

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 PROF. STEVEN L. SCHWARCZ
AS AMICUS CURIAE

Steven L. Schwarcz
Stanley A. Star Professor of Law & Business
Duke Law School
Box 90360
Durham, NC 27708
Phone: 919-613-7060
Fax: 919-613-7231
schwarcz@law.duke.edu

TABLE OF CONTENTS

TABLE OF AUTHORITIES	ii
STATEMENT OF INTEREST OF <i>AMICUS CURIAE</i>	2
SUMMARY OF ARGUMENT	4
BACKGROUND	7
ARGUMENT	10
I. Securitization is designed to transfer the future risk on the underlying loans from the seller to the investors.	10
II. Plaintiffs vastly overstate the importance of an enlarged limitations period to investors in mortgage-backed securities.	16
III. Six years from a loan's sale is ample time to bring a repurchase claim.....	20
IV. Sellers and investors reasonably understood New York's statute of limitations to bar repurchase claims filed six years after the loan sale.	22
CONCLUSION	26

TABLE OF AUTHORITIES

	Page(s)
STATUTES	
Rule 3a-7 under the Investment Company Act of 1940	2
OTHER AUTHORITIES	
New York, <i>Term Asset-Backed Securities Loan Facility: Frequently Asked Questions</i> (July 21, 2010) (available at http://www.ny.frb.org/markets/talf_faq.html)	3
Standard & Poor's Credit Rating Definitions & FAQs, available at http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us#def_1	17
Standard & Poor's, <i>Principles-Based Rating Methodology for Global Structured Finance Securities</i> (May 29, 2007)	17
Steven L. Schwarcz, <i>Keynote Address: Understanding the Subprime Financial Crisis</i> , 60 S.C. L. REV. 549, 563 (2009)	5
Steven L. Schwarcz, <i>Private Ordering of Public Markets: The Rating Agency Paradox</i> , 2002 U. ILL. L. REV. 1	16, 17, 19
Steven L. Schwarcz, <i>Securitization Post-Enron</i> , 25 CARDOZO L. REV. 1539, 1543 (2004)	11
STEVEN L. SCHWARCZ, <i>STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION</i> (3d ed) § 4:2, at 4-6	11
Steven L. Schwarcz, <i>What is Securitization? And for What Purpose?</i> , 85 S. CAL. L. REV. 1283, 1285 (2012)	2
Steven L. Schwarcz, <i>What is Securitization? And for What Purpose?</i> , 85 S. CAL. L. REV. 1283, 1298 (2012)	7
<i>Terms and Conditions</i> (available at http://www.federalreserve.gov/newsevents/monetary20081125a1.pdf)	3

STATEMENT OF INTEREST OF *AMICUS CURIAE*

My interest in securitization dates from almost the inception of this field. As a lawyer in the 1980s and '90s, I helped pioneer the development of securitization as a discipline by structuring, negotiating, and drafting hundreds of transactions involving mortgage loans and other financial assets and also by writing much of the seminal legal scholarship. And as a teacher in the 1980s, I created what I believe to have been the first law school courses on securitization.

As the subject has developed, I have continued to teach securitization and structured finance at the law schools of Yale, Columbia, and now Duke, and have lectured on the subject at Oxford University and other top universities throughout the world. I have authored two textbooks regarding securitization: *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (PLI 3d ed.), and *SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS* (LexisNexis 2004). My research and writing on the topic also include numerous articles published in many of the nation's leading law reviews. Exhibit 2 includes a complete list of my relevant publications.

This expertise and experience have enabled me to advise many public and private institutions regarding securitization specifically and the regulation and reform of capital markets generally. For example, I have testified on these topics before the U.S. Securities and Exchange Commission, committees of the U.S.

House and Senate, and numerous courts in the United States and abroad. I have also advised organizations such as the United Nations Commission on International Trade Law, the U.S. State Department, several U.S. Federal Reserve banks, the U.S. Government Accountability Office, the American Bar Association Section on Business Law, agencies of the governments of Canada, Chile, and Korea, and the chairman and secretariat of the U.K. Independent Commission on Banking.

