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 FOR *AMICUS CURIAE* THE NATIONAL CREDIT UNION ADMINISTRATION BOARD, AS LIQUIDATING AGENT OF U.S. CENTRAL FEDERAL CREDIT UNION, WESTERN CORPORATE FEDERAL CREDIT UNION, MEMBERS UNITED CORPORATE FEDERAL CREDIT UNION AND SOUTHWEST CORPORATE FEDERAL CREDIT UNION, IN SUPPORT OF PLAINTIFF-APPELLANT

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

The National Credit Union Administration ("NCUA") is an independent federal agency responsible for chartering and regulating federal credit unions, regulating federally insured state credit unions, and administering the National Credit Union Share Insurance Fund and the Temporary Corporate Credit Union Stabilization Fund (together, the "Funds"). *See* 12 U.S.C. §§ 1752a(a), 1754, 1781, 1783-1784, 1790e. The Funds protect the deposits of nearly 92 million account holders. They are financed by insured credit unions and backed by the full faith and credit of the United States. *See id.*; *id.* § 1782(c). When an insured credit union is in danger of failing, NCUA has the responsibility to step in as conservator – and, if necessary, liquidating agent – to preserve and conserve the credit union's assets, and thereby minimize losses and risks to the Funds and to other claimants against the credit union. *See id.* §§ 1766, 1786(h), 1787.

NCUA's[1] interest in litigation over residential mortgage-backed securities ("RMBS") stems from its role as liquidating agent for four large corporate credit unions (the "Credit Unions") that failed in 2010. The Credit Unions were major financial institutions that offered short-term liquidity and a variety of financial

[1] For convenience, from this point forward, this brief uses the abbreviation "NCUA" to refer solely to the agency's Board in its capacity as conservator or liquidating agent (distinct from the agency's capacity as regulator) unless the context indicates otherwise. As relevant to this case, NCUA is liquidating agent for U.S. Central Federal Credit Union, Western Corporate Federal Credit Union, Members United Corporate Federal Credit Union, and Southwest Corporate Federal Credit Union (collectively, the "Credit Unions").

services to other credit unions. They failed in part because of losses sustained by purchasing RMBS – purchases that had been represented as extremely safe investment-grade, triple-A-rated RMBS, but that, by the time NCUA became conservator of the Credit Unions, had mostly been downgraded to "junk" ratings.

To offset the Credit Unions' losses, and to make the Funds as claimants whole for amounts they had been required to pay to protect the Credit Unions' depositors, NCUA sponsored a series of resecuritization transactions that issued NCUA Guaranteed Notes ("NGNs").[2] NCUA transferred into the NGNs thousands of securities similar to the one at issue in this case. As part of those transactions, NCUA received owner trust certificates whose value will be materially affected by the outcome of this case and the ability of RMBS trustees, in general, to pursue claims against RMBS originators and sponsors. The certificates' value in turn affects NCUA's ability to pay claimants against the Credit Unions, compensate the Funds and credit union members for their losses, and reduce the need for additional assessments paid by member-owned credit unions nationwide.

NCUA therefore has a material, significant interest in supporting the efforts of Plaintiff-Appellant ("Trust") to enforce clear contractual obligations owed in connection with the sale of defective RMBS.

[2] Timely repayment of principal and interest to the investors in NGNs is guaranteed by the National Credit Union Administration, in its agency capacity, and is backed by the full faith and credit of the United States.

INTRODUCTION

The markets for private RMBS depend on effective judicial enforcement of the promises that RMBS sponsors make to RMBS trustees and the investors that trustees are charged with protecting. The decision under review incorrectly interprets contractual language that is common in the industry to limit sharply, and in some circumstances preclude entirely, enforcement of those promises. If sustained, that decision would undermine the reasonable reliance of investors on the promises made in transaction documents and would erode the efficacy of sponsors' assurances about loan quality. It would also insulate from accountability sponsors who profited from the sale of defective RMBS and then escaped their commitments to cure or repurchase bad loans. This Court can and should avoid those pernicious results by applying ordinary principles of contract interpretation.

