Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Oh, The Indemnity! New Claims May Follow RMBS Settlements

By **Joseph Cioffi**

Law360, New York (July 6, 2017, 12:55 PM EDT) --
Recent actions by certain defendants in pre-financial crisis residential mortgage-backed securities (RMBS) litigation, including Lehman Brothers Holdings, suggest that as defendants resolve claims against them, they may look to the underlying transaction documents, contract law or equitable principles to seek indemnity from other securitization parties for any settlement payouts, expenses or losses incurred. Consequently, payments in connection with settlements and verdicts may signify the beginning of a new six-year period under New York law to bring indemnity claims.

Joseph Cioffi

Background

Express indemnity provisions, such as those found in the transaction documents governing subprime residential mortgage-backed securities (RMBS), typically provide that if Party A (the indemnitee) becomes liable to Party C (a third party) as a result of acts or omissions by Party B (the indemnitor), then Party B will cover or reimburse Party A's losses, costs and expenses. Party A may negotiate for such indemnity rights wherever, based on its contacts with third parties, it believes there is a risk of claims against it based on Party B's conduct. The general notion is that, as between Party A and Party B, Party A should not be made to bear the costs associated with any failure by Party B to act as the parties agreed. In certain instances, the parties may agree that enforcement of indemnity obligations is Party A's sole remedy against Party B. In other instances, the parties may agree to indemnity as an additional or alternative remedy.

For example, mortgage loan originators and sellers, which typically have repurchase obligations in the event they breached loan-level representations and warranties, may also have indemnity obligations in favor of purchasers, such as sponsors and depositors, common defendants in RMBS repurchase litigation. Such indemnity provisions may be drafted broadly to provide purchasers with the right to recover legal fees and expenses and related costs, judgments, and other costs and expenses resulting from any claim, demand, defense or assertion in any way resulting from the seller's breach of representations and warranties.

Separately, servicers in RMBS deals may have similarly broad express indemnity obligations in favor of sponsors and depositors in the event they fail to notify such parties of breaches of representations and warranties, thereby contributing to their liability to third parties.

What the above situations have in common is the intent, evidenced by the indemnity provision, that Party B assume the risk of Party C's claim. Where express indemnity obligations do not exist, the parties may not have intended such shifting or allocation of risk. Nevertheless in such situations, parties may seek indemnity under the doctrine of implied indemnity or equitable principles.

Generally, implied indemnity is based on the idea that an agreement to perform a service contains an implied promise to perform it properly and therefore, to indemnify the counterparty for any foreseeable damages resulting from breach of its obligations. Accordingly, even where a party does not have indemnity rights against another, it may nevertheless seek indemnity for damages related to the other's failure to perform their contractual obligations (e.g., claims against RMBS servicers or trustees for failing to achieve agreed standards of care). Equitable principles may also be invoked to claim the burden of paying any damages should be shifted so that it more fairly falls on the shoulders of the party that caused the third party's claimed losses. Adjudication of nonexpress indemnity claims can be fact-specific, including in the determination of any wrongdoing, and subject to significant challenges.

Statute of Limitations for Indemnity Claims

Although courts have determined that time has expired on trustees and investors to bring repurchase and fraud claims for the last of the pre-crisis RMBS deals, the statute of limitations on any indemnity claim does not begin to run until the indemnitee incurs an indemnifiable loss. This means, under New York law for example, a defendant will likely have six years from the date of a settlement payment to start a lawsuit for breach of indemnity obligations. Consequently, potential indemnitors, who may believe they have put the last of RMBS litigation behind them, could now face the prospect of further suits for years to come.

Requirements Under Indemnification Claims

Even with a new limitations period to bring claims, however, several factors may limit the number of new lawsuits and their potential success.

First, indemnification provisions typically require compliance with procedural requirements, such as providing the indemnitor with prompt notice of an indemnifiable claim. This would appear to be Lehman's intention when it recently provided notice to a large number of mortgage loan originators of its request for an order from the bankruptcy court supervising its ongoing Chapter 11 to approve a multibillion dollar settlement with numerous trustees and investors.

In many instances, however, merely providing prompt notice of a claim would be insufficient. Under certain types of indemnity provisions, the indemnitee must also provide the indemnitor with the opportunity to defend the third-party claim that gave rise to the indemnity claim. Thus, a defendant in RMBS litigation that wanted to be the master of its own defense may not have complied with this basic procedural requirement.

If the indemnitee excluded a potential indemnitor from settlement negotiations with the third party, it may fail to meet the substantive requirement that any settlement on which the indemnity claim is based must be reasonable and entered into in good faith. In addition, a potential indemnitor may argue that the indemnitee's own conduct or knowledge of any loan defects that gave rise to the indemnitee's liability in the third-party litigation should preclude any recovery. Also, depending on the circumstances, a potential indemnitor may have an argument that the actions or events giving rise to the indemnitee's liability in the third-party litigation do not fall within the meaning of an indemnifiable claim.

In any case, practical considerations, more than the legal merits of any claim, may ultimately be what limit or delay any new suits for indemnity. Many potential indemnitors, such as loan originators, are no longer in business. Given the limited number of surviving players on both sides of the indemnity issue, the indemnitee will need to consider its past or current business relationship with any potential indemnitor and the potential impact on future business opportunities before starting any suit to enforce indemnity obligations.

Joseph Cioffi is a partner and chairman of the insolvency, creditors' rights and financial products practice group at Davis & Gilbert LLP.

Seiji Newman, a counsel at Davis & Gilbert, contributed to this article.