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SURVIVING YOUR NEXT SECURITIZATION: IDENTIFYING AND MINIMIZING UNKNOWN RISK

The massive losses suffered by RMBS investors and financial guarantee insurers in the Great Recession have demonstrated that the contractual remedies for breaches of representations and warranties were often inadequate to protect investors. Writing from a litigator's perspective, the authors recount this history, analyze procedural and substantive risks, and suggest best practices to follow both before and after things go wrong on securitization and other financial transactions.

By Robert A. Jaffe and Nicole P. Moriarty *

This article provides a litigator's insights as to how securitization transactors can better protect themselves against unknown risk. While our discussion is presented in the context of reviewing some of the lessons learned from the recent wave of residential mortgage-backed security ("RMBS") litigation, rarely does the exact same thing go wrong twice. Thus, the goal of this article is to go beyond Monday morning quarterbacking and to provide practical ways contracting parties can mitigate the damage caused by the next unexpected problem or crisis.

WHAT WENT WRONG?

What went wrong leading up to the last financial crisis was that things were too good. Between 2004 and 2007, more than 3,700 private label trusts were formed, using more than $3 trillion worth of residential mortgages.[1] Investors were buying into securitizations faster than sponsors could find the collateral to make them, and with the increase in demand for volume, came an increase in demand for speed.[2] The need to keep up with the "securitization machine" led originators to lower, and in some cases abandon, underwriting

[1] Lynn Szymoniak, Mortgage-Backed Securities, Loan Documents & the Banks/Trustees (Sept. 25, 2013), http://thjf.org/2013/09/25/mortgage-backed-securities-loan-documents-the-banktrustees/.

[2] Financial Crisis Inquiry Commission (FCIC), Financial Crisis Inquiry Report (U.S. GPO: January 2011), p. 110 ("Meeting investor demand required finding new borrowers, and homebuyers without down payments were a relatively untapped source."); Basel Committee on Banking Supervision, Report on Asset Securitisation Incentives (July 2011) at 14 ("[I]ssuers were incentivised to focus on volume and speed to market at the expense of their asset screening and monitoring practices."), *available at* http://www.bis.org/publ/joint26.pdf.

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standards,[3] and the rapid pace at which deals were being made also led to decreased transparency and less diligence.[4] The end result was an outpouring of RMBS deals backed by increasingly risky loans.[5]

By late 2006, housing prices had started to decline.[6] Homeowners began to default on their mortgages at an alarming rate and ultimately the economy crashed, producing what we have come to know as the Great Recession. As RMBS investors and the financial guarantee insurers who guaranteed payment on RMBS certificates began to suffer massive losses, legal battles began in an attempt to identify and hold accountable the responsible parties. From January 2007 through the end of June 2013, more than 900 cases related to the downturn in the financial and mortgage markets were filed.[7] What is important to realize, however, is that the Great Recession did not cause the RMBS breakdown. Rather, it simply revealed the unsustainable flaws that had become systematic in the way RMBS deals were being put together.[8]

This article examines why the standard securitization deal terms were ill-equipped to address the unexpected risk that stemmed from the systematic failures discussed above. It then discusses how procedural rights can be used to address and mitigate unknown risk, and suggests best practices to ensure your company is ready to handle the next unexpected problem.

CONTRACT TERMS THAT "FAILED"

To learn how commercial parties can mitigate the losses from future unexpected problems, we need to look to why certain contract terms failed during the last crisis. Failed, as used herein, means contract terms that had to be pressed or contorted in order to cover unexpected problems and unanticipated risk.[9]

3 FCIC, Financial Crisis Inquiry Report, p. xvii ("[F]inancial institutions made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective[.]"); *id*. at xxiii ("Many mortgage lenders set the bar so low that lenders simply took eager borrowers' qualifications on faith, often with a willful disregard for a borrower's ability to pay.").

4 *Id*. at 165 ("[T]he integrity of the market depended on two critical checks. First, firms purchasing and securitizing the mortgages would conduct due diligence reviews of the mortgage pools … Second, … parties in the securitization process were expected to disclose what they were selling to investors. Neither of these checks performed as they should have."); *id*. at 386 ("Lack of transparency contributed greatly to the crisis: the exposures of financial institutions to risky mortgage assets and other potential losses were unknown to market participants, and indeed many firms did not know their own exposures.").

