of this appeal. Given their unique vantage point to explain how the First Department's decision detrimentally affects the CMBS industry and why, in light of the important issues affecting CMBS transactions, such application would work a serious injustice for CMBS securitizations, their participation as *amici* is appropriate.

PRELIMINARY STATEMENT

The First Department's decision would upend the careful balance struck in CMBS securitizations. Investors in both CMBS and RMBS securitizations necessarily rely on the loan sellers' representations and warranties regarding the quality of loans because the sheer volume of loans included in a securitization makes loan-specific due diligence an abject impossibility. The value that comes from bundling hundreds of loans into a single securitization rests upon that efficiency. The very point of securitization is to bundle the risk so that purchasers can rely on the sellers' assertions of quality. This is a core economic principle of RMBS and CMBS securitizations.

The purpose of this securitization structure is to allocate the risk of loss due to deficiencies that may exist in the individual loans that are bundled together in

RMBS and CMBS transactions. Investors make their decision to invest in mortgage-backed securities based, in part, upon this allocation of the risk of loss. To the extent that the risk of loss is allocated to the sellers, that risk is intended to remain with the sellers for the life of the underlying loans. The First Department's decision destroys this economically rational allocation of risk by limiting the time-period during which sellers bear the risk to six years after the securitization transaction closes – even though the underlying loans may remain outstanding, and the risk does not materialize until after that six-year period has lapsed.

The due diligence that the First Department's decision effectively requires is all but impossible to meet under any rational standard of economic reasonableness. Requiring a trustee to identify a "breach" that has not yet, and might never, result in a material adverse impact would, at best, call for speculation and, in all likelihood, would compel an impossibility. Trustees would be forced to police loan status as if they were de facto real estate underwriters, responsible for assessing conditions and performance of tens of thousands of loans – *amici*, for example, are the special servicers for many thousands of separate loans – with the investors, rather than the loan sellers, bearing the economic consequences of this exercise. It would defeat the entire economic construct of CMBS securitizations.

Imposing such an extraordinary underwriting burden on CMBS purchasers and servicers would be industry-changing. It is no exaggeration to say that, if the

First Department's decision were to be affirmed, and if made applicable to CMBS repurchase obligations, it would vastly alter the entire economic underpinning of the mortgage-backed securities business. It would effectively compel trusts to act as underwriters, a practical impossibility, without providing any protection.

No significant efficiency would be achieved by forcing trusts to perform underwriting on individual loans. Trustees are neither equipped nor compensated to perform such acts. Even if a trustee were to identify a representation that is false, the trust often would not have a claim that it could pursue against the seller, because, in order for a claim for a false or inaccurate representation or warranty in a CMBS transaction to exist, the misrepresentation must have a material adverse effect on the loan or the certificateholders. This is a critical factor, because the material adverse effect from a breach of a CMBS loan representation or warranty almost always occurs and becomes evident post-securitization, well after the time for any initial due diligence. And, pursuant to some CMBS contracts, no claim arises until the loan actually defaults.

CMBS repurchase agreements, much like RMBS repurchase agreements, are structured precisely to avoid this problem. The mortgage loan seller incurs no liability for breaches that do not result in material adverse effects. In exchange for the buyers' agreement to waive direct claims for damages resulting from a misrepresentation or breach of warranty, the sellers agree to a specific obligation to repurchase the loan. The trust then has a cause of action to compel repurchase and/or for damages for refusal to repurchase. The predicate of such a claim is the failure to repurchase the loan from the trust when the seller is required to do so under the applicable agreement; the contractual triggering events are integral and essential elements of the cause of action itself.

Under the basic structure of the claim, a seller is not liable for failure to repurchase unless the triggering conditions for the repurchase obligation have occurred. Despite this self-evident truism, the First Department ruled that the conditions to the repurchase obligation are not substantive elements of the cause of action, but instead are mere procedural prerequisites that are ignored for statute of limitations purposes.

This is a fundamental misreading of CMBS and RMBS repurchase agreements. The *actionable* breach is *not* the underlying misrepresentation or breach of warranty; claims for damages arising from a misrepresentation or breach of warranty are waived. Rather, the actionable breach is the failure to repurchase when the obligation arises under the terms of the applicable agreement. By its very definition, that breach *cannot* arise until the triggering event for the obligation arises. This is a fundamentally substantive element of the cause of action itself and not, as the First Department incorrectly ruled, a collateral procedural requirement that is not integrally part of the failure-to-repurchase cause of action.

Again, this is the trade-off that the sellers bargained for in the securitization transaction: freedom from potentially enormous damages for breaches of warranty or other misrepresentations in exchange for their agreement to repurchase the loan whenever the pre-conditions to such obligation have occurred. Under the First Department's analysis, the sellers get all of the benefit of their *quid*, but the buyers get only six years of protection for their *quo*. In other words, the seller not only gains complete protection against damages for making a misrepresentation or breaching a warranty, but also shifts to the buyers much of the risk of loss. The decision below thus destroys the bargained-for economic tradeoffs in these agreements. For all practical purposes, the decision pares the repurchase cause of action down to a very limited remedy, often having no value at all, particularly in CMBS transactions. For literally thousands of securitizations written under New York law, it reverses the risks and burdens the parties negotiated regarding allocation of the indeterminate risk of loan losses arising more than six years after closing and rewrites their bargains into a one-sided giveaway.

