NEW YORK COURT OF APPEALS ROUNDUP

A REVIEW OF '*AMBAC ASSURANCE CORP. V. COUNTRYWIDE HOME LOANS*'

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The Court of Appeals issued an important decision in the residential mortgage-backed securities litigation saga in the *Ambac* case on June 27. The court found that financial guaranty insurer Ambac Assurance Corporation will be required to prove both justifiable reliance and loss causation in its upcoming fraud trial against securities issuer Countrywide Home Loans.

Ambac successfully argued in the Commercial Division that, pursuant to Insurance Law Section 3105, it was exempt from having to prove reliance on Countrywide's allegedly fraudulent statements and could recover all $2 billion of its insurance payments regardless of whether those payments resulted from the alleged fraud. The Court of Appeals rejected Ambac's argument that Section 3105 alters the insurer-plaintiff's burden of proving the traditional elements of a fraud claim, and further held that Ambac was limited to the repurchase protocol provided in the parties' contracts as its exclusive remedy for breach of contract and could not recover attorney fees.

Ambac provided financial guaranty insurance to Countrywide with respect to 17 residential mortgage-backed securitizations that Countrywide issued to investors between 2004 and 2006. The securitizations were backed by over 300,000 individual mortgage loans that Countrywide had either originated or acquired from other originators. Ambac's policies were unconditional and irrevocable (which was a significant factor in the court's decision) and guaranteed income streams to the investors if the underlying mortgage holders failed to make payments.

Pursuant to Insurance and Indemnity Agreements with Ambac ("Insurance Agreements"), Countrywide provided representations and warranties on over 60 topics, including each underlying loan's compliance with underwriting guidelines, compliance with federal regulations, appraisal issues, and the accuracy of the information in the loan schedules. The Insurance Agreements provided that the exclusive remedy for breach of these representations and warranties, as well as any defective mortgage loan, was to require Countrywide to repurchase, cure or substitute non-conforming loans. In other sections of the Insurance Agreements, Countrywide gave additional representations and warranties that there were no false statements in the securitization documents or in the information provided to Ambac regarding the loans and Countrywide's operations.

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After the 2007 recession and catastrophic downturn in the housing market, there was a substantial increase in mortgage defaults and delinquency rates. Ambac started making payments on the financial guaranty insurance policies it issued and conducted a review of a sample of 8,800 defaulting loans, allegedly finding that 90 percent were in breach of the representations and warranties in the parties' Insurance Agreements. Pursuant to the Insurance Agreements, Ambac submitted requests for Countrywide to repurchase or cure the defaulting mortgages or substitute new ones.

Ambac filed suit in 2010 asserting claims for: (i) breach of the Insurance Agreements, the representations and warranties in the Insurance Agreements, and the repurchase protocol; (ii) fraudulent inducement; and (iii) indemnification and recovery of attorney fees.

The Supreme Court held that, based on the application of Insurance Law §3105, Ambac did not have to prove justifiable reliance or loss causation in order to establish its fraudulent inducement claim. Section 3105 provides in relevant part that "[n]o misrepresentation shall avoid any contract of insurance or defeat any recovery thereunder unless such misrepresentation was material" and "no misrepresentation shall be deemed material unless knowledge by the insurer of the facts misrepresented would have led to a refusal by the insurer to make such contract." The Supreme Court also held that Ambac was not limited to the repurchase protocol as its sole remedy. The Appellate Division, First Department modified, holding that Section 3105 is not applicable to a common law fraud claim for money damages and holding that Ambac could not avoid the exclusive remedy provision by alleging that Countrywide engaged in "transaction-level misrepresentations" on top of mortgage-level misrepresentations. The First Department granted Ambac leave to appeal.

The Court of Appeals, in an opinion authored by Judge Michael Garcia and joined by Judges Stein, Fahey, Wilson and Feinman (Chief Judge DiFiore took no part in the decision), held that Section 3105 plays no role in the case, reasoning that it does not provide an independent cause of action for fraud to recover money damages nor does it modify the "longstanding common law elements of fraudulent inducement." The court found that Section 3105 is only relevant when an insurer seeks rescission or to avoid payment of an insurance claim, and here Ambac was unable to assert such a claim because its contracts were irrevocable. Moreover, Section 3105 was enacted to help policyholders by requiring insurers who were seeking to nullify their contracts to prove *material* misstatements; the statute did not otherwise relax fraud requirements in an "insurer-only" exception. The court invoked public policy in support of its finding that an insurer must prove justifiable reliance and noted that this requirement discouraged specious claims by sophisticated parties that they had "been taken in."

The court also found no reason to eliminate the loss causation requirement. The court noted that it is well-established that a false representation must result in injury in order to give rise to a cause of action: "if the fraud causes no loss, then the plaintiff has suffered no damages." Accordingly, the court found that Ambac's compensatory damages should be measured solely by reference to payments based on loans that did not conform to Countrywide's representations and warranties. In other words, Ambac could not recover damages based on losses suffered on all defaulting loans without establishing that the losses resulted from a breach. To find otherwise, and allow Ambac to seek recovery for the $2 billion of its insurance payments on all defaulting loans, would give Ambac the equivalent of rescissory damages, which it was unable to seek on its unconditional, irrevocable policies.

The Court of Appeals invoked its recent precedent in *Nomura Home Equity Loan, Series 2006-FM2 v. Nomura Credit & Capital*, 30 NY 3d 572 (2017), to reject Ambac's argument that it was not limited to the sole remedy of the repurchase protocol specified in the Insurance Agreements. Ambac argued that this protocol related solely to "loan-level" breaches and that it was free to seek broader remedies for the alleged "transactional-level" breaches. In both *Nomura* and *Ambac*, the court rejected this premise, finding that both types of breaches were supported by the same factual allegations—for example, that the loans in the securitizations failed to comply with the issuer's origination guidelines. The court observed that Ambac cannot evade the exclusive remedy provisions in the Insurance Agreements by seeking to recharacterize its claims.

In a short dissenting opinion, Judge Jenny Rivera reiterated her dissent in the *Nomura* case that the financial guaranty insurer's remedies should not be limited to the repurchase protocol where it asserts claims beyond breach of the representations and warranties covered by the sole-remedy provision. In effect, Judge Rivera disagrees that the plaintiffs in these cases are alleging claims based solely on faulty mortgages. In both cases, she found that alleged misrepresentations regarding the suitability of the securitizations as investment opportunities, the reliability of the defendant's business practices, and the nature of the overall loan pools could be a broader level breach that should not necessarily be limited to the repurchase protocol in the parties' insurance agreements.

The court's opinion is expected to have a significant impact on the future of RMBS litigation as it establishes challenging evidentiary hurdles for an insurer-plaintiff to clear in order to recover on a fraud claim. Plaintiffs like Ambac must demonstrate justifiable reliance on the alleged misrepresentations on a loan-by-loan basis and must show that their insurance payments were, in each case, the result of actionable misstatements by the issuer. The majority's decision also sends a strong message to trial court judges that the traditional elements of common law claims should not be modified based on statutory developments without a clear statement by the legislature of its intent to do so.