This case has enormous implications for the securitization industry. By 1992, securitization had become so important to the American economy that the Securities and Exchange Commission observed that it was “becoming one of the dominant means of capital formation in the United States.”¹ Although highly leveraged collateralized debt obligation (CDO) transactions unfairly gave securitization bad press during the recent financial crisis,² securitization transactions are beneficial and remain critical to the economy. Even during the financial crisis, the federal government initiated a \$200 billion Term Asset-Backed Securities Loan Facility (known as “TALF”) in order to keep the securitization

¹ Investment Company Act, Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the issuance of Rule 3a-7 under the Investment Company Act of 1940).

² See, e.g., Steven L. Schwarcz, *What is Securitization? And for What Purpose?*, 85 S. CAL. L. REV. 1283, 1285 (2012) (explaining why highly leveraged CDO transactions were different than securitization).

markets running, thereby assuring “the availability of credit to households and businesses of all sizes.”³

Given my experience in the securitization field, and my interest in its continued viability, I am participating as *amicus curiae* to illuminate the structure, intent, and broader market context of the transaction at issue. Securitization deals can be complex, and—as in this litigation—are frequently mischaracterized. Thus this brief seeks to ensure that the transactional contracts are interpreted and regulated in a sensible way that reflects their underlying logic and intent. Although my work in preparing this brief has been reimbursed at my usual rate by WMC Mortgage, LLC, the opinions and conclusions expressed in this brief represent my own independent, consistent, and strongly held views.

SUMMARY OF ARGUMENT

Plaintiff, suing on behalf of investors, contends that “commercial reality” dictates that its claims are not time-barred. Plaintiff-Appellant Reply Br. 14. The “context,” Plaintiff maintains, makes clear that investors bargained for, and the seller agreed to, a limitations period that would not end, for any defective loan, until six years after a demand for cure or repurchase of that loan. *Id.* at 2.

³ See, e.g., Federal Reserve Bank of New York, *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions* (July 21, 2010) (available at http://www.ny.frb.org/markets/talf_faq.html). Federal Reserve Board, *Term Asset-Backed Securities Loan Facility (TALF), Terms and Conditions* (available at <http://www.federalreserve.gov/newsevents/monetary20081125a1.pdf>).

This position contradicts the practice and organization of the securitization market Plaintiff purports to describe. That market does not, and would not, tolerate a limitations period that is effectively limitless. Because Plaintiff's theory assigns to itself sole control of the timing of the repurchase demand, Plaintiff would determine the start—and therefore the end—of the period in which it could sue. Such unbounded liability is at odds with the law and practice of securitization in at least three important respects.

First, Plaintiff treats the seller of the securitized loans as an ongoing guarantor throughout the life of those loans. This ignores the essence of securitization, which is to transfer risk from companies making and selling loans, on the one hand, to investors in securities based on those loan repayments, on the other. Securitization involves bundling together many loans, transferring them ultimately to a trust, and selling securities entitling investors to a portion of future loan repayments. An investor who buys the securities takes on the future risks associated with the loans in the trust. When the sale of loans occurs, the role of the seller (such as Defendant-DBSP) effectively ends. That is why an investor's rights against the seller are limited to breaches by the seller of representations and warranties as to the quality of the loans at the time of their sale, and why the limitations period must run from that point. Other participants in the securitization

process—but not the seller—play an ongoing role after that sale, the whole point of which is to transfer future risk on the loans from the seller to the investors.

Second, Plaintiff insists that, but for the lifelong assurances it perceives in this deal’s repurchase provision, mortgage-backed securities would have been too risky to market. “[T]here would have been no investors” in mortgage-backed securities, Plaintiff maintains, because “investors simply could not have taken on the risk.”⁴ Plaintiff-Appellant Brief at 27, 2. The length of time to demand repurchase of a loan in breach, however, was not remotely as important as Plaintiff makes it out to be; at the time, investors were eager to invest in these types of securities, and did so based principally on the securities’ credit rating and interest rate—not the statute of limitations.⁵

Third, Plaintiff repeatedly asserts that six years following the loan sale is too short a period within which to detect a representation-and-warranty breach and demand repurchase. This is belied by reality: The vast scope of pending RMBS litigation, most of which was filed within six years of the loans’ sale, illustrates that this is not an unfairly compressed period in which to sue. And as a logical matter, the only type of breach that triggered a repurchase obligation was a breach

⁴ See also Plaintiff-Appellant Brief 10 (“[I]nvestors simply could not agree to purchase certificates without receiving some assurance that [the seller], not the investors, would bear the risk [of false representative and warranties] for the life of the Trust”).