Amici present four issues for the Court's consideration. First, in Part One, we discuss the various reasons why CMBS securitizations and the repurchase agreements attendant to them raise important issues not addressed in ACE's brief, and why the Court should limit any adverse ruling to only the RMBS issues at hand and not disrupt the pre-*ACE* case law supporting the sellers' repurchase obligation in CMBS transactions. Second, in Part Two, we discuss why the First Department's analysis is wrong and misconstrues the nature of the cause of action for repurchase of a loan, as argued by ACE in its opening brief. Third, in Part Three, we address reasons why, beyond the reasons argued by ACE with respect to RMBS securitizations, the First Department's decision should not be applied to CMBS transactions. Finally, in Part Four, we demonstrate the First Department's misapprehension of how buyers and sellers in securitization transactions negotiate and allocate the risks of loss.

In considering these significant issues, the Court should bear in mind that the First Department's decision offers no analysis of its own. The First Department's abbreviated treatment fails to recognize the importance of the case, the strength of the trial court's detailed analysis (and numerous other decisions around the country ruling similarly on related issues), or the merit of ACE's arguments. Notwithstanding its truncated analysis, the First Department's decision is receiving wide application and is upending enforcement of RMBS and CMBS repurchase agreements alike nationwide. *Amici* respectfully ask this Court to ensure that the fundamental and essential balance struck by the parties in those agreements is maintained.

ARGUMENT

Although the First Department's decision addresses an RMBS transaction, it is receiving wide application in CMBS cases as well. *See, e.g.*, *U.S. Bank N.A. v. Dexia Real Estate Cap. Mkts.*, No. 12-cv-9412, 2014 WL 3368670, at *6 (S.D.N.Y. July 9, 2014) (citing to First Department's ruling in explaining that the demand requirement is procedural not substantive); *Wells Fargo Bank, N.A. v. JPMorgan Chase Bank*, *N.A.*, No. 12-cv-6168 (MGC), 2014 WL 1259630, at *3-4 (S.D.N.Y. Mar. 27, 2014) (applying First Department's ruling in *ACE* to find claim for breach of CMBS loan repurchase obligation was time-barred), *appeal pending*, No. 14-1414-cv (2d Cir.). Given the overlap in treatment by the courts, it is important that this Court consider the impact and application that the *ACE* decision is having and will have on CMBS transactions if left uncorrected.

I. CMBS Repurchase Claims Raise Important Considerations That Are Not Addressed in Appellant's Brief.

While the argument presented by the Appellant underscore issues of equal importance to CMBS transactions, there are additional issues that frequently arise in CMBS transactions that require reversal of the *ACE* decision or, at the very least, a narrowing of the decision to the facts of *ACE*. To understand these, it is important to start with the essential dynamics of CMBS and RMBS transactions.

Both CMBS and RMBS transactions involve the absence of any investigational underwriting activities by investors, as many loans (in this case, thousands of loans) are bundled and sold *en masse* in a single transaction. The trust does not have *any* right of discovery about the bundled loans or any right to accept or reject any of the loans being deposited into the trust corpus and instead must rely on the ratings for the loans. Due diligence by the trust or the trustee on behalf of the trust cannot and does not occur given the volume of loans, the structure of the transaction (*e.g.*, the bundling of many loans into a single transaction), the limited contractual duties of the parties, and the very limited amount of time for the buyer to conduct pre-closing due diligence. Indeed, the governing agreements generally disclaim any due diligence obligation by the trust or any person or entity acting on behalf of the trust, with some CMBS agreements providing that the trust's claims against the seller shall not be affected if the trust does not conduct due diligence.[1] Instead, the trust relies on the *sellers*' representations as to the quality and characteristics of the contributed loans, and upon the seller's promise to buy a loan out of the trust corpus if it turns out at some later date that the loan lacks the represented quality or characteristics (and the additional requirements for repurchase are met). This promise is the trust's sole

[1] Some CMBS agreements go further and expressly state that the repurchase obligation is "for risk allocation purposes." As discussed below, the case law confirms that a repurchase obligation is intended to place the risk of a defective loan on the seller.

protection against bad loans.[2] By contrast, the sellers have unfettered opportunity prior to making the representations and warranties to perform due diligence as to the represented quality and conditions of the underlying loans. Moreover, the agreements generally provide sellers with an opportunity to cure a misrepresentation or breach of warranty (to the extent cure is possible) before the obligation to repurchase is imposed. The buyers, in turn, have contractually imposed limitations on the time they can take to investigate and notice a breach that they discover. Those contract terms answer the policy argument posed by sellers that buyers are seeking a right to delay bringing their claims indefinitely into the future.