The RMBS contracts at issue in this case, like the thousands of other RMBS contracts that utilize similar language, contain two elements that work in concert to protect the interests of RMBS trustees and investors. First, they contain a standard set of representations and warranties about the mortgage loans backing the security. Second, they contain "cure or repurchase" provisions that require a sponsor to fix or replace defective loans within a specified period after the sponsor itself discovers a defect, or after it receives notice of a defect from another party. That second, independent element, upon which investors rely throughout the life of the RMBS, provides essential protection for noteholders who, unlike sponsors, are in no position to examine thousands of mortgages.

The decision under review erroneously held that a claim by a noteholder for breach of the *cure-or-repurchase obligation* accrues – and the limitations period begins to run – as soon as the contract is consummated and the sponsor is in breach of its *representations and warranties*. R.viii. Had the Appellate Division properly recognized the distinct nature of the two obligations, it would have realized that the type of claim here accrues only when an RMBS sponsor refuses to abide by its contractually agreed-upon obligation to cure or repurchase defective, non-conforming loans. The limitations period for an action for a sponsor's breach of a cure-or-repurchase obligation begins upon the refusal that constitutes the breach.

That straightforward interpretation of the contract makes sense in light of the central commercial fact underlying RMBS: the profound informational asymmetry between the investors who purchase RMBS notes and the sponsors who create them. The sophisticated firms that securitize mortgages are well positioned to understand and take responsibility for loan defects: they have either originated the mortgages themselves or purchased them with the benefit of their own seller representations and cure-or-repurchase obligations. Further, had those sponsors so intended, they could have bargained for time limits on their repurchase obligations in a transparent manner that permitted investors to gauge the resulting risks.

Investors were much less able to protect themselves. As the experiences of NCUA and others have demonstrated, discovering non-conforming loans in RMBS pools is a burdensome, expensive, and time-consuming challenge. That is precisely why RMBS contracts are structured to place the risk of non-conforming loans on the securitization sponsors, rather than on the many disparate investors in each bond issuance. The holding of the Appellate Division would reallocate that risk after the fact by prematurely extinguishing sponsors' cure-or-repurchase obligations despite the vital protection they provide for noteholders.

That erroneous curtailment of the sponsors' contractual duties is particularly damaging in light of past widespread misconduct in connection with the securitization of residential mortgage loans. As numerous governmental investigations – including NCUA's own investigation into the failure of the Credit Unions – have now revealed, the process by which many RMBS were created during the lead-up to the financial crisis of 2008 was infected by negligence (at best) and fraud (at worst). Enforcing against RMBS sponsors the contractual obligations they voluntarily undertook serves important public policy goals: fairness to investors who suffered massive losses without adequate means to protect themselves, and accountability for financial institutions that unfairly profited from selling faulty RMBS.

ARGUMENT

I. DBSP's Breach of Its Contractual Repurchase Obligation Is Separate from Its Breaches of Representations and Warranties and Accrued Separately

The Trust correctly argues that its claim for breach of contract did not accrue until Defendant-Respondent ("DBSP") breached its contractual obligation to cure or repurchase loans that do not conform to the representations and warranties in the Mortgage Loan Purchase Agreement ("MLPA") executed between the parties. As the Trust explains (at 22), "a contract containing a distinct and continuing obligation that can arise after the contract is executed is breached when that distinct obligation is breached."

The MLPA contained dozens of representations and warranties regarding relevant characteristics of the loans underlying the RMBS trust. R.38, 40-47. In recognition of the impracticality of RMBS purchasers re-underwriting those loans to verify the truth of the representations and warranties, the MLPA provides a Repurchase Obligation as a contractual remedy for their breach:

> Within sixty (60) days of [DBSP's] discovery or its receipt of notice of . . . any such breach of a representation and warranty . . . , [DBSP] *shall* . . . cure such defect or breach in all material respects or, in the event [DBSP] . . . cannot cure such defect or breach, [DBSP] *shall*, within ninety (90) days of its discovery or receipt of notice of . . . any such breach of a representation and warranty, . . . repurchase the affected Mortgage Loan.

