CADWALADER

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Clients&FriendsMemo

2019 Year in Review: Securitization Litigation and Regulation

January 30, 2020

There were significant developments in 2019 as courts continued to issue important decisions in this space and significant legislation impacting the residential mortgage-backed securities ("RMBS") market came into effect. A number of cases have called into question firmly rooted practices in the securitization market. In two actions commenced over the summer in New York federal courts, *Petersen v. Chase Card Funding, LLC*[1] and *Cohen v. Capital One Funding, LLC*,[2] credit card holders claimed that their loans became usurious in violation of state usury laws once they were securitized. While federal law permits the originating national banks to charge interest at rates above what is permitted under the usury cap of the borrower's residence (here, New York), the plaintiffs assert that the non-bank securitization trusts that purchased and then securitized the receivables (which do not benefit from the exemption for national originating banks from state usury laws) cannot continue to charge the same interest rates. These cases threaten to impede national banks' ability to originate nationwide pools of loans by exposing securitized debt with interest rates in excess of certain levels to state-by-state regulation. *See infra* Part I.A. Similar issues have been raised in two pending actions in Colorado state court. In *Meade v. Marlette Funding LLC*[3] and *Meade v. Avant of Colorado LLC*,[4] the Administrator of the Colorado Uniform Consumer Credit Code is claiming that (i) bank-made loans are subject to state lending rules (including usury laws) because the "true lenders" are the non-bank Fintech companies that arranged the loans, not the bank that technically made the loan to the borrower, and, in any event, (ii) the securitization trusts holding the loans cannot collect interest at the same rates and fees that the originating banks charge. *See infra* Part I.B.

Another well-established securitization practice was called into question by the Southern District of New York in *Powell v. Ocwen Financial Corp.*[5] In a first-of-its-kind decision, the court held at the pleading stage that RMBS might have been incorrectly characterized as debt, rather than equity, for

[1] No. 1:19-cv-00741-LJV (W.D.N.Y. filed June 6, 2019).

[2] No. 1:19-cv-03479-KAM-RLM (E.D.N.Y. filed June 12, 2019).

[3] No. 2017-CV-30376 (Colo. Dist. Ct.).

[4] No. 2017-CV-30377 (Colo. Dist. Ct.).

[5] *Powell v. Ocwen Fin. Corp.*, No. 1:18-cv-01951-VSB-SDA, 2019 WL 6210810 (S.D.N.Y. Nov. 21, 2019).

This memorandum has been prepared by Cadwalader, Wickersham & Taft LLP (Cadwalader) for informational purposes only and does not constitute advertising or solicitation and should not be used or taken as legal advice. Those seeking legal advice should contact a member of the Firm or legal counsel licensed in their jurisdiction. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. Confidential information should not be sent to Cadwalader without first communicating directly with a member of the Firm about establishing an attorney-client relationship. ©2020 Cadwalader, Wickersham & Taft LLP. All rights reserved.

ERISA purposes. Unlike the purchase of debt, equity investments by ERISA plans can implicate ERISA's rigorous regulations. If the court ultimately rules for the plaintiffs on this issue, *Powell* would cast a shadow over the many securitizations that are not structured to comply with ERISA because they are assumed to be plan-friendly debt deals. *See infra* Part II.

The courts also have handed down a number of important decisions this year in litigation over RMBS that became worthless in the wake of widespread loan defaults. The First Department dealt a number of blows to originators and sponsors in litigation over alleged breaches of representations and warranties:

- That court struck down a sole remedies provision, permitting plaintiffs to sue for damages rather than requiring repurchase of defective loans, on the basis of grossly negligent misrepresentations about the quality of mortgages in *In re Part 60 Put-Back Litigation*.[6] *See infra* Part III.A.
- The First Department rejected an argument that non-descript breach notices were insufficient to trigger liability in *Home Equity Mortgage Trust Series 2006-1 v. DLJ Mortgage Capital, Inc.*[7] *See infra* Part III.B.
- Ruling in yet another case, the First Department refused to dismiss a monoline insurer's fraudulent inducement claims against an originator as redundant of parallel breach-of-contract claims in *Ambac Assurance Corp. v. Countrywide Home Loans Inc.*[8] *See infra* Part III.C.

On at least one issue, recent precedent benefits originators. The Second Circuit held in *Lehman XS Trust, Series 2006-GP2, (LXS 2006-GP2), ex. rel. U.S. Bank N.A. v. GreenPoint Mortgage Funding, Inc.*[9] that New York's six-year limitations period for breach of contract ran from the moment the originator made mortgage-related representations and warranties, even though the parties' contract provided that claims accrued upon notice of the breach. *See infra* Part III.D.

For their part, RMBS owner trustees will find comfort in the Third Circuit's decision in *IKB International S.A. v. Wilmington Trust Co.*[10] The court rejected the theory that an owner trustee had broad supervisory duties—and thus should be liable for the misdeeds of servicers and indenture trustees—simply because the trust documents give the owner trustee general authority to "conduct the business of the Trust." *See infra* Part IV.

---

[6] 169 A.D.3d 217 (1st Dep't 2019).

[7] 175 A.D.3d 1175 (1st Dep't 2019).

