THE RMBS PUT-BACK LITIGATIONS AND THE EFFICIENT ALLOCATION OF ENDOGENOUS RISK OVER TIME

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Abstract

In many cases pending around the country, purchasers of residential mortgage-backed securities (RMBSs) are suing the financial institutions that created and sold the RMBSs, alleging that representations and warranties made by these institutions concerning the quality of the underlying mortgage loans were false in various respects. A key issue in many of these cases, concerns whether the plaintiffs' claims are barred by the statute of limitations. The issue turns on whether the statute began to run on the date that the seller made an allegedly false representation about the loans, in which case the statute would in many cases have already expired, or only on the much later date when the plaintiff demanded that the seller repurchase the allegedly non-conforming loans and the seller refused.

This seemingly highly-technical issue raises important questions about the efficient allocation of risk in sophisticated commercial agreements. The seller's representations about the loans, backed up by the repurchase provision, shifts the endogenous risks

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associated with the loans to the seller, which is exactly what economic theory would predict because the seller is undoubtedly the superior bearer of these risks. The running of the statute of limitations, however, retransfers these risks back to the holders of the RMBSs. Since all the factors that make the seller the superior risk bearer still obtain on the date the statutory period expires, it would seem that the statute of limitations is creating an inefficient allocation of risk.

This article shows why retransferring endogenous risks to the RMBS holders is in fact efficient, that is, why the seller is the efficient risk bearer for a given period of time after the closing of the transaction but that, at a certain later point in the time, the RMBS holders become the efficient risk bearers. The argument turns on the fact that error rates in determining whether loans are conforming and the transaction costs of implementing the repurchase provision both rise over time, with the result that at some point the net benefit captured by shifting endogenous risks to the seller is reduced below the costs involved in implementing the repurchase provision. At this point, which the article denominates the moment of efficient repose, it becomes efficient to allow the costs of materializing endogenous risks to remain where they fall.

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I. Introduction

Many people believe that the principal cause of the financial crisis of 2007–2008 was the securitization of subprime residential mortgages that borrowers had little or no ability to repay.[1] On this view,

[1] We find this view in the financial press, e.g., Christina Rexrode & Andrew Grossman, *BofA Accord Ends a Long Legal Drama*, WALL ST. J., Aug. 22, 2014, at C1 ("The Justice Department's case against Bank of America provides perhaps the clearest window yet into the behavior that fueled the 2008 financial crisis: Lenders knowingly providing credit to borrowers who couldn't afford

banks and other mortgage originators lent money in flagrant violation of their own underwriting guidelines, including, for example, by making loans with fantastically high loan-to-value ratios or loans to borrowers who had delivered obviously fraudulent loan applications.[2] Normally, of course, a rational lender does not lend if there is little chance that he will be repaid, and so key to this account of the financial crisis is the idea that, after lending money that would never be repaid, mortgage originators were able to securitize these bad loans—that is, effectively sell them to investors in the form of residential mortgage-backed securities ("RMBSs").[3] As the mortgage originators lent ever more money to ever more unqualified borrowers, housing prices were driven to irrationally high levels, and when rationality was restored and the prices crashed, the RMBSs backed by these loans lost a large fraction of their value.[4] The result was that some of the financial institutions holding these securities were bankrupted and others had to be saved by government bail-outs.[5]

In my view, nearly every step in this argument is substantially wrong.[6] The aim of this paper, however, is not to demonstrate the

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the loans and selling those mortgages to unwitting investors. Borrowers ultimately defaulted, sending them into foreclosure and saddling investors with hefty losses."); in popular books about the financial crisis, e.g., MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 262 (2010) (asserting that "[e]very major firm on Wall Street was either bankrupt or fatally intertwined with a bankrupt system," and that "without government intervention every single [powerful financier] would have lost his job"); in scholarly books about the financial crisis, e.g., ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 71–74, 100 (2013); and in law school casebooks, e.g., JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 12–13 (7th ed. 2013).

[2] *See supra* note 1.

[3] *See* BLINDER *supra* note 1, at 72–79.

[4] *See id.* at 121.

[5] *See id.* at 100–19.

[6] For example, subprime mortgages were not predatory loans to borrowers who could not repay, but a sorting mechanism that allowed lenders to identify worthy borrowers who would not qualify for prime loans. *See* Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT. 10, 12 (2009). In securitizing mortgage loans, originators and other sponsors did *not* pass off all the risk associated with these loans but in fact retained a very large share of it, in part through the retention of endogenous risk as explained in this Article, and in part through credit enhancements built into the transaction, primarily through the originators or sponsors holding the most junior tranches of the securitized

multiple misunderstandings embedded in this account, but to examine only one set of closely related issues it raises. In particular, as in all securitization transactions, when a mortgage originator or other financial institution securitizes residential mortgage loans, it sells the loans to a special purpose entity, usually a trust, which then issues RMBSs to investors.[7] This transaction is memorialized in a loan purchase agreement, much of which is devoted to a set of elaborate representations and warranties that the seller makes to the purchaser (ultimately for the benefit of the investors in the RMBSs) concerning the quality of the mortgage loans being securitized.[8] These

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assets. *See* SULEMAN BAIG & MOORAD CHOUDHRY, THE MECHANICS OF SECURITIZATION 11–14 (2013); STEVEN L. SCHWARCZ ET AL., SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS § 7.05, at 161 (2004); SECURITIZATION OF FINANCIAL ASSETS, § 8.02 (Jason H.P. Kravitt ed., 3d ed. 2014); CHARLES AUSTIN STONE & ANNE ZISSU, THE SECURITIZATION MARKETS HANDBOOK 385–96 (John Wiley & Sons, Inc. 2d ed., 2012) (2005); Russell B. Brewer II & Linda S. Iseley, *Credit Enhancement for Asset-Backed Transactions*, *in* THE HANDBOOK OF ASSET-BACKED SECURITIES 127, 130–31 (Jess Lederman ed., 1990); Theodore V. Buerger & Linda S. Iseley, *An Overview of Securitization Risks*, *in* THE ASSET SECURITIZATION HANDBOOK 505, 505–28 (Phillip L. Zweig ed., 1989). This is precisely why, when the housing bubble burst and RMBSs lost so much value, so many originators were bankrupted. *See* Gorton, *supra*, at 32, 38. And, in any event, at the time of the financial crisis in 2008, the total amount of all subprime securities in the world was only about $600 billion; if they had all instantly become worthless, the total loss would have been less than the losses resulting from a bad day on the New York Stock Exchange and cannot begin to explain a world-wide financial crisis. *See* BEN S. BERNANKE, THE FEDERAL RESERVE AND FINANCIAL CRISIS 69–72 (2013). For a more cogent overview of the causes of the financial crisis, see generally Gary Gorton & Andrew Metrick, *Getting Up to Speed on the Financial Crisis: A-One-Weekend-Reader's Guide*, 50 J. ECON. LITERATURE 128 (2012). To be clear, however, I am denying that there were significant numbers of very poor loans securitized towards the peak of the housing market; I see this, however, as more an effect of the housing bubble than a cause, and in any event the bursting of the housing bubble was no more than the precipitating cause of the financial crisis, the origins of which lay in the runnability of certain segments of the shadow-banking market. *See id.*

[7] *See generally* SCHWARCZ ET AL., *supra* note 6, § 7.05, at 161; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6; STONE & ZISSU, *supra* note 6.

[8] *See, e.g.*, SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 18.02; Buerger & Iseley, *supra* note 6, at 506–07.

representations invariably include representations about the loan-to-value ratio of the loans, appraisals of the underlying residential properties, the accuracy and completeness of the documentation supplied by the borrowers, the compliance of the loan transaction with applicable underwriting guidelines, and the absence of fraud in the making of the loans.[9] Hence, if the popular account of mortgage originators making shoddy loans and then securitizing them is correct, the representations and warranties made by the entities selling the loans must have been grossly false when made.[10]

This proposition is currently being tested in a slew of cases across the country, the most important of which are making their way through the New York state courts[11] and the federal courts in the

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[9] *See infra* note 58.

[10] Undoubtedly influenced by such considerations, in September of 2014 the Securities and Exchange Commission promulgated significant changes to its Regulation AB governing public offerings of asset-backed securities, including RMBSs. *See* Asset-Backed Securities Disclosure and Registration, Securities Act Release No. 9638, Exchange Act Release No. 72982, 2014 WL 4820167 (Sept. 4, 2014). Among other things, the new rules require asset-level disclosure in both the prospectus and periodic reports regarding the mortgage loans securitized in RMBSs. Also, to be eligible for shelf-registration, the transaction must provide for an independent third-party reviewer of the seller's representations and warranties and a dispute resolution procedure for claims under the Repurchase Provision. The reviewer, who must be named in the prospectus and meet certain independence requirements, must review the accuracy of the seller's representations and warranties if, either, a specified percentage of the loans in the pool become delinquent, or a specified percentage of the securityholders vote to require a review. Subject to certain limits, the required percentages may be determined by the parties in the relevant agreements. *See* Theodore Mirvis, Wachtell, Lipton, Rosen & Katz, SEC Adopts Long Awaited Rules for Asset-Backed Securities, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., http://blogs.law.harvard.edu/corpgov/2014/09/20/sec-adopts-long-awaited-rules-for-asset-backed-securities/ (Sept. 20, 2014, 9:40 AM), *archived at* http://perma.cc/6M4H-7GNM.

[11] *E.g.*, *In re* Bank of N.Y. Mellon, No. 651786/11, 2014 WL 1057187 (N.Y. Sup. Ct. Jan. 31, 2014); Assured Guar. Mun. Corp. v. DB Structured Prods., Inc., No. 650705/2010, 2014 WL 3282310 (N.Y. Sup. Ct. July 3, 2014); HSH Nordbank AG v. Goldman Sachs Grp., No. 652991/12, 2013 WL 8476977 (N.Y. Sup. Ct. Nov. 26, 2013); CIFG Assurance N. Am., Inc. v. Bank of Am., N.A., No. 654028/12, 2013 WL 5380385 (N.Y. Sup. Ct. Sept. 23, 2013); ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844 (N.Y. Sup. Ct. 2013); Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit &

Southern District of New York and the Second Circuit.[12] The relevant purchase agreements in the underlying transactions tend to be substantially identical, and virtually all of them are governed by the laws of New York.[13] One of the most important issues in these cases thus far concerns provisions in the purchase agreements that define a specific contractual remedy for investors if the seller's representations regarding the loans turn out to have been false.[14] Under these so-called "Repurchase Provisions," if a loan sold in the transaction does not conform to the seller's representations in the agreement, then the seller is required to cure the breach within a specified period of time (typically sixty days) or, after demand by the purchaser, repurchase the loan at full value.[15] That is, the investors effectively have a put option against the seller for any non-conforming loan. Thus, the primary remedy sought by the plaintiffs in these cases is generally an order requiring the seller to repurchase all non-conforming loans in accordance with the Repurchase Provision.[16] For this reason, the

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Capital, Inc., No. 653541/2011, 2013 WL 2072817 (N.Y. Sup. Ct. May 10, 2013); HSH Nordbank AG v. Barclays Bank PLC, No. 652678/2011, 2014 WL 841289 (N.Y. Sup. Ct. Mar. 3, 2014).

[12] Deutsche Bank Nat'l Trust Co. v. Quicken Loans, Inc., No. 13 Civ. 6482(PAC), 2014 WL 3819356 (S.D.N.Y. Aug. 4, 2014); Landesbank Baden-Württemberg v. RBS Holdings USA Inc., No. 12 Civ. 5476(PGG), 2014 WL 1388408 (S.D.N.Y. Apr. 9, 2014); IKB Int'l v. Bank of Am., No. 12 Civ. 4036(LAK), 2014 WL 1377801 (S.D.N.Y. Mar. 31, 2014); ACE Sec. Corp. Home Equity Loan Trust, Series 2007-HE3 v. DB Structured Prods., Inc., 5 F. Supp. 3d 543 (S.D.N.Y. 2014); Lehman XS Trust, Series 2006-4N v. Greenpoint Mortg. Funding, Inc., 991 F. Supp. 2d 472 (S.D.N.Y. 2014); Fed. Hous. Fin. Agency v. WMC Mortg., LLC, No. 13 Civ. 584(AKH), 2013 WL 7144159 (S.D.N.Y. Dec. 17, 2013); Deutsche Alt-A Sec. v. DB Structured Prods., 958 F. Supp. 2d 488 (S.D.N.Y. 2013); Fed. Hous. Fin. Agency v. JPMorgan Chase & Co., 902 F. Supp. 2d 476 (S.D.N.Y. 2012). There are other cases pending in other courts around the country as well. *See, e.g.*, Residential Funding Co. v. Mortg. Access Corp., No. 13-3499 (DSD/FLN), 2014 WL 3577403 (D. Minn. July 21, 2014); CMFG Life Ins. Co. v. UBS Sec., No. 13-cv-576-wmc, 2014 WL 2986472 (W.D. Wis. July 2, 2014); Deutsche Bank Nat'l Trust Co. v. WMC Mortg., LLC, 2014 WL 1289234 (D. Conn. Mar., 31, 2014); MASTR Asset Backed Sec. Trust 2006-HE3 v. WMC Mortg., LLC, 983 F. Supp. 2d 1104 (D. Minn. 2013); Republic Bank & Trust Co. v. Bear, Stearns & Co., 707 F. Supp. 2d 702 (W.D. Ky. 2010).

[13] *See supra* note 12.

[14] *See infra* Part II.B.

[15] *See infra* note 59 and accompanying text.

[16] *See infra* Part II.B.2.

various pending lawsuits related to alleged breaches of the seller's representations and warranties in RMBS securitization transactions are sometimes called RMBS Put-Back Litigations.

This Article treats a technical issue in the RMBS Put-Back Litigations that in fact illuminates a fundamentally important issue about the allocation of risk in sophisticated commercial transactions. The technical issue concerns the statute of limitations applicable to the plaintiffs' claims: is the relevant breach of contract the falsity of the seller's representations and warranties, which were made at the date of sale, so that the statute began to run on that date (and thus has already expired in many cases), or is the relevant breach of contract the failure of the seller, after demand by the purchaser, to repurchase a non-conforming loan, so that the statute began to run only at a much later date when the seller discovered the breaches and demanded repurchase?[17] Since a finding that a plaintiff's claims are time-barred would end the particular RMBS Put-Back Litigation, and since the value of the loans at stake in most such litigations amounts to many hundreds of millions of dollars, the total amount turning on the resolution of this issue easily aggregates scores of billions of dollars.[18] Precisely this issue is currently before both the United States Court of Appeals for the Second Circuit in *Lehman XS Trust, Series 2006-4N v.*

[17] *Compare Lehman XS Trust*, 991 F. Supp. 2d at 477, Lehman Bros. Holdings, Inc. v. Evergreen Moneysource Mortg. Co., 793 F. Supp. 2d 1189, 1193–94 (W.D. Wash. 2011) (finding that the "statute of limitations begins to run from the date of the first alleged breach," even in the event that damages do not accrue to a later date under NY law), *and* Structured Mortgage Trust 1997-2 v. Daiwa Fin. Corp., No. 02 Civ. 3232(SHS), 2003 WL 548868, at *2 (S.D.N.Y. Feb. 25, 2003) (holding that statute of limitations begins at time of breach), *with* ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844 (N.Y. Sup. Ct. May 13, 2013) (stating that "[t]he statute of limitations began to run when DBSP improperly rejected the trustee's repurchase demand. . . . [thus,] the breach is the failure to comply with the demand"), *and* Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *5–6 (N.Y. Sup. Ct. May 10, 2013) ("A cause of action for breach of contract accrues at the time of the breach."). On the statute of limitations issue in the RMBS Put-Back Litigations generally, see Joseph Cioffi & James R. Serritella, *When Is It Too Late for Investors to Bring RMBS-Related Claims?*, 130 BANKING L.J. 813 (2013).

[18] *See supra* note 17.