R.300 (MLPA § 7(a)) (emphases added).

Thus, the parties agreed that DBSP would either "cure" a mortgage that failed to conform to the MLPA's representations and warranties within sixty days of when DBSP discovered or was notified of the defect or, failing that, "repurchase" any non-conforming mortgage within ninety days. The text of the MLPA underscores the obligatory nature of the promise – DBSP "shall" cure or, if unable, it "shall" repurchase the offending mortgage loans. The obligation to cure or repurchase appears in the contract separately from the MLPA's representations and warranties themselves, and breach of the cure-or-repurchase obligation is thus separate from any failure of the loans to satisfy those representations and warranties.

The MLPA contains no provision limiting the duration of this obligation. Rather, the cure-or-repurchase obligation terminates along with all other "obligations created by the Agreement," which occurs upon "payment to the Certificateholders of all amounts . . . required to be paid to them pursuant to the Agreement following the earlier of (i) the final payment . . . of the last Mortgage Loan remaining . . . [or] (ii) the purchase . . . of all the Mortgage Loans." R.224. Accordingly, DBSP's obligation to cure or repurchase "affected Mortgage Loan[s]" persists throughout the life of the Trust and of the contract.

As the Trust correctly observes, this Court has made clear that, where a contract provides that a seller both guarantees the integrity of its product and also agrees to fix any defects in that product brought to its attention, the seller's failure to abide by its agreement to fix defects is an independent breach of the contract that accrues upon that failure. In *Bulova Watch Co. v. Celotex Corp.*, 46 N.Y.2d 606 (1979), this Court considered a roofer's contract that both guaranteed the quality of the roof and agreed to repair the roof if it leaked. The Court explained that the roofer "did not merely guarantee the condition or performance of the goods, but [also] agreed to perform a service" – that is, to fix the broken roof. *Id.* at 612. As a result, it was "clear that the separate [repair] obligations, as agreements contemplating services, were subject to a six-year statute running separately . . . each time a breach of the obligation to repair the bonded roof occurred." *Id.* at 611 (citations omitted). Until the decision below, the Appellate Divisions had therefore uniformly recognized that a claim for a breach of such a continuing obligation accrues when that obligation is violated. *See* Trust Br. 23 & n.5 (collecting cases).

The Appellate Division's break from that precedent was unwarranted. The court mischaracterized the complaint to "allege[] that defendant breached representations and warranties in connection with the securitization of a pool of mortgage loans." R.viii. It thereby ignored the true nature of the Trust's allegations: that DBSP had breached its distinct promise to cure or repurchase non-conforming loans. Based on that mistake, the court held that the Trust's claims "accrued on the closing date of the MLPA, March 28, 2006, when any breach of the representations and warranties contained therein occurred." *Id.* It may well be that a breach of the representations and warranties themselves occurred on that date; but, at that time, the Trust did *not* yet have a claim for breach of the cure-or-repurchase promise, because, at that time, DBSP did not yet have an obligation to repurchase any loans. Absent DBSP's independent discovery of loan defects, that obligation came into being only later when the Trust made its demand and DBSP refused it.

DBSP argues (at 8-10, 25-28) that the cure-or-repurchase obligation is not itself a contractual duty, but is instead merely a remedy for breaches of warranties and representations. It relies on MLPA § 7(c), which states that

> the obligations of the Sponsor set forth in this Section 7 to cure or repurchase a defective Mortgage Loan (and to make payments pursuant to Section 7(b)) constitute the sole remedies of the Purchaser against the Sponsor respecting a missing document or a breach of the representations and warranties contained in Section 5(xii) or Section 6.

R.300. But § 7(c) cannot bear the load that DBSP seeks to place on it. As an initial matter, that provision refers to the cure-or-repurchase promise both as "obligations of the Sponsor" and as "remedies of the Purchaser." It thus underscores that the parties intended to create a legally binding cure-or-repurchase obligation, and nothing in the MLPA prevents the Trust from bringing an action to enforce that obligation. Thus, § 7(c) only reinforces the Trust's argument that the sponsor's failure to cure or repurchase defective loans, rather than its underlying breach of any representations or warranties, should govern the statute of limitations analysis.

