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The Flow Challenge

RMBS Putback Litigation 2012: Actions By or Against the Trustees?

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As we write, parties with an interest in the proposed \$8.5 billion **Bank of America** residential mortgage-backed securities (RMBS) representation and warranty settlement are in the midst of motion practice, jurisdictional challenges and settlement negotiations. In addition, for well over a year, institutional investors and other market participants have been investigating a number of avenues for enforcement of mortgage loan-level representation and warranty breaches, so-called “putbacks.” In our experience representing investors and third-party servicers in these endeavors, some putback repurchase counterparties have honored their contractual putback obligations, while others have been reluctant to do so. Likewise, some RMBS trustees have been more willing than others to facilitate the efforts of investors to pursue putback remedies.

To date, hundreds of billions of dollars in RMBS trust assets (if not more) have wasted away, and a material portion of that waste relates to the selling of assets into RMBS trusts in breach of specific representations and warranties. As 2012 approaches, bringing with it the possibility of the lapsing of statutes of limitation in New York for 2006-vintage transactions, we believe it is instructive both to assess the state of RMBS putback efforts, generally, and to discuss how the trustee/investor dynamic may evolve over time.

The State of RMBS Putbacks



Jonathan Wishnia

To understand the state of RMBS putbacks, it is necessary to understand the typical RMBS trust structure and distinguish the structure from a traditional New York trust. A typical RMBS trust is a New York common law trust in which the related trustee (rather than the trust itself, which is a legal fiction) holds the assets for the benefit of certificateholders (who are the beneficiaries of the trust). Under this legal structure, the trustee itself is recognized under New York law as the party-in-interest for purposes of, among other things, defending the interests of the trust’s beneficiaries.

The nature and scope of this trust relationship, however, has been at issue in light of historic wasting of trust assets. As noted above, upwards of hundreds of billions of dollars worth of vintage-year 2006 and 2007 RMBS trust have gone to waste. Under traditional New York trust law, a trustee overseeing such monstrous wasting would be bound to take action to limit or remedy this wasting, because a traditional New York trustee owes fiduciary duties to the trust’s beneficiaries.

Most RMBS trustees, though, liken their obligations not to those of a traditional trustee, but to that of an indenture trustee, a party whose trust responsibilities are cabined by the express provisions of the indenture, and generally understood to be administrative in nature prior to an event of default. Accordingly, and despite this waste, the typical RMBS trustee has refused to seek, or erect substantial roadblocks for investors seeking putbacks in the absence of either (a) the existence of events of default (which are often predicated on a notice or declaration by the trustee and are notoriously difficult to prove in the absence of litigation), or (b) particularized information establishing specific breaches for a mortgage loan or group or loans owned by the trustee on behalf of the trust fund.



Scott Walker

The general refusal by RMBS trustees to act has put these institutional investors in a precarious position. Many institutional investors are regulated entities or fiduciaries to their own investors and, even if they aren’t, may have suffered tens or hundreds of millions of dollars in RMBS losses (if not more). These investors want to—and, in certain instances, are required to—seek remedies for their losses, to the extent of available contractual claims, and would do so if afforded the opportunity.

If the opportunity for remedying the wasting of trust assets is available, but for the refusal of the trustee to act or at least facilitate action, these investors must now consider whether action against the trustee is appropriate. This is particularly important, given the paucity of case law addressing an

RMBS trustee's duty to act at all, let alone under the current circumstances in which (a) there is a massive amount of publicly available data from numerous sources evidencing the collapse of a sound mortgage origination and securitization process in the 2000s, and (b) the events of default in a typical indenture trust structure (such as a failure of the securities to pay principal and interest) that would trigger the indenture trustee's fiduciary duties bear no reasonable relation to the events of default in RMBS transactions (which are principally servicing-focused and do not relate to the sale of mortgages at issue in the putback context or otherwise).

The Evolving Trustee/Investor Dynamic

In the standard RMBS transaction, regrettably, the trustee is often the only party that can remedy the wasting of trust assets. More specifically, many RMBS transactions were structured as passive investments, so much so that both prior to and after closing, investors were not able to access collateral and credit files relating to the mortgages that collateralized the deals. Instead, trustees—on behalf of certificateholders as trust beneficiaries—were given contractual audit and inspection rights. These rights, if exercised, would afford the reviewing party access to sufficient information and materials to build a deal-level putback case.

With a limited number of exceptions (including publicly disclosed matters, such as the proposed Bank of America settlement and a number of private putback negotiations occurring at this time), trustees have been unwilling to either take direct action or facilitate access to the information necessary to remedy these wasted trust assets, despite their knowledge that the information supporting a putback remedy exists and need only be organized for enforcement purposes. Investors cannot, and should not, hold the trustee responsible for loan-level breaches (because the trustee did not make the loan-level representations and warranties), but the refusal of the typical RMBS trustee to provide investors an avenue for pursuing remedies of those breaches may force those investors to bring claims against the trustees.

At this point, the two most probable outcomes to the putback situation are (a) trustees will investigate and commence substantial enforcement negotiations and proceedings against repurchase counterparties or (b) investors will bring suits against the trustees for failure to do so, especially as statutes of limitation barring putback enforcement continue to expire. As gatekeepers heading into 2012 (the first potential statute of limitations milestone year), the RMBS trustees, therefore, can either do nothing or cause enforcement activity, either themselves or by actively allowing bondholders to do so.

Under a "do nothing" scenario, RMBS assets will waste away without remedy. At some point after statutes of limitation have lapsed and deals have been collapsed or depleted substantially all of their assets, investors who were prohibited from causing

putback enforcement will look to the trustee to make them whole. In a perfect situation for the reticent RMBS trustee, where courts find that the trustee had no duty to investigate or enforce, the trustee will likely bear the cost of that successful defense, because trust assets will not be available to pay attorneys' fees. While legally vindicated, the trustee will have won that battle at a cost far in excess of the fees received for its work on the given transaction or set of transactions at issue. In a less favorable situation for trustees—where investor claims survive initial motion practice—trustees will find themselves forced to consider settlements at amounts almost as staggering as the Bank of America settlement numbers, again without any party or trust fund to indemnify them for such

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settlement amounts and without the massive profits that existing repurchase counterparties earned in 2006 and 2007.

Hope for Investors?

In our experience, one need not review many loan files to find the existence of representation and warranty breaches on a systemic basis, ranging from specific problems like fraud in underwriting to the more general problems of certain originators lending money to almost any borrower for any property. Moreover, courts are increasingly receptive to the use of sampling analyses to support claims as to the massive pools of loans that secure RMBS deals.

Given that the trustee had no part in originating or servicing the assets securing the deals for which they act as trustee, we hold out hope that the unfortunate threat of litigation against trustees and massive forced settlements will lead trustees to be more proactive, either by investigating these matters themselves or by facilitating bondholders' investigations. There is very little question that material waste was suffered by RMBS trusts arising out of breaches of representations and warranties. The question now is whether the parties that breached those representations and warranties bear the final cost of that waste or, because of their unnecessary intransigence, RMBS trustees do.