

Clients & Friends Memo

Accrual Clauses in RMBS Contracts Violate New York Law and Public Policy

October 18, 2018

I. Introduction

On October 16, 2018, the New York State Court of Appeals held that contractual attempts to extend the statute of limitations for causes of action involving breaches of contract are unenforceable because they violate New York law and public policy.¹

Before the mortgage crisis, many contracts for the transfer of mortgage loans into securitizations contained what are known as “accrual clauses.” A typical accrual clause provides that causes of action for breaches of representations and warranties would only accrue upon (i) discovery of a breach by, or notice of breach to, the purchaser, (ii) failure by the seller to cure such breach, substitute a conforming mortgage loan for the non-conforming mortgage loan or repurchase the non-conforming mortgage loan and (iii) demand upon seller by the purchaser for compliance with the related transfer agreement.

In the case at issue, the plaintiff argued, first, that the accrual clause created a substantive condition precedent, namely that demand must be made upon the seller for compliance with the related transfer agreement and seller must fail to so comply and, second, that the accrual clause expressed the parties’ clear intent to delay accrual of a breach of contract cause of action until the specified events had occurred. The plaintiffs argued that the court should therefore honor the parties’ intent, consistent with New York’s public policy supporting freedom of contract.

The New York State Court of Appeals disagreed with both arguments.²

The decision has important implications for all structured finance and other transactions governed by New York law that involve transfers of financial assets, the term of which exceeds the six year

¹ *Harborview Mortg. Loan Tr. Series 2007-7 v. Flagstar Capital Markets Corp.*, No. 96, 2018 WL 4976777 (N.Y. Oct. 16, 2018).

² *Id.* at 2.

statute of limitations.

II. Background

In the case at issue, Quicken Loans (the “**Defendant**”) was the originator of certain mortgage loans that were subsequently securitized in Harborview Mortgage Loan Trust 2007-7 (the “**Trust**”). Plaintiff Deutsche Bank National Trust Company, as trustee of the trust (the “**Plaintiff**”), brought suit to enforce representations and warranties that were made by the Defendant and ultimately assigned to the Trust. The representations and warranties concerning the mortgage loans were made “as of the related closing date for such Mortgage Loan.” The mortgage loans were conveyed in two groups and the closing date for each group occurred between December 7, 2006 and May 31, 2007. The sole remedy for a breach of the representations and warranties was the Defendant’s obligations to cure or repurchase any non-conforming mortgage loan.

In 2013, a certificateholder in the Trust engaged an underwriting firm to review a sample of the mortgage loans to determine whether they complied with the Defendant’s representations and warranties. Based on the results of the review, the Plaintiff commenced an action against the Defendant on August 30, 2013. The Defendant moved to dismiss the complaint, arguing, among other things, that the action was time-barred by the six-year statute of limitations applicable to breach of contract actions because it was commenced more than six years after the closing date for the sale of each package of mortgage loans, the most recent of which was May 31, 2007. Plaintiff responded that the statute of limitations had yet to run because the related mortgage loan purchase and warranties agreement (the “**Agreement**”) contained what is known as an “accrual clause.” The accrual clause in the Agreement provided that:

“Any cause of action against the Seller relating to or arising out of the breach of any representations and warranties made in Subsections 9.01 and 9.02 shall accrue as to any Mortgage Loan upon (i) discovery of such breach by the Purchaser or notice thereof by the Seller to the Purchaser, (ii) failure by the Seller to cure such breach, substitute a Qualified Substitute Mortgage Loan or repurchase such Mortgage Loan as specified above and (iii) demand upon the Seller by the Purchaser for compliance with this Agreement.”

The Supreme Court held that any breach had occurred on the closing date of the loans, i.e. no later than May 31, 2007, and therefore Plaintiff’s cause of action accrued no later than that date.³ The

³ *Id.* at 4.