Greenpoint Mortgage Funding, Inc.[19] and New York's highest court, the New York Court of Appeals, in *ACE Securities Corp. v. DB Structured Products, Inc*.[20]

Although this issue concerning the statute of limitations may seem to be a merely technical one, it in fact raises extremely important questions about how commercial transactions are structured to efficiently allocate risk. For although the sale of the mortgage loans by the seller to the purchaser shifts the risks associated with holding the loans to the purchaser in the first instance, nevertheless the representations by the seller, backed up by the Repurchase Provision, effectively shift the endogenous risk associated with the loans back to the seller.[21] This makes perfect economic sense because the seller, who is usually either the originator of the loans or an affiliate of an investment bank specializing in securitizing assets, is almost certainly able to detect and prevent many errors related to endogenous risk in a cost-effective manner and is much more familiar with the loans than the ultimate investors; hence, the seller is the cheaper cost-avoider with respect to preventable errors in the underwriting process and, more generally, the superior risk bearer of the endogenous risk associated with the loans.[22] The seller's representations, together with the Repurchase Provision, thus constitute a contractual mechanism that shifts certain risks to the party that can bear them most cheaply—precisely the sort of efficient provision we should expect in an agreement between sophisticated, well-advised, profit-maximizing commercial parties. Notwithstanding all this, however, when the statute of limitations expires (regardless of when it begins to run), the effect is to shift the relevant risks back to the purchaser.[23] This should seem very mysterious: for if the seller was the superior risk bearer of the endogenous risks associated with the loans at the time the loans were sold, it is very difficult to see why at some point years later, the purchaser would suddenly become the superior risk bearer so that the risks should be shifted back again to the purchaser.[24]

[19] Notice of Appeal at 1, Lehman XS Trust, Series 2006-4N v. Greenpoint Mortg. Funding, Inc., 991 F. Supp. 2d 472 (S.D.N.Y. 2014) (No. 13 CIV 4707 (SAS)) (2d Cir. Filed Feb. 7, 2014).
[20] 977 N.Y.S.2d 229 (N.Y. App. Div. 2013), *leave to appeal granted*, 2014 WL 2891678 (N.Y. June 26, 2014).
[21] *See infra* Part III.C.
[22] *See infra* Part III.C.
[23] *See infra* Part III.C.
[24] *See infra* Part III.C.

Nor is the reallocation of endogenous risk to the purchaser a mere artifact of the statute of limitations. That is, this is not a case of a legislature imposing an inefficient contractual term on parties engaged in market transactions. We know this because, despite the statute of limitations, it would be very easy for sophisticated commercial parties to draft an agreement that resulted in the endogenous risk being permanently allocated to the seller.[25] Even the plaintiffs in the RMBS Put-Back Litigations, however, do not argue that the purchase agreements have this effect.[26] The disagreement between the plaintiffs and the defendants does not concern whether the endogenous risk is eventually reallocated to the purchasers but only *when* this reallocation occurs.[27] Thus, assuming that the sophisticated, well-advised, and profit-maximizing financial institutions that participate in securitization transactions are allocating risk efficiently in their agreements, it really must be that, although the seller is the superior risk bearer of the endogenous risk at the time the loans are securitized, at some subsequent time the purchaser becomes the superior risk bearer.[28] It is very difficult to see, however, how the mere passage of time could change which party is the superior risk bearer. In particular, all the arguments that tend to show that the seller was the superior risk bearer at the time the transaction was completed still apply at all later points in time.

Why, then, is it efficient for the endogenous risk associated with the loans to be shifted back to the purchaser at some point several years after the closing of the transaction? This Article attempts to answer that question. In particular, I shall show that the arguments in favor of the seller being the superior bearer of the endogenous risk assume that (a) non-conforming loans can be identified infallibly and costlessly, and, (b) the parties can implement the Repurchase Provision with respect to such loans costlessly. In other words, the arguments showing that the seller is the superior risk bearer implicitly assume that the relevant information and other transaction costs are zero.[29] This, of course, is not really the case. In fact, because information costs are positive, there will be a positive error rate in determining whether loans conform to the representations: hence, some conforming loans will be put back to the seller, and some non-conforming loans will remain with

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[25] *See infra* Part III.B.
[26] *See supra* notes 11–12.
[27] *See supra* notes 11–12.
[28] *See infra* Part III.D.
[29] *See infra* Part III.D.

the purchaser. In addition, there will be other transaction costs, both for the seller and the purchaser, in determining whether a given loan alleged to be non-conforming really is so and in implementing the Repurchase Provision with respect to those loans determined (perhaps erroneously) to be non-conforming.[30]

At the time the contract is made, therefore, the expected benefit to be gained by shifting the endogenous risk associated with a given loan from the purchaser to the seller is not merely the difference between the seller's expected cost of bearing this risk and the purchaser's expected cost, as is implicitly assumed by the arguments suggesting that the seller is the superior risk bearer for such risks. Rather, the benefit gained is this difference, discounted by the possibility that the loan will be non-conforming but erroneously not put back, less the expected transaction costs of implementing the Repurchase Provision, including both the costs the parties incur in determining whether a loan is conforming or not and the costs they incur in transferring back to the seller those determined to be non-conforming.[31] But the error rate and at least some of the transaction costs will increase over time, and so at some point in time after the contract is made, the expected benefit to be gained by shifting the endogenous risk associated with the loan back to the seller will become zero.[32] From that point in time onward, the purchaser, not the seller, is the superior risk bearer.[33] In this Article, I call that point in time the Moment of Efficient Repose. Hence, we should expect to see, as we in fact do see, a system in which the seller bears the endogenous risks associated with the loans only for a certain period of time, with the purchaser bearing these risks thereafter. This explains why sophisticated, well-advised, profit-maximizing entities like the parties involved in securitization transactions have not contracted around the statute of limitations, and it indicates incidentally, the correct resolution of cases such as *ACE Securities* and *Lehman XS Trust*: the sellers should win those cases.[34]

Part II of this Article will briefly review the relevant aspects of securitization transactions and describe in detail the statute of limitations issues in the RMBS Put-Back Litigations pending in the Second Circuit Court of Appeals and the New York Court of Appeals.

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[30] *See infra* Part III.D.
[31] *See infra* Part III.D.
[32] *See infra* Part III.D.
[33] *See infra* Part III.C.
[34] *See infra* Parts IV–V.

Part III will explain in detail how the statute of limitations issue implicates questions of the efficient allocation of risk and will elucidate the analysis of how the efficient allocation of risk over time limned above changes over time as a function of error rates and certain kinds of transaction costs. In Part IV, I shall apply the analysis in Part III to the RMBS Put-Back Litigations, arguing that the statute of limitations for claims based on breaches of the seller's representations and warranties should begin to run at the time the false representations were made, not any date related to the alleged non-performance of the purchaser to repurchase the loans. In Part V, I shall make some concluding remarks.

II. The Statute of Limitations in the RMBS Put-Back Litigations

In this Part, I shall (a) briefly review the structure of a typical residential mortgage securitization transaction of the kind at issue in the RMBS Put-Back Litigations, (b) describe the relevant contractual provisions at issue in those litigations, (c) explain the statute of limitations issue related to those provisions currently before the New York Court of Appeals in *ACE Securities*, and (d) explain the related but slightly different statute of limitations issue currently before the Second Circuit in *Lehman XS Trust*. This discussion will provide the necessary background for the investigation of the efficient allocation of risk over time in Part III.

A. The Structure of Typical Residential Mortgage Securitization Transactions[35]

Although there are many variations depending on the type of assets being securitized, applicable provisions of the Internal Revenue Code, and other factors, since the invention of securitization as a financing technique in the 1980s, the structures used in securitization transactions have been essentially standardized.[36] In general, either the

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[35] On the extremely complex matter of asset securitizations, see generally BAIG & CHOUDHRY, *supra* note 6; SCHWARCZ ET AL., *supra* note 6; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6; STONE & ZISSU, *supra* note 6; THE ASSET SECURITIZATION HANDBOOK, *supra* note 6; THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 6.

[36] The reasons for this are many. Among other things, to be value-enhancing for the parties involved, the transaction has to qualify as a true-sale for bankruptcy purposes. *See* STONE & ZISSU, *supra* note 6, at 184–85. The transaction has to obtain pass-through tax treatment at the special purpose

original owner of the assets (in the case of residential mortgages, the loan originator) or else a financial institution that specializes in securitizing assets and that has purchased the assets from the original owner (in either case, the seller) sells the assets to another entity, in most cases a trust (the purchaser).[37] Sometimes this sale is made directly from the seller to the purchaser (a one-step or one-tier securitization), and sometimes it is accomplished by selling the assets first to a subsidiary of the seller that then sells them to the purchaser (a two-step or two-tier securitization).[38] The purpose of these transactions is to ensure that the transfer of assets is treated (a) as a true-sale for bankruptcy purposes, which ensures that, if the seller becomes insolvent, its creditors will be legally unable to reach the assets in bankruptcy, and (b) for some transactions, as a sale rather than a secured financing under generally accepted accounting principles ("GAAP") with the assets being held on the balance sheet of an entity not required to be consolidated with the seller,[39] which ensures that the assets being securitized are removed from the seller's balance sheet and no liabilities are added to that balance sheet as a result of the transaction. When the assets in question are mortgage loans, the relevant agreement memorializing the sale of the assets is often called a Mortgage Loan Purchase Agreement.[40]

The purchaser pays for the assets being transferred either with the proceeds of securities sold to investors or else by delivering such

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entity ("SPE") level. *See id.* at 98–100. The transaction also has to be treated as a sale rather than a financing under generally accepted accounting principles at the originator or sponsor level. SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § § 19.01–19.09. Meeting all these requirements simultaneously largely fixes the structure of the transaction. In addition, as Judge Winter first pointed out in connection with corporate bonds and the indentures under which they are typically issued, standardization of transactional terms lowers information costs for market participants buying and selling the asset-backed securities, which encourages a liquid market. *See* Sharon Steele Corp. v. Chase Manhattan Bank, N.A., 691 F.2d 1039, 1048 (2d Cir. 1982).

[37] SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 4.02[B].

[38] *Id.* § 4.04.

[39] *Id.* § 4.04, at 4-55 to 4-56.

[40] Throughout this Article, I shall refer to agreements having this function as Mortgage Loan Purchase Agreements, even though such agreements are styled in different ways in different transactions, except when discussing a particular agreement in connection with a particular transaction, in which case I shall refer to the agreement in accordance with the title given it by the parties.

securities to the seller, which then itself sells them to investors.[41] In either case, the securities entitle the investors to receive from the purchaser a portion of the cash flows derived from the underlying assets, with the purchaser's obligations under the securities being secured by the assets in the trust.[42] In the case of a transaction securitizing residential mortgages, the purchaser is generally organized as a trust that will qualify as a real estate mortgage investment conduit ("REMIC") under the Internal Revenue Code, which ensures that the investors receive pass-through tax treatment, the trust itself being ignored for tax purposes.[43] The trustee of the trust (the "trustee") is typically a financial institution that receives a fee for administering the trust, much like an indenture trustee does with corporate bonds.[44] Typically, there is another party to this transaction as well—usually the seller or one of its affiliates—that agrees, in exchange for a fee, to service the assets by, for example, collecting payments from the borrowers, handling escrows related to residential mortgages, foreclosing on borrowers who do not repay, and so on (the "servicer").[45] This transaction among the purchaser, the trustee, and the servicer is memorialized in an agreement often styled as a Pooling and Service Agreement.[46] Although the trust is the legal purchaser of the mortgage loans, the investors in the RMBSs issued by the trust are the true parties in interest. Since, under the relevant agreements, the investors can generally act only through the trust, the trustee becomes the party with the legal right to enforce the relevant agreements.[47] For this reason, I shall refer to the trust as the purchaser of the loans, it being understood that the investors who hold the RMBSs are the true

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[41] *See generally* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § § 4.01–4.05.

[42] *See* BAIG & CHOUDHRY, *supra* note 6, at 4–14. Sometimes the certificates are issued to the seller, which then sells them to investors, or to an underwriter, which them sells them to investors, but these complications may be safely ignored here.

[43] *See* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 16.02.

[44] *See id.* § 9.01.

[45] *See id.* § 16.05.

[46] As with Mortgage Loan Purchase Agreements, *supra* note 40, I shall refer to agreements serving the same function as Pooling and Service Agreements under that rubric except when discussing a particular agreement in connection with a particular transaction, in which case I shall refer to the agreement in accordance with the title given it by the parties.

[47] *See* Walnut Place LLC v. Countrywide Home Loans, Inc., 948 N.Y.S.2d 580, 581 (N.Y. App. Div. 2012).

parties in interest and often the trustee will be the party acting on behalf of the trust.

B. The Contractual Provisions Relevant to the Statute of Limitations Issue

The Mortgage Loan Purchase Agreement between the seller and the purchaser typically contains three related contractual provisions that together allocate to the seller the endogenous risks associated with the mortgage loans being transferred: (1) representations and warranties by the seller regarding the loans being securitized,[48] (2) a repurchase provision, which defines a limited contractual remedy for the purchaser for loans that breach the representations and warranties (the "Repurchase Provision"), and (3) a sole remedy provision, which provides that the Repurchase Provision shall be the sole and exclusive remedy for the seller's breach of its representations and warranties regarding the loans (the "Sole Remedy Provision").[49] All these provisions appear in the agreements at issue in *ACE Securities* and *Lehman XS Trust*.[50] In addition, some Mortgage Loan Purchase

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[48] The seller also typically makes additional representations and warranties regarding its due organization, its authority to enter into the agreement, the enforceability of the agreement, its non-violation of its certificate of incorporation and bylaws, its non-violation of law, its status as an approved seller or servicer with Fannie Mae and Freddie Mac, its good standing under Section 203 of the National Housing Act, its good title to the loans being transferred, the absence of certain legal proceedings, required consents and approvals, the non-applicability of bulk-transfer laws, its own solvency, and similar matters. See, e.g., Mortgage Loan Purchase Agreement, dated Mar. 28, 2006, between DB Structured Prods., Inc., and ACE Sec. Corp., § 5 (on file with author), which is the agreement at issue in *ACE Securities*. These representations and warranties *about the seller* are distinct from the representations and warranties *about the loans*, and typically even appear in different sections of the agreement (in the Mortgage Loan Purchase Agreement at issue in *ACE Securities*, representations and warranties about the loans appear in Section 6, which is captioned "Representations and Warranties of the Sponsor Relating to the Mortgage Loans," in contradistinction to Section 5, which is captioned "Representations, Warranties and Covenants of the Sponsor"). *See id.* § § 5–6. The RMBS Put-Back Litigations invariably concern the representations and warranties regarding the loans, not the seller.

[49] *See id.* § 7.

[50] *See id.* § § 1–19; *see also* Flow Mortgage Loan Purchase and Warranties Agreement, dated Dec. 12, 2001, between Lehman Bros. Bank, FSB, and Greenpoint Mortg. Funding, Inc., § § 1–27 (on file with author).

Agreements also contain (4) a claims accrual provision, which provides that any claims of the purchaser related to breaches of the seller's representations and warranties will accrue only after the seller does not repurchase a non-conforming loan under the Repurchase Provision (the "Claims Accrual Provision").[51] The agreement at issue in *Lehman XS Trust*, but not that at issue in *ACE Securities*, contains a Claims Accrual Provision.[52] I describe each of these provisions in more detail below.[53]

1. The Seller's Representations and Warranties About the Loans

In Mortgage Loan Purchase Agreements, the seller typically makes an extensive set of representations and warranties to the purchaser about the loans being sold and the underwriting process that produced them. There are commonly fifty or more individual representations, including representations about (a) the correctness of information about the loans that the seller has provided to rating agencies, (b) the absence of delinquent payments on the loans, (c) the absence of delinquent tax or insurance payments affecting the loans or underlying properties, (d) the absence of any modifications to the terms of the loans or mortgages, (e) the existence and maintenance of

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[51] *See, e.g.*, Lehman XS Trust, Series 2006-4N v. Greenpoint Mort. Funding, 991 F. Supp. 2d 472, 475–76 (S.D.N.Y. 2014).