⁵ Cf. Steven L. Schwarcz, *Keynote Address: Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 563 (2009) (discussing investor overreliance on credit ratings).

of a representation and warranty of a loan's quality *at the time of its sale*. If a loan becomes delinquent or defaulted within a few years of the sale, that suggests there might have been such a representation-and-warranty breach. If, however, the loan is timely repaid for several years, any subsequent default almost certainly would be caused by a change in the borrower's circumstances. Plaintiffs also decry the burden and expense of reevaluating (or "re-underwriting") all loans. But that's a red herring: re-underwriting all of the loans would never be the only or most efficient way to detect possible breaches.

These and other mistakes reveal Plaintiff's fundamental misunderstanding of the mortgage-backed securities market. Nothing in the contract at issue, or its commercial context, indicates an intent to depart from New York's familiar default rule of contract law. A judicial decision embracing that misunderstanding would introduce dangerous uncertainty into the contract law that has made New York the world's jurisdiction of choice for capital-markets transactions. The Court should reject Plaintiffs' mistaken characterizations of the securitization process and affirm the decision below.

BACKGROUND

"Securitization" refers to transactions in which investors buy securities issued by a special-purpose entity, such as a trust, which uses the proceeds to purchase income-producing assets such as accounts receivable, lease rentals, or,

most commonly, residential mortgage loans. Collections on the income-producing assets constitute the primary source of repayment of those securities.⁶ The securitization process for residential mortgage loans, somewhat simplified as described here, involves several steps and parties:

- An **originator** (a bank or other lender) makes mortgage loans. The decision to lend and the terms of repayment are generally based on an evaluation of the borrower's (*i.e.*, homeowner's) assets, liabilities, income, and overall creditworthiness, as well as the relationship between the appraised value of the mortgaged home (the collateral for the loan) and the principal of the loan (typically known as the loan-to-value ratio).
- A **seller**, which may be the originator or a third-party sponsor that buys loans from originators, pools together many loans for a given securitization transaction. This statistically spreads the risk of individual loan defaults and also justifies the transaction costs. In this case, Defendant-DBSP acted as the seller.
- A **depositor**, which is a "bankruptcy remote" special-purpose vehicle, purchases the pool of loans from the seller. The sale is governed by a contract customarily known as a mortgage loan purchase agreement, or MLPA. The MLPA is usually intended to create a true sale for bankruptcy purposes.
- A **trust**, which is another type of special-purpose vehicle, pays the depositor to transfer the pool of loans into the trust. The trust exists to hold title to the loans. The trust raises money to make that payment by issuing securities to investors.
- The **securities** issued by the trust give investors the right to repayment from (a) the principal and interest payments made by borrowers on the loans held in the trust and (b) if a borrower defaults, foreclosure and other remedies against the collateral (*i.e.*, the mortgaged home). The securities and the trust itself are governed by a pooling and servicing agreement, or PSA. This

⁶ See, *e.g.*, Steven L. Schwarcz, *What is Securitization? And for What Purpose?*, 85 S. CAL. L. REV. 1283, 1298 (2012).

defines the terms of the securities, which vary within a given securitization in their interest rate and risk profile.

- An **underwriter** assists the trust in selling the securities to investors. Under federal securities laws, underwriters provide investors with a prospectus that provides detailed information regarding the issued securities, including their risks. (Underwriting the securities is different than “underwriting” the mortgage loans. The latter refers to the originator’s credit-analysis process in making the mortgage loans.)
- **Investors** buy the securities in hopes of making a return on their investment over time as the loan payments are distributed. Investors in “residential mortgage-backed securities,” or RMBS, typically are large, sophisticated investors, such as hedge funds, mutual funds, insurance companies, and commercial banks.
- A **trustee** acts as the agent on behalf of the various investors, whose identity changes whenever securities are traded in the market. The trustee, usually a large financial institution, allocates payments to the investors according to the amounts and priority set forth in the PSA. As in this case, the trustee (HSBC Bank USA, National Association) also acts on behalf of investors in the event of litigation.
- A **servicer** acts on behalf of the trust to collect payments from the mortgage loans. The servicer’s administrative duties include mailing billing statements, collecting payments, monitoring delinquent accounts, and engaging in debt workouts and foreclosure proceedings.

