PAUL
HASTINGS

(212) 318-6098
shahzeblari@paulhastings.com

February 13, 2017

John P. Asiello
Clerk of the Court
New York State Court of Appeals
20 Eagle Street
Albany, NY 12207

Re: **Morgan Stanley Mortgage Loan Trust 2006-13ARX, by U.S. Bank National Association, solely in its capacity as Trustee on behalf of the Trust, v. Morgan Stanley Mortgage Capital Holdings LLC, APL-2016-00240**

Dear Mr. Asiello:

Pursuant to Rule 500.23(a)(2), the Securities Industry and Financial Markets Association respectfully submits this letter brief as *amicus curiae* in support of Defendant-Appellant Morgan Stanley Mortgage Capital Holdings LLC.

STATEMENT OF INTEREST OF *AMICUS CURIAE*

The Securities Industry and Financial Markets Association ("SIFMA") is a securities industry trade association representing the interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to support a strong financial industry while promoting investor knowledge, capital formation, job creation, economic growth, and trust and confidence in the financial markets. SIFMA has offices in New York and Washington, D.C., and is the United States' regional member of the Global Financial Markets Association. Although it is judicious in its case selection, SIFMA regularly files *amicus curiae* briefs in cases that raise matters of vital concern to participants in the securities industry—cases that raise important policy issues that impact the markets represented by SIFMA, or that otherwise concern common practices in the financial services industry.

This case presents important issues regarding the application of "sole remedy" provisions that define the remedies for breaches of contractual

representations and warranties in issuances of residential mortgage-backed securities ("RMBS"). This Court's resolution of this appeal, which will address whether standard contractual terms commonly contained in RMBS contracts between sophisticated parties will be enforced as written pursuant to longstanding New York law, will likely have financially significant implications for SIFMA's members. SIFMA therefore respectfully submits this brief as *amicus curiae* to present the position of SIFMA's members on this important issue, and to provide the Court with information about the RMBS marketplace, as well as the practical consequences of affirming or reversing the Appellate Division's decision below.

PRELIMINARY STATEMENT

This case is one of the many currently pending cases involving RMBS repurchase (or put-back) claims that have proliferated in the years following the 2008 financial crisis. Issuances of RMBS—which, in a nutshell, are securities that provide their holders with the right to cash flows from pools of mortgage loans—are predicated upon standardized contracts such as the contracts at issue here, which govern the mortgage pools underlying the securities.

These contracts (mortgage loan purchase agreements and pooling and servicing agreements) typically contain extensive representations and warranties made by the sponsor of the RMBS transaction (here, Defendant-Appellant Morgan Stanley Mortgage Capital Holdings LLC, successor in interest to sponsor Morgan Stanley Mortgage Capital, Inc.) about the loan characteristics of the thousands of mortgage loans in each pool. The contracts also contain "sole remedy" provisions which, in the event there is a breach of loan-related representations, provide that the aggrieved party's remedies are requiring the sponsor to cure, replace, or repurchase the offending loan.

Under longstanding precedent holding that contractual provisions negotiated between sophisticated parties must be enforced as written, these "sole remedy" provisions cannot be disregarded. However, in the last several months, the Appellate Division has twice ruled—first in *Nomura Home Equity Loan, Inc., Series 2006-FM2 v. Nomura Credit & Capital, Inc.* ("*Nomura*"), 133 A.D.3d 96 (1st Dep't. 2015) (appeal from 1st Department's decision currently pending) and

then in this action—that sole remedy provisions in RMBS contracts may *not* apply to claims respecting breaches of representations and warranties relating to mortgage loans. In both instances, the Appellate Division has incorrectly allowed plaintiffs to plead around the applicable sole remedy provisions through the expedient of alleging "pervasive" loan-related breaches.

As discussed below, not only is the Appellate Division's refusal to recognize and enforce the selection of remedies contained in the sole remedy provisions contrary to New York law, it also runs the very real risk of overturning the carefully considered and negotiated structure of RMBS transactions and the benefits they provide to homeowners, as well as casting substantial uncertainty over the ongoing efficacy of liability and exclusive remedy provisions across the spectrum of commercial transactions. Therefore, this Court should reverse the Appellate Division's decision and reconfirm that this standard "sole remedy" provision will be respected by New York courts.

BACKGROUND

Residential mortgage loan securitization revolutionized housing finance when it was introduced in the 1970s. Prior to the creation of the RMBS structure (now ubiquitous across the industry), a bank making a mortgage loan to a family for the purchase of a residential property had to consider the investment benefits and risks of keeping that single loan on the bank's balance sheet for the term of the mortgage (often as long as 30 years). Under this system, any bank or financial institution would require a substantial return on its investment in order to compensate it for committing its capital in this way for an extended period of time, imposing significant transaction costs on homeowners seeking housing finance.

