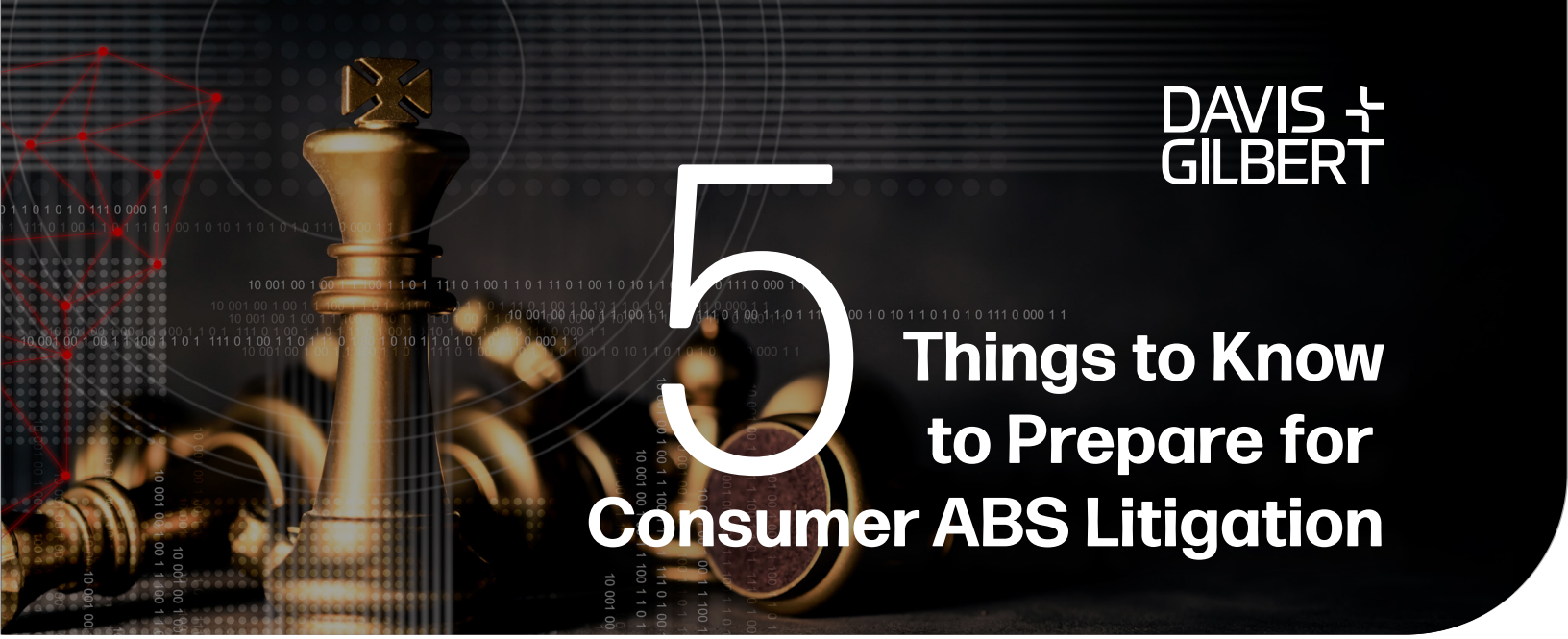

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5 Things to Know to Prepare for Consumer ABS Litigation

If economic forces such as rising consumer debt and inflation overcome deal structures and credit enhancements in consumer ABS (e.g., auto, residential mortgages, credit cards), the ensuing battles over loss allocation between noteholders and trust representatives acting on their behalf, on the one hand, and deal parties, on the other, will need to recognize recent changes in applicable law arising from litigation related to pre-financial crisis subprime RMBS.

Below is a brief look at the five most significant ways subprime RMBS disputes are likely to continue to broadly impact ABS deal structures and potential litigation, particularly among trust representatives, sponsors and originators.

1. Plaintiffs Will Need to "Fully Bake" Claims Before Filing Suit / Repurchase Protocols Must Be Followed

– For many years, a trust representative was permitted to pursue repurchase claims for entire pools of loans based on a pre-suit forensic review of a loan sample, and then expand its claims through expert opinions after suit was commenced. That is no longer the case following the New York Court of Appeals' decision in *U.S. Bank National Association v. DLJ Mortgage Capital, Inc.*, 138 N.Y.3d 169 (2022) ("*HEAT*"), where the Court held that the plaintiff trustee was required to give the defendant sponsor pre-suit, loan specific (and breach specific) notice of all repurchase claims in accordance with the governing repurchase protocol.

– Going forward, for deals already completed, parties making repurchase requests—to the extent repurchase reviews are not automatically triggered for defaulting loans by governing deal documents—will need to complete comprehensive forensic reviews and strictly adhere to all repurchase protocol requirements (which, we note, have changed significantly since the 2008

financial crisis), and do so within the applicable statute of limitations. For deals yet to be done, parties should be mindful of the *HEAT* Court's enforcement of the contract as written when crafting repurchase protocol language (i.e., the language means what it says).