5 *Id*. at xvi ("Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world."); *id*. at xx ("As the mortgage and real estate markets churned out riskier and riskier loans and securities, many financial institutions loaded up on them."); *id*. at 101 ("The Commission concludes that there was untrammeled growth in risky mortgages. Unsustainable, toxic loans polluted the financial system and fueled the housing bubble.").

6 *Id*. at 214-215.

7 Posting of Noam Noked, co-editor, Harvard Law School Forum on Corporate Governance and Financial Regulation, to Credit Crisis Litigation Update: It is Settlement Time, http://blogs.law.harvard.edu/corpgov/2013/11/30/credit-crisis-litigation-update-it-is-settlement-time/ (Nov. 30, 2013, 9:00 EST).

8 FCIC, Financial Crisis Inquiry Report, p. xx ("When the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans, and the risky assets all came home to roost. What resulted was panic. We had reaped what we had sown."); *id*. at 125 ("The originate-to-distribute model undermined responsibility and accountability for the long-term viability of mortgages and mortgage-related securities, and contributed to the poor quality of mortgage loans.").

9 Unanticipated events or risks (such as widespread intentional breaches by a counterparty) by their very nature cannot be explicitly addressed in the parties' documents, and disputes and litigation often arise where the terms of the parties' agreement are otherwise insufficient to address such unknown risks.

Remedy Provisions

During the financial crisis, investors and financial guarantee insurers suffered devastating losses as a result of massive defaults. These defaults were ultimately traced back to widespread, and sometimes intentional, breaches of representations and warranties provided by originators and sponsors that were intended to ensure the quality of the collateral underlying the RMBS deals.[10] When the injured parties went back to their documents to look at the available remedies for such conduct, the best provision they could find was the standard-form "repurchase" remedy, designed to address losses caused by normal production risk (the *isolated* and *unintentional* failure to following underwriting guidelines). The repurchase remedy typically provided for sponsors or originators to repurchase materially defective loans upon demand or notice of the defect and, as such, placed the risk of material defects on the party in the best position to have prevented them.

Such remedy was not well-calibrated to address the unanticipated widespread and intentional breaches that occurred. As one court explained, "[t]he repurchase protocol is a low-powered sanction for bad mortgages that slip through the cracks. It is a narrow remedy ('onesies and twosies') that is appropriate for individualized breaches and designed to facilitate an ongoing information exchange among the parties."[11] Thus, a large reason for the breadth and protracted nature of the recent RMBS litigation is that the parties were essentially left to cure a square problem (widespread intentional breaches) with a round remedy (designed to address occasional unintentional breaches).

Cash Flow and Timing Provisions

The absence of an appropriate and effective remedy for the unanticipated problem of widespread intentional breaches, and the resulting losses that inured to the detriment of investors, exposed another shortcoming in the standard RMBS deal provisions, namely those dealing with cash flow and timing.

In a typical deal, the expectation was that the collateral underlying the securitization would match the descriptions and guidelines set forth in the deal documents. In the small number of cases where it did not, sponsors and originators would repurchase the breaching or defective loans, thereby preventing such defective collateral from affecting investors. Historically, the instances of such breaches were so small that there was effectively no negative impact on investors due to non-conforming collateral. However, when breaches became both intentional and widespread, two critical things happened: sponsors and originators often refused to comply with the express repurchase remedy, which constituted a separate breach, and the magnitude of such unaddressed breaches become significant enough to substantially impact the performance of the securitization to the detriment of investors.

Whether intentional or not, in the absence of a specified remedy, the parties' agreements allocated to the investors and monoline insurers the burden of resolving a dispute over massive wide-scale breaches of originator and sponsor representations and warranties. The parties' agreements were premised on monies being paid at a certain time (such as on or prior to a monthly distribution date), but without a timing provision (requiring payment as to any item in dispute until the dispute was otherwise resolved). Therefore, any dispute over the obligation to make the payment left the party expecting the money at risk for at least the time it would take to resolve the dispute (in the case of litigation, potentially years), even when that party would ultimately prevail. The inherent unfairness of this allocation may be one of the reasons sophisticated RMBS-litigation plaintiffs have been able to maintain fraud claims in addition to contract claims against their equally sophisticated counterparties. Even if you are able to maintain a fraud action against your counterparty, however, it does not mean you should want to rely on such a remedy. In addition to being more difficult to prove than a breach of contract claim, asserting fraud claims may come with significant reputational risk.