Securitization produces many economic benefits for the parties involved: for originators, it provides access to capital and liquidity; for homeowners, it reduces the cost of borrowing (and thus the cost of owning a home); and for investors, it creates a simpler and more efficient way to assess risk. In the broader economy, securitization supplies funding needed to finance capital-intensive investments, efficiently allocates risk to parties best able to assess and undertake the risk, and fosters home ownership.

ARGUMENT

Plaintiff's position rests on three fundamental misconceptions of the market for mortgage-backed securities. Those pertain, *first*, to the structure of a securitization transaction, which is designed to transfer the future risk on the underlying mortgage loans from the seller to the investors; *second*, to the appetite for risk and the concerns of investors who bought mortgage-backed securities; and *third*, to the ability of investors to detect breaches and pursue repurchase claims. These errors lead to Plaintiff's mistaken conclusion that the statute of limitations does not bar a repurchase claim made at any point during the life of a loan—a position at odds with the text of the underlying contract and the understanding of the market.

I. Securitization is designed to transfer the future risk on the underlying loans from the seller to the investors.

Securitization transactions are designed to transfer the future risk on the assets being sold (in this case, mortgage loans) from the seller to the buyer (in this case, the depositor and thus ultimately the investors). This removes the seller from any ongoing role with the mortgage loans. Nonetheless, in light of its litigation interests, Plaintiff attempts to recast the seller as a crucial participant in the securitization throughout the life of these loans. *See, e.g.*, Plaintiff-Appellant Br. 22 (referring to Defendant-DBSP's "distinct and continuing obligation to cure or

repurchase”). That position is not only wrong but antithetical to the fundamental structure and aims of securitization.

Securitization is a particular process designed to achieve particular goals. If investors simply wished to invest in home-mortgage loans, there are of course familiar ways to do so: one could acquire the equity or debt of a company that made and collected on mortgage loans—such as a local bank that held its mortgage loans on its own balance sheet. But investing in such a company exposes investors to a wide range of risks: even if its mortgage loans are paid in full, the company’s other lines of business may perform poorly, its management may be ineffectual, its accounting may not be transparent, or a local economic downturn may devalue the company’s other assets.

Securitization, however, allows investors to make a targeted investment in only the home-mortgage loans. Investor exposure is thereby isolated to a specific set of income-producing assets, not an entire operating company. Moreover, because loans of differing types and locations can be selected for a given securitization, investors can custom tailor their investments to well-defined and well-diversified assets. This simplifies the risk-assessment process for investors by limiting their exposure to risks associated with the company. In other words, the risk of a company’s default or even bankruptcy need not drive an investor’s analysis; in a securitization, even if the originator or seller fails, investors will be

unaffected because their repayment comes from the loans sold to the depositor and held by the trust.⁷ This aspect of “bankruptcy remoteness”—an essential part of any securitization—is achieved only if the transfer of loans from the seller to the depositor is a “true sale.”⁸

Extending a seller’s obligation to cure or repurchase defective loans throughout the life of the securitization transaction would undermine this true-sale requirement, which is crucial to the structure and benefits of securitization. Investors, eager to avoid bankruptcy risks, of course demand that the true-sale requirement be satisfied, and they are not the only ones; credit-rating agencies also insist on a true sale before rating the securities as investment-grade.⁹ An obligation that makes a seller responsible for the risk of future performance on the underlying loans, throughout the life of the securitization transaction, would undermine the true sale, thereby jeopardizing the separation of the seller from the underlying financial asset.¹⁰

⁷ See, e.g., Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1543 (2004) (“Perhaps the most critical issue in a securitization is whether the [trust’s] investors will continue to be repaid in the event of the originator’s bankruptcy. If the [depositor/trust] owns the financial assets, its investors will continue to be repaid; if not, their right to be repaid will be suspended and subject to possible impairment.”).