The common thread is a careful, deliberate, and contracted-for allocation of risks regarding potential losses on the underlying loans. The structure of mortgage-backed securities allocates the risk of loss due to the lack of certain characteristics or quality of the loans such that the burden of due diligence and the risk from a failure to perform due diligence is on the seller, not the purchaser.

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[2] One caveat should be noted regarding subordinate bonds (commonly referred to as “B-pieces”) that bear the first allocation of losses in a securitization trust. The investors in B-pieces (commonly referred to as “B-buyers”) perform limited due diligence for their own benefit, they do not perform such due diligence on behalf of the trust. Their activities therefore are immaterial here. Moreover, B-buyers do not conduct the level of due diligence that would be required by the First Department’s decision. B-buyers have limited time and thus do not re-underwrite the bundled loans. Instead, like the trusts, the B-buyers rely upon the representations and warranties given by the sellers.

Consistent with that allocation of risk, the seller makes representations and warranties and accepts a contractual obligation to buy a loan back that ultimately does not have those required characteristics; the buyer is insulated from that risk. In exchange for obtaining this promise to buy back a defective loan, the purchaser foregoes its common law claim for damages due to breach of the representations and warranties and instead agrees to a limited *exclusive* remedy of enforcing the seller's obligation to repurchase the loan, subject to the contractual prerequisites that the seller repurchase the loan upon notice of a breach with a material and adverse effect and lapse of any applicable cure period.[3] Given this basic framework, which bargains away all remedies other than the right to enforce the repurchase obligation, the First Department's ruling limiting the life of those representations to six years following the securitization closing date, dramatically alters the bargain.

For several reasons, these principles apply with particular force to CMBS agreements not discussed in the Appellant's brief.

[3] Typically, the agreement terms say that "the obligations of the Seller … to cure or repurchase a defective Mortgage Loan … constitute the sole remedies of the Purchaser against the Seller respecting … a breach of the representations and warranties." This fairly standard language is taken from the RMBS repurchase agreement at issue in *Nomura Asset Acceptance Corp. Alternative Loan Trust* v. *Nomura Credit* & *Capital, Inc.*, No. 653390/2012, 2014 WL 2890341, at *2 (N.Y. Sup. June 26, 2014). Similar language is found in the agreement at issue in *U.S. Bank v. Dexia*. *See* 2014 WL 3368670 at *2 (the repurchase provision "provide[s] the sole remedy available for ... breaches of representations and warranties" of the purchase agreement).

First, in a typical CMBS transaction, the material and adverse effect of the breach on the value of the loan or interest of certificateholders rarely exists at the time of the securitization closing. By contrast, the representations violated in this RMBS case, which include overstated borrower income, failure to underwrite, misstated debt-to-income ratios and existing debt status, overstated occupancy status, overstated loan-to-value ratios, all had occurred either on or prior to the securitization closing date. (R.40-47, ¶ 29). Those factual inaccuracies could cause a material and adverse effect at the time of securitization closing, and, in fact, ACE alleged as much in its complaint, stating: "these breaches … materially and adversely affected the value of the [] Loans because, among other things, they overstated the [] Loans' quality and value as of the date the [] Loans were purchased by the Trust." (R.47, ¶ 30). In CMBS transactions, a factual inaccuracy rarely manifests a material effect on loan value at the time of closing.

The existence of a material and adverse effect requirement and the timing of such an event are critical issues in CMBS cases. For example, in a case recently adjudicated in the U.S. District Court for the Southern District of New York, where the breach involved a guaranty agreement given by the borrower that proved years later to be unenforceable under its terms, the court held that no material and adverse effect on the trust had occurred until years after the securitization closing, when the trust was unsuccessful in enforcing the guaranty agreement. *See U.S.*

Bank N.A. v. Dexia Real Estate Cap. Mkts., 959 F. Supp. 2d 443, 448 (S.D.N.Y. 2013); *see also Wells Fargo Bank, N.A. v. Bank of Am., N.A.*, No. 11-cv-4062, 2013 WL 372149, at *2, 7-8 (S.D.N.Y. Jan. 31, 2013) (holding that, because the plaintiff CMBS trust was unable to foreclose on and realize against its collateral because of a pre-existing first mortgage lien, the loan seller's breach caused a material and adverse effect when the first mortgagor foreclosed which was three years after the securitization closing). Similarly, in the *Wells Fargo Bank* case currently pending before the Second Circuit cited above, the breach involved a lease restriction on utilization of a retail shopping mall. At the time of securitization, the mall was fully occupied so no material and adverse effect had yet occurred; the event causing a material and adverse effect occurred years later, when the anchor stores vacated the mall. *See Wells Fargo Bank*, 2014 WL 1259630, at *1-2. Such cases are far from uncommon. *See U.S. Bank N.A. v. Bank of Am., N.A.*, Case No. 14-cv-1492 (S.D. Ind.), Dkt. No. 1, at ¶¶ 21-23 (claiming breach where material adverse effect did not manifest itself until a primary tenant vacated and a replacement could not be found due to restrictive covenants).