Supreme Court further held that the accrual clause described above could not serve to extend the statute of limitations.⁴

The Appellate Division affirmed the Supreme Court's ruling and held that the accrual clause did not create a substantive condition precedent nor did the language requiring cure, substitution or repurchase constitute a promise of future performance.⁵ The Appellate Division further concluded that to the extent that the parties intended for the accrual clause to delay accrual of the breach of contract cause of action, the accrual clause was unenforceable because it violates New York public policy.⁶

III. The NYS Court of Appeals Ruling

In affirming the Appellate Division's decision, the Court of Appeals noted that the language of the accrual clause itself refers to a "breach" of the representations and warranties, and that the contract nowhere suggests that Defendant's transfer of non-conforming loans is not a "breach" of the Agreement.⁷ The Court of Appeals further noted that the Agreement provides that cure or repurchase are the "sole remedies" available to the Plaintiff for a breach of the representations and warranties relating to the mortgage loans.⁸ In addressing the Plaintiff's argument that the accrual clause created a substantive condition precedent, the Court of Appeals held that the performance required under the Agreement was delivery of mortgage loans that complied with the representations and warranties on the closing date and that the cure or repurchase protocol was merely the remedy for a breach of the representations and warranties.⁹ As a result, nothing in the accrual clause created a condition to the Defendant's obligation to deliver loans that complied with the representations and warranties on the closing date and nothing in the accrual clause created a subsequent condition precedent to the relevant performance that the Plaintiff alleged was breached.¹⁰

In addressing the Plaintiff's argument that the accrual clause manifested the parties' clear intent to extend the statute of limitations, the Court of Appeals pointed out that, while parties may agree to a shorter limitations period under New York law, New York's public policy precludes parties' ability to

⁴ *Id.*

⁵ *Id.* at 4-5.

⁶ *Id.*

⁷ *Id.* at 8.

⁸ *Id.*

⁹ *Id.* at 9.

¹⁰ *Id.*

extend the statutory period before a claim accrues.¹¹ According to the court, “[i]f the agreement to waive or extend the Statute of Limitations is made at the inception of liability it is unenforceable because a party cannot in advance make a valid promise that a statute founded in public policy shall be inoperative.”¹² The court went on to discuss extensions of statutes of limitation that are made after the related cause of action has accrued, which the court stated must be made in compliance with NY General Obligations Law Section 17-103.¹³ The Plaintiff contended that its accrual clause did not violate GOL Section 17-103 because the statute does not expressly prohibit contract provisions defining an accrual date. The court disagreed, citing language in the statute requiring any such extensions to be entered into “after accrual of the cause of action” as with typical tolling agreements.¹⁴ The court further found that the accrual clause violated GOL Section 17-103 because it purported to extend the statute of limitations to a future date uncertain, which, under the Plaintiff’s theory, “might occur decades into the future.”¹⁵

IV. Discussion and Conclusion

The Court of Appeals squarely held that, to the extent the parties intended at the time of the contract and before the breach, to postpone accrual of a breach of contract cause of action to a subsequent uncertain date, the accrual clause could not extend the statute of limitations.¹⁶ Because of the New York public policy in favor of enforcing the statutory period of limitations (or some shorter period agreed to by the parties), the bar to create contractual provisions that would either serve to create a true substantive condition precedent or to extend the statute of limitations in a way that does not run afoul of New York’s law and public policy is very high. However, the court took pains to make clear that its holding had no impact on (i) contracts creating true substantive conditions precedent to a party’s performance, (ii) separate promises of future performance or (iii) contractual provisions for post-accrual tolling agreements that comply with GOL Section 17-103.¹⁷

For New York law-governed RMBS transactions and other transactions involving the transfer of financial assets, the term of which exceeds the applicable statute of limitations, the Court of Appeals’ holding likely means several things. First, existing contracts that provide that cure or repurchase are the sole remedies for a breach of representations and warranties are unlikely to support an argument that a cause of action for breach accrued at any time after the making of the related contract. Second, accrual clauses as currently drafted in typical agreements that purport to

¹¹ *Id.* at 12.

¹² *Id.* at 13.

¹³ *Id.*

¹⁴ *Id.* at 15.

¹⁵ *Id.* at 16.

¹⁶ *Id.* at 18-19.

¹⁷ *Id.* at 18.

delay the accrual of causes of action need to be carefully evaluated in future transactions and redrafted to address the shortcomings identified by the court. Accrual clauses that simply attempt to delay the accrual of the cause of action are likely unenforceable. Rather, such clauses could be drafted to create true substantive conditions precedent to the seller's performance or promises of future performance.

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If you would like to discuss how this decision might implicate the redrafting of existing provisions or the crafting of new ones to address the issues discussed, please contact the following attorneys, or your usual contacts at Cadwalader:

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