⁸ *Id.* (the depositor/trust—as opposed to the seller—“will own the financial assets only if the transfer of those assets from the originator to the [depositor] constitutes a sale under applicable bankruptcy law—usually referred to as a ‘true sale.’”).

⁹ *Id.* at 1545–46.

¹⁰ See, e.g., STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d ed) §4:2, at 4-6 (observing that the “most significant factor in the true sale

Plaintiff now seeks to shift the risk of future loan performance onto the seller. It suggests that Defendant-DBSP, as seller, has a “continuing contractual obligation to cure or repurchase defective loans.”¹¹ Plaintiff-Appellant Brief at 4. The “basic bargain,” Plaintiff asserts, was that the seller should “shoulder the burden of curing or repurchasing *whenever* a defective loan was discovered.” *Id.* at 21 (emphasis in original). And Plaintiff misleadingly claims that there exists a “crucial guarantee that [the seller], not the Trust or its investors, would bear responsibility for the life of the Agreements should any loans prove defective.” *Id.* at 27. But, as explained above, the seller’s role in the securitization effectively ends when it sells its loans to the depositor. At that point, the seller either has or has not breached its representations and warranties as to the quality *at that time* of the sold loans; while investors may be able to seek *remedies* from the seller before the close of the statute of limitations, there is no further opportunity for a *breach* to occur.

Plaintiff’s conception of the seller’s ongoing role is, to my knowledge, atypical of the industry view. Sellers are not regarded as the perpetual guarantors Plaintiff makes them out to be. To start, sellers are compensated in a manner typical of a one-time sale: they are paid a negotiated purchase price at the closing,

determination appears to be the nature and extent of recourse that the transferee of the [loans] has against the transferor. As the degree of recourse increases, the likelihood that a court will find a true sale decreases.”).

¹¹ See also Plaintiff-Appellant Brief at 20 (arguing there is a “continuing obligation”).

after which the future risks associated with the sold mortgage loans are assumed by the buyer of those loans (the depositor in this case, and thus effectively the investors). The only risk the seller retains is associated with its representations and warranties about the quality of the loans *at the time they are sold*.

If the investors wanted protection against the risk of future performance of the mortgage loans, other parties and mechanisms—familiar to the industry—exist to fill that insurer-type role. The primary protection against the risk of faulty and nonperforming loans, Plaintiff implies, is the seller’s repurchase obligation. In reality, securitization transactions commonly feature several forms of “credit enhancement” that play a far more important role in limiting risk and ensuring payment.

Credit enhancement refers to steps taken to improve the likelihood of full and timely payment of investors in securitization transactions. It includes both the internal structuring of a transaction and external guarantees by third parties. Three common forms of credit enhancement are illustrative.

First, securities within a transaction vary in their risk level according to a “waterfall” structure. The least risky “senior” tranche of securities has the first claim on mortgage-loan repayment proceeds, a second tranche receives payment only after the more senior securities are fully paid, and so on until the riskiest and most “junior” tranche is payable last. If there is a shortfall in repayment proceeds,

the junior security holders may receive a reduced payout or nothing at all. Investors choose the tranche of securities in which they invest based on their appetite for risk (and the higher contractual rate of return associated with higher risk).

Second, the interest rate on the sold mortgage loans often exceeds the interest rate on the securities whose payment is backed by those mortgage loans. As “excess interest” accrues on the mortgage loans, it adds to the “overcollateralization” of those securities by providing value marginally in excess of the amount needed to repay the securities. Thus unexpected losses on some of the mortgage loans should not affect payouts to even the most junior security holders.

Third, insurance companies often provide, in exchange for a premium payment, “monoline” or “bulk mortgage” insurance that, respectively, guarantees repayment of the securities or payment of a portion of the underlying mortgage loans that default. These forms of insurance are the surest way by which investors typically limit the risk of future performance of the mortgage loans. Many of the securitization transactions currently in litigation include both of these forms of insurance.

All of these mechanisms serve to spread, hedge, and insure against risk of nonpayment during the up-to-30-year time horizon of most residential mortgage-

backed investments. And they explicitly and clearly account for that risk, in contrast to Plaintiff's forced argument in this case that the seller should take on that risk through the blunt instrument of repurchase claims.