Indeed, as the Trust correctly points out in its reply (at 4-5), it could bring a breach-of-contract action *only* to remedy a breach of the cure-or-repurchase obligation. It could never bring such an action directly for breach of the representations and warranties, because, if DBSP had complied with the cure-or-repurchase obligation, it would have fulfilled its duties in that regard. Further, the contract contemplates that DBSP's cure-or-repurchase obligation could arise independently of any breach of warranty, such as from DBSP's failure to deliver certain required documents. *See* R.300 (MLPA § 7(a)). There can be no argument that a breach of that plainly independent obligation would accrue when DBSP failed to cure it. It would be odd, however, if a failure to deliver documents gave rise to liability that could long outlast liability for significant substantive defects in the underlying loans.

II. Contractual Repurchase Obligations Are an Important Part of RMBS Contracts That Account for Purchasers' Inability To Perform Independent Due Diligence

Cure-or-repurchase provisions in RMBS contracts like those in the MLPA serve a vital role in RMBS markets. Their core function is to make investors whole when the mortgage loans underlying RMBS fail to conform to the representations and warranties made by the sponsor. Those representations and warranties typically include assurances regarding the lenders' underwriting guidelines, the borrower's income, the borrower's other debt obligations, appraisal of the property value, occupancy status, and the loan-to-value ratios for each of the many mortgages in the securitization pool. Both individual investors and the market as a whole need such information in order to assess how likely the borrowers are to repay their mortgage obligations, as well as the extent to which an RMBS trust is likely to recover its losses from available collateral if borrowers default. Such assessments in turn shed light on the amount of risk that investors assume when they buy a particular RMBS and determine the amount that the market will be willing to pay for that RMBS. The representations and warranties are thus at the core of the bargain embodied in an RMBS contract.

All this is true both with respect to the specific RMBS contracts at issue here and more generally in the industry. For example, in its investigation of the RMBS purchased by the Credit Unions for which it serves as liquidating agent, NCUA has identified breaches of representations and warranties involving the systematic disregard by loan originators of their underwriting guidelines; loan-to-value ratios that were higher than represented; and percentages of owner-occupied homes that were lower than represented. Courts hearing NCUA's actions have accepted allegations of such inaccuracies as sufficient to support claims for actionable material misrepresentations.[3] Other courts hearing similar cases, including the First and Second Circuits, have reached similar conclusions.[4]

RMBS contracts sensibly put the burden to ensure the correctness of the representations and warranties on the sponsors. As the Trust correctly observes (at 25-26), it would have been impractical and inefficient – and in many cases impossible – for RMBS purchasers to conduct their own independent due diligence on each of the thousands of mortgages underlying each note. Examining the same problem, the federal Financial Stability Oversight Council ("FSOC") made a similar point in 2011:

> One important informational friction highlighted during the recent financial crisis has aspects of a "lemons" problem that exists between the issuer and investor. . . . [T]he large number of assets and the disclosures provided to investors may not include sufficient information on the quality of the underlying financial assets for investors to undertake full due diligence on each asset that backs the security.

FSOC, *Macroeconomic Effects of Risk Retention Requirements* 9 (2011).

NCUA's own experience confirms this point: when investigating the failure of the Credit Unions, NCUA commissioned a review from which it was able to conclude that, in the aggregate, the loan pools for the RMBS purchased by the

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[3] *See*, *e.g.*, *National Credit Union Admin. Bd. v. Morgan Stanley & Co.*, No. 13 Civ. 6705, 2014 WL 241739, at *16-17 (S.D.N.Y. Jan. 22, 2014); *National Credit Union Admin. Bd. v. Credit Suisse Sec. (USA) LLC*, 939 F. Supp. 2d 1113, 1129-32 (D. Kan. 2013).

