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How subprime RMBS can prepare us for subprime auto litigation in the time of COVID-19

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"Madness . . . is like gravity, all it takes is a little push."

- The Joker, The Dark Knight, 2008

As our readers know, as far back as 2017, we sounded the alarm on the parallels between pre-crisis residential-mortgage backed securities (RMBS) and today's subprime auto ABS.

Since then, we've shared the viewpoints of participants and analysts who have echoed reasons for concern and the competing reasons for disregarding those concerns. Despite all of the differences of opinions, however, and as we noted recently, there has consistently been widespread concern in the market that a macroeconomic shock could severely impact vulnerable auto subprime borrowers' ability to pay.

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Now the shock is here and it's bigger than imagined.

Unless governmental action and scientific breakthroughs quell the crisis quickly, defaults are bound to spread and overcome structural protections. When investors suffer losses, the battles over loss allocations will begin. In that case, COVID-19 is the push that will bring on the next wave of ABS litigation.

The pandemic shows us what happens when there's a failure to plan. It's time to look at what those battles may look like.

REALISTIC EXPECTATIONS BEGIN WITH RMBS

Subprime auto litigation could be expected to mirror RMBS litigation in scope and scale, and could wind its way through the courts in much the same way until finally running its course. Lawyers who have lived through RMBS litigation will bring to bear the knowledge and expertise they've gained, and auto ABS participants who were involved in RMBS deals will know the drill.

But there are misconceptions and knowledge gaps in the market regarding RMBS litigation that could lead to unrealistic expectations and missed opportunities for those who don't have the benefit of RMBS litigation experience. Below are a few of the most consequential.

Misconception #1: The tidal wave of mortgage defaults witnessed during the 2008 financial crisis must have been caused by shoddy mortgage lending practices, so if subprime auto lending practices are proper, everything will be fine.

- No, widespread borrower defaults were more likely caused by the crash of the housing market, which, in turn, brought the securitization market to a halt and caused losses to RMBS investors, who then sought to recover losses through repurchase actions based on breaches of loan-level representations and warranties, and fraud actions based on misstatements in offering materials.

- The mounting losses called into question the underwriting originally performed on the mortgage loans and prompted RMBS investors to conduct sample reviews of loan pools, which investors alleged revealed all sorts of misdeeds in lending and appraisal processes, and formed the basis for repurchase demands and fraud claims. Significantly, these sample reviews were sufficient to support lawsuits as to all loans in RMBS deals, not just those that were reviewed and were allegedly defective. In fact, plaintiffs were permitted to bring suits on all loans by alleging pervasive breaches, without identifying specific individual breaches for each loan.

- The economic crisis may or may not ultimately freeze the auto ABS market, but it has already caused the type of massive unemployment that suggests a large spike in defaults and lower recoveries are on the horizon, which will lead to losses on at least subordinated and lower quality tranches. When investors incur losses, they will commence or cause the commencement of the same type of litigation commenced with regard to RMBS, using the same playbook.

- Key Takeaway: Good lending practices will not prevent claims when the rubber hits the road. The drive to shift or allocate losses is an unstoppable force. Just as RMBS courts yielded and opened the door to massive litigation, the same should be expected for subprime auto. Once the door is opened, and depending on whether the action is in state or federal court, plaintiffs may be granted leeway to develop their claims through discovery before any decision on a motion to dismiss.

Misconception #2: The COVID-19 crisis is going to create liability for subprime auto sponsors, just like the financial crisis did for RMBS sponsors.

- No, the COVID-19 crisis will not create liability; however, untrue statements in the deal documents will. The key issues in evaluating legal exposure to repurchase claims of the type that comprised a large portion of RMBS litigation against sponsors are:

  a. Whether the representations and warranties were true at the time they were made and

  b. Whether lawsuits are timely filed.

  Under New York's statute of limitations for breach of contract, repurchase claims will likely need to be filed within six years from the deal closing.

- If investors sue directly for fraud based on misrepresentations in offering documents, a further issue may become the point in time that the investor became aware, or should have become aware, of its claims in order to meet applicable statutes of limitations. For example, several RMBS fraud claims brought in 2013 were thrown out as untimely under New York's two-year "discovery rule" because it was found that the plaintiff should have known - based on the widespread reports of subprime mortgage issues - of its claims by 2010. Separately, fraud claims under securities laws may have shorter limitations periods.

- Key Takeaways: First, there are points in time when liability crystallizes under the law, and now is not one of them. The legal exposure already exists, if at all, based on untrue statements already made. The crisis, combined with losses and investor diligence, will only reveal any such misrepresentations. Second, some claims, such as for fraud and under certain securities laws, may have a shorter window of opportunity for investors versus repurchase claims. In other words, it can get late early for those who sleep on their claims.

Market Misconception #3: The requirement that a breach have a material and adverse effect on the loan as a condition to repurchase will only be satisfied if the loan is in default.

- Not necessarily. Most RMBS courts have held that, despite the market practices in place at the time of the deal, plaintiffs need only show that a breach of representation and warranty caused a "material increased risk of loss," whether or not the loan is in default.

- Key Takeaway: It remains to be seen if the same standard is applied in subprime auto, but it serves as reminder that legal standards don't always match expectations based on in-market experience.

LOOKING AHEAD

It doesn't take someone who will rattle the cages to see that the market's direction now largely depends on things that are beyond the control of participants - the effectiveness of government relief and stimulus programs, the success of scientific initiatives, compliance with social distancing and the coronavirus's rate of mutation. While there are deals, and tranches in deals, which are better positioned than others to withstand spikes in defaults and lower recoveries, COVID-19 is likely to first impact investors in lower quality tranches and deals with lower reserve accounts and credit enhancements.

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All participants need a realistic view of their position and potential outcomes when pushed to litigation. Three years ago, our experience in all phases of the subprime mortgage market cycle, from the good times of M&A, to the bad times of large-scale repurchase and fraud litigations, with several bankruptcies and distressed sales along the way, helped us spot the warning signs. Our continued work in the trenches of RMBS litigation to this day shows there is much in developed and developing law of RMBS from which subprime auto can learn.

And . . . here . . . we . . . go . . .

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