The material-and-adverse-effect requirement also inures to the seller's benefit. The trust cannot sue for a representation or warranty violation that has not caused harm; rather, it must wait until material and adverse effect is manifested. This is a real requirement that benefits both sides of a CMBS transaction.

Second, CMBS repurchase agreements frequently provide that the contractual obligation to repurchase exists for the life of the underlying loans, making clear that continuing performance by the seller throughout the life of the transaction is a bargained-for component of the deal. For example, the CMBS agreement at issue in the *Wells Fargo* case specifically provides that "[t]he warranties and representations and the agreements made by the Seller herein shall survive delivery of the Mortgage Loans to the Trustee until the termination of the Pooling and Servicing Agreement." *See Wells Fargo Bank*, No. 14-1414-cv (2d Cir.), JA 44 (§ 14) of the agreement). This, in turn, is entirely consistent with the fact that, in CMBS transactions, the material and adverse effect from the breach typically can occur years after the securitization closing.

Third, CMBS transactions often contain express contractual terms authorizing the trust to sue the seller for breach of its obligation to repurchase the loan. Such terms underline the point that refusal to repurchase is a triggering, substantive condition for a claim against the seller and not a mere procedural step that can be ignored in a limitations analysis.

Fourth, in CMBS transactions, the term of the loans is generally much shorter than in residential mortgages, typically ten years or less , not thirty years as often is the case for residential mortgages, like those at issue here. The sellers' expressed concern that their potential liability will stretch decades into the future simply does not apply in CMBS. This is a clear distinction between RMBS and CMBS agreements.

These typical characteristics of CMBS agreements lead to a broader point. Each RMBS and CMBS repurchase agreement stands on its own and must be assessed on a case-by-case basis without applying a one-size-fits all formulaic approach. Here, the Court should be careful not to make broad or sweeping pronouncements that could inadvertently affect transactions involving materially different contract provisions. For CMBS transactions, where the contract terms are materially different – and stronger – it is especially important that the Court not lump them together with RMBS transactions without recognizing the salient and fundamental differences.

II. The First Department's Limitations Analysis Is Contrary to the Basic Structure of Mortgage-Backed Securities.

Putting the distinctions between CMBS transactions and the RMBS transaction that is before the Court aside for the moment, many common features do exist. *Amici* therefore strongly support reversal of the limitations analysis as applied to MBS transactions generally. The following issues merit further discussion.

First, as the repurchase agreement in this case illustrates, RMBS and CMBS agreements alike expressly disclaim any obligation by the trust or any party acting on behalf of the trust to perform due diligence as a precondition for asserting a claim for repurchase. *See* ACE Br. 28 (quoting R.292, § 4(e)). Even the *seller* disclaimed a duty to perform due diligence. *See id.* (quoting R.15). This reflects the practical reality of securitization underwriting: the scope of the task is far too enormous to permit reasonable investigation by either the seller or buyer. Neither side can possibly underwrite 8,815 separate loans as would have been required in this securitization. Instead, both sides agreed to a specific allocation of the underwriting risks: for its part, the seller agreed to repurchase should a loan fail to have the represented qualities or characteristics, causing a material adverse effect; whereas the trust, in return, waived its right to sue the seller for damages arising from the breach of a representation or warranty standing alone. The bargain is neat, clear, fair, cost-efficient, and well-balanced in providing equipoise to the parties. Neither side need investigate or take action until a specific need arises.

The very purpose of a repurchase obligation is to impose on the seller the risk of certain agreed-upon defects in a loan. This principle is well understood, as the trial court found below. *See* R.17-19; *see also, e.g.*, *Resolution Trust Corp. v. Key Fin. Servs., Inc.*, 280 F.3d 12, 18 (1st Cir. 2002) (upholding award of damages for liquidated loans due to a seller's breach of a repurchase provision, and stating that "[a] repurchase provision is designed to shift the risk to the selling party in the event that a dispute arises"); *Deutsche Alt-A Sec. Mortg. Loan Trust, Series 2006-OA1 v. DB Structured Prods., Inc.*, 958 F. Supp. 2d 488, 504 (S.D.N.Y. 2013) ("'[t]he whole point of how the MLPA and PSA [CMBS agreements] were structured was to shift the risk of non-complying loans onto [the seller]'") (quoting trial court); *Assured Guar. Mun. Corp. v. Flagstar Bank, FSB,* No. 11 Civ. 2375, 2011 WL 5335566, at *7 (S.D.N.Y. Oct. 31, 2011) (finding that seller cannot insulate itself through securitization … by "simply charging off the offending loan"); *Nomura Asset Acceptance Corp. Alternative Loan Trust v. Nomura Credit & Capital, Inc.*, No. 653390/2012, 2014 WL 2890341, at *10 (N.Y. Sup. June 26, 2014) ("As the Courts have repeatedly noted in construing sole remedy provisions, '[t]he whole point of how the MLPA and PSA [CMBS agreements] were structured was to shift the risk of noncomplying loans onto [the Seller].'" Otherwise, the seller "'would be perversely incentivized to fill the trust with junk mortgages that would expeditiously default so that they could be released, charged off, or liquidated before a repurchase claim is made'") (quoting trial court)).

