

INSOLVENCY, CREDITORS' RIGHTS & FINANCIAL PRODUCTS

>>ALERT

OH, THE INDEMNITY! CLAIMS FOR REIMBURSEMENT MAY FOLLOW RMBS LITIGATION SETTLEMENTS

Recent actions by certain defendants in residential mortgage-backed securities (RMBS) litigation, including Lehman Brothers Holdings (Lehman), suggest that as defendants resolve claims against them, they may look to indemnity provisions in the underlying transaction documents to seek reimbursement or contribution from other securitization parties for any settlement payouts or losses incurred. 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.

BACKGROUND

Indemnity provisions, such as those found in the transaction documents governing subprime RMBS, typically provide that if a party (the indemnitee) becomes liable to a third party as a result of acts or omissions by another party (the indemnitor), then the indemnitor will cover or reimburse the indemnitee's losses, costs, and expenses.

For example, sponsors and depositors, common defendants in RMBS repurchase litigation, may have contractual indemnity rights against loan originators for making any misrepresentations, or against servicers for failing to notify them of the same, that may have contributed to the defendant's liability. Where contractual indemnity obligations do not exist, parties, such as RMBS trustees, may seek indemnity from other deal parties under principles of implied or common law indemnity.

THE BOTTOM LINE

The statute of limitations may have expired on new claims for repurchase or fraud based on alleged loan defects in pre-financial crisis subprime RMBS deals, but a settlement or litigation award paid out by a defendant may mark the beginning of a new six-year limitations period for the defendant to seek reimbursement or contribution from other deal parties. However, there are procedural, substantive, and practical challenges to maintaining these claims that may limit their effectiveness.

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 that, under New York law, a defendant will likely have six years from the date of a settlement payment to start a lawsuit for breach of indemnity obligations. Potential indemnitors, therefore, 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.

>> continues on next page

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This would appear to be Lehman's intention when it recently provided notice to thousands of mortgage loan originators of its request for an order from the bankruptcy court supervising its ongoing chapter 11 case to approve a multi-billion 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.

In addition, 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. Also, 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. Further, 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.

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