RMBS lowered these transaction costs associated with individual loans, providing individuals and families seeking financing with greater flexibility and lower costs.[1] Under the RMBS structure, a financial institution, usually called the

---

[1] *See* Jason H.P. Kravitt & Robert E. Gordon, Securitization of Financial Assets, § 16.01 (3d ed. 2014) (explaining that the high transaction costs and associated risks with loan originators maintaining individual loans on the bank's

"sponsor" or "seller," purchases, aggregates, and then sells thousands of residential mortgage loans to a depositor, which then conveys the mortgage loans to a trust. The trust then issues securities—or "certificates"—that entitle the purchaser of each certificate to cash flows generated by the loans in the trust.[2] The purchasers of the certificates are typically sophisticated parties, including "banks, insurance companies, hedge funds, mutual funds, foreign central banks, and sovereign wealth funds, as well as Fannie Mae and Freddie Mac."[3]

The certificates are freely bought and sold because the terms of the contracts negotiated among the sponsor and trust, defining the rights of the certificates and their purchasers, are fully disclosed and standardized across the industry. As is the case here, the contracts typically include mortgage loan purchase agreements ("MLPAs") and pooling and servicing agreements ("PSAs"). The MLPAs and PSAs typically contain numerous representations and warranties regarding the mortgage loans securitizing the certificates, but also contain a corresponding provision that establishes an exclusive remedy for a breach of representations or warranties regarding the loans.

Specifically, the PSAs (including the one at issue here) provide that the sole remedy available in respect of a material breach of a loan-related representation or warranty is the cure of the breach or repurchase of the particular loan that is the subject of the representation or warranty. Therefore, if a breach cannot be cured, the trustee, acting on behalf of the certificate-holders, can require the sponsor to buy back a particular offending loan at a "purchase price" that is defined to include the unpaid principal balance plus applicable interest, and therefore makes the trust whole with respect to any breaching loan.

---

balance sheets is reduced by securitizing pools of mortgage loans and selling them in the secondary market).

[2] *See* Thomas P. Lemke et al., Mortgage-Backed Securities § 1.1 (2014).

[3] Office of Fed. Hous. Enter. Oversight, *A Primer on the Secondary Mortgage Market*, Mortgage Market Note 08-3 at 8 (July 21, 2008), *available at* http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/20080721_MMNote_08-3_N508.pdf.

This structure provides a complete remedy for any proven breach. If a loan breaches the representations and warranties made in the PSA or MLPA and cannot be cured, that loan is repurchased or replaced and thereby removed from the mortgage pool, without disturbing the rest of the portfolio or the RMBS issuance as a whole. This is consistent with the fundamental structure of "[t]he mortgage securitization process," which is "designed to distribute risk" and provide liquidity to loan sellers for the benefit of borrowers.[4]

The enforceability of the sole remedy provision has become increasingly important since the financial crisis of 2008, which saw a rise in mortgage delinquencies and the collapse of the RMBS market. Unsurprisingly, this led to a wave of RMBS litigation, including actions brought by RMBS trustees. Certain of those trustees—including the Appellee in this action—have sought to avail themselves of remedies outside of the loan-by-loan cure/repurchase protocol expressly set forth in the governing contracts. This is contrary to New York law and the very structure of the RMBS securitization contracts. New York courts had repeatedly rejected such efforts until the Appellate Division's recent decisions in *Nomura* and this action.

ARGUMENT

I. The Appellate Division's Application of the Gross Negligence Exception to the Sole Remedy Provision was Erroneous

It is black-letter law that contractual provisions restricting available remedies are binding and enforceable—contracting parties are free to delineate remedies in the event of a breach, and courts must enforce such provisions. *See Metro. Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 84 N.Y.2d 430, 436 (1994) ("the courts should honor" such provisions); *see also Bd. of Educ. of Hudson City Sch. Dist. v. Sargent, Webster, Crenshaw & Folley*, 71 N.Y.2d 21, 29 (1987) ("Parties to a contract have the power to specifically delineate the scope of their liability at the time the contract is formed. Thus, there is nothing unfair in defining a contracting party's liability by the scope of its promise as reflected by the

4 *See, e.g.*, Mortgage-Backed Securities §1.

agreement of the parties. Indeed, this is required by the very nature of contract law, where potential liability is determined in advance by the parties.").

