The Banking Law Journal

Established 1889

AN A.S. PRATT & SONS PUBLICATION OCTOBER 2013

The Banking Law Journal (ISBN 978-0-76987-878-2) (USPS 003-160) is published ten times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices. For customer support, please contact LexisNexis Matthew Bender, 1275 Broadway, Albany, NY 12204 or e-mail Customer.Support@lexisnexis.com. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., PO Box 7080, Miller Place, NY 11764, smeyerow@optonline.net, 631.331.3908 (phone) / 631.331.3664 (fax). Material for publication is welcomed — articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys.
POSTMASTER: Send address changes to The Banking Law Journal LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974.

When Is It Too Late for Investors to Bring RMBS-Related Claims?

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The authors explain that residential mortgage-backed securities litigation is in the early stages and due to conflicting decisions by lower courts the legal standards to be applied with respect to statutes of limitations are still somewhat in flux.

The subprime mortgage market collapsed more than seven years ago, but only recently has there been a rush to courthouses by investors to try to recover losses suffered on residential mortgage-backed securities ("RMBS") from sellers, sponsors and other securitization participants. The length of time since most subprime RMBS deals have closed has brought statutes of limitations to the forefront of defendants' attempts to dismiss such claims. Statutes of limitations are typically technical and straightforward to apply, but in the RMBS context they have required consideration of complex substantive issues. Although RMBS litigation is generally in the early stages, the application of statutes of limitations is already yielding controversial results in cases concerning the main types of RMBS-related claims brought by investors today.

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BACKGROUND

During the subprime mortgage boom, RMBS certificates were created through a process that involved multiple steps, including the aggregation of pools of mortgage loans from various originators by so called "sponsors" who then transferred those loans through "depositors" to issuing trusts. The trusts issued certificates which were sold to investors through an underwriter pursuant to various offering documents, including shelf registration statements, prospectuses, and prospectus supplements for each individual security offering.

Recent RMBS lawsuits have been in the form of fraud actions or "put-back" (*i.e.*, repurchase) actions. In fraud actions, investors have sued directly to recover their own losses based on alleged misrepresentations in the offering documents. In put-back actions, due to provisions commonly found in securitization transaction documents that restrict the ability of investors to bring breach of contract claims (so called "no action" clauses), a trustee has typically brought suit on behalf of all investors to enforce repurchase obligations based on alleged breaches of representations and warranties by sellers of the mortgage loans underlying the RMBS.

An investor deciding whether to either pursue a fraud action or request that the trustee pursue put-back may consider such factors as:

- the higher pleading standard for fraud claims that requires the elements of fraud to be pleaded with particularity;
- procedural hurdles related to put-back demands contained in securitization transaction documents, including notice and timing requirements and no action clauses;
- the fact intensive inquiry that may be required to resolve a put-back claim based on loan-level representations; and
- the applicable statute of limitations.

Under New York law, for example, a claim for fraud is untimely if it is brought more than six years after it accrues and more than two years after it has been or should have been discovered with reasonable diligence (the "discovery rule") by the plaintiff. In contrast, a breach of contract claim, such as a put-back claim, is barred after six years from the date it accrues, without the benefit to the plaintiff of any discovery rule. Accordingly, an investor giving primary weight to statute of limitations concerns may attempt to meet the higher pleading standard on a fraud claim, rather than pursue repurchase. However, recent decisions have blurred the typical straightforward application of statutes of limitations in both fraud and put-back cases, leading to unexpected and sometimes inconsistent results.

TIMELINESS OF PUT-BACK ACTIONS

The law regarding the timeliness of put-back actions has been shaped by two federal court decisions: *Structured Mortg. Trust 1997-2 v. Daiwa Fin. Corp.*[1] ("*Daiwa*") and *Lehman Bros. Holdings, Inc. v. Evergreen Moneysource Mortg. Co.*[2] ("*Evergreen*"). Those courts had held that under New York law, the statute of limitations begins to run at the time of the breach of the applicable representations and warranties (otherwise known as an "accrual-at-breach" rule). Justice O. Peter Sherwood of the Supreme Court of the State of New York recently followed this prevailing view in *Nomura Asset Acceptance Corp. Alternative Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc.*[3] ("*Nomura*"). However, days later, Justice Shirley Kornreich of the Supreme Court of the State of New York in *ACE Sec. Corp. v. DB Structured Products, Inc.* [4] ("*DBSP*") disagreed with the prevailing view and held that under New York law, the statute of limitations does not start to run on a put-back claim until the defendant refuses to satisfy a put-back demand. The DBSP decision is significant because it comes at a time when, under the prevailing view, the window may have been closed or was nearly closed on new put-back actions.

