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SECURITIES

Securities Litigation Forecast: Will Trends in RMBS Litigation Influence the CMBS Litigation Trajectory?



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In recent years, U.S. residential mortgage-backed securities (“RMBS”) litigation has captured the attention of securities lawyers. More recently, lawsuits involving commercial mortgage-backed securities (“CMBS”) are beginning to be filed. Despite the similarities in name of RMBS and CMBS, publications addressing key lessons to be drawn from RMBS cases and applied to the growing line of CMBS cases are scarce. As described below, developments in RMBS litigation may impact future CMBS litigation, and securities lawyers involved in

high-stakes CMBS litigation will benefit from understanding significant RMBS cases that may shape, in similar or dissimilar fashion, the CMBS legal landscape.

An Overview of RMBS and CMBS Litigation

In the wake of the 2008 mortgage crisis, various stakeholders have pursued claims related to RMBS loans. Plaintiffs in RMBS cases generally include sophisticated investors, RMBS trustees, and insurers; the legal claims differ depending on which entity brings suit. Individual investors, sometimes on behalf of a purported class, often allege that the RMBS offering documents contained material misrepresentations or omissions regarding the underlying loans. RMBS trustees, on the other hand, typically assert claims for breaches of representations and warranties made in the applicable pooling and servicing agreements (“PSAs”) or claims relating to duties to provide the trustee with access to loan and servicing documents. Insurers typically allege breaches of representations or warranties made in the RMBS transaction documents or claims that they were fraudulently induced to issue policies based on incomplete information. Thus, RMBS litigation generally centers on the underlying loans, the corresponding origination and due diligence process, and the governing agreements.

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Although there has been limited CMBS litigation to date, one can expect certain players in CMBS litigation to try to mimic RMBS litigation in material respects. The specifics of any case will depend on the particular facts, roles of the parties, and language of the governing agreements, but CMBS claims could arise against underwriters, issuers, dealers, and possibly rating agencies, for fraud, misrepresentation, breach of contract, as well as securities violations.

Key Cases in RMBS Litigation

1. Retirement Board: Statistical Sampling One of the most significant RMBS cases, *Retirement Board of the Policemen's Annuity and Benefit Fund of Chicago v. Bank of New York Mellon*, 775 F.3d 154 (2d Cir. 2014), addressed the use of statistical sampling to prove liability. In *Retirement Board*, the plaintiff certificateholders sued the trustee for losses allegedly caused by the originator's breaches of its representations and warranties. *Id.* at 156. The certificateholders alleged, among other things, that the trustee violated its contractual duties under the trusts' governing agreements. *Id.* at 157. The trustee moved to dismiss, arguing that the certificateholders lacked standing to bring claims on behalf of investors in the hundreds of trusts in which the certificateholders themselves did not invest. *Id.* at 158. The district court granted the motion, holding that the certificateholders did not have standing to bring claims pertaining to RMBS trusts in which no named plaintiff had invested. *Id.* The certificateholders appealed, seeking to use statistical sampling to show that loans in all of the trusts were defective. *Id.* at 162.

The Second Circuit Court of Appeals affirmed the district court's dismissal for lack of standing, holding that plaintiffs may not use samples of loans pulled from various trusts to show that loans in all of the trusts were defective, to establish liability of a defendant trustee. *Id.* at 163. The court held that plaintiffs must prove their claims "loan-by-loan and trust-by-trust." *Id.* at 162. The court further held that plaintiffs have the burden of proof with respect to each alleged breach regarding each loan for which they seek relief. *Id.* In light of this holding, parties in a CMBS context should be prepared to address whether representation or warranty breaches or losses arising from other theories of liability must be established on a loan-by-loan basis rather than through statistical sampling.

2. Royal Park: Statistical Sampling Another RMBS case that is instructive in the CMBS context is *Royal Park Investments SA/NA v. HSBC Bank USA National Association*, Nos. 14-cv-08175, 14-cv-09366, 14-cv-10101, 15-cv-02144, 15-cv-10096, and 15-cv-10032, 2017 U.S. Dist. LEXIS 35353 (S.D.N.Y. Mar. 10, 2017), which also addressed the use of statistical sampling to establish liability. In *Royal Park*, dozens of certificateholders sued the trustee, alleging that the trustee violated its contractual duties under the PSAs, mortgage loan purchase agreements ("MLPAs"), and other related agreements. *Id.* at *232. The certificateholders asked permission to re-underwrite a sample of loans to establish breaches across the underlying loans of the trusts at issue to prove liability and damages. *Id.* The trustee argued that the certificateholders could not prove their case through sampling but had to prove each element of their claims on a loan-by-loan and trust-by-trust basis. *Id.*

The court agreed with the trustee, and denied the certificateholders' motion to re-underwrite a sampling of the loans. *Id.* at *233. The court held that the trustee's duties were triggered only when it knew or received written notice of a defect for a particular loan in the trust. *Id.* at *253. The court further held that conducting a sampling review years after the fact could not establish which specific loans the trustee would have actually found to be in breach had it performed an investigation at the time. *Id.* This decision is significant because parties may rely on it in an effort to limit the use of sampling to prove liability in CMBS repurchase actions.