Second, ACE correctly explains why the agreements address the lone policy concern raised by the First Department: by the agreements' express terms, purchasers cannot unduly delay litigation by sitting on their hands despite knowledge of breaches of representations. *See* ACE Br. 40-46.[4] Indeed, even

[4] The following cases are illustrative of the attention courts have paid to this issue. *See, e.g., Lehman Bros. Holding v. Laureate Realty Servs.*, No. 1:04-cv-1432-RLY-TAB, 2007 WL 2904591, at * 12-13 (S.D. Ind. Sept. 28, 2007); *LaSalle Bank N.A. ex rel. Lennar Partners, Inc. v. Capco Am. Secur'n Corp.*, No. 02-cv-9916, 2005 WL 3046292, at *4 (S.D.N.Y. Nov. 14, 2005); *Trust for Certificate Holders*

where parties do not contractually require prompt notice, courts may impose a requirement for reasonable notice to avoid indefinite extension of limitations periods. *See, e.g.*, *Cont'l Cas. Co. v. Stronghold Ins. Co.*, 77 F.3d 16, 21 (2d Cir. 1996) (a provision that limitations commenced to run when the plaintiff sent demand to defendant could not be used to put off limitations indefinitely because the plaintiff "could not unreasonably delay reporting [its] losses" to the defendant) (citing, *e.g.*, *Snyder v. Town Insulation, Inc.*, 81 N.Y.2d 429, 435 (1993); *Solomon R. Guggenheim Found. v. Lubell*, 77 N.Y.2d 311, 319 (1991)).

Third, as ACE explains, the First Department fundamentally erred in holding that the seller's obligation to repurchase does not, in itself, constitute a cause of action, but instead is a mere remedy for the seller's underlying violation of the securitization agreement. *See* ACE Br. 20-31. This is clear from the face of the agreements themselves. In the case at bar, for instance, the purchase and sale agreement has a separate section titled "Repurchase *Obligation*" that expressly requires the seller to repurchase if it cannot effect a cure. *See id.* at 11 (quoting R.300, § 7(a); emphasis added). And it expressly provides that the Trustee, or,

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of Merrill Lynch Mortg. Passthrough Certificates Series 1999-C1 v. Love Funding Corp., No. 04 Civ. 9890, 2005 WL 2582177, at *7 (S.D.N.Y. Oct. 11, 2005); *LaSalle Bank N.A. v. Lehman Bros. Holdings, Inc.*, 237 F. Supp. 2d 618, 637-38 (D. Md. 2002); *Morgan Guar. Trust Co. of N.Y. v. Bay View Franchise Mortg. Accept. Co.*, No. 00-CIV. 8613 (SAS), 2002 WL 818082, at *7 (S.D.N.Y. Apr. 30, 2002); *Hahn Auto. Warehouse, Inc. v. Am. Zurich Ins. Co.*, 18 N.Y.3d 765, 771 (2012); *LaSalle Bank N.A. v. Nomura Asset Capital Corp.*, 846 N.Y.S.2d 95 (N.Y. App. Div. 2007).

under certain circumstances, the certificateholders, may "enforce *the obligations*" of the seller "to repurchase such Mortgage Loan[.]" *Id.* at 13 (quoting R.121) (emphasis added). In other words, the agreement's plain text makes clear that the claim is for a breach of the *obligation* to repurchase and is not a remedy for the violation. Similar provisions are standard throughout the industry. For instance, in the *Wells Fargo* case, the agreement states that "no limitation of remedy is implied with respect to the Seller's breach of its *obligation to cure or repurchase* in accordance with the terms and conditions of this Agreement." *Wells Fargo Bank*, No. 14-1414-cv (2d Cir.), JA 42, § 6(g) (emphasis added). Again, the actionable breach is the seller's failure to honor its express contractual duty to repurchase.

Where contracts expressly establish a distinct obligation for a party to act after notice of an underlying problem, the courts typically view the requirement as a contractual duty and not as a remedy. *See, e.g.*, *Bulolva Watch Co. v. Celotex Corp.*, 46 N.Y.2d 606, 608-09 (1979) (holding that, even though limitations had expired on a warranty for a watertight roof, a separate bonding agreement to repair any leaks for the next twenty years created a separate agreement to perform a service in the future, which was triggered every time the defendant breached the obligation to repair the bonded roof). This is the rule for general commercial contracts, and it is the rule applied in numerous RMBS and CMBS cases applying New York law. *See Assured Guar. Mun. Corp. v. Flagstar Bank, FSB*, 920 F.

