O'MELVENY & MYERS LLP

Repurchase Liability Arising out of Mortgage Securitizations

July 27, 2012

In light of a recent federal court ruling, banks may wish to reevaluate litigation risk from plaintiff insurers claiming injury from alleged breaches of representations and warranties regarding mortgage securitization notes that they insured.

The Issue: On June 19, the Southern District of New York ruled that a residential mortgage originator that securitized those mortgages into mortgage-backed securities ("MBS" or "notes") could be liable for alleged breaches of representations and warranties it made, to the insurance company that insured principal and interest payments to investors in the MBS, and could be forced to repurchase non-conforming mortgages even if (a) the breaches did not cause the underlying mortgages to default and (b) the underlying mortgages have not yet defaulted.[1]

In a March 2007 securitization, EMC Mortgage Corporation (EMC) placed 9,871 home equity (HELOC) mortgages in a trust, and the notes issued by that trust were sold to investors. As part of the transaction, the monoline insurer Syncora Guarantee Inc. (Syncora) agreed to insure the senior tranche of these notes, thus guaranteeing principal and interest payments to the senior noteholders. As a result of the financial crisis and corresponding economic downturn, during which many of the mortgages collateralizing the notes became delinquent or defaulted, Syncora had to pay over $168 million on the policy. On March 31, 2009, Syncora sued EMC demanding, inter alia, that EMC repurchase the underlying mortgages from the trust and thus essentially rescind the deal vis-à-vis Syncora. Syncora based its demand on alleged breaches by EMC of the representations and warranties regarding the practices used to originate, underwrite and service the loans that EMC has made in both the Insurance and Indemnification Agreement between EMC and Syncora and in the Mortgage Loan Purchase Agreement, to which Syncora was a third-party beneficiary. Syncora also relied on a repurchase provision in the Insurance and Indemnification Agreement that provided for such a remedy where the originator's breach materially and adversely affected the interests of the insurer. On March 25, 2011 the court granted Syncora's motion for partial summary judgment, ruling that under the Insurance and Indemnification Agreement, which granted broad rights to the insurer, Syncora was not required to identify specific breaches of representations or warranties with respect to each of the 9,871 mortgages and that instead, it could use statistical analysis of a sample of mortgages to identify breaches across the pool of mortgages, and thereby obtain a pool-wide remedy.[2]

In its motion for partial summary judgment before the court, Syncora argued that it was not required to prove that the alleged breaches of the representations and warranties caused the underlying loans to default and that its interests were harmed by the breach itself because its willingness to insure the loans and pricing for the risk incurred was based on the truth of EMC's representations and warranties.[3] Agreeing with Syncora, the court rejected EMC's argument that breach alone is insufficient to trigger the repurchase provision. The court, focusing on plaintiff's role as insurer, noted that under New York law, "an insurer has an interest in receiving complete and accurate information before deciding whether to issue a policy,"[4] and that, "the truthfulness of [EMC's] representations and warranties [was] a condition precedent to Syncora's obligation to issue the Policy."[5] The court also stated that the relevant contractual language "do[es] not provide that breaches of representations or warranties must cause [a] loan to default, before [Syncora] can enforce its remedies under the repurchase provision. Had the parties intended this requirement, they could have included such language."[6] The court also distinguished between claims brought by insurance companies and those brought by noteholders, observing that a case relied on by EMC, which involved noteholders, "did not involve an insurer with legally distinct interests from those of the certificateholders" and was thus "inapposite[.]"[7]

The court also held that Syncora could obtain relief even if the underlying mortgage had not yet defaulted by showing that the alleged breaches materially increased its risk of loss. Again emphasizing the unique role of the insurer, the court reasoned that regardless of whether a loss occurs, insurance companies must be provided with accurate information sufficient to permit them to evaluate the risk of loss. The court stated that under Section 3106 of the New York Insurance Law, "Syncora may establish a material breach of the [insurance policy] by proving that EMC's alleged breaches increased Syncora's risk of loss[,] irrespective of whether the breaches caused any of the HELOC loans to default."[8] In response, EMC tried to argue that Section 3106 only allowed rescission of the insurance policy as remedy and does not create a right for damages. The court rejected the argument, noting that Syncora did not argue that Section 3106 created such a right and that the statute merely "recognizes the insurance law principle that an insurer relies on receiving complete and accurate information when deciding whether to issue a policy and how to price risk, and that a material breach of a representation or warranty can adversely affect an insurer's interests as a matter of law."[9]

Implication: Currently there are many dozens -- if not hundreds -- of lawsuits against mortgage originators, seeking hundreds of billions of dollars due to alleged misrepresentations about the quality of mortgages sold into securitizations. Such suits can be brought by various parties, including, among others, an investor who purchased the MBS, the insurance company that insured the underlying mortgages and/or principal and interest payments on the MBS, the guarantor of the MBS, the servicer of the underlying mortgages, and the trustee of the mortgage pool. All of the above categories of plaintiffs will undoubtedly argue that the *Syncora* decision should apply equally in those cases. Defendants will counter by pointing out that with its emphasis on insurance principles, *Syncora*, on its face, makes clear that these different plaintiffs should not be conflated as their legal rights may vary. The case also demonstrates that the language used in the related documents can be determinative, as the court specifically relies on the terms in the operative agreements and observes that the parties could have included different language in their contract that could have provided for other rights and remedies.

Institutions facing such lawsuits may wish to re-evaluate their exposure, and possibly adjust reserves set aside to cover such risks, based on the type of plaintiff and the specific language in the securitization agreements at issue.

Rob Stern - (202) 383-5328
Lauren N. Moore - (202) 383-5119

[1] *Syncora Guarantee Inc. v. EMC Mortg. Corp.,* --- F. Supp. 2d ---, 2012 WL 2326068 (S.D.N.Y. June 19, 2012).
[2] *Id.* at *1-3; see also *Syncora Guarantee Inc. v. EMC Mortg. Corp.,* 09 CIV. 3106 PAC, 2011 WL 1135007 (S.D.N.Y. Mar. 25, 2011).

[3] *Syncora Guarantee Inc.,* 2012 WL 2326068, at *4-5.
[4] *Id.* at *4.
[5] *Id.* at *5.
[6] *Id.* at *5.
[7] *Id.* at *8 & n.5.
[8] *Id.* at *9.
[9] *Id.* at *9