Hedge Fund Law Report hflawreport.com

Mar. 14, 2024

Mortgage-Related Assets

Opportunities for Private Fund Managers in CMBS Repurchase Litigation

By Justin M. Ellis, *MoloLamken LLP*

Following the 2008 financial crisis, many investment advisers – including advisers to private funds – pursued "repurchase" litigation claims in connection with residential mortgage-backed securities (RMBS) securitization trusts. Such claims compel the sponsor of a securitization trust to repurchase assets it sold to the trust, with the proceeds flowing to investors through the trust's waterfall. The following decade of litigation clarified the scope of the repurchase remedy, often in plaintiffs' favor. Now, with increasing dislocation in the commercial real estate market, a similar but more targeted opportunity may exist in connection with commercial mortgage-backed securities (CMBS) trusts.

This article explains the repurchase remedy, describes how its scope was clarified in the context of RMBS litigation and outlines the opportunity in CMBS trusts.

For insights from other MoloLamken attorneys, see "Agency Power and Adjudication: The Government Seeks Supreme Court Review of *Jarkesy v. SEC*" (Jun. 8, 2023).

Repurchase Remedies in Securitization Trusts

Although securitization trusts have a range of collateral types, payment priorities, certificate holder rights and other features, they all follow the same basic structure. A sponsor pools assets and conveys them into a trust, which then issues debt securities. Investors receive payments from the securities as the assets generate income. This pass-through structure has multiple advantages, including:

- efficiency;
- diversification of risk;
- bankruptcy remoteness from the sponsor; and
- favorable tax treatment in many cases.

However, the structure also has an inherent disadvantage for investors because of the asymmetry of information they face compared to the sponsor. For example, investors in the securities do not have the same knowledge as the sponsor does about the quality of the collateral. Such asymmetries of information about the quality of collateral can cause market collapse because investors will insist on paying lower prices for collateral of unknown quality.

Securitization trusts address this problem through representations and warranties backed by a repurchase remedy. Specifically, the sponsor makes representations and warranties about the assets' quality and characteristics as of the closing date. For example, in a mortgage-backed securities trust, a sponsor may represent that:

- none of the loans are in default;
- the loans' origination complied with applicable law; or
- information about the loans on a defined "Mortgage Loan Schedule" is correct.

Further, upon notice or discovery that a given asset is in breach of those representations and warranties, the sponsor promises to repurchase the asset from the trust at a contractually defined "repurchase price." In the case of a loan, that price is typically the loan's unpaid principal balance and accrued interest. Proceeds from a repurchase are then distributed to investors through the trust's waterfall, often as a defined type of unscheduled principal called "subsequent recoveries." By assuring certificate holders that a trust's assets will either meet bargained-for quality standards or be repurchased, the repurchase remedy reduces information asymmetry and allows investors to understand the risk and return of the securitization certificates in which they invest.

Crucially, however, the repurchase remedy cannot be enforced in the usual course directly by investors in a securitization trust. Rather, the authority to enforce the repurchase remedy is typically vested in the trust's trustee, a servicer or another entity that is charged to act in the interests of certificate holders. The party vested with that enforcement authority may choose of its own accord to enforce the trust's repurchase rights, or, in appropriate circumstances, investors may direct such party to pursue repurchase claims if they first offer indemnification to that party against its costs and losses in doing so. Such direction and indemnity agreements usually require the directing investor to hold a certain percentage of the trust's certificates or of a given class of certificates.

RMBS Repurchase Litigation

After the 2008 financial crisis, the repurchase remedy became a vital tool to mitigate losses for investors in RMBS trusts. In the lead-up to the crisis, originators and sponsors had conveyed large numbers of poorly underwritten, if not fraudulent, mortgage loans into private-label RMBS trusts marketed to investors.

See "$16-Million Enforcement Action Against Merrill Lynch Demonstrates SEC's Continued Pursuit of Misleading Broker Sales Talk and Excessive Markups in Mortgage-Backed Securities Trading" (Jul. 19, 2018); and "SEC Settlement With Ex-Goldman Head RMBS Trader Highlights Risk That Puffery May Become Misrepresentation When Trading Illiquid Securities" (Sep. 8, 2016).