This principle, of course, is equally applicable to sole remedy provisions in the RMBS context. *See, e.g.*, *U.S. Bank Nat'l Ass'n v. DLJ Mortg. Capital, Inc.*, No. 650369/2013, 2013 WL 6997183, at *3 (Sup. Ct. N.Y. Cnty. Jan. 15 2014), *aff'd*, 121 A.D.3d 535 (1st Dep't 2014) (sole remedy provision precludes relief not specified in the provision); *Assured Guar. Corp. v. EMC Mortg., LLC*, No. 650805/2012, 2013 WL 1442177, at *6 (Sup. Ct. N.Y. Cnty. Apr. 4, 2013) ("[plaintiff] is limited to the remedy of compelling [defendant] to repurchase defective loans"); *ACE Sec. Corp. Home Equity Loan Trust, Series 2007-HE3 v. DB Structured Prods., Inc.*, 5 F. Supp. 3d 543, 553 (S.D.N.Y. 2014) (under New York law, parties in RMBS contract may expressly select the remedies available as a result of breach).

Nonetheless, the Appellate Division found that Plaintiff's remedies may *not* be limited by the sole remedy provision if it proved "illusory". *See Morgan Stanley Mortg. Loan Trust 2006-13ARX v. Morgan Stanley Mortg. Capital Holdings LLC* ("*Morgan Stanley*"), 36 N.Y.S.3d 458, 463 (1st Dep't 2016). As was the case in *Nomura*, the Appellate Division's decision appears to have been animated by concern over Plaintiff's allegations of "widespread breaches across the loans being held by the Trust." *Id.* at 462; *Nomura*, 19 N.Y.S.3d at 106.

However, as courts have repeatedly explained, such concerns are an insufficient basis to disregard the clear language of a the sole remedy provision. *See, e.g.*, *Nomura Asset Acceptance Corp. Alternative Loan Trust 2006-S4 v. Nomura Credit & Capital, Inc.*, No. 653390/2012, 2014 WL 2890341, at *11-13 (Sup. Ct. N.Y. Cnty June 26, 2014) ("the sole remedy provision is not restricted to occasional breaches of Mortgage Representations"); *Assured Guar. Mun. Corp. v. DB Structured Prods. Inc.*, No. 65075/2010, 2014 WL 3282310, at *4 (Sup. Ct. N.Y. Cnty. July 3, 2014) (allegations of "pervasive breach" "cannot substitute for the contract remedy contemplated by the sophisticated parties who negotiated the Repurchase Protocol"); *Assured Guar. Corp.*, 2013 WL 1442177, at *4-5 (same). That is, the sole remedy provision does not become inoperative simply because a

plaintiff alleges that a large number of loans did not comply with the PSA's representations and warranties.[5]

Apparently recognizing that fact, the Appellate Division instead found that Plaintiffs' allegations of "pervasive" breaches fit within New York's "gross negligence" exception to the enforceability of limitation of remedy provisions. *Morgan Stanley*, 36 N.Y.S.3d at 463.[6] As detailed in Appellants' briefing, this was error for two primary reasons:

- The sole remedy provision neither "exonerates" Appellant from liability nor limits Plaintiff's damages to a "nominal sum"—the only circumstance in which the gross negligence exception applies. *See Sommer*, 79 N.Y.2d at 554 ("a party may not insulate itself from damages caused by grossly negligent conduct. This applies equally to contract clauses purporting to exonerate a party from liability and clauses limiting damages to a nominal sum.") (citation omitted). Rather, it fully compensates the trust for any injury caused by the offending loan by requiring either a cure or repurchase of the underlying loan. Indeed, the

---

[5] The plain language of the sole remedy provision in the MLPA makes clear that it applies to any and all alleged misrepresentations, regardless of number: "[I]t is understood and agreed that the obligations of the Seller in this Section 3.01 to cure, repurchase or substitute for a defective Mortgage Loan constitutes the sole remedy of the Purchaser respecting a missing or defective document or a breach of the representations or warranties contained in this Section 3.01." R. 77. The PSA contains an analogous provision: "[T]he obligations of the Originators and [Morgan Stanley] to cure or to repurchase (or to substitute for) any related Mortgage Loan . . . as to which such a breach has occurred or is continuing shall constitute the sole remedy against the such [sic] party respecting such omission, defect or breach available to the Trustee on behalf of the Certificateholders." R. 156 § 2.05(a).

[6] "It is the public policy of this State, however, that a party may not insulate itself from damages caused by grossly negligent conduct." *Sommer v. Federal Signal Corp.*, 79 N.Y.2d 540, 554 (1992).