[4] *See New Jersey Carpenters Health Fund v. Royal Bank of Scotland Grp., PLC*, 709 F.3d 109, 123 (2d Cir. 2013); *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 773-74 (1st Cir. 2011).

Credit Unions contained a material number of defective loans. That review involved (among other things) retaining forensic economists to calculate what should have been the *expected* losses from defaults and delinquencies on loans backing a particular RMBS certificate based on its anticipated return and credit rating, and then comparing that expected rate to the *actual* default rate.[5] Doing so consumed far more resources and took far more time than it would be reasonable to expect from an ordinary investor making or monitoring an investment. Even after that, moreover, NCUA still did not (until discovery) have access to the loan-level detail necessary to identify particular defects in particular loans.[6]

RMBS sponsors, by contrast – together with the large financial institutions of which they are generally affiliates, and which often serve partially or entirely as underwriters for the issued RMBS – have the information and infrastructure to perform as much due diligence on loans as they see fit. The sponsors and their affiliates have access to loan files, have the ability to request information from the originators of the loans, and often have third-party contractors to assist them with due diligence on loans. To be sure, many of those who earned massive profits from securitizing mortgages did not make good use of their opportunities for

[5] *See*, *e.g.*, Second Am. Compl. ¶¶ 57-92 & fig. 2, *National Credit Union Admin. Bd. v. RBS Sec., Inc.*, No. 11-cv-2340-JWL-JPO (D. Kan. filed Nov. 17, 2014) (Doc. 435).

[6] *See*, *e.g.*, *National Credit Union Admin. Bd. v. RBS Sec., Inc.*, 900 F. Supp. 2d 1222, 1252-53 (D. Kan. 2012) (describing the facts NCUA pleaded to support its claims, which did not include loan-level analysis of the loans backing any particular RMBS).

quality control. One major provider of due diligence services later testified to the federal Financial Crisis Inquiry Commission ("FCIC") that nine major securitizers "waived" credit quality defects on an average of 39% of loans found to be defective in due diligence from early 2006 to mid-2007.[7] That widespread practice of ignoring known defects – which materially increased the credit risk of many securitized loans – underscores the importance of the sponsor's cure-or-repurchase obligation for investors who lacked access to similar information.

The cure-or-repurchase provisions – including their character as a continuing obligation that runs for the entire lifetime of the RMBS – are a key part of the agreed-upon allocation of the risk of defective loans. If DBSP's obligation to repurchase loans was cut off six years (more precisely, as the Trust observes (at 30), five years and nine months) after the date of settlement, then the Trust and its investors – and other similarly situated investors, of which there are many – bear the risk of loss from loan defects that later come to light. The unqualified repurchase obligations in the contract gave the parties and investors no fair warning of that surprising and arbitrary result.

[7] *See* FCIC, *Financial Crisis Inquiry Report* 166-67 & fig. 9.1 (2011) ("FCIC Rep.") ("Rejected Loans Waived in by Selected Banks"). These figures are based on a sample taken by Clayton Holdings, which "was a major provider of third-party due diligence services" for major RMBS sponsors and their affiliates. *Id.* at 166. Clayton found that only 54% of loans in the pools it examined satisfied the lenders' own underwriting guidelines, and another 18% were deemed satisfactory on the basis of "compensating" factors like an above-guidelines borrower income. *Id.* Of the 28% of loans that failed the underwriting guidelines outright, 39% – or 11% of the total – "were 'waived in' by the banks" – that is, "were accepted [into the securitization pool] even though the [due diligence provider] had found a basis for rejecting them." *Id.*

III. Contractual Repurchase Obligations Protect Investors and Hold RMBS Sponsors Accountable

Considerations of public policy further support giving the cure-or-repurchase provisions of the contract their natural reading as a separate obligation that lasts for the life of the RMBS. As the Court is undoubtedly aware, many RMBS that were originally sold during the last ten years as safe investments turned out to be very risky. Downgrades of previously investment-grade securities to junk status; sharp declines in investment value; and widespread defaults were all common and caused severe injury to investors. A number of governmental investigations, including NCUA's own, have found that these harms to investors – and, indeed, much more massive harm to the economy as a whole – resulted from widespread fraud and negligence in the origination and resale of residential mortgage loans to be used as collateral for RMBS. Those findings strongly suggest that many RMBS investors (or their successors-in-interest) have meritorious claims against the financial institutions that reaped vast profits by repackaging defective loans to be sold as purportedly safe investments. Contracts like the one at issue are best read to provide an enforceable continuing obligation that will protect investors and hold sellers of defective RMBS accountable.