Although primary investors could, in some instances, recover directly against sponsors through fraud claims under federal securities laws or state common law, those causes of action impose strict time limits and have higher burdens of proof for showing fraudulent intent, reliance by the plaintiff on the fraudulent statement and causation. By comparison, a breach of contract claim for enforcement of the repurchase remedy enjoys a longer statute of limitations – six years from the trust's closing date under New York law – and has less demanding standards of proof. As long as a given loan is in material breach, it is subject to repurchase – regardless of whether the specific breach caused any particular losses or the sponsor specifically intended for investors to rely on the particular representation. Thus, when properly and timely enforced, repurchase claims offered a powerful tool for investors in RMBS trusts to be made whole for losses from shoddy securitization practices.

Notably, the repurchase remedy also offered a valuable investment strategy for investors willing to pursue more opportunistic, litigation-based trades. One of those strategies entailed purchasing RMBS certificates that were trading at a discount in the wake of the financial crisis. The investor would then direct RMBS trustees to first serve repurchase demands and then, if sponsors did not repurchase loans or settle those demands, bring repurchase claims in litigation. Given that RMBS trust agreements (typically called "pooling and servicing agreements") were executed in New York and have New York choice-of-law clauses, such claims were typically brought in New York state or federal court. Then, once a judgment was recovered or a settlement was reached, the directing investor would obtain a profit when repurchase proceeds were paid through the trust's waterfall. Such a strategy required careful analysis of:

- the particular collateral subject to repurchase;
- the costs of direction and indemnification;
- the time and cost of litigation; and
- the particular proceeds that a certificate holder stood to receive in a trust waterfall.

Regardless of the strategy driving RMBS litigation, the numerous repurchase cases brought after the financial crisis produced multiple decisions that clarified the scope of the remedy under New York law. Many of those decisions were favorable to investors. For example:

- As described above, multiple courts held that a breach does not have to specifically cause loss to be "material" and thus subject to repurchase. Rather, it is enough for materiality purposes that the type of breach increases the investors' risk of loss (*MASTR Adjustable Rate Mortgages Tr. 2006-OA2 v. UBS Real Est. Sec. Inc.*).
- A loan does not need to be in default to be subject to repurchase (*MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*).
- A trustee may directly seek damages for a breach of a representation and warranty, and is not limited to specific performance of the repurchase remedy (*Deutsche Bank Nat'l Tr. Co. v. Morgan Stanley Mortg. Cap. Holdings LLC*).
- The repurchase remedy extends even to liquidated loans (*Nomura Home Equity Loan, Inc. v. Nomura Credit & Cap., Inc.*).

In addition, courts have tended to read representations and warranties broadly and in an investor-friendly manner, rejecting technical interpretations by defendants that limit their liability. For example, courts have held that representations that the Mortgage Loan Schedule containing information about the loans is "complete, true, and correct" warrant that the information on that schedule is objectively correct – not merely that it was correctly transcribed by the sponsor (*MBIA Ins. Corp. v. Credit Suisse Sec. (USA) LLC*).

At the same time, courts also clarified that repurchase plaintiffs must strictly comply with the requirements of the repurchase protocol:

- The statute of limitations for a repurchase claim expires six years from a trust's closing date, regardless of when breaches of representations and warranties were discovered (*ACE Sec. Corp v. DB Structured Prod., Inc.*).
- To trigger the repurchase obligation, a responsible party must receive loan-by-loan pre-suit notice of each loan asserted to be in breach (*U.S. Bank N.A v. DLJ Mortg. Cap., Inc.*).
- Attempts by repurchase plaintiffs to avoid the requirements of the repurchase remedy by alleging or trying to prove that a defendant was grossly negligent have been rejected (*Matter of Part 60 Put-Back Litig.*).

CMBS Repurchase Litigation

State of the CMBS Market

The lessons from the RMBS repurchase trade are timely now given increasing dislocation and potential mounting losses in CMBS. Following the coronavirus pandemic and rapid interest rate hikes, commercial real estate prices have declined, especially in the office sector. According to media reports, commercial property values overall in the U.S. have declined more than 21% from their 2022 peak, with one analysis finding that commercial real estate valuations dropped by 42% on average in 2023.

Given this precipitous drop in valuations, many commercial real estate loans are in distress. A recent NBER working paper estimates that nearly 14% of all commercial loans securitized in CMBS – and 44% of all office loans – appear to be underwater, *i.e.*, the loan's balance is larger than the value of the property securing that loan. And that decline comes at a vulnerable time for the commercial real estate market, with a large proportion of loans overall coming due in 2024.