[8] 175 A.D.3d 1156 (1st Dep't 2019).

[9] 916 F.3d 116 (2d Cir. 2019).

[10] 774 F. App'x 719 (3d Cir. 2019).

On the other coast, the Washington Supreme Court rendered a decision that could ignite RMBS litigation under state blue sky laws. The court held that reliance is not a required element for misrepresentation claims under the Securities Act of Washington, and reinstated an investor's suit against Barclays and Credit Suisse arising from its ill-fated $900 million investment in RMBS. *See infra* Part V.

In addition to significant decisions, there also was notable legislation as well, as 2019 marked the first year in which a new framework for European securitizations took effect. On January 1, 2019, Regulation (EU) 2017/2402 of the European Parliament and of the Council (the "Securitization Regulation") began to apply to securitization transactions, the securities of which are issued on or after January 1, 2019. The mandated changes to securitization practices brought about pursuant to the Securitization Regulation are significant and not limited to European Union entities—U.S. issuers may also be affected as well. *See infra* Part VI.

I. Valid-When-Made Under Attack

Plaintiffs have filed multiple lawsuits challenging securitized consumer loans as usurious by relying on the Second Circuit's 2015 ruling in *Madden v. Midland Funding, LLC*.[11] In *Madden*, the Second Circuit addressed whether a non-bank assignee of loans originated by a national bank could take advantage of Section 85 of the National Bank Act ("NBA"), which authorizes a national bank to charge interest nationwide at rates permitted by the state where the bank is "located."[12] The court held that a nonbank assignee cannot avail itself of the NBA, and instead remains subject to state usury limits. *Madden* is an outlier among circuit court decisions and has been widely criticized as a matter of both law and policy—even the Office of the Comptroller of the Currency called it "incorrect" in an amicus brief at the certiorari stage.[13] The Second Circuit declined to recognize the well-established valid-when-made doctrine (pursuant to which a loan is enforceable by its terms as long as it was not usurious when made) and instead ruled that the applicability of state usury limits depends on whether the current holder of a loan is a national bank (or an agent or subsidiary of a national bank). Under that ruling, bank-originated consumer loans can be less valuable if sold, thus devaluing the loans on the books of the originating bank prior to sale. The net result, observers

---

[11] 786 F.3d 246 (2d Cir. 2015). For a full analysis of *Madden* and the valid-when-made doctrine, see our Clients & Friends Memo titled *It's a Mad, Mad, Madden World* (June 29, 2016).

[12] As to the issue of where a national bank is "located" for purposes of the statute, the Office of the Comptroller of the Currency ("OCC") has "conclude[d] that an interstate national bank may charge interest permitted by the laws of its home state unless the loan is made—that is, the loan is approved, credit is extended and funds are disbursed—in a branch or branches of the bank in a single host state" (in which case the law of that state dictates the maximum permissible interest rate). *See* OCC Interpretive Letter #822 (Feb. 17, 1998).

[13] While the OCC asserted that the Second Circuit "erred in holding that state usury law may validly prohibit a national bank's assignee from enforcing the interest-rate term of a debt agreement that was valid under the law of the State in which the national bank is located," it considered granting certiorari inappropriate due to lack of a circuit split. Brief for the United States as Amicus Curiae at 5-6, *Midland Funding, LLC v. Madden*, No. 15-610 (U.S. May 24, 2016).

believe, is a tightened consumer credit market—particularly for subprime borrowers. Even so, because the Supreme Court denied certiorari and Congress's work to craft a legislative fix stalled, *Madden* remains governing law in the Second Circuit.

A. Cardholders Seek to Leverage *Madden*

Petersen v. Chase Card Funding, LLC, No. 1:19-cv-00741-LJV (W.D.N.Y. filed June 6, 2019)
Cohen v. Capital One Funding, LLC, No. 1:19-cv-03479-KAM-RLM (E.D.N.Y. filed June 12, 2019)

In June, two putative class actions relying on *Madden* were commenced in New York federal courts: *Petersen* in the Western District of New York, and *Cohen* in the Eastern District of New York.[14] In both cases, the originating national bank assigned credit card receivables to securitization trusts. The plaintiffs allege that the assignment of the receivables destroys the national bank's right to collect interest at rates above the limits of New York's usury laws. And because the interest charged allegedly exceeds New York's sixteen percent limit, the plaintiffs seek to recoup the allegedly excessive interest payments, as well as an injunction to cap the interest rates going forward.

Because *Madden* is binding in the Eastern and Western Districts, at this stage the Defendants are relegated to distinguishing *Madden*—and there are persuasive grounds for doing so. The loan in *Madden* was a nonperforming credit card account that Bank of America's Delaware-based credit card bank, FIA, had sold to Midland Funding, which then raised the rates charged per the terms of the originating contract and sought to enforce the past-due loan. The Second Circuit relied on the fact that "neither BoA nor FIA has retained an interest in Madden's account"[15] to distinguish cases like *Krispin*[16] and support its holding that "subjecting the defendants to state regulations does not prevent or significantly interfere with the exercise of BoA's or FIA's powers."[17] In *Petersen* and *Cohen*, however, receivables from performing loans have been deposited into securitization trusts—and under that structure, a national bank retains a portion of the credit risk and remains the cardholders' contractual counterparty with the right to, among other things, charge interest and set credit limits. There is thus a strong argument that despite *Madden*, under the structures in *Petersen* and *Cohen*, Section 85 of the National Bank Act[18] preempts New York law and allows the national

[14] We have covered these cases in a Clients & Friends Memo titled *Cardholders Seek to Capitalize on Madden* (June 18, 2019).