As the FCIC concluded in a detailed 2011 report, "collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis" that resulted in the massive financial crisis that struck the

United States in 2008 and pushed it into a lengthy and severe recession. FCIC Rep. xxiii. The FCIC described mortgage securitization abuses as part of a "systemic breakdown in accountability and ethics" and an "erosion of standards of responsibility and ethics that exacerbated the financial crisis" and "damage[d] . . . the trust of investors, businesses, and the public in the financial system." *Id.* at xxii. Among other things, the problems it identified included "major financial institutions" that "knew a significant percentage of . . . loans" they examined in due diligence "did not meet their own underwriting standards or those of the originators," but "[n]onetheless . . . sold those securities to investors." *Id.* The staff of the United States Senate Permanent Subcommittee on Investigations ("PSI") reached similar conclusions in its own 2011 report.[8] In the same vein, Attorney General Eric Holder recently explained that the practices of "bund[ling] toxic loans and sell[ing] them to unsuspecting investors" in the form of RMBS "helped sow the seeds of the mortgage meltdown."[9]

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[8] The PSI's staff found that "unacceptable lending and securitization practices . . . were present at a host of financial institutions that originated, sold, and securitized billions of dollars in high risk, poor quality home loans that inundated U.S. financial markets," and that "[m]any of the resulting securities ultimately plummeted in value, leaving banks and investors with huge losses that helped send the economy into a downward spiral." Staff of S. Permanent Subcomm. on Investigations, 112th Cong., Wall Street and the Financial Crisis: Anatomy of a Financial Collapse 4 (Subcomm. Print 2011).

[9] U.S. Dep't of Justice, *Justice Department, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages* (Nov. 19, 2013), http://www.justice.gov/opa/pr/2013/November/13-ag-1237.html.

Although the immediate consequences of those widespread failures by financial institutions were felt by investors (and, ultimately, by the financial markets and the economy as a whole) as early as 2008, it took time for the underlying causes of the problem to be understood – as the 2011 reports by the FCIC and PSI illustrate. Even after the general picture became clear, moreover, significant barriers to investor and trustee claims often remained. As described above, it takes a substantial investment of time and resources to make a case that a decline in value for a particular RMBS can be traced to problems with the particular loans for that RMBS. *See supra* pp. 12-13. Contractual repurchase claims in particular face numerous impediments, including RMBS trustees that must decide whether to take action on behalf of investors and significant collective action problems that those investors face in asserting their own rights. Many RMBS contracts, like the ones here, require a significant percentage of investors to band together before they can direct a trustee to take legal action. *See* Trust Br. 13 (quoting provision requiring 25% of certificateholders to demand that the trustee act before any individual certificateholder may assert a claim).

As a result, an affirmance of the Appellate Division's holding would deprive not only the Trust here but also a large number of other RMBS investors of an effective remedy for the refusal of RMBS sponsors to honor their repurchase obligations. Especially as applied to RMBS contracts made in the lead-up to the financial crisis of 2008, that deprivation would undermine efforts to hold accountable financial institutions that have profited immensely at the expense of their customers and of the market as a whole. This Court should enforce those RMBS contracts as written to include a continuing cure-or-repurchase obligation, thereby signaling that sponsors cannot avoid their repurchase obligations by successfully running out the clock.

As the Trust has persuasively shown, none of the unfortunate results of the decision under review are required by precedent; all can be avoided simply by enforcing the contract to which the parties agreed. This Court should do just that.

CONCLUSION

The decision of the Appellate Division should be reversed.

Dated: March 13, 2015

Respectfully submitted,

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