This combination of dropping prices, increasing distress and looming maturities will mean losses for CMBS investors, especially those that hold lower rated, non-investment grade "B-piece" securities. An analysis by J.P. Morgan Chase last year predicted that 21% of outstanding office loans would default, with total losses to CMBS investors ranging from $35 to $60 billion.

Further, there is evidence of potentially widespread fraud in commercial underwriting. As *ProPublica* has reported, a whistleblower has alleged that numerous properties in CMBS trusts sponsored by two investment banks have evidence of inflated net operating incomes.[1] That allegation is corroborated by a study from the University of Texas-Austin, which concluded that nearly 28% of CMBS loans underwritten between 2013 and 2019 overstate actual net income by 5% or more. Of course, although these allegations raise suspicions of income inflation and fraud across the CMBS market, fraud or other actionable wrongdoing for any given loan will have to be proven on a case-by-case basis.

See "SEC Complaints Against Former CMBS Traders Highlight Need for Fund Managers to Verify Broker Pricing for Thinly Traded Securities" (Jun. 1, 2017).

RMBS Litigation Versus CMBS Litigation

Given the distress in the commercial real estate market, opportunities for CMBS repurchase litigation may arise for appropriate loans and trusts. Investors, such as private fund managers, seeking to make repurchase claims can take advantage of the favorable law developed in prior RMBS litigation. At the same time, investors should be aware that CMBS pooling and servicing agreements often have significant differences from RMBS agreements.

One major – and favorable – difference is that, in many CMBS pooling and servicing agreements, repurchase claims are subject to expedited arbitration before an industry expert. For example, the agreement may specify that:

- the arbitrator must have a certain number of years' experience in the commercial real estate industry;
- the arbitral hearing must be held within a set period of time; or
- the arbitrator must issue a decision within a set period of time after the hearing.

Such arbitration clauses promise to drastically reduce the cost and delay of pursuing repurchase claims in CMBS trusts compared to RMBS trusts, which often required expensive and time-consuming litigation.

At the same time, CMBS trusts also commonly have features that, combined with court rulings on RMBS, make the prior approach to RMBS litigation inappropriate. In post-financial-crisis RMBS cases, trustees would often bring suit on hundreds or thousands of residential mortgage loans at a time, using either a loan-by-loan review or a statistical sampling approach. Such claims were often based on broad, investor-friendly representations and warranties, such as representations that the loans all complied with underwriting guidelines or that the loans' appraisals complied with professional standards. Those sweeping kitchen-sink tactics are no longer possible after the New York Court of Appeals' ruling that an enforcing party must give pre-suit notice of breaches on a loan-by-loan basis.

Moreover, CMBS representations and warranties are often not as strict as the representations and warranties made to investors in RMBS in the lead-up to the financial crisis. Although the scope of representations and warranties will vary from trust to trust, the most common candidates for repurchase may be loans that had inaccurate information, fraud in the origination of the loan or significant violations of local zoning or other laws.

Thus, private fund managers pursuing repurchase claims in CMBS should consider a more targeted strategy of finding loans with serious defects in trusts with favorable enforcement language and a clear path toward recovery through the trust's waterfall. That strategy will require more careful planning than the shotgun approach seen in early RMBS litigation. At the same time, the nature of CMBS trusts can make such a strategy worthwhile. Given that a single large commercial loan can have a repurchase price equal to tens or hundreds of residential mortgage loans, and given the opportunity for recovering that repurchase price far faster through expedited arbitration, a targeted approach may well produce favorable results compared to traditional RMBS litigation.

Conclusion

As turmoil unfolds in the commercial real estate market, private fund managers should consider whether repurchase claims might be appropriate. The scope of those claims has been substantially clarified by the proceeding decade of RMBS litigation. However, CMBS and RMBS repurchase claims are not the same, and fund managers should understand the differences. In consultation with counsel, fund managers can develop targeted repurchase claims to identify individual loans that may be subject to repurchase and that can generate appropriate returns.

Justin Ellis is a partner in the New York office of MoloLamken LLP. He tries cases and argues appeals in complex commercial disputes, particularly in the areas of distressed debt, bankruptcy and structured-finance litigation.

[1] Note that MoloLamken LLP represents this whistleblower.