[15] 786 F.3d at 252.

[16] *See Krispin v. May Dep't Stores Co.*, 218 F.3d 919 (8th Cir. 2000) (state usury laws preempted under the National Bank Act where originating national bank sold receivables to department store but continued to issue credit, process and service customer accounts, and set such terms as interest and late fees).

[17] 786 F.3d at 252-53.

[18] Section 85 permits national banks to "charge on any loan . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located." 12 U.S.C. § 85. It also provides the exclusive cause of action for usury claims

banks to continue to charge any rate of interest allowed by the laws of the banks' home states. And because applying New York law on the facts of *Petersen* and *Cohen* would undermine the efficacy of the commonplace securitization vehicles at issue, there is also a strong argument that applying New York law would significantly interfere with national banks' exercise of their powers, in violation of 12 U.S.C. § 25b(b)(1).[19]

On January 22, 2020, the Magistrate Judge in *Petersen* recommended that the Western District grant defendants' motion to dismiss the case. In his Report and Recommendation, the Magistrate Judge held that because applying New York's usury laws to defendants would prevent the originating national bank's ability to sell or assign the receivables from its credit card accounts, New York's usury laws were preempted.

The motion to dismiss in *Cohen* has been fully briefed and remains pending.

B. Colorado on the Offensive

Meade v. Marlette Funding LLC, No. 2017-CV-30376 (Colo. Dist. Ct.)
Meade v. Avant of Colorado LLC, No. 2017-CV-30377 (Colo. Dist. Ct.)

As discussed in earlier Client & Friends Memos,[20] the Administrator of the Colorado Uniform Consumer Credit Code (the "UCCC")[21] sued Fintech companies Avant and Marlette, alleging that they made loans to Colorado consumers and charged interest at rates in excess of those permitted by the UCCC. The Administrator amended the complaints to add as defendants the securitization trusts holding the Avant and Marlette Colorado loans (the "Trusts"), as well as the two trustees of the Trusts. The Administrator contends that the Trusts violated the UCCC by collecting impermissible finance charges and late fees. The Administrator asserts that although the loans were nominally made by out-of-state FDIC-insured state-chartered banks that are entitled to charge higher rates, the "true lenders" were Avant and Marlette. It also argues that even if the partner banks had originated the loans, the Colorado court should follow *Madden* and bar the Trusts from collecting the rate of interest and fees that the national banks would have been allowed to charge. These cases thus present another attack on the "valid-when-made" doctrine. And the relief sought by the Administrator is exceptional: it seeks not merely disgorgement of excessive interest and

---

against national banks, and "therefore completely preempt[s] analogous state-law usury claims." *Sullivan v. Am. Airlines, Inc.*, 424 F.3d 267, 275 (2d Cir. 2005).

[19] Section 25b(b)(1) provides that a state law is preempted if it "prevents or significantly interferes with the exercise by the national bank of its powers." 12 U.S.C. § 25b(b)(1).

[20] *See* *Who's My Lender?* (Mar. 4, 2018); *Another Rocky Mountain Remand* (Mar. 29, 2018); *Litigation Mounts to New Highs in Colorado – Securitizations Under Attack* (Jan. 2, 2019); *The Very Long Arm of Colorado Law* (Apr. 24, 2019).

[21] The Administrator of the UCCC is employed by the Colorado Office of the Attorney General.

fees, but also civil penalties of ten times the amount by which the interest and fees exceeded the statutory maximum.[22]

If the Administrator were to prevail on its alternative theory under *Madden*, the secondary market for loans in Colorado would be at risk of disruption in much the same way commentators believe *Madden* has disrupted the secondary market for loans in the Second Circuit. One study found "clear evidence" that in New York and Connecticut, "*Madden* reduced the flow of credit, especially to higher-risk borrowers whom lenders normally charge above-usury rates."[23]

The Administrator has had the upper hand in the litigation so far. It first defeated the non-Trust Defendants' efforts to move the case to federal court on a complete preemption theory. The Administration also defeated the Trusts' motion to dismiss for lack of personal jurisdiction. On that motion, the Trusts argued that they did not purposefully avail themselves of the benefits and protections of Colorado and that their only link to the forum was a small amount of income based on Colorado loans. Such a limited connection, they argued, could not support jurisdiction, especially when the Trusts received income from similar loans in almost every state in the country. In denying the motion, the court ruled that by acquiring Colorado consumer loans, the Trusts qualify as a "creditor" under Colorado's UCCC because they "receive payments collected by others from Colorado consumer credit transactions." While the court stated that it was unable to locate a Colorado case allowing for personal jurisdiction over non-resident creditors, the court stated that Colorado courts had exercised personal jurisdiction under state statutes with long-arm provisions like those of the UCCC. Additionally, the court ruled that by acquiring the loans and collecting payments, the Trusts had "purposefully established 'minimum contacts'" with Colorado sufficient to satisfy due process.