Prevailing Law

Evergreen and *Daiwa* courts rejected arguments that the statute of limitations begins to run when the plaintiff obtains knowledge of the occurrence of the breach. In addition, the *Evergreen* court specifically addressed and rejected the plaintiff's argument that refusal to repurchase was a separate breach of contract as to which its claim was timely. Applying the same reasoning, the *Nomura* court rejected the plaintiff's argument that the statute of limitations began to run upon the defendant's refusal to comply with a repurchase demand. The *Nomura* court looked instead to the fact that the repurchase demand was triggered by an alleged breach of representations and warranties and therefore the plaintiff possessed the right to demand payment back in 2005 when the representations and warranties were made. Accordingly, because the breach occurred more than six years ago, the claims were untimely under New York law.

Although *Evergreen*, *Daiwa* and *Nomura* all involved representations and warranties that the defendants made directly to the plaintiffs or their predecessors, the reasoning in those decisions would appear to apply with equal force to RMBS deal structures where sellers or sponsors "wrapped" or "backstopped" representations and warranties made by loan originators, agreeing to repurchase loans if the originators fail to do so within the relevant cure periods. In these instances, the statute of limitations for a claim based on a refusal to repurchase may start to run when the representation is made, which could be as early as the date the loan originator first made the representation, but in any event, no later than the closing of the securitization.

DBSP Decision Goes Against Prevailing View

Although the *DBSP* case involved similar facts to *Evergreen*, *Daiwa* and *Nomura,* the *DBSP* court diverged from the prior courts' reasoning and held that the statute of limitations did not begin to run until the defendant refused to satisfy a repurchase demand. The *DBSP* court relied on NY CPLR 206(a), under which, according to the court, the statute of limitations begins to run "when the party making the demand first becomes entitled to make the demand, and not from the time the actual demand is made." [5] Specifically, under the facts presented, the *DBSP* court determined that the trustee, which brought the action on behalf of a securitization trust, was not entitled to make a demand until after the defendant had discovered or was given notice of the breaches of representations and warranties and the relevant cure period lapsed. This determination is at odds with *Daiwa's* rejection of the plaintiff's argument that NY CPLR 206(a) saved its claims from being untimely.

The *DBSP* court also relied on New York's so called "continuing performance" doctrine that provides that where a contract provides for continuing performance over a period of time, each breach begins the running of the statute of limitations anew. Applying this view, the court found that the repurchase obligation functions as continuing insurance for the trustee such that a claim may be brought under New York law within six years after each refusal to repurchase.

The *DBSP* decision is at odds with prevailing law and its reasoning may be vulnerable to attack by defendants in RMBS put-back litigation. A troubling conclusion one could reach from the decision is that if the statute of limitations does not start to run until the date of refusal to comply with a repurchase demand, there would arguably be no limit on the time within which plaintiffs could bring a claim. The *DBSP* court seemed to acknowledge this problem and noted that a plaintiff must make a repurchase demand within a "reasonable" time. However, a standard that permits courts to decide on a case-by-case basis the reasonableness of timing of seemingly stale breach of contract claims may be said to be contrary to the fundamental objective of statutes of limitation — to prevent the revival of claims that remained dormant while memories were allowed to fade, evidence was lost and witnesses disappeared.

In addition, although the *DBSP* court suggested that a repurchase obligation is similar to a continuing guaranty, under established New York law regarding guaranties, an obligee's right to demand payment from the guarantor is deemed to accrue, and therefore the statute of limitations begins to run, at the time of breach by the obligor on the underlying debt,[6] not upon the guarantor's failure to satisfy a demand for payment. Also, the *DBSP* court's analogy to reinsurance cannot be squared with its holding that NY CPLR 206(a) saved the trustee's claim because the reinsurance case that the *DBSP* court primarily relied upon held that NY CPLR 206(a) did not apply in the context of that case.[7]

Given the difference in opinion among the courts, the *DBSP* and *Nomura* decisions have been appealed, but it may take several months for the appeals to be finally decided. In the meantime, an administrative judge ordered that going forward all newly filed actions in state court in Manhattan that allege misrepresentations in the sale of RMBS will be assigned to Justice Marcy S. Friedman. It appears that the decision to assign future cases to the same judge is an attempt, at least in part, to avoid additional inconsistent rulings on key issues impacting RMBS litigation. Nonetheless, as Justice Friedman does not yet have a public track record concerning RMBS cases as of the writing of this article, plaintiffs may feel encouraged to file seemingly untimely put-back actions.