Supp. 2d 475, 509 (S.D.N.Y. 2013) (stating that if the seller fails to repurchase defective loans within 90 days "it has breached the terms of the contract" and purchaser may compel repurchase); *Fed. Hous. Fin. Agency v. WMC Mortg., LLC*, No. 13-cv-584 (AKH), 2013 WL 7144159, at *1 (S.D.N.Y. Dec. 17, 2013) (ruling that seller breached when it failed to repurchase, not when a representation or warranty was violated); *Lehman Bros. Holdings, Inc. v. Nat'l Bank of Ark.*, 875 F. Supp. 2d 911, 917 (E.D. Ark. 2012) (ruling that failure to repurchase is a breach of the contract); *CitiMortgage, Inc. v. Reunion Mortg., Inc.*, No. 10-cv-1632, 2012 WL 5471165, at *4 (E.D. Mo. Nov. 9, 2012) (same); *CitiMortgage, Inc. v. Allied Mortg. Grp., Inc.*, No. 10-cv-1863, 2012 WL 5258745, at *4, 13 (E.D. Mo. Oct. 24, 2012) (same); *Lehman Bros. Hldgs., Inc. v. Key Fin. Corp.*, No. 8:09-CV-623-T-17EAJ, 2011 WL 1296731, at *11 (M.D. Fla. Mar. 31, 2011) ("[a] loan seller's failure to repurchase non-conforming loans upon demand as required by a contract is an *independent breach of contract*") (emphasis added); *LaSalle Bank Nat. Ass'n v. Lehman Bros. Hldgs., Inc.*, 237 F. Supp. 2d 618, 638 (D. Md. 2002) (same); *F.D.I.C. v. Key Fin. Servs., Inc.*, No. 89-cv-2366, 1999 WL 34866812, at *12 (D. Mass. Dec. 23, 1999) ("breach of the agreement … occurred when it refused to repurchase the Key Loans upon … demand as required in the Agreement"), *aff'd sub nom. Resolution Trust Corp. v. Key Fin. Servs., Inc.*, 280 F.3d 12 (1st Cir. 2002).

By its terms, contract language declaring that a party has an on-going obligation to do something in the event a problem occurs in the future is not remedial. A landlord's duty to fix a code violation upon notification is an independent and continuing obligation, not a remedy that is lost because the tenant fails to provide swift enough notice (even if the tenant's right to compensatory damages were lost due to delay). Long-term guaranties, such as the bonding agreement in *Bulova*, are premised on the fact that the obligation continues throughout the contract term, even if an underlying breach no longer is actionable due to limitations. The black-letter law is pellucid that such continuing obligations are not time-barred.

Had the sellers desired a different result, they could have written the securitization agreements differently to make it clear that they have no independent obligation to repurchase and that any obligation instead arises only as a remedy for a claim of breach of a representation or warranty. The agreements are not written that way because it would substantially alter the parties' bargain of waiving such claims for breach of warranty in exchange for establishing the limited claims for failure to repurchase. Indeed, as ACE points out (ACE Br. 12), the obligation to repurchase is in some cases self-executing: it arises even if the seller independently discovers an offending condition without notice from another party. Thus, the repurchase obligation is an enforceable duty under the contract. It makes little sense to treat a mandatory, self-executing contract obligation as if it merely were a remedy for some other breach.

Fourth, in loan securitization repurchase agreements, the seller generally has no obligation to repurchase a loan until triggering conditions, typically including a material and adverse event, have occurred. Thus, occurrence of the contracted-for triggering events is necessary before repurchase can be demanded. This Court's precedent makes clear that the legal cause of action accrues only when the right (here, repurchase) may first be asserted. As this Court held in *Hahn Automotive Warehouse, Inc. v. Am. Zurich Ins. Co.*, "where the claim is for payment of a sum of money allegedly owned pursuant to a contract, the cause of action accrues when the party making the claim possesses a legal right to demand payment." 18 N.Y.3d 765, 770 (2012) (internal citations, quotation marks, and brackets omitted); *see id.* at 771 (affirming Appellate Division cases holding that the statute of limitations is "triggered when the party that [is] owed money ha[s] the right to demand payment, not when it actually [makes] the demand").

The First Department acknowledged that, under the facts of this case, the legal right to sue for repurchase of the loan did not arise until expiration of a 90-day period measured from notice of breach (a conclusion reached in the course of finding that the trust's claim was both too early and too late). *See* R.viii ("The MLPA and PSA provided that the trustee was not entitled to sue or to demand that defendant repurchase defective mortgage loans until it discovered or received notice of a breach *and* the cure period lapsed.") (emphasis in original). Under the rule set forth in *Hahn*, therefore, that claim has not accrued because the Trustee does not "possess a legal right to demand payment." *Hahn*, 18 N.Y.3d at 770.