Thus, under the court's ruling, secondary-market purchasers that acquire even a small number of Colorado consumer loans can be dragged into Colorado courts and face lawsuits that seek disgorgement and civil penalties over any loan that allegedly does not comply with the UCCC.

As this case and *Petersen* and *Cohen* show, plaintiffs are aggressively targeting securitization vehicles in which national banks originate loans and non-banks are entitled to the receivables.

---

[22] The UCCC provides that "[i]f a creditor has made an excess charge in deliberate violation of or in reckless disregard for this code or if a creditor has refused to refund an excess charge within a reasonable time after demand by the consumer or the administrator, the court may also order the respondent to pay to the consumers a civil penalty in an amount determined by the court not in excess of the greater of either the amount of the finance charge or ten times the amount of the excess charge." Colo. Rev. Stat. Ann. § 5-6-114(b).

[23] Colleen Honigsberg et al., How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment, 60 J.L. & ECON. 673, 694 (2017).

At least until those cases are resolved, secondary-market purchasers should continue to approach with caution loans involving consumers residing in Colorado, New York, Vermont, and Connecticut.

II. Securitizations Structured to Avoid ERISA at Risk

Powell v. Ocwen Fin. Corp., No. 1:18-cv-01951-VSB-SDA, 2019 WL 1227939 (S.D.N.Y. Mar. 15, 2019)

The Southern District held at the pleading stage in *Powell v. Ocwen Financial Corp.* that RMBS sold to ERISA plans that were carefully structured to qualify as debt for ERISA purposes could actually be equity. Classifying plan-held securities as equity is no small matter: it means that the underlying mortgages could be deemed "plan assets," and, therefore, that the mortgage servicers and other parties handling the mortgages could be ERISA fiduciaries. Among those duties—which are "the highest known to the law"[24]—are the duty to act "prudently," to diversify plan assets, and to avoid certain prohibited transactions. *Powell* thus has the potential to create significant uncertainty for similarly designed securitizations across the market that may not be structured to comply with ERISA or an exemption from ERISA.

The plaintiffs in *Powell* are trustees of ERISA plans that bought notes from indenture trusts created by subprime lender American Home Mortgage Investment Corp. The complaint asserts ERISA claims against Ocwen, the mortgage servicer, based on allegations of misconduct ranging from misapplying mortgage payments to misleading courts and regulators. The plaintiffs also target Wells Fargo, the master servicer, for its alleged failure to properly investigate Ocwen's misconduct.

The defendants' leading motion to dismiss argument was that the RMBS were structured and sold as debt instruments not subject to ERISA. Under the "look-through" rule in the Department of Labor's ("DOL") Plan Asset Regulation, a plan's equity investment in another entity can render the assets of that entity "plan assets"—thereby implicating ERISA's rigorous fiduciary regime.[25] Debt investments, on the other hand, do not implicate ERISA.[26] The securities at issue in *Powell* bear the hallmarks of debt:

---

[24] *LaScala v. Scrufari*, 479 F.3d 213, 219 (2d Cir. 2007) (quoting *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982)).

[25] In the absence of a statutory or administrative exemption, a Plan's equity investment in another entity is subject to the "look-through" rule, which gives the plan investors "an undivided interest in each of the underlying assets of the entity." 29 C.F.R. § 2510.3-101(a)(2). By holding assets deemed to be "plan assets," the entities must be managed in compliance with ERISA.

[26] The Plan Asset's Regulation's look-through rule is not implicated when a Plan holds debt securities—i.e., those that qualify as "indebtedness under local law" and lack "substantial equity features." 29 C.F.R. § 2510.3-101(b). Unlike equity investments, debt investments "are not likely to be vehicles for the indirect provision of investment management services" which the Plan Asset Regulation is intended to prevent. *See* Proposed Amendment to Prohibited Transaction Exemption 97-34 Involving Bear, Stearns & Co. Inc., Prudential Sec. Incorporated, et al., 65 Fed. Reg. 51454, 51460 (proposed Aug. 23, 2000).

- The securities took the form of notes under an indenture;
- The sponsor obtained a legal opinion that the notes would be treated as debt for tax purposes;
- The notes bear interest at fixed rates and payments are senior to any distributions to subordinate certificate-holders;
- The notes lack equity-like features, such as conversion features, warrant rights, and contingent payment terms.

These are the types of structuring practices many sponsors have relied on for years to avoid regulation under ERISA by virtue of selling RMBS to ERISA plans. While the court expressed "considerable doubt" about whether the securities were incorrectly characterized as debt, it converted the motions to dismiss into motions for summary judgment and ordered discovery and briefing on whether (1) the mortgages underlying the trusts qualify as "plan assets," and, if so (2) whether Ocwen acted as a fiduciary.