[52] *See id.*

[53] In two-tier transactions, the originator or sponsor first sells the assets to one of its subsidiaries, which is then usually called the "depositor," and the depositor then sells the assets to the ultimate purchaser. *See* HSH Nordbank AG v. Barclays Bank PLC, No. 652678/2011, 2014 WL 841289, at *2–4 (N.Y. Sup. Ct. Mar. 3, 2014) (discussing the relationship between originators and purchasers); SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 4.04. In such transactions, the agreement between the originator or sponsor and the depositor generally contains representations and warranties by the originator or sponsor backed up by a Repurchase Provision. *See, e.g.*, Mortgage Loan Purchase Agreement, *supra* note 48, § § 5–7. The agreement between the depositor and the purchaser then contains an assignment to the purchaser of all the depositor's rights and interests, including for breach of representation, under its agreement with the originator or sponsor. *See HSH Nordbank AG*, 2014 WL 841289, at *2–4, *12. In discussing the purchaser's contractual rights, therefore, it is convenient to ignore the depositor and treat the transaction as being between the originator or sponsor as seller and the purchaser, which is how I shall proceed in this Article unless the context requires otherwise.

appropriate levels of insurance on the underlying properties, (f) the compliance of the loan and mortgage with various applicable laws, including usury, truth-in-lending, anti-predatory lending, real estate settlement procedures, consumer credit protection, equal credit opportunity, and fair housing and disclosure laws, (g) the absence of any subordination of the mortgages, (h) the due recordation of the mortgage, (i) the valid and binding nature of the loans and mortgages on, and the enforceability of the loan and mortgage against, the borrower, (j) the seller's good title to the loan and mortgage and the absence of any other liens or charges against the loan and the mortgage, (k) the existence of title insurance related to the mortgage, (l) the absence of events of default under the loan, (m) the absence of mechanics' and similar liens against the underlying property, (n) the reasonability and customary nature of all servicing practices used in servicing the loans, (o) the absence of any condemnation proceedings against the underlying property, (p) the customary nature and enforceability of the terms of the loans and mortgages, (q) the absence of any physical damage to the underlying property, (r) the legal capacity of the individual borrowers to execute the notes related to the mortgage loans, (s) the compliance of the underlying properties with applicable zoning laws, and (t) the absence of legal proceedings related to the property under applicable environmental laws.[54]

For purposes of the RMBS Put-Back Litigations, however, there are certain representations that are especially important. The *Absence of Fraud Representation* typically provides that no misrepresentation or fraud has taken place on the part of the seller, the borrowers on individual loans, the originator (if the seller is not itself the originator), or any appraiser or other party involved in the

[54] *See, e.g.*, Mortgage Loan Purchase Agreement, *supra* note 48, § 6; *see also* Deutsche Bank Nat'l Trust Co. v. Quicken Loans, Inc., No. 13 Civ. 6482(PAC), 2014 WL 3819356, at *1 (S.D.N.Y. Aug. 4, 2014) (describing representations by the seller regarding mortgage loans); *Lehman XS Trust*, 991 F. Supp. 2d at 474–75 (discussing representations by the seller and loan representations in a purchase agreement); ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 846 (N.Y. Sup. Ct. 2013) (discussing representations in the Mortgage Loan Purchase Agreement); Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, *2–4 (N.Y. Sup. Ct. May 10, 2013) (describing some of the thirty-nine representations made by the seller); Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 7; SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 18.02.

origination of the mortgage loan.[55] The *No Adverse Selection Representation* typically provides that the seller used no selection procedures in choosing the loans to include in the securitization that identified loans as being less desirable or valuable than other comparable loans in the seller's portfolio.[56] The *Underwriting Representation* typically provides that the loans were underwritten in accordance with the originator's underwriting guidelines in effect at the time the loans were originated, except with respect to loans that had compensating factors permitting a deviation from the applicable guidelines (that is, a factor that made a loan worth making despite the fact that it otherwise failed to conform in some respects to the underwriting guidelines).[57]

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[55] *See, e.g.*, Mortgage Loan Purchase Agreement, *supra* note 48, § 6(ii) ("No misrepresentation or fraud has taken place on the part of the Sponsor, the Mortagor or any third party originator of such Mortgage Loan, or to the Sponsor's knowledge, any other person, including without limitation, any appraiser, any builder or developer, or any other party involved in the origination of the Mortgage Loan or in the application of any insurance in relation to such Mortgage Loan . . . ."); Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 7(yy) ("No error, omission, misrepresentation, negligence, [or] fraud . . . w[as] employed in the origination of the mortgage loan."); *see also Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *2 (describing representation about absence of fraud in the origination of the loans).

[56] *See e.g.*, Mortgage Loan Purchase Agreement, *supra* note 48, § 6(lviii) ("No selection procedures were used by the Sponsor that identified the Mortgage Loans as being less desirable or valuable than other comparable mortgage loans in the Sponsor's portfolio . . . ."); Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 6(g) ("The Mortgage Loans were not intentionally selected in a manner so as to affect adversely the interests of the Purchaser . . . ."); *see also Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *2 (describing representation on the process whereby loans were selected).

[57] Mortgage Loan Purchase Agreement, *supra* note 48, § 6(xxiii); Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 7(v); *see Lehman XS Trust*, 991 F. Supp. 2d at 474–75 (discussing underwriting representations in the Flow Mortgage Loan Purchase and Warranties Agreement); *see also Deutsche Bank Nat. Trust Co.*, 2014 WL 3819356, at *1 (describing seller's representation regarding mortgage loans' compliance with underwriting standards); *Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *2–3 (describing representation about origination of loans complying with originator's underwriting guidelines).

Most important, the agreement will contain *Financial Representations*, often made by means of a complex schedule detailing each of the thousands of loans being transferred, including regarding the principal and interest rate of the loan, whether the property is owner-occupied, and such crucial valuation variables as the loan-to-value ratio and combined loan-to-value ratio at the date the loan was originated, the appraised value of the property (in an appraisal done for the originator and made in accordance with certain procedures accepted in the industry), the borrower's debt-to-income ratio, and the borrower's FICO score.[58]

[58] In the Mortgage Loan Purchase Agreement at issue in *ACE Securities*, the seller represents in clause (lix) of Section 6 that the information set forth on the Closing Schedule is true and correct in all material respects, and Section 2 of the agreement provides that the Closing Schedule shall conform to the requirements set forth in the definition of "Mortgage Loan Schedule" in Section 1.01 of the related Pooling and Servicing Agreement, dated March 1, 2006. Pooling and Servicing Agreement, dated Mar. 1, 2006, between ACE Sec. Corp., Ocwen Loan Servicing, Wells Fargo Nat'l Ass'n, and HSBC Bank USA Nat'l Ass'n., §1.01 (on file with author); *see also* Mortgage Loan Purchase Agreement, *supra* note 48, § 2. Under that definition, the Mortgage Loan Schedule must set forth, for each loan, among other things, (1) the address of the property, (2) "a code indicating whether the Mortgaged Property is owner-occupied," (3) the original duration of the loan, and (4) "the Loan-to-Value Ratio at origination" (the value here being defined as the lesser of the value as determined by a conforming appraisal made for the originator and the purchase price of the property). Pooling and Servicing Agreement, *supra*, at § 1.01. Moreover, the Mortgage Loan Schedule also sets forth (1) the interest rate, (2) "the stated maturity date," (3) the loan's original principal amount, (4) the outstanding balance, (5) "a code indicating the documentation style" of the loan (i.e., the amount and quality of information the borrower provided the originator in the loan application—in the jargon of the mortgage industry, "full, stated, or limited"), (6) the appraised value of the property (although the phrase "Appraised Value" is capitalized in the agreement, indicating that it should be a defined term, it is not defined in the agreement, and so presumably means the value at which the property was appraised for the originator in a conforming appraisal), (7) the borrower's "debt to income ratio," and (8) the borrower's FICO score. *Id*. In the Flow Mortgage Loan Purchase and Warranties Agreement, dated Dec 12, 2001, Section 7(yy), between Lehman Brothers Bank, FSB, and Greenpoint Mortgage Funding, Inc., the seller represents in Section 7(a) that the information about the mortgage loans set forth in the Mortgage Loan Schedule is true and correct. Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § § 7(a), 7(yy). As defined in Section 1 of the agreement, that schedule must set forth, for each loan, among other things, (1) the address of the property, (2) the original and current

2. The Repurchase Provision

Although the common law of contracts provides various remedies for breach of representation, Mortgage Loan Purchase Agreements typically include a special contractually created remedy related to the seller's representations regarding the mortgage loans being securitized. A typical Repurchase Provision provides as follows:

> Upon discovery by the seller, the purchaser or any assignee, transferee or designee of the purchaser of a breach of any of the representations or warranties by the seller related to the mortgage loans that materially and adversely affects the value of any mortgage loan or the interest therein of the purchaser or the purchaser's assignee, transferee or designee, the party discovering such breach shall give prompt written notice to the seller. Within sixty (60) days of its discovery or its receipt of notice of any such breach of a representation or warranty, the seller promptly shall cure such defect or breach in all material respects or, in the event the seller cannot cure such breach, the seller shall, within ninety (90) days of its discovery or receipt of notice of any such breach of a representation or warranty, either (i) repurchase the affected mortgage loan at the purchase price, or (ii) cause the removal of such mortgage loan from the trust fund and substitute one or more substitute mortgage loans.[59]

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duration of the loan, (3) the combined loan-to-value ratio of the loan at origination (value here being the lesser of the value shown on the related appraisal for the property and the purchase price paid for the property by the borrower), (4) the interest rate on the loan, (5) information about when and how the interest can be adjusted for adjustable rate mortgages, (6) the monthly payment on the loan, (7) the original principal amount of the loan, (8) a code indicating whether the property is owner-occupied, 9) the borrower's debt to income ratio, 10) the borrower's FICO score, 11) and the appraised value of the property (based on the appraisal made by the originator). *Id.* § 1; *see also Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *2 (describing representation about appraisals under the underlying properties and combined loan-to-value ratios).

[59] The text in the article is based on a review of various agreements, including Mortgage Loan Purchase Agreement, *supra* note 48, § 7(a) and Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 8; *see*

The purchase price at which a seller has to repurchase a non-conforming loan is essentially the price the purchaser originally paid for the loan.[60] More accurately, since the loan will have been owned by the purchaser for a time when the Repurchase Provision is implemented, the purchaser may have received some payments on the loan, including as to both principal and interest, may have not received others it should have, and may have incurred transaction costs as a result of the loan being non-conforming. Hence, the purchase price in the Repurchase Provision is the original purchase price of the loan, minus any return of principal the purchaser has received on the loan, plus unpaid interest and the expenses the purchaser incurs in retransferring the loan to the seller.[61]

3. The Sole Remedy Provision

Having created the Repurchase Provision as a contractual remedy for the purchaser in the event that a loan breaches the seller's representations, Mortgage Loan Purchase Agreements also typically go on to provide that the Repurchase Provision shall be the sole remedy

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also Deutsche Bank Nat'l Trust Co., 2014 WL 3819356, at *1; *Lehman XS Trust*, 991 F. Supp. 2d at 475; *ACE One*, 965 N.Y.S.2d at 846; *Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *2.

[60] *See infra* note 61.

[61] Section 7(a) of the Mortgage Loan Purchase Agreement, *supra* note 48, requires the seller to repurchase non-conforming loans at the Purchase Price as defined in the Pooling and Service Agreement, *supra* note 58, § 1.01. Section 1.01 of the Pooling and Service Agreement defines the Purchase Price as the stated principal balance of the loan at the time of the securitization transaction, plus unpaid interest, advances by the servicing agent, and certain expenses incurred by the purchaser. Pooling and Service Agreement, *supra* note 58, § 1.01. Section 8 of the Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, requires the seller to repurchase non-conforming loans at the Repurchase Price, which is defined in Section 1 as a price equal to the stated principal balance of the loan at the time of the securitization transaction, plus unpaid interest on the loan, less any amounts received by the purchaser and less any amounts advanced by the servicer. Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § § 1, 8.

available to the seller for such breaches.[62] Such Sole Remedy Provisions generally contain language such as:

> It is understood and agreed that the obligation of the seller to cure or to repurchase any mortgage loan as to which a breach of representation or warranty has occurred and is continuing shall constitute the sole remedy respecting such breach available to the purchaser and the investors.[63]

The relevant agreements thus first expand on the purchaser's remedies for breach of the seller's representations (which would generally be limited to monetary damages) by effectively giving the purchaser the right to put back to the seller any non-conforming loans, but then, in the Sole Remedy Provision, the agreements contractually deprive the purchaser of all common law remedies for breach of representation. As I shall argue below in Part III, this sole remedy provision is a critically important part of an overall scheme to allocate risk efficiently between the parties.

4. The Claims Accrual Provision

Some Mortgage Loan Purchase Agreements also contain a provision stating that the purchaser's claims under the Repurchase Provision accrue only after notice to the seller and demand by the purchaser,[64] often in language such as the following:

> Any cause of action against the seller relating to or arising out of the breach of any representations and warranties concerning the mortgage loans shall accrue

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[62] *See* ACE Sec. Corp. Home Equity Loan Trust, Series 2007-HE3 v. DB Structured Prods. Inc., 5 F. Supp. 3d 543, 549 (S.D.N.Y. 2014); *ACE One,* 965 N.Y.S.2d at 846; *Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *3.

[63] The text here is based on Mortgage Loan Purchase Agreement, *supra* note 48, § 2.03(a). The Flow Mortgage Loan Purchase and Warranty Agreement in *Lehman XS Trust* does not have an analogous provision, but the mandatory language of the Repurchase Provision, coupled with the Claims Accrual Provision, serves a similar function. *See Lehman XS Trust*, 991 F. Supp. 2d at 475.

[64] See *Lehman XS Trust,* 991 F. Supp. 2d at 475; Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 8(c).

> as to any mortgage loan upon (i) discovery of such breach by the purchaser or notice thereof by the seller to the purchaser, (ii) failures by the seller to cure such breach or repurchase such mortgage loan, and (iii) demand upon the seller by the purchaser for compliance with this Agreement.[65]

The relevant agreement in *Lehman XS Trust* has such a provision, but the agreement in *ACE Securities* does not.[66] As we will see below, the existence of a Claims Accrual Provision in *Lehman XS Trust* afforded the purchaser in that transaction an additional argument to support its view that the statute of limitations for claims based on breach of representations began to run only after the seller failed to repurchase allegedly non-conforming loans under the Repurchase Provision.[67]

C. ACE Securities Corp. v. DB Structured Products in the New York Court of Appeals

In the underlying transaction in *ACE Securities Corp. v. DB Structured Products, Inc.*, DB Structured Products, Inc. ("DBSP"), an affiliate of Deutsche Bank, purchased several thousand mortgage loans from "at least three [different loan] originators" and then sold the loans to ACE Securities Corp. ("ACE"), as purchaser, under a Mortgage Loan Purchase Agreement, dated March 28, 2006.[68] ACE then deposited the mortgage loans in a trust pursuant to a Pooling and Servicing Agreement, dated March 1, 2006, and the trust ultimately issued pass-through certificates backed by the mortgage loans with a face amount in excess of $500 million.[69] Sometime after March 28, 2012, the sixth anniversary of the Mortgage Loan Purchase Agreement, the trustee for the certificate holders, as purchaser, sued DBSP as seller

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[65] The text here is based on Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 8(c). *See also* Deutsche Bank Nat'l Trust Co. v. Quicken Loans, Inc., No. 13 Civ. 6482(PAC), 2014 WL 3819356, at *3 (S.D.N.Y. Aug. 4, 2014) (describing claims accrual provision in the agreement at issue).

[66] *See supra* note 64 and accompanying text; *see also* Mortgage Loan Purchase Agreement, *supra* note 48 (lacking a similar provision).

[67] *See infra* text accompanying notes 97–108.

[68] ACE Sec. Corp. v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 846–47 (N.Y. Sup. Ct. 2013).

[69] *Id.*

in the Supreme Court of New York, alleging that a large fraction of the mortgage loans breached one or more of the seller's representations about them in the Mortgage Loan Purchase Agreement and that seller had refused to cure or repurchase the non-conforming loans under the Repurchase Provision in the agreement.[70] The seller moved to dismiss the case on the grounds that New York's six-year statute of limitations for contracts claims[71] had expired on March 28, 2012, before the purchaser brought suit.[72]

The seller's argument was straightforward. It maintained that the breach of contract alleged was the falsity of its representations and warranties in the Mortgage Loan Purchase Agreement.[73] All of these representations, as is true of contractual representations generally, concerned matters of past or present fact as of the time the representations were made, and so, if any of its representations were false, they were false at the time they were made.[74] The breach, if there was one, thus occurred on the date the parties entered into the Mortgage Loan Purchase Agreement, which was March 28, 2006.[75] On the seller's view, its failure to repurchase any non-conforming loans under the Repurchase Provision could not be an independent breach of contract because the Repurchase Provision is merely a contractually created remedy for the only genuine breach of contract alleged by the

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[70] *Id.*

[71] N.Y. C.P.L.R. 213 (McKinney 2003); Mendelsohn v. City of New York, 934 N.Y.S.2d 3, 4 (N.Y. App. Div. 2011).

[72] *ACE One*, 965 N.Y.S.2d at 846–47.

[73] *Id.* at 848.