To put the same point differently, the refusal to repurchase, despite a contractual obligation to do so, is a substantive requirement of the claim for repurchase. The Second Circuit explained the principle as follows:

> *Where the demand requirement is substantive, that is, where a demand and refusal are requisite elements of the cause of action*, it accrues and the statute of limitation begins to run only after such demand and refusal. On the other hand, where the demand is merely procedural, that is, where demand and refusal are not requisite elements of the cause of action and the *defendant's actionable conduct was complete prior to demand*, § 206(a) of the N.Y.C.P.L.R [] governs and the limitation period begins to run when the "right to make the demand is complete."

Kuntsammlungen Zu Weimar v. Elicofon, 678 F.2d 1150, 1161 (2d Cir. 1982) (emphasis added); *accord Cont'l Cas. Co.*, 77 F.3d at 21 (explaining that under CPLR 206(a), "where a demand is a predicate to suit" New York courts "distinguish between substantive demands and procedural demands"); *Frigi-Giffin, Inc. v. Leeds*, 52 A.D.2d 805, 806 (N.Y. App. Div. 1976) (holding that under CPLR 206(a), a "demand is of a substantive nature (i.e. an essential element of the cause of action), the statute runs only after a demand has been refused") (citing 1 Weinstein, et al., N.Y. Civ. Prac. § 206.01)); *Menzel v. List*, 22 A.D.2d 647, 647

(N.Y. App. Div. 1964) (holding that under CPLR 206(a), limitations "did not begin to run until demand and refusal" for conversion action by purchaser of personal property against seller, as "a demand by the rightful owner is a substantive, rather than a procedural, prerequisite to the bringing of an action for conversion by the owner"). Under the facts of this case, the seller's actionable conduct is not the breach of its representations and warranties, but the refusal to repurchase.

The contractual requirements that trigger a repurchase obligation under the terms of a CMBS transaction are "integral" to the claim and thus are inherently substantive because no claim exists in their absence. Again, the claim is for failure to repurchase, *not* for selling a defective loan. Indeed, the latter claim is expressly precluded in CMBS transactions. Thus, the purchaser cannot satisfy the test that "the defendant's actionable conduct was complete prior to demand," as used in CPLR 206(a). *Kuntsammlungen*, 678 F.2d at 1161.

Finally, as ACE explains (ACE Br. 40), the demand provision serves the sellers' interests by starting the period within which the sellers have an opportunity to cure, if possible, before being required to repurchase the loan or facing litigation for breach of contract.[5] Having chosen a contractual structure that makes failure to repurchase the *sine qua non* of a breach of contract claim, the

[5] The demand requirement is not the only accommodation to the sellers. Even in the context of a breach of contract action, the sellers' interests are protected because the amount of their liability is limited by a contractually agreed-upon formula.

sellers should not benefit from a contrary rule that the claim accrued before that refusal and failure occurs.

III. The First Department's Analysis Should Not Be Applied to CMBS Agreements.

For the typical CMBS agreement, the First Department's decision is particularly problematic. Some courts, however, have failed to make this distinction and have reached especially illogical and strained conclusions in applying the First Department's approach to CMBS agreements.

Perhaps the foremost issue is the material and adverse effect element. Numerous cases have made clear that this element is a separate requirement from the breach itself and needs to be established as a separate factual matter. *See, e.g.*, *Dexia*, 2014 WL 3368670, at *6 ("The 'material and adverse' effect is an element of the breach – the [plaintiff] had no legal right to make a demand until it occurred."); *Dexia*, 959 F. Supp. 2d at 447-48 (explaining that, "in order for the Special Servicer to demand cure or repurchase, the material and adverse condition must be met"); *LaSalle Bank v. CIBC Inc.*, No. 08-cv-8426, 2011 WL 4943341, at *3 (S.D.N.Y. Oct. 17, 2011) (explaining that an actionable breach must have a "material and adverse effect" on the property, the loan, or the interests of investors); *LaSalle Bank v. Citicorp Real Estate, Inc.*, No. 01-cv-4389, 2002 WL 31729632, at *3 (S.D.N.Y. Dec. 5, 2002) (ruling that, to "state a claim, LaSalle must allege both a breach of a representation or warranty ... and a material and adverse effect caused by the breach”); *see also LaSalle v. Nomura Asset*, 846 N.Y.S.2d at 108 (explaining, in a CMBS case, that the obligation to repurchase “could only arise *when plaintiff could reasonably be charged with having a valid basis to establish the breach*” of the governing contracts) (emphasis in original).

In a CMBS case, where the material and adverse effect typically manifests post-closing, this requirement becomes a pivotal element of the limitations analysis: the clock does not begin ticking until a material adverse event has occurred even though a breach of the representation or warranty may already have taken place. *See, e.g.*, *ACE Sec. Corp. Home Equity v. DB Structured Prods.*, 5 F. Supp. 3d 543, 552, 559-60 (S.D.N.Y. 2014) (rejecting limitations defense in light of material adverse event provision that triggered limitations timeline as of post-closing event); *Dexia*, 2014 WL 3368670 at *6 (ruling that material adverse event occurred after breach and thus limitations did not begin to run at closing).