Even if the court ultimately rules that the RMBS were correctly characterized as debt and finds no fiduciary liability, the Southern District's decision still paves the way for ERISA plaintiffs to survive pleading stage challenges in suits arising from securitizations that are carefully structured to avoid ERISA. From a structuring perspective, one way to avoid the specter of liability is to limit plan participation to below twenty-five percent, as the DOL has recognized an exemption where plan participation remains below that threshold.[27]

III. Little Relief for Defendants in Reps-and-Warranties Cases

Sponsors and originators had little success this year avoiding liability for breaches of representations and warranties relating to allegedly defective mortgages underlying RMBS. A trio of decisions by the First Department rejected defendants' attempts to dismiss such claims based on sole remedies clauses, the sufficiency of breach notices, and the redundancy of fraud and contract claims. *See infra* Parts III.A-C. The Second Circuit, however, adopted an originator's argument that breach of contract claims were time-barred, despite the existence of an accrual clause in the transaction documents that, had it been given effect, would have meant that the claims were timely. *See infra* Part III.D.

---

[27] The Plan Asset Regulation provides an exception to its "look-through" rule if less than twenty-five percent of each class of equity by an entity is held by plans. *See* 29 C.F.R. § 2510.3-101(f)(1). The drawback of this approach is that, as a practical matter, the only way to track plan participation levels is through the outmoded use of physical notes and a ledger.

A. Another Sole Remedies Clause Falls to Gross Negligence

In re Part 60 Put-Back Litig., 169 A.D.3d 217 (1st Dep't 2019)

In *Part 60*, the First Department held that a sponsor and a transferor of RMBS were grossly negligent in their characterizations of the quality of the mortgages underlying the issued securities, and on that basis effectively wrote a sole remedies clause out of the contracts pursuant to which the securities were sold to investors. Sole remedies clauses typically provide that the seller's obligation to cure, repurchase or substitute for a defective mortgage loan constitutes the purchaser's sole remedy for a breach of the seller's representations and warranties. The ruling follows the First Department's 2016 decision in *Morgan Stanley Mortg. Loan Tr. 2006–13ARX v. Morgan Stanley Mortg. Capital Holdings LLC* that the public policy prohibiting a party from insulating itself from damages caused by gross negligence applies to sole remedies that are illusory.[28]

The plaintiffs in *Part 60* sought damages over virtually worthless RMBS. The defendants argued that the sole remedies clause foreclosed such a claim. Relying on *Morgan Stanley*, plaintiff-trustee argued that the sole remedies clause was invalidated by the defendants' grossly negligent representations and warranties about borrower income, debt obligations, and appraisal value. The facts were extreme—in every one of the eight hundred loans sampled, the representations and warranties were breached—and the First Department sided with the trustee.

While the court acknowledged that sole remedies clauses generally are binding, it held that they should not be given effect when that result is compelled by statute or public policy. And on this point, New York's rule is clear: grossly negligent conduct "cannot be contractually immunized as a matter of public policy."[29] The court also allowed a claim for punitive damages based on the representation breaches.

B. Broadly Worded Breach Notices Held Sufficient to Trigger Repurchase Obligations

Home Equity Mortg. Tr. Series 2006-1 v. DLJ Mortg. Capital, Inc., 175 A.D.3d 1175 (1st Dep't 2019)

In *DLJ Mortgage Capital*, the First Department rejected a mortgage loan seller's summary judgment argument that it cannot be required to repurchase defective mortgage loans that were not specifically identified in timely breach notices. As is standard, the pooling and servicing agreements required the seller DLJ to cure, substitute, or repurchase defective loans following timely notice of a material breach of any representation or warranty. The trusts timely notified DLJ that there were breaches "on a massive scale"; the defective loans specifically identified in the

[28] 143 A.D.3d 1, 9 (1st Dep't 2016).

[29] 169 A.D.3d at 223.

notices were "just the tip of the iceberg"; and an investigation was ongoing.[30] DLJ argued to no avail that the trusts' references to widespread defects across the entire pool of loans were insufficient to give notice under the repurchase protocol. Relying on its earlier "relation back" decisions,[31] the court concluded that the trusts' timely complaints identifying certain specific breaches may be supplemented to include additional breaches raised in the litigation.

Nor did the First Department find any reason to "disturb the [lower] court's decision to permit the use of statistical sampling to prove liability and damages."[32] The *Home Equity* decision thus recognizes the reality that the sheer volume of defective mortgage loans in a typical RMBS suit may effectively prevent not only loan-specific breach notices, but also loan-specific evidence.

C. Fraudulent Inducement Claims Not Barred by Overlapping Contract Claims

Ambac Assurance Corp. v. Countrywide Home Loans Inc., 175 A.D.3d 1156 (1st Dep't 2019)

On the same day the First Department ruled against the seller in *DLJ Mortgage Capital*, it decided in *Ambac Assurance* that a monoline insurer's fraudulent inducement claim against Countrywide was not impermissibly duplicative of contract claims based on the same nonconforming loans.

It is settled that a claim for fraudulent inducement can be dismissed as duplicative of a claim for breach of contract *if it seeks the same damages*.[33] In this case, the Court of Appeals already had recognized distinct measures of damages for Ambac's fraud and contract claims. Damages for any breaches of Countrywide's representations and warranties about its loan-origination practices or the quality of the loans in the securitizations were to be measured under the repurchase protocol in the parties' agreement.[34] Damages for fraud, on the other hand, were to be measured "by reference to claims payments made based on nonconforming loans," and would include certain expenses incurred by Ambac that are not recoverable in contract.[35] On that basis, the court allowed the fraud claim against Countrywide to survive, and removed yet another weapon from originators' arsenal.