[74] E. ALLEN FARNSWORTH, CONTRACTS § 4.11, at 236–39 (4th ed. 2004).

[75] *See* W. 90th Owners Corp. v. Schlechter, 525 N.Y.S.2d 33, 35 (N.Y. App. Div. 1988) (holding that, if a "representation . . . was false when made," then "the breach occur[s] at the time of the execution of the contract" and "'the cause of action accrues and the Statute of Limitations begins to run'"). *See also* Ely-Cruikshank Co. v. Bank of Montreal, 615 N.E.2d 985, 987 (N.Y. 1993) (quoting Varga v. Credit-Suisse, 171 N.Y.S.2d 674, 677 (N.Y. Sup. Ct. 1958)) (holding that "[k]nowledge of the occurrence of the wrong on the part of the plaintiff is not necessary to start the Statute of Limitations running in [a] contract [action]"); Varo, Inc. v. Alvis PLC, 691 N.Y.S.2d 51, 57 (N.Y. App. Div. 1999); Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *8 (N.Y. Sup. Ct. May 10, 2013) ("Those representations [by the seller about the mortgages] did not arise or change over time. If the Mortgage Representations were false when made, they are still false today. If they were true when made, they are still true today.").

purchaser—that is, the falsity of certain of the seller's representations regarding the mortgage loans.[76] Exactly this argument had been accepted by the federal district court in the Southern District of New York in *Structured Mortgage Trust 1997-2 v. Daiwa Finance Corp.*,[77] in 2003, and by Judge Sherwood of the New York Supreme Court in a different RMBS Put-Back Litigation, *Nomura Asset Acceptance Corp. Alternative Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc.*[78] In both cases, the court dismissed the claim as time-barred.[79]

In *ACE Securities*, however, Judge Kornreich rejected this argument and held that "the mere fact that a Representation is false does not mean that DBSP 'breached' the [agreement]."[80] Rather, under the agreement, "DBSP has no duty to ensure that the Representations are true," and so "upon discovery or notice of the falsity, DBSP's obligation is to follow the Repurchase [Provision]."[81] "In sum, the *only* contractual wrong that DBSP could commit is failure to abide by Section 2.03," that is, the Repurchase Provision.[82] Accordingly, Judge Kornreich held that the breach, if such there was, occurred only when the seller refused to repurchase allegedly non-conforming loans: indeed, "DBSP commits an independent breach of the [agreement] each time it fails to abide by and fulfill its obligations under the Repurchase [Provision]," and so "each breach may begin the running of the statute of limitations anew."[83] Hence, the purchaser's claims were not barred by the statute of limitations. Soon thereafter, however, the Appellate Division, First Department, reversed, essentially adopting the holdings of *Daiwa* and *Nomura*.[84] It held that "the claims accrued on the closing date of the [Mortgage Loan Purchase Agreement] . . . when any breach

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[76] *ACE One*, 965 N.Y.S.2d at 848.
[77] No. 02 Civ. 3232(SHS), 2003 WL 548868, at *2 (S.D.N.Y. Feb. 25, 2003).
[78] 2013 WL 2072817, at *6–7 (N.Y. Sup. Ct. May 10, 2013).
[79] *Structured Mortg. Trust 1997-2*, No. 02 Civ. 3232(SHS), 2003 WL 548868, at *3; *Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *10.
[80] *ACE One*, 965 N.Y.S.2d at 848.
[81] *Id.*
[82] *Id.* at 849.
[83] *Id.* (citations and internal quotation marks omitted); *accord* Fed. Hous. Fin. Agency v. WMC Mortg. LLC, No. 13 Civ. 584(AKH), 2013 WL 7144159, at *1 (S.D.N.Y. Dec. 17, 2013) (relying on Judge Kornreich's opinion in *ACE Securities* in stating that "[t]he causes of action stated in the complaint alleged failures to cure after defendants received notice of the breach, not of the original breaches themselves").
[84] ACE Sec. Corp. v. DB Structured Prods., Inc., 977 N.Y.S.2d 229 (N.Y. App. Div. 2013).

of the representations and warranties contained therein occurred."[85] The New York Court of Appeals has granted leave to appeal this decision.[86]

D. *Lehman XS Trust, Series 2006-4N v. Greenpoint Mortgage Funding* in the United States Court of Appeals for the Second Circuit

The underlying transaction in *Lehman XS Trust v. Greenpoint Mortgage Funding* is substantially similar to that in *ACE Securities Corp. v. DB Structured Products, Inc.* and other RMBS Put-Back Litigations. In particular, a Lehman affiliate purchased several thousand mortgage loans from Greenpoint under a Flow Mortgage Loan Purchase and Warranties Agreement, dated as of December 21, 2001 (an agreement substantially similar, for relevant purposes, to the Mortgage Loan Purchase Agreement at issue in *ACE Securities*),[87] and then, under a Flow Interim Servicing Agreement, dated December 1, 2001 (an agreement substantially similar to the Pooling and Servicing Agreement in *ACE Securities*), deposited the mortgage loans into the Lehman XS Trust, Series 2006-4N.[88] The trust ultimately issued pass-

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[85] *Id.* at 231 (internal citations omitted); *accord* Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *9 (N.Y. Sup. Ct. May 10, 2013).

[86] ACE Sec. Corp. v. DB Structured Prods. Inc., 2014 WL 2891678, at *1 (N.Y. June 26, 2014) (granting leave to appeal).

[87] More accurately, the Flow Mortgage Loan Purchase and Warranties Agreement is a master agreement intended to cover multiple securitization transactions effected at different times. *See generally* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 4.03 (explaining the function of a Flow Mortgage Loan Purchase and Warranties Agreement). Such master agreements contain general terms applicable to each transaction effected under them, including, in this case, the seller's representations and warranties about the mortgage loans, the Repurchase Provision, and the Claims Accrual Provision. For each securitization transaction effected under the master agreement, there is a separate loan sale agreement that transfers the loans involved in the transaction. Section 7 of the Flow Mortgage Loan Purchase and Warranties Agreement provides that the seller makes the representations and warranties in the agreement with respect to the loans involved in a particular transaction as of the related closing date of that transaction. *Lehman XS Trust* concerns loans all of which were transferred under particular loan sale agreements on or before March 1, 2006. Greenpoint thus argued that the statute of limitations expired no later than March 1, 2012. Lehman XS Trust, Series 2006-4N v. Greenpoint Mortgage Funding, Inc., 991 F. Supp. 2d 472 (S.D.N.Y. 2014).

[88] *Lehman XS Trust*, 991 F. Supp. 2d at 474.

through certificates backed by the mortgage loans with an original face amount of over $1.3 billion.[89]

In July of 2013, the purchaser[90] sued Greenpoint as seller in the United States District Court for the Southern District of New York,[91] alleging that a large fraction of the mortgage loans breached one or more of the seller's representations in the Flow Mortgage Loan Purchase and Warranties Agreement and that the seller had refused to cure or repurchase the non-conforming loans under the Repurchase Provision in that agreement.[92] Greenpoint moved to dismiss the case on the grounds that New York's six-year statute of limitations[93] for contracts claims had expired in 2012, long before the purchaser brought suit.[94]

The seller's arguments were substantially identical to those of DB Structured Products in *ACE Securities* and the defendants in *Daiwa* and *Nomura*.[95] The purchaser's arguments were substantially similar to those of ACE and the plaintiffs in *Daiwa* and *Nomura*.[96] There was, however, one important difference. The Flow Mortgage Loan Purchase and Warranties Agreement between Lehman Brothers Bank and Greenpoint Mortgage Funding contained not only a Repurchase Provision but also a Claims Accrual Provision.[97] That is, the agreement provided that any cause of action against the seller arising out of the breach of any representations or warranties made by the seller concerning the mortgage loans accrued upon discovery of such breach

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[89] *Id.*

[90] As in *ACE Securities,* the plaintiff is actually the trust, in this case U.S. Bank National Association, solely in its capacity as trustee, suing on behalf of the certificate holders. *Id.* at 473–74.

[91] *Id.* at 472.

[92] *Id.*

[93] N.Y. C.P.L.R. 213 (McKinney 2003); *see also* Mendelsohn v. City of New York, 934 N.Y.S.2d 3, 4 (N.Y. App. Div. 2011).

[94] *Lehman XS Trust*, 991 F. Supp. 2d at 476–77.

[95] *See supra* notes 71–75 and accompanying text.

[96] *See supra* notes 80–85 and accompanying text.

[97] Section 8(C) of that agreement provides: "Any cause of action against the Seller relating to or arising out of the Breach of any representations or warranties made in Sections 6 or 7 shall accrue as to any Mortgage Loan upon (i) discovery of such Breach by the Purchaser or notice thereof by the Seller to the Purchaser, (ii) failures by the Seller to cure such Breach or repurchase such Mortgage Loan as specified above, and (iii) demand upon the Seller by the Purchaser for compliance with this Agreement." Flow Mortgage Loan Purchase and Warranties Agreement, *supra* note 50, § 8(c).

by the purchaser or notice thereof by the seller to the purchaser, failure by the seller to cure such breach or repurchase the non-conforming mortgage loan under the Repurchase Provision, and demand upon the seller by the purchaser for compliance with this provision of the agreement.[98] Thus, Lehman made the same argument that the plaintiffs in other RMBS Put-Back Litigations made (that the relevant breach of contract is not the falsity of certain of the seller's representations and warranties, which would have occurred on the date the parties entered into the contract, but the failure of the seller after demand from the purchaser to repurchase non-conforming loans under the Repurchase Provision), but, in addition, was able to buttress this argument by pointing to the plain language of the Claims Accrual Provision. That provision stated in so many words that the purchaser's cause of action against the seller arising out of the seller's breach of its representations about the mortgage loan "shall accrue" only after the seller's failure to cure the breach or repurchase the loan under the Repurchase Provision and the purchaser's demand that the seller comply with the agreement.[99]

Judge Scheindlin of the Southern District of New York began her analysis by quoting from another RMBS Put-Back Litigation, *Deutsche Alt-A Secured Mortgage Trust, Series 2006-OA1 v. DB Structured Products, Inc.*, to the effect that, "under New York law, claims which are subject to pre-suit cure or demand requirements accrue when the underlying breach occurs, not when the demand is subsequently made or refused."[100] Expressly relying on the opinion of the Appellate Division in *ACE Securities*, Judge Scheindlin then held that the breach of contract occurred, and so the relevant cause of action accrued, on the closing date of the relevant agreement.[101] Of course, the agreement in *ACE Securities* did not include a Claims Accrual Provision, but Judge Scheindlin rejected the purchaser's argument that that provision changed the analysis.[102] Rather, she held that "parties may not contractually adopt an accrual provision that effectively

[98] *Id.*

[99] *See supra* note 97.

[100] Lehman XS Trust, Series 2006-4N v. Greenpoint Mortgage Funding, Inc., 991 F. Supp. 2d 472, 477 (S.D.N.Y. 2014) (quoting Deutsche Alt-A Sec. Mortg. Loan Trust, Series 2006-OA1 v. DB Structured Prods., Inc., 958 F. Supp. 2d 488, 499–500 (S.D.N.Y. 2013)) (internal quotation marks omitted).

[101] *Id.* at 477–78.

[102] *Id.* at 479.

extends the statute of limitations before any claims have accrued."[103] The court thus dismissed the purchaser's claims as time-barred.[104]

The court's treatment of the Claims Accrual Provision tends to suggest that it found that the intended effect of the provision was to delay the time at which the statute of limitations begins to run. Since such an agreement is illegal under New York law,[105] the provision would then simply be void. Nevertheless, the Claims Accrual Provision need not be read this way. Rather, since "[g]iven a choice between two reasonable interpretations of an agreement, a court will prefer the one under which the agreement involves no contravention of public policy and is enforceable to the one under which it involves such a contravention and is not enforceable,"[106] the Claims Accrual Provision should probably be read not as an unenforceable agreement to postpone

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[103] *Id.* at 478; *see also* Lehman Bros. Holdings, Inc. v. Evergreen Moneysource Mortg. Co., 793 F. Supp. 2d 1189, 1194 (W.D. Wash. 2011) (holding that parties may not effectively extend the statute of limitations by agreeing that the statute begins to run only at a date later than that determined by the statute itself). In so holding, Judge Scheindlin was on very firm grounds—for New York law clearly prohibits parties from agreeing to extend the statute of limitations, including by agreeing to delay the time from which the statutory period begins to run. In particular, by statute in New York, "[a] promise to waive, to extend, or not to plead the statute of limitation," unless "made after the accrual of the cause of action" "has no effect." N.Y. GEN. OBLIG. LAW § § 17–103(1), (3) (McKinney 2010). Thus, the New York Court of Appeals has held that, "[a]lthough the Statute of Limitations is generally viewed as a personal defense," it "also expresses a societal interest or public policy of giving repose to human affairs." John J. Kassner & Co. v. City of New York, 389 N.E.2d 99, 103 (N.Y. 1979) (internal quotation marks and citations omitted). "Because of the combined private and public interests involved, individual parties are not entirely free to waive or modify the statutory defense." *Id.* In particular, although parties may generally agree to shorten the statutory period, "[t]he public policy represented by the statute of limitations becomes pertinent where the contract not to plead the statute is in form or effect a contract to extend the period as provided by statute or to postpone the time from which the period of limitation is to be computed." *Id*. (internal citation and quotation marks omitted). *See also* Brief Pro Se as Amici Curiae at 18, ACE Sec. Corp. v. DB Structured Prods., Inc., 977 N.Y.S.2d 229 (N.Y. App. Div. 2013) (No. 650980/2012) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2382642, *archived at* http://perma.cc/Z8DM-UUXK.

[104] *Lehman XS Trust*, 991 F. Supp. 2d at 479.

[105] *See supra* note 103 and accompanying text.

[106] FARNSWORTH, *supra* note 74, § 5.1, at 7.

the start of the statutory period but as an enforceable agreement requiring the purchaser to wait until the end of the cure period and to make demand for repurchase under the Repurchase Provision before suing to enforce its rights under the agreement. If, in addition, the agreement does not contain a Sole Remedy Provision (and, as noted above, the *Lehman XS Trust* agreement did not), the Claims Accrual Provision would require the seller to pursue a remedy under the Repurchase Provision before resorting to litigation.[107] The Claims Accrual Provision thus makes explicit what is already implicit in the Sole Remedy Provision: that the purchaser should actually use the contractual procedure for cure or repurchase and not immediately resort to litigation.[108]

The purchaser has appealed Judge Scheindlin's decision to the United States Court of Appeals for the Second Circuit.[109]

III. The Efficient Allocation of Risk over Time in Securitization Transactions

In this Part, I shall take a step back from the details of the RMBS Put-Back Litigations and consider the economic functions of the various contractual provisions at issue in those cases. In particular, I shall (a) begin by considering the separation of endogenous and exogenous risks associated with mortgage loans in RMBSs and how these can be allocated efficiently between the parties, (b) explain how the seller's representations and warranties, the Repurchase Provision, the Sole Remedy Provision, and the Claims Accrual Provision should be understood as contractual devices that implement an efficient allocation of risk, (c) consider how the statute of limitations affects the allocation of risk over time effected by the agreements between the

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[107] In other words, whereas the Sole Remedy Provision limits the purchaser to the Repurchase Provision for breaches of the seller's representation, the Claim Accrual Provision allows the purchaser the full panoply of remedies for breach of contract, but only after it has sought to obtain a remedy under the Repurchase Provision.

[108] See my *pro se amicus curiae* brief in *ACE Securities Corp. v. DB Structured Products, Inc.* Brief Pro Se as Amici Curiae at 18, ACE Sec. Corp. v. DB Structured Prods., Inc., 977 N.Y.S.2d 229 (N.Y. App. Div. 2013) (No. 650980/2012) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2382642, *archived at* http://perma.cc/Z8DM-UUXK.

[109] Notice of Appeal at 1, Lehman XS Trust, Series 2006-4N v. Greenpoint Mortg. Funding, Inc., 991 F. Supp. 2d 472 (S.D.N.Y. 2014) (No. 13 CIV 4707 (SAS)) (2d Cir. Filed Feb. 7, 2014).

parties, and finally (d) provide a model of how sophisticated commercial parties will rationally allocate risk over time.