Common provisions in CMBS agreements that the representations and warranties and the right to compel a repurchase of a defective loan survive through the duration of the loan also are significant. Again, as the material and adverse effect in a CMBS loan transaction almost invariably occurs years after the securitization closing took place, such provisions take on even greater significance in a CMBS case. The purchasers in CMBS transactions understand and bargain for the right to bring claims for repurchase throughout the life of the loan, knowing well that the material and adverse effect can occur at any time and thus obtaining contractual lifetime protection against that risk. Indeed, many CMBS transactions require the loan to be in default before a repurchase obligation arises.

Finally, the policy considerations favoring a rule that the claim accrues when the right to make a demand first arises (*i.e.*, at the time that a material adverse effect first manifests itself), have an even stronger application in CMBS cases. It is simply not the bargained-for obligation of trusts, through their trustees and servicers, to exercise post-closing underwriting of each and every loan bundled into a CMBS securitization. The buyers of interests in the trust invest based on the representations and warranties and the financial strength of the loan sellers to stand behind their repurchase obligations. They invest with the express understanding that no parties to the securitization have performed due diligence with respect to the loans. The parties' contracts spell out rights, duties, and obligations of the trustee and the servicers, and do not provide authority for conducting, or duty to conduct, due diligence with respect to the trust corpus and, indeed, generally disclaim any such duty. Applying the First Department's ruling to CMBS transactions would destroy their economic underpinnings and do incalculable damage to the industry.

IV. The Decision Below Wrongly Reverses the Bargained-for Contractual Risks and Burdens in MBS Repurchase Agreements.

The issues presented by this case have great significance for the national real estate mortgage loan securitization industry, as many, if not most, MBS agreements apply New York law. And, in the wake of the real estate collapse during the Great Recession, the volume of claims involving defective loans has exploded. The question of whether and when these claims for repurchase may be brought thus is crucial for the entire real estate and CMBS industry.

Given how important these issues are for the industry, the First Department's decision stands out for its conspicuously abbreviated reasoning. Its terse and conclusory analysis offers little substantive insight to guide future decisions, failing for instance, to discuss and analyze the clear splits and disagreements in the case law. Indeed, the important policy and economic considerations that explain the bargains underlying the MBS repurchase agreements are never even addressed.

At its core, the decision rewrites the basic bargain made by buyers and sellers in MBS securitization agreements. Though the sellers like to portray the policy question as a matter of plaintiffs having slept on their rights, that argument assumes the false premise that, notwithstanding the existence of sellers' representations and warranties as to the condition and quality of the loans, it is the trust, not the sellers, who bear the risk that those representations were false. The actual bargain made in a loan securitization is something quite different. The agreements generally are written to make clear that no due diligence is done and that none is expected or required. In fact investors generally rely, not on due diligence, but, rather on the ratings assigned to their respective investments. The ratings, in turn, generally rely in part on the strength of the representations being made and the creditworthiness of the mortgage loan sellers that back the repurchase obligations. Without the representations and warranties, the investments would not get the ratings needed to close the transaction. The existence of the representations and warranties, and the corresponding obligation to repurchase any loan with respect to which those are false, is fundamental to the securitization industry. Rating agencies do not rely on anyone's due diligence in order to assign their ratings and they, as do the investors, understand that no such due diligence occurs. Moreover, even the seller often disclaims having done any such diligence. The foundation for the transaction is that the parties may assume that the representations and warranties as to the quality of the loans are correct and thereby avoid the prohibitive cost of investigating to verify the assertions. Thus, the risk of a defective loan stays with the loan seller, with the seller agreeing to buy the loan back only when, and if, the defect has a material and adverse effect on the value of the loan or the interest of the certificateholders. If the seller refuses to repurchase the loan in accordance with its agreement to do so, it is at that point that the trust has a right to sue to enforce the repurchase obligation or for damages if the seller fails to repurchase.

The First Department's decision destroys that bargain. Particularly for CMBS transactions, but also for RMBS deals, the decision would force purchasers to perform precisely the underwriting functions that the securitization process was supposed to avoid and thereby significantly affect certicateholders' rights to the benefit of their bargain, with no evidence or assurance that this function could be successfully exercised. If this were to occur, the effect on the housing and commercial real estate finance and construction markets could be catastrophic.

Applying the plain bargained-for language of the agreements and allowing a CMBS or RMBS trust to sue to compel repurchases if the seller refuses to comply, does not encourage litigation of stale claims or reward delay and procrastination. It merely implements the fundamental economic bargain that underlies all MBS transactions, a bargain that would be destroyed by the First Department's decision.

CONCLUSION

For the foregoing reasons, the decision of the Appellate Division, First Department should be reversed and the Supreme Court's decision should be reinstated.

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Respectfully submitted,

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