Appellate Division recently held that to be the case in Nomura. *See* 19 N.Y.S.3d at 106.

- "The conduct necessary to pierce an agreed-upon limitation of liability in a commercial contract must smack of intentional wrongdoing." *Metro. Life*, 84 N.Y.2d at 438-39 (internal quotation marks omitted). That is, the offending conduct must be independently tortious. Simply alleging that a breach of contract was reckless or intentional—which is all that Plaintiff has alleged here—is not sufficient to invoke the gross negligence exception. *See id.*; *Net2Globe Int'l, Inc. v. Time Warner Telecom of New York*, 273 F. Supp.2d 436, 454 (S.D.N.Y. 2003) (application of the exception requires "nothing short of [] a compelling demonstration of egregious intentional misbehavior evincing extreme culpability").

In effect, the Appellate Division's decision permitted Plaintiff to adorn what is ultimately a straightforward contractual claim—that Appellant did not comply with its representations and obligations under the PSA and MPLA—with tort terminology, thereby allowing Plaintiff to avoid the specific remedy negotiated between the parties.

Such a result is contrary to New York law. "Repeated incantations of 'willful' do not magically transform an economically motivated breach into the egregious conduct required to negate an unambiguous contract term negotiated by sophisticated parties." *ACE Sec. Corp. Home Equity Loan Trust, Series 2007-HE3*, 5 F. Supp. 3d at 556; *see also, e.g., AXA Mediterranean Holding, S.P. v ING Ins. Int'l, B.V.*, 106 A.D.3d 457, 458 (1st Dep't 2013) ("The mere allegation that the alleged breach of contract was maliciously intended or constituted willful misconduct does not render the breach of contract claim a separate and independent tort claim"); *OFSI Fund II, LLC v. Canadian Imperial Bank of Commerce*, 82 A.D.3d 537, 539 (1st Dep't 2011) (same). To hold otherwise would

be to allow a plaintiff to evade contractual provisions governing its remedies through artful pleading.[7]

II. Affirmance of the Appellate Division's Order Would Upset the Carefully Structured Allocation of Risk in RMBS Contracts

New York precedent is rooted in a recognition of the importance of maintaining predictability in contractual relations and allowing sophisticated commercial actors to efficiently allocate risk when negotiating the terms of their business transactions.[8] In the RMBS context, the sole remedy provision is of critical importance to the entire—and carefully considered—structure of RMBS transactions.

The sponsor selects the individual mortgage loans to be aggregated into the mortgage pools that are sold to the depositor and eventually conveyed to the trust.

---

[7] The Appellate Division's reliance on the fact that "this case is only a pleading stage" was misplaced. The sole remedy provision is required to be enforced as a matter of law, and the uncertainty engendered by the Appellate Division's decision is precisely what the sole remedy provision is designed to eliminate. That uncertainty will apply to all of the many other RMBS litigations that are pending, because all such contracts contain these same provisions.

[8] *See, e.g.*, Final Report of the New York State Bar Association's Task Force on New York Law in International Matters 6 (June 25, 2011), *available at* https://www.nysba.org/WorkArea/DownloadAsset.aspx?id=49552 ("The New York Legislature and its courts have developed New York law with the policy in mind of ensuring predictability in commercial transactions"); *Holy Props. Ltd., L.P. v. Kenneth Cole Prods., Inc.*, 87 N.Y.2d 130, 134 (1995) ("Parties who engage in transactions based on prevailing [New York] law must be able to rely on the stability of such precedents"); *see also* Theodore Eisenberg & Geoffry P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts*, 30 CARDOZO L. REV. 1475, 1485 (2009) ("Unpredictable courts would undermine New York's campaign to attract contracts.").

The sponsor then makes extensive representations and warranties about the loans, including specific representations about loan-to-value ratio and the credit worthiness of the borrowers. While this risk allocation makes sense given the sponsor's role and its closer proximity to the loan originator, the sponsor opens itself to liability for breach of contract if the loans do not, in fact, have the characteristics provided for in the representations and warranties. Of course, no sponsor would be willing to make such representations about each individual loan among thousands of loans if it would be subjected to pool-wide damages claims that are untethered to proof of specific breaching loans.

In other words, the sole remedy provision provides each party with a predictable outcome in the event of breach. The sponsor, the trustee and the certificate-holders know exactly what is required in the event of a breach of the representations and warranties that materially and adversely affects the interests of the certificate-holders—cure or repurchase of the offending loan or loans. That certainty allows the parties to control the costs of securitization. Permitting pool-wide damages claims based on alleged "pervasive breaches" and extrapolated "breach rates" would drive up the costs of securitization and have the concomitant impact of increasing the costs of borrowing for consumers.