A. The Allocation of Endogenous and Exogenous Risk in RMBS Transactions

Like the cash flows from all investments, the cash flows deriving from mortgage loans are inherently risky. Prior to any of the transactions involved in securitizing a given pool of loans, the seller owns the loans outright, and thus holds both the upside and the downside of every kind of risk associated with the loans.[110] As explained above, in securitizing the loans, the seller sells the loans, in one or more steps, to the purchaser, which then issues the RMBSs to investors.[111] In theory, the parties to this transaction could allocate between themselves the risks associated with the loans in any manner whatsoever. At one extreme, the seller could retain all of the credit risk associated with the loans by promising the buyer that all of the loans would be paid in full, including as to principal and interest, in accordance with their terms,[112] and it could retain all of the market risk (including interest rate risk) by promising to support the market price of the RMBSs at par for the life of the securities. At the other extreme, the purchaser could assume all of the risks associated with the loans, including both credit risk and market risk, by agreeing that it was taking the loans on an as-is basis, that it was relying on no representations or warranties of any kind by the seller, and that the seller would have no liability of any kind to the purchaser after the closing.

In fact, however, the contracts between the parties provide for an elaborate allocation of the risks associated with the loans.[113] Elementary economic theory explains why this is so. For, just as the joint surplus of a transaction is increased when a right is allocated to the

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[110] *See* Gorton, *supra* note 6, at 39.

[111] *See supra* Part I(a).

[112] *See* Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979); *see also* SCHWARCZ ET AL., *supra* note 6, § 3.03, at 72–73.

[113] The courts involved in the RMBS Put-Back Litigations are well aware that the various contractual provisions at stake in those litigations function to allocate risk between the parties. E.g., Judge Kornreich in *ACE Securities* said, "The whole point of how the [Mortgage Loan Purchase Agreement] and [Pooling and Service Agreement] were structured was to shift the risk of noncomplying loans onto DPSP." ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 849 (N.Y. Sup. Ct. 2013).

contracting party that values the right more highly, so too is the joint surplus of a transaction increased when liabilities (or risks of liabilities) are allocated to the party that can bear them more cheaply.[114] If a risk can be borne by one party at a cost of $100, but by the other party at a cost of only $20, profit-maximizing parties will allocate the risk to the party that can bear the risk at the lower cost: this increases the joint surplus of the transaction by $80, potentially making both parties better off.[115] Hence, in complex commercial agreements between sophisticated, profit-maximizing parties, we should expect there to be a careful (often elaborate) allocation of risks so that each of the various kinds of risk will be assigned to the party that can bear it most cheaply, thus producing the greatest joint surplus for the parties to divide between them.[116]

Unsurprisingly then, that is exactly what we find in the agreements governing securitization transactions. Although the sale of the loans to the purchaser first places on the purchaser, as owner of the loans, all of the risks associated with the loans, nevertheless the contract shifts back to the seller certain endogenous risks related to the loans—that is, risks such as fraud in the underwriting process, departures from good underwriting practices, or failures of key financial variables (such

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[114] Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 88–91 (1977). For an application of the principle to the allocation of risks in commercial agreements, see generally Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007 (2009).

[115] There are several reasons why parties may have very different costs of bearing a given risk. On the one hand, the risk may be preventable at a reasonable cost (that is, a cost less than its expected cost if it materializes), and if so, one of the parties may be able to prevent it at a lower cost than the other (that is, one of the parties may be the cheaper cost avoider of the risk). Posner & Rosenfield, *supra* note 114, at 90. On the other hand, even if the risk is not preventable at a reasonable cost, the cost in this context is the expected cost of bearing the risk, and parties may have different information about the probability of the risk materializing and its magnitude in dollar terms in case it does. *Id.* at 90–91. In that case, the parties may calculate the expected cost of the risk differently. In addition, one party may be able to diversify its investments better than the other, making the cost of holding the risk less for that party. *Id.* at 91–92. Or again, one party may have cheaper access to financial markets to hedge a given risk (for example, through the use of credit default swaps or other derivatives), which again would allow that party to bear the risk more cheaply. *Id.* at 92. There could well be other reasons as well.

[116] *See id.* at 88–92.

as the value of the property, the loan-to-value or combined loan-to-value ratios, or the borrower's income or FICO score), to be as the parties believed them to be when they valued the loans and the RMBSs backed by them.[117] The reason for shifting such endogenous risks back to the seller is clear: when the seller was itself the originator of the loans, it could at the lowest cost detect such errors and prevent them from occurring,[118] and even when the seller was not the originator but purchased the loans from the originator, the seller rather than purchaser was in a position to contract with the originator to get the originator to assume these risks.[119] Moreover, the real party in interest is not the purchaser itself but the investors holding the RMBSs issued by the purchaser, and the seller is obviously able to detect and prevent errors of the kind involved more cheaply than the investors could. There is, in addition, a great efficiency in having one party, the seller, expend resources detecting and preventing such errors rather than in having multiple parties—the investors—each perform this task independently. Indeed, if the investors expended resources to check the accuracy of the representations, they would certainly underinvest in this activity because their efforts would benefit all investors while the costs would fall entirely on the investor undertaking the investigation (that is, there would be a classic free-rider problem). There is no doubt, therefore, that the seller is the cheapest cost avoider with respect to errors affecting endogenous risks, which implies that shifting these risks back to the seller increases the joint surplus of the transaction.

The point above concerns only risks that are preventable at a reasonable cost (that is, a cost less than the expected cost of the risk).[120] There will be some endogenous risks that cannot be prevented from materializing at a reasonable cost, and with respect to these risks too, the seller will be the superior risk bearer. The reason is that at the time of the securitization transaction, the seller almost certainly knows more

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[117] *See infra* Part III.B.

[118] That is, in this case the seller was the cheapest cost avoider of the risk.

[119] Agreements under which a financial institution specializing in securitizing mortgage loans purchases such loans from originators tends to look substantially like the Mortgage Loan Purchase Agreements discussed in Part II, including with respect to representations and warranties by the originator about the quality of the loans, backed up by a Repurchase Provision. *See supra* Part II.B. Hence, if the financial institution purchasing the loans from the originator later became obligated to repurchase non-conforming loans from the purchaser, it would normally be able to resell the non-conforming loan back to the originator. *See supra* Part II.B.

[120] *See supra* note 115.

about the loans than does the purchaser and so can better estimate the probability that such risks will materialize and the magnitude of the losses if they do.[121] It is thus the superior bearer of these non-preventable endogenous risks, and, just as with the preventable endogenous risks discussed above, shifting these risks back to the seller thus also increases the joint surplus of the transaction.[122]

In contradistinction to endogenous risks, exogenous risks, such as the risk that the loans will lose value due to an economic recession, downturns in the housing or employment markets, or a borrower losing his job,[123] stay with the purchaser.[124] Neither party has any ability to

[121] *See* Miller, *supra* note 114, at 2080–81.

[122] *See id*.

[123] The fact that the risk that a borrower loses his job is an exogenous risk emphasizes the point that the distinction between endogenous risks and exogenous risks is not the same as that between systematic risks and non-systematic risk. *See generally id*. The former concerns the cause of the risk, which arises from factors inside or outside the system or model in question; the latter concerns which risks can be eliminated by diversification. *See generally* W. H. Wagner & S. C. Lau, *The Effect of Diversification on Risk*, FIN. ANALYSTS J., Nov.–Dec. 1971, at 48. Even if all the endogenous risks associated with the loans are shifted to the seller and the purchaser thus holds only exogenous risks, nevertheless the risk the purchaser holds could be eliminated through diversification only in part: the risk the purchaser is holding is thus partly non-systematic. *See id*.

[124] As Judge Kornreich wrote in *ACE Securities*:

> DBSP does not bear the risk of loss on all loans that default. Conforming loans, where the Representations are true, will sometimes default for reasons that have nothing to do with borrowers lying or underwriter fraud. If "good" mortgages did not have real default risk, mortgage interest rates would be even lower than their current historically depressed levels.

ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 850 (N.Y. Sup. Ct. 2013). Rather, "[i]n reality, borrowers will occasionally default due to myriad unexpected circumstances, such as losing their job. In those cases, the Certificateholders bear the risk of loss and their recovery is limited to whatever proceeds can be obtained through foreclosure." *Id.* But Judge Kornreich then goes on to say, "[i]n contrast, where, as here, borrowers allegedly defaulted due to the Representations being false, such risk is meant to be borne by DBSP." *Id.* This seems to introduce the idea that the cause of the borrower's default is somehow relevant, but this is not correct. Regardless of whether a loan is in default, and regardless of why a defaulted loan is in default, the contract requires the seller to repurchase the loan if, but only if, the loan does not conform to the representations in the contract. *See supra* note 59 and accompanying text. The affect whether such risks materialize, and in general neither party can value these risks more accurately than the other by better computing the probability they will materialize and their magnitude if they do.[125] If neither party is the superior bearer of the risk, then it would be wasteful to incur the transaction costs of shifting the risk from one party to the other; the risk should stay where it is—in this case, with the purchaser.[126] These risks then become the risks associated with investing in the RMBSs created in the securitization transaction. That is, these are the risks that the investors are compensated for bearing.[127] Indeed, since these are the risks that the investor is in effect electing to bear by purchasing the RMBSs, it would seem likely that, because of the characteristics of the investor's existing portfolio or because of its regulatory requirements[128] or for some other reason, the investor is the superior risk bearer of the exogenous risks.

B. Contractual Mechanisms in Securitization Transactions for the Efficient Allocation of Endogenous Risks

As noted above, when the purchaser becomes the owner of the mortgage loans, all of the risks associated with the loans are transferred to the purchaser.[129] For the reasons given above, the parties want the purchaser to bear the exogenous risks, and so no further action is necessary to achieve this end.[130] The endogenous risks, however, must

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seller must repurchase non-conforming loans that go into default for reasons wholly unrelated to any breach of representation and even non-conforming loans that are not in default. *See supra* note 59 and accompanying text. Any inquiry into *why* a defaulting loan went into default would obviously be difficult, costly, and imprecise, and the agreements in securitization transactions do not require or permit the parties to open such issues.

[125] *See* Miller, *supra* note 114, at 2057, 2065.

[126] *See id.* at 2103.

[127] More precisely, the investor is compensated for bearing the systematic, non-diversifiable portion of the exogenous risk involved. *See generally* JACK CLARK FRANCIS & DONGCHEOL KIM, MODERN PORTFOLIO THEORY (2013).

[128] *See* Roberta Romano, *Regulating in the Dark and a Postscript Assessment of the Iron Law of Financial Regulation*, 43 HOFSTRA L. REV. 25, 34–35 (2014) (discussing how capital regulation of banks under the Basel accords assigned low risk-weights to certain asset-backed securities and so encouraged banks to hold such assets).

[129] *See supra* text accompanying note 117.

[130] *See supra* notes 123–28 and accompanying text.

be shifted back to the seller. The contract between the parties must effect this result.

The primary contractual mechanism for shifting endogenous risks back to the seller lies in the seller's representations and warranties. By representing and warranting that the loans have certain characteristics, the seller makes itself liable for breach of contract if the loans did not have these characteristics as of the date the seller represented and warranted that they did.[131] If the contract included these representations and warranties but said nothing else about the allocation of the relevant risks, then the relevant statute of limitations for contract claims[132] would apply to claims arising from breaches of the representations and warranties, and the statutory period would undoubtedly begin to run from the date the false representation was made.[133] Depending on the circumstances, the remedy in such a suit

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[131] Several of the RMBS Put-Back Litigations have raised the issue of whether the seller's representations and warranties about the mortgage loan made in the governing contract were made as of the date of that agreement or were made (or remade) as of the closing date of the securitization related to the contract. *E.g.*, Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *6 (N.Y. Sup. Ct. May 10, 2013). This issue raises some important questions about which party is the efficient bearer of the risk during the executory period of the contract. Very likely, that party is the seller, but the issue is beyond the scope of this Article.

[132] As noted above, New York law governs virtually all of the agreements relevant to the RMBS Put-Back Litigations, and in such cases the period would be New York's six-year statutory period for claims sounding in contract. N.Y. C.P.L.R. 213 (McKinney 2003) (providing that actions on a contract must be brought within six years).

[133] *See* W. 90th Owners Corp. v. Schlechter, 525 N.Y.S.2d 33, 35 (N.Y. App. Div. 1988) (holding that if a "representation . . . was false when made," then "the breach occur[s] at the time of the execution of the contract" and "the cause of action accrues and the Statute of Limitations begins to run"); *see also* Ely-Cruikshank Co. v. Bank of Montreal, 615 N.E.2d 985, 987 (N.Y. 1993) (quoting Varga v. Credit-Suisse, 171 N.Y.S.2d 674, 677 (N.Y. Sup. Ct. 1958)) (holding that "[k]nowledge of the occurrence of the wrong on the part of the plaintiff is not necessary to start the Statute of Limitations running in [a] contract [action]"). This point shows, incidentally, that Judge Kornreich's holding in *ACE Securities* that "the mere fact that a Representation is false does not mean that [the party making the representation] 'breached' the [agreement]" has to be wrong. ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 848 (N.Y. Sup. Ct. 2013). If it were right, in an agreement (a) in which a party

would be either expectation damages, the usual remedy in contract law, or rescission of the entire contract.[134]

Now, although expectation damages are the theoretically correct measure of contract damages in the sense that expectation damages create incentives for parties to breach if, but only if, breaching is efficient,[135] nevertheless in securitization transactions allowing such damages would be inefficient. The reason is that the efficiency of expectation damages presupposes that such damages can be calculated and awarded costlessly,[136] and although this is approximately true in many contexts, it is very far from being true in this context. In particular, calculating the purchaser's expectation damages for a breach of the seller's representations would require courts to determine the difference in value between the loan as represented in the contract and the actual value of the loan as it really existed. The former would be extremely difficult to determine, and if the court actually undertook such an inquiry, the results would be highly unpredictable; most likely, the court would simply assume that the value of the loan as it was represented to be was the purchase price of the loan, which could be readily determined from the four corners of the contact. This would likely be a slight underestimate, but it would be approximately correct. The value of the loan as it actually existed at the time of suit, however, would be even more difficult to determine, and given the relatively small value of an individual loan (generally no more than a few hundred thousand dollars), the transaction costs involved in determining its true value would be huge in relation to the amount in controversy. Moreover, when the purchaser alleges breaches of representations about many loans, the inquiry would have to be performed separately for each loan.[137] Calculating the purchaser's

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made various representations but (b) that contained no contractual remedy for breach of those representations, the result would be that the representations could not be breached, and so no matter how false they were, the counterparty would have no claim for breach of contract, which is absurd.

[134] FARNSWORTH, *supra* note 74, § 12.2, at 734–35 (discussing the principle types of remedies available for breach of contract); *see also* Graham v. James, 144 F.3d 229, 237 (2d Cir. 1998) ("Under New York law, rescission is permitted if the breach is 'material and willful, or, if not willful, so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract.'").

[135] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 128–38 (9th ed. 2014).

[136] *See* FARNSWORTH, *supra* note 74, § 12.15, at 799–800.

[137] This problem could be mitigated by sampling techniques: that is, the court could allow the plaintiff to prove its damages by taking a sample of the non-

expectation damages for breaches of the seller's representations about the loans is thus a very inefficient remedy in the context of RMBS securitizations.

Rescission of the entire securitization transaction would be an even more inefficient remedy. Returning the full purchase price to the purchaser would be easy enough, but returning all the mortgage loans to the seller (along with whatever proceeds the purchaser had realized on the loans while it held them, unless there was some appropriate offset for these against the purchase price that the seller would refund), would involve unwinding the entire securitization transaction. All of the RMBSs backed by the mortgage loans retransferred to the seller would have to be retired, and these would typically amount to hundreds of millions of dollars of securities in the hands of scores, sometimes hundreds (and occasionally thousands), of security-holders around the world. In addition, rescinding the transaction would return the mortgage loans to the seller's balance sheet, which would adversely affect the interests of the seller's creditors, including those who became creditors after the securitization transaction had been completed and thus on the assumption that the mortgage loans had been removed from seller's balance sheet. Rescission would thus have significant external effects.[138] In sum, the costs of such a remedy would be obviously prohibitive. Because both expectation damages and rescission would be inefficient, it was thus in the joint interest of the parties to devise a remedy that would leave the complex transactional structure in place but would have the same economic effect as providing the purchaser with expectation damages.[139]

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conforming loans and compute its damages for the sample and then extrapolate to its total damages in the suit. On the use of sampling in the context of liability, not damages, in RMBS Put-Back Litigations, see *ACE One*, 965 N.Y.S.2d at 851 (discussing the possibility of the parties using sampling techniques).