---

[30] 175 A.D.3d at 1176.

[31] *See*, *e.g.*, *Nomura Home Equity Loan, Inc., Series 2006-FM2 v. Nomura Credit & Capital, Inc.*, 133 A.D.3d 96, 108 (1st Dep't 2015) (amendments expanding a timely complaint about defective loans "relate back" to the original complaint and are thus timely), *aff'd as mod.*, 92 N.E.3d 743 (N.Y. 2017).

[32] 175 A.D.3d at 1177.

[33] See Mosaic Caribe, Ltd. v. AllSettled Grp. Inc., 117 A.D.3d 421 (1st Dep't 2014).

[34] 175 A.D.3d at 1156.

[35] Id.

D. Accrual Clauses Cannot Extend the Statutory Limitations Period
Lehman XS Tr., Series 2006-GP2, (LXS 2006-GP2), ex. rel. U.S. Bank N.A. v. GreenPoint Mortg. Funding, Inc., 916 F.3d 116 (2d Cir. 2019)

While originators of nonconforming loans have achieved little success disputing the sufficiency of breach notices, they have fared well attacking the timeliness of breach claims. In *GreenPoint*, the Second Circuit rejected as untimely an RMBS trustee's contract action against an originator arising from its sale of over $3 billion of largely nonconforming loans to Lehman. The trustee's claim for breach of representations and warranties was held to be barred by New York's six-year statute of limitations for breach of contract because the claim accrued and the statute started to run at the transaction closing (i.e., when the representation were made), not upon notice of the breach.[36]

The Second Circuit relied on the Court of Appeals' decision in *ACE Sec. Corp. v. DB Structured Products, Inc.*[37] to hold that a claim for breach of representations and warranties that guarantee particular facts as of a certain date, but do not guarantee future performance, accrues on the date the representations and warranties became effective.

The court was guided by another Court of Appeals decision, *Deutsche Bank National Trust Co. v. Flagstar Capital Markets Corp.*,[38] in ruling that accrual was not delayed by the parties' agreement that a claim of breach "shall accrue" upon the trustee's demand for compliance. *Flagstar* establishes that an accrual clause "cannot operate to delay the commencement of a limitations period under New York law, regardless of the parties' sophistication or clearly expressed intentions."[39] The accrual clause did not create a promise of future performance or substantive condition precedent: the originator was obligated to deliver mortgages that complied with the representations and warranties at the moment the contract was executed.[40] The statutory limitations period thus commenced at closing.

For trustees, *GreenPoint* counsels timely diligence of the mortgages underlying RMBS. For originators, the decision underscores a key defense that might otherwise have been foreclosed by an accrual clause.

---

[36] The court also rejected two contractual indemnification claims—one as "merely a reformulation" of the untimely representations-and-warranties claim, and one as untimely because it was not raised in the original complaint and did not "relate back" to the original complaint for purposes of the statute of limitations. *See GreenPoint*, 916 F.3d at 126-29.

[37] 36 N.E.3d 623 (N.Y. 2015).

[38] 112 N.E.3d 1219 (N.Y. 2018).

[39] *GreenPoint*, 916 F.3d at 125.

[40] See id.

IV. Owner Trustees Remain a Tough Target

IKB Int'l S.A. v. Wilmington Tr. Co., 774 F. App'x 719 (3d Cir. 2019)

In *IKB International*, the Third Circuit rejected claims against an owner trustee by a pair of European banks whose $168 million investments in RMBS had become worthless. In affirming the dismissal of the banks' claims for breach of contract and breach of the duty of good faith and fair dealing, the court refused to construe general contractual language about the owner trustee's authority to "conduct the business of the Trust" to create broad oversight duties.

The complaint alleged "pervasive breaches throughout the securitization chain" —from sellers that stuffed the trusts with non-compliant mortgages to indenture trustees and servicers that failed to identify the defects and carelessly serviced the loans. The plaintiffs claimed that the owner trustee should be liable because it "sat idly by watching" the alleged malfeasance instead of ensuring that those actors faithfully fulfilled their obligations. The problem with that theory, the court held, was that the owner trustee's duties were narrowly circumscribed in the trust documents, and concerned purely administrative acts like executing documents and accepting legal process on behalf of the trust. The court refused to find "an overarching duty to protect the trusts" based on general language about the owner trustee's authority to administer the trust. Nor could plaintiffs lean on common law trust principles because the securities were issued by a Delaware statutory trust.

The plaintiffs' implied-duty arguments fared no better than those based on the language of the agreements: "an implied duty to protect the trusts would fundamentally alter the parties' rights and responsibilities under the agreements," the court held. The takeaway is that even under an egregious set of facts, the exposure of an owner trustee is minimal if it has complied with its express contractual duties.

V. New Life for RMBS Claims Under Blue Sky Laws

Fed. Home Loan Bank of Seattle v. Credit Suisse Sec. (USA) LLC, 449 P.3d 1019 (Wash. 2019)

A recent decision by the Washington Supreme Court may lower the bar for purchasers of RMBS to prevail on claims under state securities laws. In *Federal Home Loan*, the court held that a plaintiff-purchaser need not establish reliance for its claims under the Securities Act of Washington that it was misled in connection with its purchase of over $900 million of RMBS from Credit Suisse and Barclays.