TIMELINESS OF FRAUD ACTIONS

The consolidation of RMBS cases before Judge Friedman should provide more predictably in adjudication of RMBS fraud claims where there has not been a discernible prevailing view with respect to key issues impacting their timeliness.

Because most RMBS fraud cases have been filed in New York and plaintiffs in such actions have a principal place of business outside of New York, CPLR 202, also known as the New York borrowing statute, is typically implicated. This statute prevents nonresidents from forum shopping for a more favorable statute of limitations and "requires the cause of action to be timely under the limitations period of both New York and the jurisdiction where the cause of action accrued."[8] A cause of action accrues where the injury is sustained, which in the case of a purely economic injury, is typically where the plaintiff resides or has its principal place of business if the plaintiff is a corporate entity. Thus, even if an action is timely under New York law, defendants often have an opportunity to argue that it is nonetheless time-barred because the plaintiff has not satisfied the statute of limitations of the jurisdiction within which its principal place of business is located.

To avoid the need to satisfy both statutes of limitations of New York and the jurisdiction in which the parent bank is located, foreign investors have brought and may continue to bring fraud actions in the name of a "New York Branch" to support an argument that its injuries were sustained in New York. Investors are likely to have difficulty succeeding with such an argument, however, given that courts have held that a branch "is the same legal entity as its parent bank."[9]

Application of a Statute of Limitations with a "Discovery Rule"

As of the writing of this article, several significant decisions addressing the timeliness of RMBS fraud claims in New York have turned on the statute of limitations of other jurisdictions because the claims at issue were brought within six years and thus timely under New York law. U.S. District Court Judge Victor Marrero's decision in *Woori Bank v. Merrill Lynch*[10] *("Woori Bank")* is a good indicator of how a court may apply a statute of limitations that contains a discovery rule to RMBS fraud cases where the information on which a plaintiff relies in its complaint is arguably sufficient to place it on notice of its claims.

The *Woori Bank* court rejected the plaintiff's attempt to use public information that had been available for several years to supports its claims, while at the same time denying that it was aware of such claims. The court held that the fraud claims were time-barred under the three-year Korean statute of limitations regardless of whether the clock started to run for the limitations period under the New York discovery standard (when a plaintiff using reasonable diligence could have discovered the alleged fraud) or the more plaintiff-friendly discovery standard advanced by the investor (when a plaintiff could practically file a claim given the totality of the objective evidence).[11] The deadline to sue had passed because most of the supporting evidence in the complaint, including old articles, reports and government investigations, was available to the plaintiff by 2009, more than three years before the lawsuit was filed.[12] Moreover, the court noted that "[i]f Woori claims that this extensive publicly available information cited in its complaint supports its claims, then these public materials would also have contributed to the totality of the circumstances putting the bank on notice of possible claims."[13]

Certain state courts dealing with similar allegations have not been swayed by what the *Woori Bank* viewed as an inherent contradiction in plaintiffs' use of such information. For example, in *Stichting Pensioenfonds ABP v. Credit Suisse Group AG*,[14] the court held that whether the plaintiffs gave "prompt notice" to the defendants after they discovered or should have discovered that the certificates did not conform to the contract under which they were purchased, and thus satisfied the Dutch statute of limitations, was an issue of fact that could not appropriately be decided on a motion to dismiss. In addition, in several cases brought by Allstate Insurance Company ("*Allstate*"), Justice Eileen Bransten of the Supreme Court of the State of New York held that she could not conclude at the pleadings stage when Allstate with reasonable diligence should have known of a securities violation pursuant to the Illinois statute of limitations.[15]

The *Allstate* decisions, and other decisions holding similarly with respect to the application of discovery rules, may arguably be limited to the state laws at issue, under which, for example, a plaintiff is not put on notice of its claims until it could have known that the defendant allegedly had knowledge of the misstatements and acted with intent to deceive. However, in *Phoenix Light SF Ltd. v. ACE Sec. Corp.*,[16] Justice Kornreich relied on the reasoning in the *Allstate* decisions to reject the defendants' argument in their motion to dismiss that the claims were untimely under the German statute of limitations. (The German statute of limitations begins to run three years from the end of the calendar year in which the plaintiff becomes aware of its claims or failed to become aware as a result of its own gross negligence.) Accordingly, New York state court decisions seem to suggest that general, public information available years ago may be sufficient to plead fraud with particularity, yet for purposes of statutes of limitations, such information may not be adequate to put investors on notice of their claims. Appeals have been filed and it remains to be seen whether the holdings of these lower courts will stand.