[138] I am indebted to Richard Epstein for this point.

[139] A possible exception could arise if a very large fraction of the loans turn out to be non-conforming. Although the plaintiffs in some of the RMBS Put-Back Litigations have alleged that large fractions of the loans involved the breach of one or more of the seller's representations, *e.g.*, Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *5 (N.Y. Sup. Ct. May 10, 2013) (seeking rescission because of the alleged "pervasive nature of the breaches" of the representations), clearly that possibility was not in the contemplation of the parties at the time they entered into the relevant agreements. For the question as to whether the Sole Remedy Provision prohibits a purchaser from seeking

To deal with this problem, parties to securitization transactions have developed an elegant contractual mechanism that generates efficient incentives for the parties, as expectation damages normally would do, but that avoids the high transaction costs that such damages would occasion in the securitization context. This mechanism is the Repurchase Provision. Under this provision, the seller agrees to repurchase any non-conforming loan at its original purchase price, minus any return of principal that the purchaser has received on the loan, plus unpaid interest and certain expenses the purchaser incurs in retransferring the loan to the seller.[140] On the one hand, this Repurchase Provision leaves the overall transaction structure in place and so avoids the tremendous costs that rescission would entail. On the other hand, it transfers value to the purchaser equal to what the purchaser would have from expectation damages (assuming the true value of the loan as represented is the original purchase price for the loan) but without the cost and uncertainty of computing those damages. It thus produces the right economic effect (that is, creates the proper incentives) at relatively low cost.

The other contractual provisions discussed above—the Sole Remedy Provision and the Claims Accrual Provision[141]—work in tandem with the Repurchase Provision to ensure its effectiveness. That is, as explained above, ex ante both expectation damages and rescission would be inefficient remedies, but it could happen that, ex post, a purchaser could conclude that it would be better off being able to seek such remedies.[142] The efficient solution, therefore, is to block such a move by requiring the purchaser to use the Repurchase Provision to seek compensation for any breaches of the seller's representations and warranties about the loans. This can be accomplished most effectively by including in the relevant agreement a Sole Remedy Provision, which contractually bars the purchaser from seeking other remedies normally available for breach of contract.[143] Similarly, though less drastically, the

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rescission, see Danielle Gibbs, *Protecting Acquisition Agreements From Rescission for Fraud in the Inducement*, METROPOLITAN CORP. COUNS., Dec. 2006, at 10, 10, *available at* http://www.metrocorpcounsel.com/pdf/2006/December/10.pdf, *archived at* http://perma.cc/SSH6-KPHA.

[140] *See supra* notes 59–61 and accompanying text. The repurchase price generally also takes account of advances made by the servicer as well. *See supra* note 61 and text accompanying notes 45–46.

[141] *See supra* Part II.B.3–4.

[142] *See supra* notes 135–39 and accompanying text.

[143] *See supra* Part II.B.3.

agreement may include a Claims Accrual Provision, which allows the purchaser to seek whatever remedies may be available to it at law, but only *after* it has attempted to obtain a remedy under the Repurchase Provision.[144] In other words, both the Sole Remedy Provision and the Claims Accrual Provision function to require the purchaser to use the efficient remedial scheme created by the Repurchase Provision.

C. The Statute of Limitations and the Retransfer of Endogenous Risks

As explained above, one of the key issues in the pending RMBS Put-Back Litigations is the application of New York's six-year statute of limitations for contract claims to the relevant agreements.[145] Even though billions of dollars are at stake, the question may seem to be a highly technical one of little moment outside the immediate context: is the relevant breach of contract the falsity of the seller's representations and warranties, which were made at the date of contract, so that the statute of limitations began to run on that date (and thus has already expired in many cases), or is the failure of the seller, after demand by the purchaser, to repurchase a non-conforming loan under the Repurchase Provision the relevant breach of contract, so that the statute began to run only at a much later date when the seller discovered the breaches and demanded repurchase?[146] Before considering how the above analysis of the allocation of endogenous risks under securitization agreements illuminates this issue, it is important to see how the very existence of the statute of limitations creates a puzzle about the efficient allocation of risk.

As I argued above, for various reasons, the seller is the superior bearer of the endogenous risks associated with the mortgage loans being securitized, and so efficiency requires that these risks be allocated to the seller, as indeed is accomplished through a complex of interrelated contractual provisions.[147] But, regardless of when the statute of limitations begins to run, at some point the statutory period expires, and at that point the purchaser may no longer seek to enforce the Repurchase Provision. Hence, at that point in time, all endogenous risks associated with the loans are effectively retransferred from the seller back to the purchaser. But why should this be? The passage of

[144] *See supra* Part II.B.4.
[145] *See supra* note 17 and accompanying text.
[146] *See supra* notes 17–18 and accompanying text.
[147] *See supra* text accompanying notes 117–19.

time does nothing to undermine any of the arguments tending to show that the seller was the superior risk bearer of the relevant endogenous risks. Those arguments were generally based on the seller's superior knowledge of the details of the individual mortgages.[148] As time goes by, these informational asymmetries and the related incentives do not change. It would seem, therefore, that if the seller was the superior risk bearer at the time the parties entered into the contract, which is undeniable, then the seller should remain the superior risk bearer forever. The effect of the statute of limitations, however, is to retransfer the endogenous risks back to the purchaser. This raises a difficult question as to whether the relevant risks are being efficiently allocated after the statutory period has run.[149]

One possibility is that the retransfer of the endogenous risk to the purchaser is an inefficient result generated by the legislature's imposing a contractual term on parties who would have chosen a different (and efficient) result. There might be some reason for a legislature to do this. For, very old disputes are especially difficult to litigate, and this difficulty will likely result in the state expending additional resources in the form of court time to settle a dispute between the parties. If the added costs borne by the state are larger than the benefits captured by the parties in settling very old disputes, then, although the parties are better off, society as a whole is worse off. In this respect, the statute of limitations may be similar to the statute of frauds in that it limits litigations that tend to produce external costs in excess of the benefits captured by the parties.[150]

Nevertheless, it seems very unlikely that the statute of limitations is in fact imposing a contractual term—whether or not that term is socially efficient—on parties involved in securitization transactions that the parties themselves do not really want. The reason

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[148] *See supra* text accompanying notes 117–19.

[149] It is true that, at least prior to the financial crisis, breaches of the seller's representations tended to be discovered quickly after the closing of the transaction and well within the statutory period, regardless of when that period was thought to begin to run. *See* SCHWARCZ ET AL., *supra* note 6, § 5.01, at 108. Breaches discovered more than six years after the date of the contract, therefore, would likely be very few. *See id.* At most, however, this shows that the quantum of endogenous risk retransferred to the purchaser by the statute of limitations is relatively small; it does nothing to show why such a retransfer would be efficient.

[150] On the externalities guarded against by the statute of frauds, see Eric A. Posner, *Norms, Formalities, and the Statute of Frauds: A Comment*, 144 U. PA. L. REV. 1971, 1974 (1996).

is that, with clever drafting, the parties could produce a contract that effectively allocated the endogenous risks associated with the mortgage loans to the purchaser for whatever period of time was desired. All that would be necessary would be a provision in which the purchaser covenanted that, for as long as any of the RMBSs remained outstanding, if a mortgage loan goes into default and that loan did not have stated characteristics (that is, the same characteristics that the seller represents them to have in the representations and warranties in Mortgage Loan Purchase Agreements as customarily drafted), then the purchaser shall repurchase the loan in a manner parallel to that set forth in a typical Repurchase Provision.[151] Such a provision would unmistakably be a promise of continuing performance[152] and not a mere representation, and it would undoubtedly be enforceable in accordance with its terms.[153]

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[151] In any earlier draft of this paper, I had suggested that the parties could achieve the desired effect by including a covenant by the seller that, for as long as any of the RMBSs remain outstanding, if the parties discover that a loan does not have the required characteristics (i.e., the same characteristics that the seller represents them to have in the representations in a conventional agreement), then the seller shall repurchase the loan. Christopher Horn pointed out to me, however, that such a provision might be void as a disguised attempt to extend the statute of limitations, and he very well may be right about this. *See* John J. Kassner & Co. v. City of New York, 389 N.E.2d 99, 103 (N.Y. 1979). The suggestion in the text, by making the repurchase obligation applicable only to a loan that defaults (and that, of course, only after it defaults), should avoid this problem. *See id.*

[152] *See* Bulova Watch Co. v. Celotex Corp., 389 N.E.2d 130, 132 (N.Y. 1979); Airco Alloys Div. v. Niagara Mohawk Power Corp., 430 N.Y.S.2d 179, 186 (N.Y. App. Div. 1980). For the analogous issue under Article 2 of the Uniform Commercial Code, see Chris Williams, *The Statute of Limitations, Prospective Warranties, and Problems of Interpretation in Article Two of the UCC*, 52 GEO. WASH. L. REV. 67, 68 (1983).

[153] Compare the issue of the seller's perpetual obligation to indemnify the purchaser for retained liabilities in an asset purchase agreement. *E.g.*, LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 11.01[3] (2014). See also Certainteed Corp. v. Celotex Corp., No. CIV.A. 471, 2005 WL 217032, at *1 (Del. Ch. Jan. 24, 2005), in which then Vice Chancellor Strine held that, in a transaction involving an asset purchase agreement, the statute of limitations for a breach of the seller's representations and warranties began to run on the date of the agreement, but a breach arising from a failure to indemnify the purchaser for a retained liability began to run from the date the seller failed to indemnify the purchaser as required by the agreement, whenever such failure occurred. *See*

Nevertheless, securitization agreements do not contain such provisions; they contain the complex of representations and warranties, Repurchase Provisions, Sole Remedy Provisions, and Claims Accrual Provisions described above.[154] Regardless of how the statute of limitations question related to these provisions at issue in the pending RMBS Put-Back Litigations should be resolved, therefore, the sophisticated, well-advised, and profit-maximizing commercial parties who enter into such transactions are intentionally opting for contractual arrangements that, for a considerable period of time, allocate the endogenous risks associated with the mortgage loans to the seller, but then, at some point, retransfer those risks to the purchaser. We can be very confident, therefore, that this pattern of risk allocation is efficient. The question thus becomes why the efficient allocation of endogenous risk changes over time: why is it efficient to allocate these risks for a time to the seller but then eventually reallocate them to the purchaser?

D. Error Rates, Transaction Costs, and the Moment of Efficient Repose

The answer to this question begins from the observation that, once the loans are transferred from the seller to the purchaser but prior to any risk shifting effected by the contract between the parties, the purchaser bears all of the risks, including all of the endogenous risks, associated with the mortgage loans.[155] Although it is perfectly correct that, for the reasons given above, the seller is the superior risk bearer of these risks,[156] shifting these risks to the seller is not costless. I am not referring to the costs of producing and negotiating a contract that includes the complex of representations and warranties backed by the Repurchase Provision that together shift these risks from the purchaser to the seller; designing and drafting those provisions may have been expensive as an initial matter, but once they are widely understood by transactional lawyers, as these provisions have been for many years, the marginal cost of including them in a securitization agreement is

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also Melissa DiVincenzo, *Repose vs. Freedom—Delaware's Prohibition on Extending the Statute of Limitations by Contract: What Practitioners Should Know*, 12 DEL. L. REV. 29, 35 (2010); Louis G. Hering & Melissa DiVincenzo, *Considerations for Contractual Provisions Extending Statutes of Limitations*, 69 BUS. LAW. 1007, 1011–12 (2014).

154 *See supra* Part II.B.

155 *See supra* text accompanying note 117.

156 *See supra* note 118 and accompanying text.

virtually zero.[157] Rather, I am referring to the costs the parties will have to bear when, after the agreement is signed, allegedly non-conforming loans are discovered, and the parties have to determine whether these loans really are non-conforming and how, if at all, they will implement the Repurchase Provision in regard to such loans.

For each such potentially non-conforming loan, each party will face certain transaction costs in determining whether it believes the loan is in fact non-conforming. Naturally, there is no guarantee that the parties will agree on this issue, and either party could be in error. Now, when a conforming loan is erroneously determined (whether by the parties or judicially, if the parties cannot agree and the matter is settled in the courts) to be non-conforming, the seller will repurchase it, but there will be no efficiency gain from this. More important for our purposes, however, when a non-conforming loan is erroneously determined to be conforming, the loan will remain with the purchaser, and again there will be no efficiency gain. If we ignore all these complications, ex ante, the contract should provide that an endogenous risk, R, will be shifted from the purchaser to the seller if, and only if, the seller's expected cost of bearing the risk $C_S(R)$ is less than the purchaser's expected cost of bearing the risk $C_P(R)$, that is, if and only if,

$$(1) \qquad C_S(R) < C_P(R)$$

In such cases, the gain from shifting the risk is $C_p(R) - C_S(R)$, the difference between the higher cost the purchaser incurs in bearing the risk and the lower cost the seller incurs in bearing it. Taking account of the complications noted above, however, the contract should shift the risk from the purchaser to the seller if, and only if,

$$(2) \qquad (1-\varepsilon(R))(C_P(R) - C_S(R) > E(TC_p(R)) + E(TC_S(R)))$$

where $\varepsilon(R)$ is the error rate with respect to the risk (that is, the probability that the loan, if non-conforming, will be treated as conforming, with the result that the purchaser need not repurchase it under the Repurchase Provision), E is an expectation operator, and $TC_p(R)$ and $TC_S(R)$ are the transaction costs to be incurred by the

[157] Indeed, since parties (and their counsel) now expect these provisions to appear in virtually all securitization documents, it may be more costly *not* to include them.

purchaser and seller, respectively, in connection with the repurchase of the loan (including both costs associated with determining whether the loan is non-conforming and costs incurred in implementing the Repurchase Provision if the loan is determined, rightly or wrongly, to be non-conforming). In other words, taking account of (a) the possibility that the seller will fail to repurchase some non-conforming loans erroneously determined to be conforming, (b) the transactions costs involved in determining whether loans are conforming or non-conforming, and (c) the transaction costs involved in implementing such repurchases as are actually made, it is efficient for the contract to provide for a repurchase remedy if and only if the expected gain from shifting the endogenous risk associated with the loan from the purchaser to the seller (that is, $C_P(R) - C_S(R)$), multiplied by the probability that a genuinely non-conforming loan will be correctly determined to be non-conforming and so repurchased (that is, $(1 - \varepsilon(R))$, is greater than the total expected transaction costs of the parties arising from the repurchase (that is, $E(TC_p(R)) + E(TC_S(R))$). Of course, if the error rate is zero, and if there are no transaction costs involved in the repurchase, then the inequality in (2) above reduces to

(3) $$C_P(R) - C_S(R) > 0$$

which is equivalent to $C_S(R) < C_P(R)$ in (1) above. In other words, the inequality in (2) reduces to the simple idea, expressed in the inequality in (1), that the parties should allocate a risk to the seller if the seller can bear the risk more cheaply than can the purchaser, *if* we assume that all transaction costs (including information costs, which are reflected in the error rate) are zero.

Now, the key thing to understand in regard to the efficient allocation of risk over time is that the error rate, $\varepsilon(R)$, and the parties' expected transaction costs, $E(TC_p(R))$ and $E(TC_S(R))$, are increasing functions of the time elapsed from the date of the transaction. That is, as time passes, the probability that a non-conforming loan will be held to be conforming (and, incidentally, the probability that a conforming loan will be held to be conforming), and the costs involved in repurchasing a loan, will increase. In general, the reasons for this are the reasons conventionally cited for having statutes of limitations: with the passage of time, determining disputed issues becomes much more difficult (that is, more costly) because documents are lost, memories fade, and witnesses become unavailable.[158] This means that the error rate in such cases will rise, and the costs of investigating and disputing issues will rise as well.[159]

This is particularly apparent in the RMBS Put-Back Litigations. In these suits, the purchasers' allegations have generally centered on alleged breaches of the sellers' Absence of Fraud Representation, No Adverse Selection Representation, Underwriting Representation, and Financial Representations.[160] As explained above, in the Absence of Fraud Representation, the seller represents that no misrepresentation or fraud has taken place on the part of the seller, the borrowers on individual loans, the originator (if the seller is not itself the originator), or any appraiser or other party involved in the origination of the mortgage loan.[161] Purchasers have generally argued that these representations are breached because the fraud is apparent within the four corners of the documents appearing in the loan documentation related to the mortgage loan.[162] This is a very unusual way to allege fraud, but the reason for it is clear: so long after the date

[158] POSNER, *supra* note 135, at 81 (arguing that the economic purpose of the statute of limitations is to "reduce the error costs that are caused by using stale evidence to decide a dispute").