II. Plaintiffs vastly overstate the importance of an enlarged limitations period to investors in mortgage-backed securities.

Plaintiff asks this Court to impose a perpetual statute of limitations because, in Plaintiff's view, "it is unthinkable that investors would have agreed to invest" in these securities without a repurchase obligation that lasted for the 30-year life of the loans. Br. for Plaintiff-Appellant 27; *see also, e.g.*, Reply Br. 10–11. This continuing assurance that sellers would repurchase loans in breach at *any* point during the life of the loan was, according to Plaintiff, an "essential component of the basic risk-shifting bargain." Br. for Plaintiff-Appellant at 25. Otherwise, "investors simply could not have taken on the risk" of mortgage-backed securities, *id.* at 1,¹² and "there would have been no investors," *id.* at 27. This is a totally misleading and inaccurate characterization of the market for mortgage-backed securities in the mid-2000s.

For the sophisticated institutions investing in mortgage-backed securities at that time, the window for filing repurchase claims was hardly a critical issue. Under New York's generous statute of limitations, they had six years to bring a

¹² *Cf. id.* at 10 (arguing that "investors simply could not agree to purchase certificates without receiving some assurance that [the seller], not the investors, would bear the risk [of false representations and warranties] for the life of the Trust").

claim. Because the only contractual basis for such a claim was a breach of seller's representations and warranties about the quality of the mortgage loans *at the time they were sold*, any consequences of such a breach would be expected to surface well within that six-year period. Thus the value of an extended limitations period would be marginal at best.

Investors paid much more attention to a given security's interest rate (which compensated the investor for the time value of money and the future risk of nonpayment) and the credit rating (which purported to benchmark the risks of delayed payment or nonpayment). The interest rate reflects and compensates for greater or lesser degrees of risk. If investors were troubled by uncertainty regarding the statute of limitations for repurchase claims, market factors would have adjusted interest rates upward to compensate for that uncertainty. There is no reason to presume (as Plaintiff does) that contemplation of a six-year limitations period would have simply dried up the pool of potential investors. *See* Br. for Plaintiff-Appellant 27 (“[T]here would have been no investors.”).

Moreover, rating agencies such as Standard & Poor's and Moody's provide credit ratings for debt securities, including mortgage-backed securities. A rating reflects the rating agency's assessment of the likelihood of timely payment of

interest and return of principal to investors.¹³ The higher the rating, the lower the perceived credit risk associated with the securities in question.¹⁴ This information helps investors find securities that match their appetite for risk (and hence for returns on their investments). The rating agencies follow explicit methodologies in deriving their ratings—reviewing, for example, the credit quality of the underlying mortgage loans, legal and regulatory risks, payment structure and cash flow mechanics, operational and administrative risks, and counterparty risk.¹⁵ Nothing suggests any risk associated with the limitations period would have affected, or was inappropriately excluded from, their rating analyses. Certainly nothing supports Plaintiff’s insinuation that enforcing a six-year statute of limitations, running from the date of sale, would effectively transform desirable investment-grade securities into junk securities that no investor would touch.¹⁶ In fact, mortgage-backed securities were viewed as highly attractive investments—in part

¹³ See generally Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1.

¹⁴ The highest rating on long-term debt securities is AAA, with ratings descending to AA, then to A, and then to BBB and below. See generally Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. Ill. L. Rev. 1. Ratings below BBB- are deemed non-investment grade (or “junk,” as in junk bonds), and indicate that full and timely repayment on the securities may be speculative. See, e.g., Standard & Poor’s Credit Rating Definitions & FAQs, available at http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us#def_1.

¹⁵ Standard & Poor’s, *Principles-Based Rating Methodology for Global Structured Finance Securities* (May 29, 2007).

¹⁶ Moreover, the representations and warranties were provided by unrated sellers. If the investors truly could not have taken on the risk of mortgage-backed securities without a lifetime “guaranty” from the seller, they logically would have required the seller to have an investment grade rating. Investors did not require any minimum rating of the sellers.

because they were considered more transparent and less risky than other market options. Many institutional investors purchased mortgage-backed securities to comply with guidelines meant to ensure relatively safe investment choices. These guidelines often restricted investments to securities with a credit rating above a certain minimum threshold; they did not, to my knowledge, consider the length of the repurchase statute of limitations an important factor. The risk of loss for senior securities was perceived to be quite low because the underlying loans were numerous and geographically diverse, not because the period for bringing suit was unusually long.