The Securities Act of Washington, which is modeled on the Uniform Securities Act of 1956, makes it unlawful for any seller or purchaser of securities, in connection with a sale, "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the

statements made, in light of the circumstances in which they are made, not misleading."[41] Federal Home Loan asserted violations of the statute based on allegations that Credit Suisse and Barclays misrepresented (i) loan-to-value ratios for thousands of the mortgages in the pool, (ii) the occupancy status of properties in the collateral pool, and (iii) the quality of their underwriting standards. The trial court granted summary judgment for Credit Suisse on the ground that the plaintiff did not rely on the alleged misrepresentations, and summary judgment for Barclays on the ground that any reliance was unreasonable. Although that decision was initially affirmed on appeal, the Washington Supreme Court disagreed, holding in a 6-1 decision that reliance is not required under the statute.

First, the court looked to the plain language of the statute, which nowhere mentions reliance, either in "term" or in "concept." Having concluded that the statute is plain on its face, the court refused to read common-law requirements for fraud into the statute, and cautioned against relying too heavily on "federal law while interpreting our own Securities Act."[42]

Second, the court determined that its decision furthers the purpose of the Securities Act. The analysis here is as straightforward as the textual analysis: the Act "has as its purpose broad protection of the public," and "an investor who has *not* relied on a misrepresentation can still be harmed by that misrepresentation."[43]

Third, the court rejected the respondents' argument that precedent requires proof of reliance. One case they cited, *Shermer v. Baker*,[44] was a non-binding decision by the Court of Appeals holding that reliance on a material misrepresentation or omission is *sufficient* to make out a claim, not that it is *required*. The other case, *Hines v. Data Line Systems, Inc.*,[45] was a proximate-cause case, not a reliance case, and the court's passing reference to reliance was at most "unadorned" dictum.

Fourth, the court concluded that its ruling would not "open up the floodgates of unlimited liability."[46] The court dismissed the respondents' purported concern about creating "absolute liability" because the statute's requirement of materiality and three-year limitations period provided sufficient checks.

---

[41] Wash. Rev. Code Ann. § 21.20.010(2) (West 2020).

[42] *Fed. Home Loan*, 449 P.3d at 1023 ¶ 18.

[43] *Id.* ¶ 20.

[44] 472 P.2d 589 (Wash. Ct. App. 1970).

[45] 787 P.2d 8 (Wash. 1990).

[46] *Fed. Home Loan*, 449 P.3d 1028 ¶ 43.

Federal Home Loan may have implications outside of Washington: courts in other states that follow the Uniform Securities Act of 1956 may be guided by the Washington Supreme Court's analysis.

VI. The New European Securitization Framework: An Overview

Applying to securitization transactions where securities are issued on or after January 1, 2019, the Securitization Regulation represents a fundamental overhaul of the European Union's regulations applicable to securitizations. The Securitization Regulation is silent as to the jurisdictional scope of many of its fundamental requirements, including the risk retention requirement and certain onerous transparency requirements. It is therefore unclear whether these obligations directly apply to U.S.-established entities involved in securitization transactions.[47] However, the Securitization Regulation's requirements may apply to U.S.-established entities on an "indirect basis" through the operation of Article 5 of the Securitization Regulation, which requires EU-regulated institutional investors to confirm as part of their regulatory due diligence that any securitization transaction in which they invest complies with specific provisions of the Securitization Regulation. Accordingly, U.S. issuers not subject to EU jurisdiction may need to structure a securitization transaction to comply with both U.S. and the Securitization Regulation's requirements when offering and selling securitizations that may be sold to EU investors. In addition, recent amendments to the EU's Capital Requirements Regulation ("CRR") require EU banks and investment firms subject to the CRR to satisfy the due diligence requirements of the Securitization Regulation on a consolidated or sub-consolidated basis, meaning subsidiaries of such institutions, whether established in the EU or outside of the EU, must comply with the due diligence requirements if they are consolidated for regulatory purposes.

The Securitization Regulation introduces two key, overarching changes to the European securitization framework:

First, the Securitization Regulation repeals and replaces prior European Union regulations governing securitizations and replaces them with a harmonized regime applicable to all European Union institutional investors and originator/sponsor entities. The Securitization Regulation's impact on three key areas—risk retention, transparency, and due diligence—warrants discussion.

In terms of risk retention, Article 6 of the Securitization Regulation largely preserves the prior rules (i) mandating that the originator, sponsor or original lender retain on an ongoing basis at least 5 percent risk retention in a securitization transaction, and (ii) permitting five retention methods.[48]

[47] Regarding the jurisdictional scope of the risk retention requirement, the Explanatory Memorandum to the original European Commission proposal for a Securitization Regulation implies that the direct risk retention obligation would not apply where none of the originator, sponsor or original lender are established in the European Union.