[159] Not reflected in the analysis in the text are costs arising from another kind of error—errors that conforming loans will be erroneously determined to be non-conforming, with the result that the seller will be required to repurchase them. The transaction costs associated with such repurchases are costs arising from having a Repurchase Provision in the first place (the costs shifted, apart from the transaction costs involved, are a wash that is irrelevant to efficiency), and since these costs also rise with the time elapsed since the date of the agreement (because the rate of this kind of error also increases as time passes), they should be included in a more complete analysis of the efficient allocation of risk over time. It is worth noting that, since the decision to bring a suit rests with the plaintiff, the suits that will be brought will disproportionately be suits in which the plaintiff believes it has a probability of prevailing, including because of errors of this kind—that is, errors in favor of the plaintiff.

[160] *See* Lehman XS Trust, Series 2006-4N v. Greenpoint Mortgage Funding, Inc., 991 F. Supp. 2d 472, 474–75 (S.D.N.Y. 2014); ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 846 (N.Y. Sup. Ct. 2013); Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *1–2 (N.Y. Sup. Ct. May 10, 2013).

[161] *See supra* note 55 and accompanying text.

[162] *See Nomura Asset Acceptance Corp.*, 2013 WL 2072817, at *5 (describing how plaintiffs alleged that "misrepresentations . . . [were] readily apparent on the Mortgage Loan Files").

the loan was originated, the costs to the purchaser of conducting any kind of investigation into the facts and circumstances of the loan's origination other than by reviewing the documents in the loan file are prohibitively high.[163] Hence, the only type of fraud that can be detected at this date and form the basis of a claim that the seller must repurchase the loan under the Repurchase Provision is fraud that could be proved from within the four corners of documents in the loan file.[164] Since many, indeed probably most, instances of fraud could not be detected and proved merely from within the four corners of the loan documents (it's a poor fraudster whose lies would be so obvious), the relevant error rate—the probability that a non-conforming loan will be found to be conforming—is likely very high.

In the No Adverse Selection Representation, the seller typically represents that it used no selection procedures in choosing the loans to include in the securitization that identified loans that were less desirable or valuable than other comparable loans in the seller's portfolio.[165] A purchaser can argue with some initial plausibility that, if the loans included in the transaction show high rates of delinquency, this tends to show that the loans were selected in a manner adverse to the purchaser. The seller will respond, of course, that because of the general collapse of the housing market and resulting recession, an abnormally high percentage (as measured by historical norms) of even the best loans went into default in the years following the financial crisis. For the purchaser to show convincingly that the seller used some selection procedure adverse to the purchaser in choosing loans to be included in the securitization, the purchaser would ideally like to compare the default rates on the loans included in the transaction to the default rates

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[163] In *ACE Securities Corp. Home Equity Loan Trust, Series 2007-HE3 v. DB Structured Products Inc.*, 5 F. Supp. 3d 543, 550 (S.D.N.Y. 2014), the "[p]laintiff[s] assert[ed] that the 'inaccuracies, misrepresentations, omissions, and other breaches [of the seller's representations] were so fundamental and numerous as to preclude any notion that they were the result of mere inadvertence or accident.'" In other words, the *quantity* of the misrepresentations suggests fraud.

[164] Of course, if the file suggests fraud in this way but in fact there was no fraud, a seller defending against this claim soon after the loan was made and securitized would likely be able to access other information not in the file to rebut the allegation. Six or seven years later, however, accessing this information may be extremely difficult, which increases the probability of an erroneous determination that the loan was non-conforming. *See supra* notes 158–59 and accompanying text.

[165] *See supra* note 56 and accompanying text.

of all comparable loans in the seller's portfolio at the time the selection was made. This would require tracking down all the comparable loans held by the seller during the relevant period several years in the past, and probably almost all of these will have been securitized in other securitization transactions or otherwise disposed of. Locating these loans now and determining their status would thus be extremely difficult and costly. In addition, in litigating this claim, both parties would want to call as witnesses employees of the seller involved in the selection process and would want to access documents from the business records of the seller related to that process, but both of these may well have become unavailable in the years following the events in the question. Again, the probability of non-conforming loans being found to be conforming rises, as do the costs of involved in disputing the relevant issues.[166]

In the Underwriting Representation, the seller typically represents that the loans were underwritten in accordance with the originator's underwriting guidelines in effect at the time the loans were originated, except with respect to loans which had compensating factors permitting a deviation from the applicable guidelines (that is, a factor that made the loan worth making despite the fact that it otherwise failed to conform in some respects to the underwriting guidelines).[167] With claims of fraud in the underwriting process, in some cases the failure of a loan to conform to the relevant underwriting guidelines will be apparent from the documents in the loan file.[168] In many other cases, however, proving that a loan did not conform to the guidelines would require an investigation into facts not covered by documents in the file. Such an investigation may be possible at a reasonable cost soon after the loan is originated, but many years later, it will become more difficult and more costly. Certainly, it becomes harder to call as witnesses employees of the originator who were involved in the process, and any documents not included in the loan file are more likely to have been lost or destroyed. In particular, for loans that fail to meet the underlying guidelines but had compensating advantages, accessing information beyond that included in the loan file regarding such purported advantages may be especially difficult. In each case, the relevant error rate—the probability that non-conforming loans will be found to be conforming—will rise.[169]

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[166] *See supra* notes 158–59 and accompanying text.
[167] *See supra* note 57 and accompanying text.
[168] *See, e.g.*, *supra* note 162.
[169] *See supra* notes 158–59 and accompanying text.

Finally, the critically important Financial Representations include representations regarding, with respect to each individual loan being securitized, whether the property is owner-occupied, the loan-to-value ratio and combined loan-to-value ratio at the date the loan was originated, the appraised value of the property (in an appraisal done for the originator and made in accordance with certain procedures accepted in the industry), and the borrower's debt-to-income ratio.[170] Here again, disputes on these points are more likely to be settled quickly and correctly if they arise soon after the loans are securitized, but the error rate and costs will rise with time. For example, suppose that the seller represented that a certain property was owner-occupied and in fact it was not. If a dispute on this point arises soon after the securitization transaction closes, the purchaser will likely be able to prove that the representation was in fact false: it will be a question of where the borrower was living a few months ago. But if the dispute arises six or seven years later, the matter will be much more difficult to settle. The only information on the point in dispute that is accessible at low cost may be the documents in the loan file, and so whatever these documents say on the question will likely be de facto conclusive. But if the borrower was intentionally misleading the originator, or if the originator was intentionally misleading the purchaser, then the documents in the loan file are unlikely to show this; on the contrary, they would have been prepared (or doctored) to conceal this fact. Once again, the chances that a non-conforming loan will be held to be conforming will increase.[171]

Similarly, with respect to representations involving loan-to-value or combined-loan-to-value ratios, the key fact will generally be the actual value of the property on the date the loan was originated.[172] If the dispute arises soon after the securitization transaction, an appraisal of the property made at the time of the dispute will be highly probative of the value of the property a little earlier in time when the loan was made. If the purchaser disputes the appraisal included in the loan file, it can easily commission an appraisal itself, and this appraisal will be highly probative as to the value of the property on the relevant date not long in the past. But several years after the time the loan was securitized, it becomes very difficult to determine accurately the true

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[170] *See supra* note 58 and accompanying text.

[171] *See supra* notes 158–59 and accompanying text.

[172] *See, e.g.*, Pooling and Service Agreement, *supra* note 58, § 1.01 (defining "Loan-to-Value Ratio" as "the fraction, expressed as a percentage . . . the denominator of which is the Value of the related Mortgaged Property").

value of the property at the time the loan was originated, then a date long in the past. In many of the RMBS Put-Back Litigations, purchasers base their allegations that Financial Representations of one kind or another were breached on a claim that the value of the property differs from that shown in the appraisal included with the loan documentation, and their proof that this is so is often the output of a financial model that values the property on the basis of a set of variables such as the prices of other supposedly comparable properties sold around the time the loan was made.[173] Of course, no appraiser would value the property in so simplistic a way if the issue were the value of the property in the present or the very recent past. Allegations that the seller breached the Financial Representations in the agreement, therefore, may degenerate into battles of the experts about the reliability of financial models that everyone concedes are inaccurate in significant ways.

As should be clear from this discussion, almost all of the claims regarding false representations that the purchasers are making in the RMBS Put-Back Litigations have this common feature: in determining whether the allegedly breached representation really is breached, in general the only easily accessible evidence will be the documents in the loan file, and, although there may be some exceptions, these will of course tend to support the truth of the representation. If the purchaser brought its claim soon after the securitization transaction had closed, the purchaser may well have been able to access additional information that would have been relevant to proving its claims of breach of representation. But accessing such information tends to get more difficult and more costly as time passes, and so as time goes on the probability that the purchaser will be able to prove that an allegedly non-conforming loan really was non-conforming falls. Hence, the corresponding error rate—the probability

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[173] In *Nomura*, the plaintiffs' experts "employed . . . Automated Valuation Models ('AVM') to assess the values of properties underlying the loans," and found that "[f]or many of the loans, the value determined by the AVM was significantly lower than the reported value of the property," with the result that the combined loan-to-value ratios were higher than represented. *Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc.*, No. 653541/2011, 2013 WL 2072817, at *3 (N.Y. Sup. Ct. May 10, 2013). The plaintiffs in *Nomura* also alleged breaches of the seller's representation about the appraisals in the loan files, arguing that "the AVM reveal[ed] that there were discrepancies between the actual value of the properties and the appraised values, with the vast majority of the discrepancies arising from over-reporting of the appraised value." *Id.*

that a non-conforming loan will be found to be conforming—rises, and of course the costs of litigating the matter rise as well.[174]

Thus, if we regard the error rate $\varepsilon(R)$ and the parties' expected transaction costs $E(TC_p(R))$ and $E(TC_S(R)))$ all as functions of *t*, the time since the securitization transaction closed, then the inequality in (2) becomes

$$(4) \qquad (1-\varepsilon(R,t))(C_p(R)- C_S(R)) > E(TC_p(R,t))+ E(TC_S(R,t)))$$

Assuming, as seems reasonable, that $\varepsilon(R,t)$, $E(TC_p(R,t))$, and $E(TC_S(R,t)))$ are all monotonically increasing functions of *t*, there will be some *t* at which the inequality in (4) ceases to hold—that is, some point in time after the date of the securitization transaction at which it is no longer efficient to attempt to shift endogenous risks back to the seller.[175] From that moment on, the purchaser, not the seller, is the

[174] *See supra* notes 158–59 and accompanying text.

[175] The argument in the text assumes that the probability of a risk materializing is independent of the statute of limitations for bringing a claim under the Repurchase Provision in the agreement. Stephen Yelderman has pointed out to me that this assumption is false if the seller can affect the probability that a risk will materialize by varying the level of care it takes in originating the loan. That is, the longer the period for bringing a claim, the greater the chance the seller will be obligated to repurchase a non-conforming loan with a materialized risk; hence, the seller will use more care in originating the loan, and so the probability that the risk will materialize will be lower. For instance, if the period during which the purchaser could bring a claim was shortened to just one day, the effect would be virtually the same as if there were no Repurchase Provision at all. In that case, the risk would effectively remain with the purchaser, and we would expect that the seller would take much less care in originating loans (indeed, no care at all, except as may arise from factors independent of the Repurchase Provision, such as reputational considerations). Yelderman's point is perfectly true, and a more realistic model would have to take account of this fact. Even in that more complex model, however, the basic point of the simpler model in the text would hold good: there would eventually come a point in time after which the benefits of shifting risks from the purchaser back to the seller would be less than the costs. Moreover, at least in the present context of RMBS put-backs, I think however this complication may be safely ignored. For, historically, the relevant risks related to RMBSs materialized quickly (that is, within a year or so) if at all, *see* SCHWARCZ ET AL., *supra* note 6, § 5.01, at 108, and so, as long as the period for bringing claims clearly included the period during which risks could be expected to materialize (which, at six years from the date of the contract, it clearly did), extending the period during which claims could be brought would have little

superior risk bearer of these risks. Let us call this moment in the time the Moment of Efficient Repose—the moment when it becomes efficient to allow losses from materializing risks to remain where they fall. If the functions above are indeed monotonically increasing functions of t (or even if, for some time t_0, the functions are monotonically increasing functions of t after time t_0), then there must exist a Moment of Efficient Repose, and we can see how the retransferring of endogenous risks from the seller back again to the purchaser is efficient.

Now, the economic effect of the statute of limitations is to create a moment at which the contract ceases to shift endogenous risks from the purchaser back to the seller, that is, a moment at which the risks begin to remain where they otherwise fall—on the purchaser. There is no guarantee, of course, that this moment determined by the statute is really the Moment of Efficient Repose: the law could set the moment either too early or too late in time. Moreover, it seems obvious that the uniform rule established by the statute could not possibly be right in every case. That is, in different kinds of agreements and in different kinds of circumstances, the Moment of Efficient Repose may come earlier or later. It seems wise, therefore, that the law allows parties to shorten the statute of limitations by agreement,[176] for

effect on the level of care used by the originator in originating the loans (that is, since the marginal increase in risk to the seller from extending the period would be small, the effect on its level of care in originating the loans would be small as well). To resume the example from above, while it is true that reducing the period to bring a claim to one day would reduce the incentive for the seller to use care in originating the loans almost to zero (because almost no claims could be brought in one day), reducing the period from ten years to six years would not much reduce the seller's incentive to use care in originating the loans because whatever risks would ever materialize would very likely materialize well within the six year period, and so, regardless of the level of care used, the number of risks materializing after six years but before ten years would be almost zero.

[176] Specifically, in *John J. Kassner & Co. v. City of New York*, 389 N.E.2d 99, 103 (N.Y. 1979), the court held that "[b]ecause of the combined private and public interests involved, individual parties are not entirely free to waive or modify the statutory defense." In particular, although parties may generally agree to shorten the statutory period, "[t]he public policy represented by the statute of limitations becomes pertinent where the contract not to plead the statute is in form or effect a contract to extend the period as provided by statute or to postpone the time from which the period of limitation is to be computed." *Id.* (internal quotation marks omitted).

sometimes the Moment of Efficient Repose comes sooner rather than later.[177] Perhaps, in some cases, the Moment of Efficient Repose would fall even further in the future than the end of the statutory period. In such cases, the statute would impose an inefficient solution on the parties, and so, although the law in important commercial jurisdictions such as New York[178] and Delaware[179] does not permit it, there is a plausible argument that the law ought to allow parties to extend the statute of limitations by agreement.[180] On the other hand, as explained above, clever drafting and the use of covenants of continuing performance rather than representations would often allow sophisticated commercial parties to achieve the desired end.[181]

However this may be, the argument in this Section III.D shows that, although it is efficient for the parties to shift endogenous risks related to the mortgage loans from the purchaser back to the seller by means of the seller's representations and warranties regarding the loans and the Repurchase Agreement, nevertheless at some point in time after the date of the agreement, such shifting becomes inefficient. Although this argument shows that there is a Moment of Efficient Repose, it shows nothing about when this moment occurs. That is, the purchasers and the sellers in the RMBS Put-Back Litigations can both agree with this analysis and still maintain their dispute: in terms of the analysis given in this Section, the purchasers are arguing for a much later, and the sellers are arguing for a much earlier, Moment of Efficient Repose. Nevertheless, the analysis above suggests that the sellers are much

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[177] For example, business combination agreements involving private company targets typically include provisions under which the seller agrees to indemnify the buyer for breaches of the seller's representations and warranties about the company being sold. Such agreements also typically provide that such representations shall survive for only a limited period of time, and this period is often well short of the statutory period for claims sounding in contract. *See* KLING & NUGENT, *supra* note 153, § 15.02[2].

[178] *John J. Kassner & Co.*, 389 N.E.2d at 103.

[179] *See* DiVincenzo, *supra* note 153, at 29; Hering & DiVincenzo, *supra* note 153, at 1007.

[180] *See* DiVincenzo, *supra* note 153, at 44–46; *but see supra* text accompanying notes 149–50 (considering the possibility that the costs borne by third parties arising from litigating disputes long after the relevant events have taken place exceed the benefits to the parties and so is socially inefficient).