Thus it is historically inaccurate and analytically misleading to try to link the limitations period to investors' willingness to buy mortgage-backed securities. Plaintiff points to no contemporaneous evidence of such a linkage, and in my experience I am unaware of any. To the contrary, few if any investors or other observers at that time contemplated a cratering of the real-estate market that would spawn massive mortgage-loan defaults. To the extent any investor might have considered a statute of limitations, it would have been vastly overshadowed by the interest rate and credit rating on the securities. And it is important to recall that the question is not whether an investor (or trustee) had any repurchase remedy *at all* for a breach of its representations and warranties. The only question before the Court is whether they should have more than six years from the date of the

transactions to pursue that remedy. Plaintiff, in short, grossly exaggerates the ex ante importance to securities investors of the length of the statute of limitations.

III. Six years from a loan's sale is ample time to bring a repurchase claim.

Plaintiff complains that investors would lack “any meaningful protection” if they had to sue within six years of the date of sale. Br. for Plaintiff-Appellant 29. Plaintiff similarly alleges that it “blinks reality” to contend that investors could discover breaches within six years of the closing, or that it would be commercially reasonable to expect them to do so. *Id.* Moreover, complying with a six-year limitation period, Plaintiff insists, would require “the exceedingly costly and time-consuming burden of reunderwriting nearly 9,000 loans.” *Id.* at 10. These contentions are at odds with the reality for investors and trustees like those involved in this case.

Plaintiff's argument fails as a factual matter. In the first place, numerous plaintiffs have been able to identify alleged breaches within six years of the loan sales. Nothing suggests the plaintiffs in those cases were unusually swift or diligent in reviewing the relevant loans; they simply exercised their rights in the window ordinarily granted breach-of-contract plaintiffs in New York courts.

Moreover, identifying a breach is not the needle-in-a-haystack endeavor that Plaintiff describes. The simplest way is to use delinquent or defaulted loans as a

proxy for the possibility that there might have been a breach.¹⁷ Trustees and investors can identify these nonperforming loans simply by reviewing monthly reports compiled and issued by trustees, which identify, among other information, delinquencies and defaults on the underlying mortgage loans. Seeing multiple delinquent or defaulted loans, especially soon after the closing, would alert the trustee and investors to investigate whether a breached representation-and-warranty provision might have been the cause, and whether any problem extended beyond the loans already identified.

Contrary to Plaintiff's description, it is not necessary to re-underwrite each loan in the trust in order to determine whether there are wide-spread breaches of representations and warranties. Reviewing a sampling of loans is one obvious way to detect any such widespread past breaches. Regardless whether sampling satisfies relevant legal standards in court (a frequently and currently disputed question), it plainly would suffice to alert trustees and investors to the possibility that there might be widespread past breaches. Nothing supports Plaintiff's notion that immediate and comprehensive re-underwriting of all the loans is required or even appropriate.

¹⁷ Delinquent or defaulted loans are not a perfect proxy for a breach because a breach of a representation and warranty might be benign—i.e., it does not impact ongoing timely payment of the loan. In that case, however, the parties would have little incentive to pursue repurchase of that performing loan.

This is particularly true because as time passes between the closing of a securitization transaction and an underlying mortgage loan's nonperformance, it becomes less and less likely that a breach of a representation and warranty about the quality of the loan at the time of the closing caused the loan's later nonperformance.¹⁸ For loans that are timely repaid for years and only later stop performing, the nonperformance is much more likely caused by a change in the borrowers' circumstances than by any original representation-and-warranty breach. Similarly, as time passes, litigation becomes a much more difficult and costly way to accurately determine liability for a past breach. As with any case, evidence becomes less clear over time, and alternative explanations mount. This is one of the fundamental policy reasons for a statute-of-limitations period.¹⁹ Thus, as a policy matter it makes perfect sense for the repurchase right to lapse after six years.

IV. Sellers and investors reasonably understood New York's statute of limitations to bar repurchase claims filed six years after the loan sale.