[48] The five risk retention methods permitted by Article 6 are: (i) retention of at least 5 percent of the nominal value of each of the tranches sold or transferred to investors, (ii) in the context of revolving securitizations or securitizations of revolving

However, one important change ushered in by Article 6 is that European Union originators, sponsors, or original lenders are now expressly under a "direct" obligation to satisfy the risk retention requirements. Consequently, these entities need to satisfy the risk retention requirements even where there is no requirement for investors to ensure that such requirements are met.[49]

Article 7 of the Securitization Regulation governs the transparency and disclosure obligations of European Union originators, sponsors, and securitization special purpose entities ("SSPE," or the issuers). Article 7 provides that these entities must make certain prescribed information relating to the transaction available to investors, competent authorities (i.e., national regulators) and, upon request, potential investors. The originator, sponsor, and SSPE of a securitization must designate as among themselves which one will be responsible for satisfying Article 7's reporting requirements.

Under Article 7, the information to be made available includes periodic reporting—at least on a quarterly basis, except with respect to asset-backed commercial paper transactions, which is to be made on a monthly basis—on the underlying assets, as well as information such as investor reports, in each case using prescribed reporting templates. On October 16, 2019, the European Commission adopted the regulatory technical standards specifying the information to be made available by the originator, sponsor and SSPE, although these standards are not expected to apply until a date falling later in the first quarter of 2020.[50]

As for due diligence, Article 5 of the Securitization Regulation mandates that European Union-regulated institutional investors must verify certain information both prior to and while holding a security covered by the Securitization Regulation. The Securitization Regulation defines "institutional investors" to include credit institutions, insurers, reinsurers, investment firms, pension funds, alternative investment fund managers and European Union retail funds (Undertakings for Collective Investment in Transferable Securities, or "UCITS"). Prior to investing in a securitization, Article 5 requires such an institutional investor to assess the risks involved as well as verify compliance with credit-granting standards and risk retention and transparency requirements under

---

exposures, the retention of the originator's interest of at least 5 percent of the nominal value of the securitized exposures, (iii) retention of randomly selected exposures equivalent to at least 5 percent of the nominal value of the securitized exposures, where the number of potentially-securitized exposures is not less than 100 at origination, (iv) retention of the first loss tranche (and if the retention does not amount to 5 percent of the nominal value of the securitized exposures, other tranches having the same/more severe risk profile) and not having an earlier maturity, than those transferred or sold to investors, resulting in a retention of not less than 5 percent of the nominal value of the securitized exposures, and (v) retention of a first loss exposure of not less than 5 percent of every securitized exposure in the securitization.

[49] This is in contrast to the prior risk retention rules, which placed the burden on investors to obtain disclosure that the risk retention requirements had been met.

[50] For an in-depth discussion regarding this regulation, see our Clients & Friends Memo titled *European Commission Adopts Disclosure Templates for EU Securitization Reporting* (Oct. 21, 2019).

Article 7. Post-investment, Article 5 imposes an ongoing obligation to monitor compliance with these obligations.

Second, the Securitization Regulation introduces and sets out the criteria for "simple, transparent and standardized" ("STS") securitizations, an optional type of securitization designed to receive a more favorable regulatory capital treatment compared to other non-STS securitizations.[51] In order for a transaction to be designated a STS securitization, the transaction not only has to follow the general requirements imposed by the Securitization Regulation, but also additional, extensive STS-specific criteria that fall into three categories—i.e., the STS' simplicity, standardization, and transparency requirements. These three categories of requirements govern a wide range of issues, including transaction structure, disclosure and verification obligations as well as requirements pertaining to the homogeneity of the underlying securitized assets.

In order to obtain a STS designation, the originator and sponsor of the securitization are required jointly to notify the European Securities and Markets Authority ("ESMA"), national competent authorities and investors that the transaction at issue meets the STS criteria. The notification must be made through ESMA's standardized notification template and include an explanation of how each STS criterion has been satisfied. If at some point a securitization no longer meets the STS criteria, the originator and sponsor are required to immediately notify ESMA.

In addition to the foregoing provisions, other changes implemented by the Securitization Regulation include formally banning resecuritizations (i.e., securities backed by other securitized assets), setting out lending criteria for originators as well as establishing a variety of administrative and criminal sanctions for non-compliance, with wide discretion given to the European Union's Member States in this regard.

While the overall framework of the Securitization Regulation has been in force since January 1, 2019, some of the technical standards and guidelines for implementing the Securitization Regulation's framework are still currently being developed by the EU's regulatory authorities, or have yet to be finalized through the EU legislative process. For example, with respect to the STS regime, because ESMA's STS official register has not yet been established, the STS notification reporting instructions and templates are still in their interim forms. While the ongoing development and finalization of the Securitization Regulation's technical standards and guidelines creates uncertainty and risk for market participants—particularly given the administrative and criminal sanctions associated with non-compliance—market practice has nonetheless in the meantime been

[51] A securitization can be eligible for the STS designation only if the originator, sponsor and SSPE are established in the European Union.

developing as market participants adjust to the new regime as well as engage with the relevant European regulators and industry groups.

*   *   *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Jason Halper	+1 212 504 6300	jason.halper@cwt.com
Jonathan Watkins	+1 704 348 5129	jonathan.watkins@cwt.com
Aaron Lang	+1 704 348 5145	aaron.lang@cwt.com
Ailsa Chau	+1 212 504 6438	ailsa.chau@cwt.com