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Indemnity may be a viable alternative to RMBS repurchase claims, but unique pitfalls exist

By Joseph Cioffi and Massimo Giugliano

As statutes of limitation appear to have closed the door on new repurchase or “put-back” litigation based on breaches of representations and warranties, investors in subprime residential mortgage-backed securities (RMBS), and the parties targeted by those investors and trustees, continue to look for ways to recover losses or cover their exposure. Indemnity provisions in the governing documents may provide a viable alternative for claimants on both sides of the repurchase battle due to more favorable law regarding indemnity claims relative to repurchase claims with respect to the statute of limitations. However, case law in the RMBS context continues to develop and claimants should be aware of the key factors and unique defenses impacting recovery on account of such claims.

Typically, under the terms of the governing sale documents, originators of subprime mortgage loans that were ultimately securitized made loan-level representations and warranties to the purchasers of those loans that passed through to the securitization trust. In many cases, other parties, such as purchasers or sponsors of the securitizations, themselves also made representations and warranties to the securitization trust based upon the originators’ representations. As evidenced by the dozens of cases commenced over the past few years involving some of the largest securitization participants, in the event of a breach of a representation or warranty, the trustee may pursue repurchase of the affected mortgage loan from such parties and such parties may, in turn, seek repurchase from the originator (at least to the extent the originator survived the subprime fallout and is still in existence).

In certain cases, the governing documents may also provide that the party suffering a loss as a result of a breach, including breach of loan-level representations or warranties, may have the right to be held harmless and indemnified against such loss by the breaching party. In essence, such indemnity provisions shift the loss



suffered by one party (the indemnitee) to another (the indemnitor) as a result of a third party claim. A key difference between indemnity and breach of contract claims is that indemnity generally allows for recovery of attorneys’ fees, which are generally not recoverable in connection with a breach of contract claim, unless specifically authorized under the governing documents. Moreover, in the RMBS context, damages on account of an indemnification claim would be based on actual losses suffered and not the repurchase price.

Indemnity claims may survive challenges based on timeliness where repurchase claims may be time-barred. Under New York law (the controlling law for most repurchase actions), claims for repurchase generally accrue, and the statute of limitations begins to run, upon the breach of the loan-level representation or warranty, which typically occurs when it was made, rather than when a defendant refuses to comply with a repurchase demand. Accordingly, barring reversal of a significant appellate decision by the New York Court of Appeals, repurchase claims related to securitizations created during the period of the greatest subprime activity (pre-2007) are now likely time-barred. In contrast, indemnity claims generally do not accrue, and the statute of limitations does not begin to run, until payment is actually made or a judgment is entered. Accordingly, to the extent available under the governing documents, securitization participants that have incurred or continue to incur losses may now shift their focus away from repurchase claims

to indemnity claims. For example, in connection with the bankruptcy case of Residential Capital, LLC, an affiliated debtor subject to repurchase liability has sued the associated loan originators for breach of loan-level representations and warranties, and for indemnification. Although a large number of the repurchase claims have been dismissed as untimely, a majority of the indemnification claims have survived motions to dismiss.

In all cases where indemnity is potentially available under the governing agreement, the indemnitee should pay close attention to any procedures contained in the agreement and be aware of applicable law. Often, indemnity provisions provide for specific notice requirements and require the indemnitor’s consent to any settlement. In any event, where no notice of an action is given to the indemnitor and the indemnitee proceeds to settle the action, the indemnitee generally must establish its own liability in the underlying action and that the settlement amount was reasonable and was entered into in good faith. Further, as a matter of public policy, a party may not be indemnified against losses incurred as a result of its own recklessness, intentional misconduct or fraud. Accordingly, entities subject to repurchase liability based on breaches grounded in fraudulent activity may face greater challenges obtaining indemnification.

Despite these pitfalls, in light of recent decisions governing RMBS repurchase litigation, indemnity claims have become more significant as an alternative to repurchase claims, and may become more prominent in the future as a source of recovery for parties subject to judgment or settlement for their role in the securitization process.

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