– Many ABS agreements today require a party to first attempt to resolve disputed requests for repurchase in mediation or arbitration before seeking adjudication by a court. Regardless, before proceeding with any mediation or arbitration, deal parties are typically required by the governing agreements to provide appropriate notice. Thus, parties will still have to be mindful of the *HEAT* decision.

2. The Trustee's Location Matters

– The choice of trustee can mean the difference between a valid action and one dismissed as untimely. Under New York's borrowing statute, when a claim is brought by a nonresident of New York, the applicable statute of limitations is the shorter of New York's limitations period and the limitations period of the state where the claim accrued. In *Deutsche Bank National Trust Co. v. Barclays Bank PLC*, 34 N.Y.3d 327 (2019) ("*Barclays*"), the New York Court of Appeals, focusing on the need for predictability, determined that in the context of a securitization trust, a claim accrues where the plaintiff resides. There, because the plaintiff-trustee, Deutsche Bank, was found to be a California resident, California's four-year statute of limitations applied, versus New York's six-year period, and the action was dismissed as untimely.

– The timing of any forensic review, analysis of claims and consideration of the forum for suit should take into account the trustee's residence (as may be determined at court). Even if a repurchase request dispute proceeds to an arbitration or mediation, the trustee's residence may determine the statute of limitations that applies, and in turn, the deadline by which repurchase protocol notice requirements must be met. For this reason, when choosing a trustee for a deal, its residence should be considered.

3. Courts' Definition of Materiality Differs from the Commercial View

– The "material and adverse effect," or "MAE" for short, standard required to be met in typical repurchase protocols has been interpreted by most courts to mean "material increased risk of loss," a standard borrowed from insurance law. As such, defendants' arguments that this standard does not reflect the business understanding of materiality and was not the basis of actual repurchase demands have been unavailing.

– Perhaps as a result of all the RMBS-related litigation on the interpretation of this term, ABS deal parties have often pre-defined in deal documents what specific circumstances would constitute a material breach of a specific representation and warranty (R&W).

4. Trustees May Be Required to Act Sooner

– In the last few years, noteholders that were contractually prohibited from bringing repurchase suits directly have filed class action suits against trust representatives that failed to timely act to protect their interests. These have often settled for undisclosed amounts.

– Now, unless MAE is specifically defined in the applicable deal documents, the judge-made materiality standard could set a lower bar for a cause of action, as the standard could be said to create an obligation on the part of the trustee or other trust representatives to act upon awareness of facts and circumstances leading to a material increased risk of loss. As a result, noteholders may now have a basis to expect trustees to investigate matters upon awareness of troubling performance trends or identification of market issues.

– On the other hand, ABS deal documents today often require independent R&W reviewers to review loan files automatically for potential breaches after a loan enters a set period of delinquency or experiences other events of default. This automatic review requirement, if required and complied with, could limit these kinds of "failure to act" disputes with noteholders, as trust representatives are generally not required to take further action aside from ensuring such reviews take place.

5. Attorneys' Fees May (or May Not) Be Recoverable from Defendants

– Under New York law, attorneys' fees are not recoverable unless permitted by "unmistakably clear" language in the applicable contract.

– In the past, plaintiff-trustees relied on indemnification provisions in deal documents for reimbursement of attorneys' fees, and sought recovery of such fees from defendants for the benefit of investors. But in the securitization context, the New York Court of Appeals has held that references to "costs and expenses" included as components to the repurchase price, did not meet the "unmistakably clear" standard. *Deutsche Bank National Trust Company v. Morgan Stanley Capital Holdings LLC,* 36 N.Y.3d 342 (2020).

Noteholders (and would be directing noteholders) should take this into account in setting expectations.

– Today, some ABS deals provide for reimbursement of expenses incurred by independent R&W reviewers from the issuing entity's funds (with specific caps on how much such reviewers may charge). Further, some ABS deal documents delineate who will bear the cost of the dispute resolution procedures that may necessarily follow a refusal to repurchase, subject to certain limitations that may be built into the deal. Such provisions must be carefully crafted to meet New York's high standard for recovery of attorneys' fees.

Conclusion

Most of the changes in the law impacting future securitization litigation (as well how ABS deal documents are drafted) have the potential to limit claims and recoveries by noteholders. But, as these laws more clearly define the contours of suits that are properly commenced, they also have the potential to lead to greater returns on litigation investment. All parties must plan accordingly to navigate the new ABS litigation landscape.

For More Information

The Insolvency + Finance practice group of Davis+Gilbert has extensive experience in all levels of ABS-related litigation, including repurchase, fraud and indemnity disputes, and claims for deficient servicing. If you would like to discuss the current ABS landscape in more detail, please contact the attorney listed below or the Davis+Gilbert attorney with whom you have regular contact.

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