

# As seen in *Non-Prime Times*

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## Lessons Learned in RMBS Litigation Will Steer Sub-prime Auto Litigation

Beyond COVID-19's impact on the public's health and safety, massive unemployment and extreme economic uncertainty are causing a realignment of Americans' financial priorities in ways that may shape the credit markets for years to come. This is especially true for those exposed to the most financially vulnerable of borrowers, such as, sub-prime auto asset-backed securities (ABS). With the prospect of rising delinquencies and investor losses, the market is nearing the event horizon of litigation on behalf of investors that mirrors the battles over loss allocations that ensued, and continues to this day, as a result of the last financial crisis.

It's time for sub-prime auto participants to become familiar with the roadmap provided by nearly a decade of sub-prime residential mortgage-backed securities (RMBS) litigation.

### CONCERNING EARLY DATA

Data from the first few months of the COVID-19 pandemic gives reasons for concern. S&P has reported broad auto extensions being granted for both prime and sub-prime auto with expectations this will need to continue for several months. Auto loan delinquencies, which were already alarmingly high at the end of last year, passed the 5 percent mark in Q1 2020 — the highest level since 2011. And yet, it's still too early to gauge the full extent of the pandemic's impact on loan performance.

Rating agencies are expecting a decline in receivables for auto loan and lease securitizations, with a number of deals already on downgrade watch. All eyes are on the lowest subordinate tranches who will face the first losses.

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When the sub-prime auto market hits its worst moment, expect investor losses to bring on the next wave of ABS litigation.

Sub-prime auto ABS litigation could be expected to mirror RMBS litigation in scope and scale, 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.

## MISCONCEPTIONS REGARDING RMBS LITIGATION

**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 sub-prime 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.
- >> 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 litigation using the same RMBS 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.*

**Misconception #2:** The COVID-19 crisis is going to create liability for sub-prime 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:
  - Whether the representations and warranties were true at the time they were made and
  - 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. 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 sub-prime mortgage issues — of its claims by 2010. Separately, fraud claims under securities laws may have shorter limitations periods.

*Key takeaways: 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. Some claims (fraud and certain securities claims) may have a shorter window of opportunity for investors versus repurchase claims. 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 market practices, 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 sub-prime auto, but it serves as a reminder that legal standards don’t always match expectations based on in-market experience.*

## THE OUTLOOK

The market’s direction now largely depends on things that are beyond the control of participants — the effectiveness of government relief programs, the success of scientific initiatives, and compliance with social distancing. All participants need a realistic view of their position and potential outcomes when pushed to litigation. 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 sub-prime auto participants can learn.