ANALYZING SUBSTANTIVE VS. PROCEDURAL RIGHTS

Although hindsight is 20/20, it is probably unfair to suggest that the massive losses suffered by investors and insurers could have been avoided if they had simply foreseen the possibility of widespread and intentional breaches, and provided for a specific remedy to deal with such risk (which would be tantamount to saying parties should have bargained for their counterparties to intentionally breach their agreements). However, sophisticated parties can always be thinking about how

[10] FCIC, Financial Crisis Inquiry Report, at xxii ("Lenders made loans that they knew borrowers could not afford and that could cause massive losses to investors in mortgage securities."); *id*. at 109-11.

[11] *Syncora Guarantee, Inc. v. EMC Mortgage Corp.*, No. 09-cv-3106, 2011 WL 1135007, at *6 n.4 (S.D.N.Y. Mar. 25, 2011) (Crotty, J.).

their documents deal with both known-unknowns *and* unknown-unknowns.

More often than not, the best way to deal with unknown risks will be by assessing any holes in the procedural provisions contained in your deal documents. While substantive provisions are those that allocate specific risks and create substantive rights, procedural provisions are those that address *how* and *when* your substantive rights are enforced. When fully drafted, procedural provisions should also address who bears the risk of enforcement of substantive rights (*i.e.*, the risk that a contractual provision is not followed or does not work). We refer to this risk as procedural risk.

While we do not expect parties to explicitly provide for true unknowns, it should be possible to address which party will bear the procedural burden when something truly unexpected does occur. For example, all things being equal, you would rather be the party with the money in hand than the one chasing the money in the event of a dispute, and contract language offers a way for a party to secure this preference. A deal document that calls for payment by a fixed date, regardless of whether or not a dispute over the right to payment is resolved, allocates the procedural risk of any dispute to the party forced to make the payment. Conversely, the failure to provide for such a date certain forces the party *seeking* payment to bear the risk of a dispute, which may take litigation and months if not years to resolve. Similarly, if there is no mechanism provided (other than litigation) to resolve a potentially recurring dispute, the parties could nonetheless include a presumption putting the burden on the party who they agree ought to bear the risk. For example, the agreement could provide that any put back request not resolved by discussions between the parties within a set period of time shall be repurchased until the dispute is otherwise resolved. Disputes over providing documents or other information under the agreement could be addressed by requiring that information shall (or shall not, depending on how the parties want to allocate the risk) be provided within a set period of days, even if there is an unresolved dispute as to whether that information is within the scope of the parties' agreement.

In our view, the party who ought to have the better knowledge about the unknown risks (or who has more control over whether a contractual provision is followed) also ought to bear the procedural risk. Ensuring that procedural risk is fully allocated serves as a back-up or catchall remedy for addressing unknown risk or unexpected problems thereby making the overall transaction less risky. Thus, during any negotiation, you should try to mitigate any procedural weaknesses (*i.e.*, procedural risks inappropriately assigned to you) or deficiencies (*i.e.*, unassigned procedural risks) as best you can, taking into account your priorities, bargaining power, and risk tolerance. For example, in the mortgage securitization context, the originator of the mortgage loans would have the best knowledge about the loans and their compliance with representations and warranties; in the event of an alleged breach, such originator should be required to perform (repurchase obligations, for example) until any dispute about and alleged breach is resolved in its favor, relieving the counterparty of any risk of bearing the loss of a breach it could not control, but leaving the parties' ultimate allocation of risk (post-dispute resolution) unchanged.

BEST PRACTICES BOTH BEFORE AND AFTER THINGS GO WRONG

While it is highly unlikely that we will see the same crisis that we did starting in 2008, it is almost certain that securitization transactors (and, in fact, transactors in any sphere) will be forced in the future to confront new unknown and unexpected risks. The best way to protect against losses related to these risks will be to ensure your transaction documents fully allocate both substantive and procedural risks, keeping the following best practices in mind:

- Ask yourself the key questions: Can I enforce my rights? Who bears the procedural risks? Am I willing to take on the risks allocated to me? Don't assume things will go the way you would like; ask the hard questions: what happens under this contract when things go wrong or there is a breach.[12] Before the transaction is finalized, it may be a good idea to involve a litigator to help answer these questions and review the deal documents with an outsider's perspective. If you are satisfied with the answers to these questions, it is more likely that you will be prepared for unexpected issues that arise.