[181] *See supra* notes 151–53 and accompanying text.

more likely to be correct than the purchasers. To that argument, I now turn.[182]

IV. The Moment of Efficient Repose in Securitization Transactions

In this Part, I shall argue that (a) in the RMBS Put-Back Litigations, whereas the sellers argue that the statutory period expires six years after the date of the relevant contracts between the sellers and purchasers, the position advanced by the purchasers entails that the statutory period could extend for many decades after that date, and (b) since the Moment of Efficient Repose in such transactions likely comes sooner rather than later, and in any event long before the date suggested by the purchasers, and since sophisticated, well-advised, profit-maximizing commercial parties like those involved in securitization transactions can reasonably be assumed to adopt efficient provisions in their agreements, the correct interpretation of the securitizations agreements at issue in the RMBS Put-Back Litigations is almost certainly that of the sellers, not that of the purchasers.

A. The Indefinitely Long Statutory Period Advocated by the Purchasers

As noted above, on the sellers' understanding, the relevant breach of contract, if any there was, was the falsity of the sellers' representations related to the mortgage loans.[183] These representations,

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[182] The argument in this Section has relied on the assumption that the probability that a non-conforming loan will erroneously be found to be conforming increases with time. The converse, however, is also true: as time passes, the probability that a *conforming* loan will be found to be *non-conforming* also increases. Everything else being equal, both kinds of errors become more likely as time passes. When conforming loans are found to be non-conforming, both parties incur transaction costs in implementing the Repurchase Provision, but there is no efficiency gain in requiring the seller to repurchase the loan (there is only a transfer payment from the seller to the purchaser). The model in the text can be interpreted to take account of the costs arising from errors in which conforming loans are found to be non-conforming: for any particular risk R, we can regard these costs as being reflected in the $E(TC_p(R))$ and $E(TC_S(R)))$ functions. The effect of this would be that these functions increase even faster as a function of time, and the Moment of Efficient Repose comes even sooner.

[183] *See supra* text accompanying notes 73–79.

if they were false at all, were false the instant they were made when the parties entered into the contract.[184] Since, under New York law, the statute of limitations for a claim sounding in contract begins to run from the moment of breach,[185] the statutory period commenced on the date of the agreement between the seller and the purchaser and expired six years later.[186] Assuming the parties chose efficient terms in their contract, this implies that the Moment of Efficient Repose is the sixth anniversary of the relevant agreements.

The purchasers, of course, have a quite different view. On their understanding, the Repurchase Provision is not a contractually created remedy for breaches of the seller's representations about the loans, but an independent promise that can be independently breached by a seller who refuses to repurchase a non-conforming loan after appropriate notice and the passage of time.[187] The relevant breach of the contract, therefore, is the seller's refusal to repurchase a non-conforming loan.[188] If the agreement also happens to contain a Claims Accrual Provision, this is especially clear, the purchasers say, because the agreement then provides in so many words that the purchaser's right of action accrues only after discovery of the breach of the seller's representations about a loan, the seller's failure to repurchase the loan under the Repurchase Provision, and demand by the purchaser for compliance.[189]

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[184] *See supra* note 74 and accompanying text.

[185] *E.g.*, Ely-Cruikshank Co. v. Bank of Montreal, 615 N.E.2d 985, 986–87 (N.Y. 1993) (holding that a claim for breach of contract accrues at the time of breach, not when the plaintiff suffers damages and regardless of whether the plaintiff is aware of the breach).

[186] N.Y. C.P.L.R. 213 (McKinney 2003) (providing that actions on a contract must be brought within six years).

[187] *See supra* text accompanying notes 80–83.

[188] *See supra* note 83 and accompanying text.

[189] *See supra* notes 97–99 and accompanying text. In many of the RMBS Put-Back Litigations concerning the statute of limitations, the parties have argued about whether the demand requirement of the Repurchase Provision is procedural or substantive. *E.g.*, Deutsche Bank Nat'l Trust Co. v. Quicken Loans, Inc., No. 13 Civ. 6482(PAC), 2014 WL 3819356, at *3 (S.D.N.Y. Aug. 4, 2014); Lehman XS Trust, Series 2006-4N v. Greenpoint Mortgage Funding, Inc., 991 F. Supp. 2d 472, 477 (S.D.N.Y. 2014); ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 847–48 (N.Y. Sup. Ct. 2013); *see also* Continental Cas. Co. v. Stronghold Ins. Co., 77 F.3d 16, 21 (2d Cir. 1996). The question arises because of N.Y. C.P.L.R. 206(a), which provides that "where a demand is necessary to entitle a person to commence an action, the time within which the

Now, for the reasons given above, the purchasers' views of the Repurchase Provision and related provisions are unsupportable. Repurchase Provisions exist because, the endogenous risk associated with the loans having been transferred back to the seller from the purchaser, the parties need some way to make this transfer legally enforceable, and the usual remedies at common law for breach of representations and warranties—expectation damages and rescission—would be very inefficient in the context of a securitization transaction.[190] Hence, the parties have adopted the Repurchase Provision, which creates the proper economic incentives at a low

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action must be commenced shall be computed from the time when the right to make the demand is complete." N.Y. C.P.L.R. 206(a) (McKinney 2003); Parker v. Town of Clarkstown, 629 N.Y.S.2d 787, 788 (N.Y. App. Div. 1995). If the demand requirement is merely procedural, then under N.Y. C.P.L.R. 206(a), the statute begins to run from the date of the breach of the representations, for at that time the purchaser's "right to make the demand is complete." Kunstsammlungen Zu Weimar v. Elicofon, 678 F.2d 1150, 1161 (2d Cir. 1982) (internal quotation marks omitted). But if the demand requirement is substantive, then making the demand is an essential element of the plaintiff's cause of action, and the statute of limitations does not begin to run until demand is made and refused. *Id.* The cases do not clearly explain why some demand requirements are procedural and others are substantive, but the analysis in this Article suggests a basis for the distinction: When the demand requirement is part of a contractually-created remedy for a breach that would, in the absence of the contractually-created remedy, support a remedy at common law, then the demand requirement is procedural. *See* Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *8 (N.Y. Sup. Ct. May 10, 2013) ("The repurchase obligation in this case is merely a remedy. It is not a duty independent of the Mortgage Representation breach of contract claims."). When making demand is one of the conditions to the counterparty's contractual obligation to the party, the obligation not being part of a remedy for another breach of contract, the requirement is substantive. For instance, in *Continental Casualty Co.*, 77 F.3d at 21, the defendant was a reinsurer who had promised that if, among other things, its counterparty had made an appropriate demand, it would pay money. Absent this promise, which includes as a condition the making of the demand, the reinsurer would have had no obligation to the counterparty that it could breach, which makes the demand requirement substantive, rather than procedural. *See id.* That is, the promise of the reinsurer to pay money conditioned on, among other things, a demand from the counterparty, was not a promise to pay money if the reinsurer breached another promise, but an independent promise made in the contract. *See id.*

[190] *See supra* notes 135–39 and accompanying text.

cost.[191] As the Sole Remedy Provision makes clear, the Repurchase Provision is in lieu of the usual remedies available for breach of contract.[192] In the absence of the Repurchase Provision, it would be beyond doubt that any claims by the purchaser for breach of contract based on the falsity of the seller's representations would accrue on the date of the agreement and expire six years later.[193] In eliminating the purchaser's common law remedies and substituting the Repurchase Provision, the parties were substituting an efficient form of remedy for an inefficient one.[194] There is nothing in this procedure to suggest that the parties were simultaneously extending the period during which claims could be brought.

Even more important, however, is that, on the purchasers' view, the period during which claims can be brought is not only extended beyond the sixth anniversary agreement but extended for utterly fantastic lengths of time. That is, on the purchasers' view, a purchaser could discover a breach at any time during the life of the loan and then notify the seller of the breach.[195] If the seller refused to repurchase the non-conforming loan under the Repurchase Provision, the statutory period would then begin to run, and so the purchaser would have six years after the seller's refusal to repurchase in order to bring suit.[196] Since securitization transactions often included fifteen and thirty year mortgages, the purchaser could theoretically bring suit up to thirty-six years after the securitization transaction was consummated. For instance, in *ACE Securities*, the Mortgage Loan Purchase Agreement was executed in 2006,[197] and so the purchaser could conceivably bring suit as late as sometime in 2042. If the relevant

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[191] *See supra* text accompanying notes 139–40.
[192] *See supra* Part II.B.3.
[193] *See supra* notes 132–33 and accompanying text.
[194] *See supra* text accompanying notes 139–40.
[195] Some of the purchasers in the RMBS Put-Back Litigations have asserted that they can seek to have the seller repurchase even a loan that has been foreclosed upon or otherwise liquidated. *See, e.g.*, ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc. (*ACE One*), 965 N.Y.S.2d 844, 849 (N.Y. Sup. Ct. 2013). If this is correct, then the purchaser could conceivably make a demand at any time whatsoever, and, if the demand is refused, bring suit at any time after that for six years. *See id*. at 848. Contrary to the argument in Part III, this implies that there exists no Moment of Efficient Repose.
[196] *See id.* at 848.
[197] *See* Mortgage Loan Purchase Agreement, *supra* note 48 (showing the Mortgage Loan Purchase Agreement was executed in 2006).

agreement contained a Claims Accrual Provision too, then, on the purchaser's view, the purchaser could wait even longer; for, after the seller refused to repurchase an allegedly non-conforming loan, the purchaser could delay indefinitely making a demand on the seller that it comply with the Repurchase Provision.[198] Since, as the purchasers would have it, their cause of action would accrue only after they had made this demand and the sellers had refused, the statute of limitations would begin to run only when the demand was refused and would expire six years later.[199] Thus, the purchasers could conceivably wait for any period of time whatsoever before making the demand, and they could bring suit at any time up to six years after that time. In this way, the purchasers could extend the time to bring a suit to literally forever and a day—or actually even longer, to forever and six years.[200] The sellers would be liable on their representations and warranties effectively forever.

B. The Likely Moment of Efficient Repose

The analysis of Part III implies that the Moment of Efficient Repose must occur at some point, and so the purchasers' interpretation of the Claims Accrual Clause must be wrong, since it effectively contradicts this view. In the *Lehman XS Trust* case,[201] therefore, the Second Circuit ought to reject the purchaser's argument that the Claims Accrual Provision should be read to extend indefinitely the time during which a purchaser could seek to enforce the Repurchase Provision.

Furthermore, the analysis in Part III also strongly suggests that the Moment of Efficient Repose will come relatively soon after origination of a loan. For example, valuing a property as of a date even a few years in the past is very difficult; valuing a property as of a date

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[198] *See supra* text accompanying note 189.
[199] *See supra* text accompanying note 189.
[200] *See* Nomura Asset Acceptance Corp. Alt. Loan Trust, Series 2005-S4 v. Nomura Credit & Capital, Inc., No. 653541/2011, 2013 WL 2072817, at *8 (N.Y. Sup. Ct. May 10, 2013) ("The statute of limitation begins to run from the date of the first alleged breach, not from the time plaintiff chooses to seek a remedy. To find otherwise would allow plaintiff to essentially circumvent the statute of limitations by indefinitely deferring its demand for payment.") (citations omitted) (internal quotation marks omitted); *see also* Deutsche Bank Nat'l Trust Co. v. Quicken Loans, Inc., No. 13 Civ. 6482(PAC), 2014 WL 3819356, at *4 (S.D.N.Y. Aug. 4, 2014).
[201] Lehman XS Trust, Series 2006-4N v. Greenpoint Mortgage Funding, Inc., 991 F. Supp. 2d 472 (S.D.N.Y. 2014).

thirty or more years in the past is virtually impossible. Market conditions will have changed so much as to make any contemporary information useless, and sufficiently detailed information from such a distant time in the past will be very difficult and costly to obtain.[202] As the pending RMBS Put-Back Litigations demonstrate, valuing the underlying properties even eight or nine years in the past (that is, determining in 2014 the value of parcels of real estate in 2006 or 2005) is so difficult that plaintiffs are already resorting to financial models rather than actual appraisals.[203] This suggests very strongly, therefore, that the Moment of Efficient Repose is much closer to the sixth anniversary of the securitization agreement, as maintained by the sellers, than to the time when the purchaser discovers a breach and makes demand, which could be thirty or more years later, as maintained by the purchasers.[204] Accordingly, in *ACE Securities*, the New York Court of Appeals should affirm the Appellate Division and hold that the relevant breach of contract, if such there was, was the falsity of the seller's representations and warranties and that the statute of limitations began to run on the contract date, expiring six years later.

V. Conclusion

It is a familiar point in the economic analysis of contracts that the joint surplus of a transaction can be increased by allocating risks associated with the transaction to the superior bearer of such risks.[205]

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[202] On the dangers of using obsolete data in financial models, see Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 63–65 (2010).

[203] *See supra* note 173.

[204] To be clear, the economic model of the statute of limitations suggested here is not sufficiently discerning to determine whether, for example, the Moment of Efficient Repose comes four years, six years, or ten years after the date of the agreement. The model does strongly suggest, however, that the Moment of Efficient Repose does not come as long as fifteen or thirty years after the date of the agreement. Although the plaintiffs in the various RMBS cases are not in fact attempting to bring claims fifteen or thirty years after the date of the relevant agreements, but only seven, eight, or nine years after such date, their argument that the statute begins to run only after discovery of a breach, demand for repurchase, and refusal of that demand, implies that claims brought as late as thirty years after the fact would not be too late. This in turn implies that the Moment of Efficient Repose would come only thirty or more years after the date of the agreement, which we can confidently say is not the case.

[205] *See supra* note 114 and accompanying text.

Implicit in this principle, but generally overlooked, has been the assumption that whichever party is the superior risk bearer at the time the agreement is made will be the superior risk bearer forever, or, at least, that the mere passage of time will not change which party is the superior risk bearer.[206] The major point of this Article is that this assumption is false. In reality, which party is the superior bearer of a risk will change over time. Even if, at the time the agreement is made, efficiency requires shifting a risk from one party to another through appropriate contractual provisions, as time goes on, implementing the cost shifting required by such provisions as risks materialize becomes more prone to error and entails increasing transaction costs.[207] At some point, the gain from shifting the risk to the superior risk bearer is decreased by the increasing error rate below the increasing transaction costs of implementing the relevant contractual provisions.[208] At that point, further shifting of costs of materializing risks becomes inefficient, and so from that point onwards, efficiency is served by allowing costs to remain where they fall.[209]

This conclusion is analogous to the familiar principle in the economic analysis of law that in evaluating the efficiency of the rule of law we need to consider not only the effect on the parties involved and the incentive effects the rule creates but also the costs of administering the rule through the legal system.[210] Some rules of law that would be efficient if they could be administered costlessly are inefficient in the real world because the costs of administering them, including the costs of erroneous applications, exceed the benefits the rules create. For example, in certain unusual circumstances price fixing agreements are actually efficient,[211] and so a rule of law that condemned only inefficient price fixing agreements would be more efficient than the actual rule under the Sherman Act[212] that condemns all such agreements—provided that courts could costlessly and infallibly identify the rare instances in which price fixing agreements are efficient. In fact, however, if courts inquired into which price fixing agreements were efficient and which were inefficient, the result would

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[206] *See supra text* accompanying notes 148–49.
[207] *See supra* Part III.D.
[208] *See supra* Part III.D.
[209] *See supra* Part III.D.
[210] *See supra* note 150 and accompanying text.
[211] *See* 12 HERBERT HOVENKAMP, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION ¶ 2012 (3d ed. 2012).
[212] Sherman Antitrust Act, 15 U.S.C. § 1 (2012).

be a great increase in the costs of administering price fixing cases and a significant error rate, both in the form of inefficient price fixing agreements being erroneously found efficient and efficient ones being erroneously found inefficient. On the whole, taking account of these costs and the positive error rate, we are likely better off with a rule that condemns all price fixing agreements. This rule is cheaper to administer and never fails to suppress inefficient price fixing agreements, which are the large majority of such agreements, but it does also suppress the few efficient price fixing agreements. On the whole, however, the net benefits of this rule exceed the net benefits of alternative rules.

This Article points out that contractual provisions, since they are in effect the law between the contracting parties, are in this manner similar to rules of law. The efficient contractual rules will take account of the costs to the parties of administering these rules, including costs from erroneous applications of the rules contained in the contract. For this reason, contracting parties consider not only the efficient allocation of risks, but also the efficient allocation of risks over time, for the error rates and transaction costs of administering contractual provisions will generally rise as the date of the contract recedes into the past.[213] The result is that the efficient allocation of a risk can change over time.

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[213] *See supra* Part III.D.