Trigger Events Under a Discovery Rule

At least one federal court has looked to other key events, such as credit ratings downgrades, as a trigger of the limitations period. For example, in *Federal Housing Finance Agency v. UBS Americas, Inc.*[17] and *Federal Housing Finance Agency v. JPMorgan Chase & Co.*,[18] both of which concerned RMBS fraud claims brought under the Securities Act of 1933, Judge Denise L. Cote held that the occurrence of a ratings downgrade started the clock to commence the action. Although these cases involved Securities Act claims, courts may determine that a similar trigger applies to common law fraud claims under statutes of limitations that contain discovery rules.

Additionally, investors have argued for purposes of the discovery rule that they could not have had knowledge of claims prior to the release of the Financial Crisis Inquiry Commission's Final Report of the National Commission on the Causes of the Financial Economic Crisis, dated January 27, 2011 (the "FCIC Report"). This argument was rejected by the *Woori Bank* court, which noted that "the FCIC began with the large body of publicly available pre-existing literature developed by congressional committees, government agencies, academics, journalists, legal investigators, and many others that had already exposed serious indiscretions relating to the crisis."[19] In *Allstate*, however, the court suggested that the FCIC may in fact have put the plaintiffs on notice, though it declined the matter at the motion to dismiss stage.

CONCLUSION

RMBS litigation is in the early stages and due to conflicting decisions by lower courts the legal standards to be applied with respect to statutes of limitations are still somewhat in flux. Nevertheless, recent decisions are shaping the arguments of both plaintiffs and defendants and they will likely also influence the manner in which new claims are made. For example, if the FCIC Report is held to be a trigger event under the New York discovery rule, it will not, by itself, necessarily save future RMBS fraud claims from being untimely because the report is now already more than two years old. Thus, future RMBS-related lawsuits may be more likely to come in the form of put-back claims as opposed to fraud claims. Put-back claims may also become favored due to the *DBSP* decision. These actions will nevertheless continue to face significant challenges from defendants on substantive and procedural grounds in addition to timeliness. Ultimately, it remains to be seen how Justice Friedman and appellate courts will address the contested issues affecting the timeliness of RMBS-related actions.

NOTES

[1] No. 02 Civ. 323, 2003 U.S. Dist. LEXIS 2677 (S.D.N.Y. Feb. 25, 2003).

[2] 793 F. Supp. 2d 1189 (W.D. Wash. 2011).

[3] No. 653541/2011, 2013 NY Slip Op 50743(U) (Sup. Ct. N.Y. County, May 10, 2013).

[4] No. 650980/2012, 2013 NY Slip Op 23159 (Sup. Ct. N.Y. County May 13, 2013).

[5] 2013 N.Y. Slip Op. 23159, at 1 (internal quotations and citations omitted)

[6] *See* N.Y. Jur. Guaranty & Suretyship 3d § 317.

[7] *See Continental Casualty Co. v. Stronghold Ins. Co.*, 77 F.3d 16 (2d Cir. 1996).

[8] *Global Fin. Corp. v. Triarc Corp.*, 93 N.Y.2d 525, 528 (1999).

[9] *See Bayerische Landesbank, New York Branch v. Barclays Capital, Inc.*, No. 12 civ.

3294 (LLS), 2012 U.S. Dist. LEXIS 160489, at *2 (S.D.N.Y. Oct. 26, 2012).

[10] No. 12 Civ. 3993 (VM), 2013 U.S. Dist. LEXIS 17476 (S.D.N.Y. Feb. 6, 2013).

[11] *Woori Bank*, 2013 U.S. Dist. LEXIS 17476, at *12.

[12] *Id.* at *11.

[13] *Id.*

[14] 2012 NY Slip Op 52433(U), at 6 (Sup. Ct. N.Y. County Nov. 30, 2012).

[15] *Allstate Ins. Co. v. Morgan Stanley*, 2013 NY Slip Op 31130(U), at 19 (Sup. Ct. N.Y. County Mar. 14, 2013); *Allstate Ins. Co. v. Ace Securities Corp.*, Index No. 650431/2011, NYSCEF Dkt. No. 79, at 17 (Sup Ct, NY County, Mar. 14, 2013), *Allstate Ins. Co. v. Merrill Lynch & Co.*, Index No. 650559/2011, NYSCEF Dkt. No. 63, at 17 (Sup Ct, NY County, Mar. 14, 2013).

[16] 2013 NY Slip Op 50653(U), at 5 (Sup. Ct. N.Y. County April 24, 2013).

[17] 858 F. Supp. 2d 306, 321 (S.D.N.Y. 2012).

[18] No. 11 Civ. 6188 (DLC), 2012 U.S. Dist. LEXIS 158442, at *61-63 (S.D.N.Y. 2012).

[19] 2013 U.S. Dist. LEXIS 17476, at *18 (internal quotations omitted).