It would also potentially jeopardize the RMBS trust's status as a tax-exempt Real Estate Mortgage Investment Conduit or "REMIC." REMICs are special purpose entities which are designed specifically to "pass through" all income derived from the mortgages in a RMBS pool directly to certificate holders as investment income, exempting the REMIC from federal income taxes. *See* 26 U.S.C. § 860A. The RMBS trust's REMIC status is essential to the success of the RMBS structure:

> In order to minimize cost, the issuer of pass-through mortgage-backed securities is structured to avoid a double layer of federal taxation. That is, an issuer of pass-through mortgage-backed securities will find it difficult to sell its securities if interest and other income payments received on the underlying mortgage loans are first subjected to tax when realized by the issuer (an

> entity level tax) and then again when such payments are passed through and received by the investors.

See Kravitt, *Securitization of Financial Assets*, at § 16.02; *see also id.* at § 10.02 ("choosing an entity that incurs little or no tax liability is a primary consideration in selecting the entity to serve as the [trust] in a securitization transaction"). REMIC status strictly limits the income that a REMIC can receive. It can only derive income from qualified mortgage loans. *See* 26 U.S.C. §§ 860D, 860F, 860G. Any other contributions or income are subject to a 100 percent tax and may result in revocation of REMIC status. *See id.* §§ 860F(a), 860D(a)(4), (b)(2). In keeping with these requirements, REMIC regulations prohibit a RMBS trust from seeking any recovery for a breaching loan, other than cure, substitution or repurchase—*i.e.*, the remedies allowed by the sole provision. *See* 26 C.F.R. § 1.860G-2(f); 26 U.S.C. § 860F. Permitting additional damages would undermine the REMIC status that makes RMBS issuances possible.

Failure to reverse the Appellate Division's Order would jeopardize this carefully constructed structure, not solely in the RMBS issuances in question in this case but across the RMBS market and in the numerous RMBS actions currently pending in New York courts, where the enforceability and impact of sole remedy provisions are being litigated.[9]

CONCLUSION

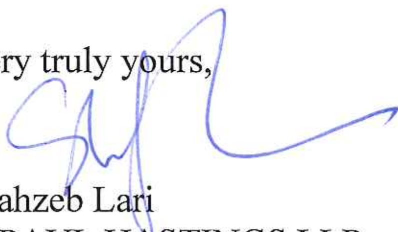
For the foregoing reasons, SIFMA respectfully submits that this Court should reverse the holdings in the Appellate Division's August 11, 2016 Decision

---

[9] *See, e.g.*, Robert T. Miller, *The RMBS Put-Back Litigations and the Efficient Allocation of Endogenous Risk Over Time*, 34 REV. BANKING & FIN. L. 255, 276 (2014) (noting the general language of sole remedy provisions throughout the RMBS market). Indeed, the ramifications of the Appellate Division's order may go beyond RMBS litigation as sole remedy provisions are employed in a wide range of commercial transactions, asset-backed securitizations, and other complex business contracts.

and Order allowing Plaintiff to pursue monetary damages beyond the contractually agreed-upon sole remedy.

Very truly yours,



Shahzeb Lari
of PAUL HASTINGS LLP

Shahzeb Lari
Jessica Montes
200 Park Ave.
New York, NY 10166
Telephone: (212) 318-6000
Facsimile: (212) 319-4090

Timothy D. Reynolds
515 South Flower St., 25th Floor
Los Angeles, CA 90071
Telephone: (213) 683-6000
Facsimile: (213) 627-0705

Attorneys for *Amicus Curiae*
the Securities Industry and Financial Markets Association

PAUL HASTINGS

(212) 318-6098
shahzeblari@paulhastings.com

RULE 500.1(f) CORPORATE DISCLOSURE STATEMENT

Pursuant to Rule 500.1(f), *amicus curiae* SIFMA states that it has no parents, subsidiaries, or affiliates.

Dated: February 13, 2017

By: ______________________
Shahzeb Lari
Counsel for the Securities Industry and Financial Markets Association

PAUL HASTINGS

(212) 318-6098
shahzeblari@paulhastings.com

WORD COUNT CERTIFICATION

The foregoing letter brief was prepared on a computer in Microsoft Word using a proportionally spaced typeface, as follows:

Name of typeface: Times New Roman
Point size: 14
Line spacing: Single

The total number of words in this brief, inclusive of point headings and footnotes and exclusive of headings, proof of service, certificate of compliance or any authorized addendum is 3,549.