- Say (don't assume) what you mean. It is vital that the answers to the above questions and the parties' intentions are stated in the plain language of your documents. If and when a dispute arises, it will almost certainly be insufficient for you to say, "we

[12] Too often transaction parties choose not to raise or address a possible breach or risk "because the other side would never do that." From a, perhaps, more jaded litigator's perspective, a party that is truly certain it would never breach should care little whether there is a specific remedy in the event of that never-to-occur breach. Parties should thus raise and try to address even worse case and unexpected events and breaches.

all know what we intend to have happen." This is especially true in the post-RMBS litigation context because even though courts allowed fraud claims to proceed based on extra-contractual representations made during the last financial crisis,[13] they may be less likely to do so the next time around.[14]

- Monitor ongoing transactions. Things will go wrong, so even on a transaction with good counterparties and a good track record, it is important to be on top of the events impacting your deals. Analyze whether the transaction is progressing the way you intended. If not, try to deal with issues that arise before they become entrenched. If you are able to anticipate or identify a problem early on, it may be easier to fix or even avoid. Even if an ongoing problem cannot be fixed within the transaction in which it is discovered, identifying the problem early on may allow you to prevent it from arising in new deals sooner than if you were not monitoring ongoing transactions. This should mitigate the overall harm caused by the problem.

- Make sure you know your documents. When a problem arises, there may not be enough time to relearn the terms of your agreement. Institutional memory is important and efforts should be taken to preserve such memory as changes are made at your organization during the life of a deal. Individuals assigned to monitor transactions should be aware of events that can trigger the need for a party to take affirmative action under the transaction documents, such as a notice requirement. Similarly, even if there are no known breaches and no losses are being incurred, the monitoring individual should regularly confirm that all required procedures are being followed by the counterparty in order to be better able to enforce such procedures or insist on their being followed when things do go wrong (or you suspect that things may be going wrong).[15]

- Don't overestimate the potential for a business-level resolution. This does not mean that you have to assume the worse at the first sight of a problem, but you should be prepared for even established business partners and counterparties with a long history not to see eye-to-eye when things go wrong in a widespread and unanticipated way. Litigation does not need to be your first option, but it should always be a possible option. In fact, the best way to avoid litigation may just be to involve litigators at the first sign of trouble.

Finally, if things look too good – if you need to do your transactions based on trust and past performance – that is not a time to rush into deals; it is time to take a step back and assess your risk. ■

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[13] *Compare CIFG Assur. N. Am., Inc. v. Goldman, Sachs & Co.*, 106 A.D.3d 437, 438, 966 N.Y.S.2d 369, 371 (App. Div. 2013) ("[T]here is a question of fact as to whether plaintiff reasonably relied on defendants' representations. It was not required, as a matter of law, to audit or sample the underlying loan files."); *MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, 39 Misc. 3d 1220(A) (N.Y. Sup. Ct. 2013) ("[T]his Court cannot state at this juncture that the due diligence performed by MBIA in vetting the Securitizations rendered its reliance [on Countrywide's representations] unreasonable."), *with HSH Nordbank AG v. UBS AG,* 95 A.D. 3d 185, 201 (1st Dep't 2012) ("Since the plaintiff stipulated in the contract that it was not relying upon any representations as to the very matter as to which it now claims it was defrauded,' such specific disclaimer destroys the allegations in the plaintiff's complaint that the agreement was executed in reliance upon the defendant's ... representations.").

[14] The circumstances under which a court will or will not allow a fraud claim to be brought in parallel with a contract claim are beyond the scope of this article. Suffice it to say the line is far from clear and has been subject to decades of litigation; and, ironically, may depend in part on the wording of the contract (no reliance clauses vs. restatement of representations and warranties). As a planning matter, a party should assume that in all but the most egregious situations, it will have to reply on its contractual rights and risk allocation.

[15] For example, parties often elect not to enforce monitoring and inspection rights when they think a deal is operating smoothly, only to later discover that their counterparty has a very different idea of the scope of those rights when things start to go bad. Exercising such rights early on will either confirm the parties' agreement as to the scope of such rights (it is easier to expect agreement on procedure when there is no dispute on substance) or, in the worst case, expose the difference in understanding earlier when perhaps there is more time to resolve the misunderstanding before major losses are incurred.