3. Law Debenture Trust: Statistical Sampling One of the more notable recent RMBS decisions is *Law Debenture Trust Company of New York v. WMC Mortgage, LLC*, No. 3-12-cv-1538, U.S. Dist. LEXIS 126046 (D. Conn. Aug. 8, 2017), which also addressed the use of statistical sampling as a method of proving liability and damages. In *Law Debenture Trust*, the trustee sued the originator of the mortgage loans transferred to the trust, alleging that the originator's grossly negligent and reckless failure to exercise due diligence regarding the loan quality resulted in a pervasive number of loans in the trust being in breach of representations and warranties. *Id.* at *61–62. The originator argued in a pretrial motion that the trustee should be prohibited from proving liability or damages by using statistical sampling. *Id.* at *61.

The court disagreed with the originator, holding that the trustee may undertake to prove the originator's liability and damages by a method of statistical sampling, with the samples to be drawn, if the trustee so elects, from the pool of mortgages that comprise the corpus of the trust. *Id.* at *65. Although the court acknowledged the limited nature of its ruling, the decision offers parties in future CMBS cases a favorable ruling on the use of statistical sampling as a means to present proof at trial.

4. BlackRock: Prior Holder Discovery Another leading RMBS decision is *BlackRock Balanced Capital Portfolio v. HSBC Bank USA*, No. 14-cv-09366 (S.D.N.Y. June 2, 2016), which addressed plaintiffs' discovery obligations with respect to claims asserted on behalf of prior holders. The plaintiff certificateholders sued the trustee, alleging breaches of contract, fiduciary duty, duty to avoid conflicts of interest, as well as Streit Act claims. *Id.* at 1. The certificateholders attempted to assert the rights of prior certificateholders on the basis that, under New York General Obligations Law § 13-107, those claims are transferred with the certificates. *Id.* The defendant trustee argued that where plaintiffs assert claims of prior holders, in addition to their own, defendants are entitled to third-party discovery from those prior certificateholders. *Id.* at 2.

The court agreed with the trustee, and held that the transfer of a claim cannot remove discovery obligations associated with that claim, and that plaintiffs should bear the burden of obtaining third-party discovery from prior owners whose rights they intend to assert. *Id.* This ruling is significant because it imposed the burden of third party discovery on plaintiffs who attempted to assert the litigation rights of prior RMBS owners. Parties in CMBS actions should consider the BlackRock ruling when assessing claims brought on behalf of prior holders. This decision is also instructive because it illustrates the unique discovery challenges presented in

mortgage-backed securities (“MBS”) litigation where there is typically a high volume of third-party discovery; documentation concerning each loan can be difficult to obtain.

5. Assured Guaranty: Expert Methodology A final bellwether decision, *Assured Guaranty Municipal Corporation v. Flagstar Bank, FSB*, 920 F. Supp. 2d 475 (S.D.N.Y. 2013), addressed whether a defendant bank breached representations and warranties made to the insurer in an RMBS “put-back” litigation. *Id.* at 477. The insurer provided financial guarantee insurance on securities backed by mortgage loans originated and/or sold by the bank originator. *Id.* at 479. The insurer claimed that the originator breached the representations and warranties made when it sold the loans because the loans failed to comply with the originator’s underwriting guidelines or were otherwise materially fraudulent. *Id.* At trial, the parties each presented conflicting expert testimony. *Id.* at 486.

Following a twelve-day bench trial, the court held that the bank breached representations and warranties regarding the mortgage loans and awarded the insurer \$90.1 million, plus attorney’s fees. *Id.* at 513, 517. The

court accepted the insurer’s expert methodology and expert testimony that more than seventy-five percent of the loans were materially defective. *Id.* at 501, 510. This decision may provide a useful model for parties in future CMBS actions to outline persuasive expert testimony of witnesses at trial.

Takeaways for Future CMBS Cases

As the cases described above illustrate, several significant issues have been addressed as MBS litigation continues to evolve. First, parties should consider potential limitations on the use of loan sampling to establish liability and damages where the underlying deal documents may require loan-by-loan evaluation. Second, parties should be prepared to address whether a party asserting claims on behalf of prior holders should bear the burden of obtaining third-party discovery from prior owners whose rights they intend to assert. Finally, parties should review the *Assured Guaranty* decision for guidance regarding expert methodology and testimony. Securities lawyers involved in future CMBS litigation will benefit from heeding the lessons gleaned from these significant RMBS cases.