The aforementioned errors underlie Plaintiff's position that the cure-or-repurchase remedy extends the limitations period in repurchase actions beyond six years from the closing. The actual commercial context and realities, rather, show

¹⁸ Cf. *supra* note 17 and accompanying text (explaining why loan nonperformance can be a proxy, albeit not a perfect proxy, for representation-and-warranty breach).

¹⁹ This explanation is consistent with the amicus brief filed in the court below by Professor Miller, who discussed the statute-of-limitations policy against uncertain and costly litigation. He argued that any attempt to determine, after more than six years, whether representations and warranties were correct on the closing date would be "difficult and could destroy[] value rather than create it." Miller Br. at 22–23.

that six years from the closing date is an appropriate limit that comports with the nature of securitization transactions.

The text and structure of the relevant remedy provisions confirm this conclusion. Those provisions have been thoroughly explicated by the parties and other *amici*. This brief will not add to that analysis, other than to observe that nothing in the contractual provisions at issue, or in similar provisions in other securitization transactions, indicates any intent to remove these transactions from New York's default statute of limitations.

The cure-or-repurchase provision plainly governs *how*, not *when*, investors may recover. Likewise, the sole-remedy provision underscores that the contract limits, rather than expands, the recourse available to Plaintiff. And the no-action and notice provisions provide procedural protections that Plaintiff must follow in bringing a claim. All of these provisions set forth the remedy for a breach of representations and warranties, not an independent duty or condition precedent that triggers the limitations period in the first place. Because these MLPA provisions do not address (and therefore do not disturb) the time within which a repurchase claim may be made, New York's default limitations period applies.

Contrary to Plaintiff's assertion of an "independent" obligation, *see* Plaintiff-Appellant Br. 11, these remedial provisions are derivative, substantively and temporally, of the seller's contractual promise to sell loans that, at the time of

their sale, comported with the seller's representations and warranties of quality. Any repurchase obligation flowed from a representation-and-warranty breach by the seller that must have occurred (if at all) on the date of closing. It is clear from Section 7(a) of the MLPA that the repurchase obligation applies to "a breach of any of the representations and warranties contained in Section 6" of the MLPA, which states that Defendant-DBSP's representations and warranties are made solely "as of the Closing Date." Defendant-DBSP thus has no obligation regarding loans that, for any reason other than a representation-and-warranty breach on the closing date, later become defective. This is a critical point that is continuously obfuscated in Plaintiff's brief. *See, e.g.,* Br. of Plaintiff-Appellant Brief 21 (arguing that the "basic bargain" was that Defendant-DBSP should "shoulder the burden of curing or repurchasing *whenever* a defective loan was discovered") (emphasis in original).

Experienced industry practitioners have never, to my knowledge, conceived of these provisions in the way Plaintiff imagines. And that's for good reason. An unbounded statute of limitations would undermine the goals of the parties in the manner described above, and would disserve consumers and the economy more generally. As noted, the benefits of securitization—reduced cost of capital, lower interest rates, enhanced liquidity, more efficient risk allocation—depend on the certainty that the steps in the securitization process effectuate a true sale of the

mortgage loans. Adoption of Plaintiff's position would seriously jeopardize that sale, in this and many other similar deals. This would be an unfortunate development for reasons beyond any effect on the national economy. Undermining the limitations period under New York contract law in this respect could threaten New York's status as the jurisdiction of choice for the world's capital-markets transactions. An erosion of the contractual certainty that makes New York law so attractive would have obvious negative consequences for the state and its economy.


Plaintiff argues that Defendant-DBSP's position poses a threat "to the future of the [mortgage-backed securities] industry" because private capital will not be attracted unless courts enforce "the allocation of risk in the contracts as written." *Id.* at 45. To the contrary, that position is precisely consistent with the contractual obligations. Therefore, the Court would preserve commercial expectations by agreeing with that position and affirming the decision below.

CONCLUSION

For these reasons, the decision of the Appellate Division should be affirmed.

Dated: Durham, North Carolina
March 13, 2015

Respectfully submitted,

By: 

Steven L. Schwarcz
Duke Law School
Box 90360
Durham, NC 27708
Phone: 919-613-7060
Fax: 919-613-7231
schwarcz@law.duke.edu

Amicus Curiae