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What If The Auto Loan Securitization Market Crashes?

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With the low interest rates that have prevailed since the Great Recession in 2008, auto loan securitizations and their higher yields have attracted significant attention from investors. More than $70 billion in auto-backed securities were sold in 2017.[1] At the same time, auto loan delinquencies are on the rise — as of the end of March 2018, 4.3 percent of auto loan balances were 90 or more days delinquent.[2] With memories of the Great Recession still fresh, fears that the auto loan securitization market is headed for a crash similar to the ill-fated residential mortgage-backed securities, or RMBS, market are on the rise.

In this article, we consider the types of claims that various participants in auto loan securitizations might assert if the market veers off course. As a benchmark, we review claims that have been asserted in lawsuits arising out of RMBS and then discuss which of those claims are likely to be asserted in any future auto loan securitization lawsuits.

Auto-Backed Securities Transactions Are Similar in Structure to RMBS Transactions

The basic structure of auto-backed and residential mortgage-backed securitizations is largely the same. Both involve asset-backed loans that are transferred into special purpose vehicles, placed into a trust as collateral, and the securities are sold to investors.

In both instances you may see the following players: (1) the loan originator, which originates the loan pursuant to prescribed underwriting guidelines; (2) the sponsor, which is often the parent entity or affiliate of the originator, drives the securitization transaction and transfers the assets to a special purpose vehicle; (3) the depositor, which is usually an affiliate of the sponsor and is the special purpose vehicle that acts as the repository for the assets to be securitized; (4) the issuing entity, which is also usually an affiliate of the sponsor and which issues the securities for sale to the securities underwriter; (5) the securities underwriter, which is typically an investment bank that evaluates the securities, purchases them from the issuing entity and then offers them to investors; (6) the trustee, which, among other things, administers the trust that holds the securitized assets, makes payments to the investors, and typically subcontracts the administration and servicing of the assets; (7) the servicer who processes

billings to and payments from the borrower; and finally (8), the investor, who purchases the securities.

The RMBS Claims

The claims asserted by the parties to RMBS transactions arose primarily from representations made by loan originators, depositors and securities underwriters regarding the origination and quality of the securitized mortgage loans made in the prospectus or in the contracts entered into between the parties.

Typically, the prospectus issued in a RMBS transaction included a representation that each loan in the securitized pool "is underwritten in accordance with guidelines established" by the originator of the loans.[3] These guidelines are the rules and standards used by the loan originators to ensure that each loan meets required credit and risk standards before a loan is approved. In addition, the standard prospectus included representations that any deviations from those guidelines would be made only on a "case-by-case basis," and that those guidelines required "verification or evaluation of the income of each applicant" even if the loan was a stated income loan.[4] The prospectus also included summary data regarding various characteristics of the pool of mortgage loans, such as the maximum and average loan-to-value and debt-to-income ratios of the loan, and the appraised value of the properties securing the loans.

One of the contracts entered into between several of the parties to an RMBS transaction, the pooling and servicing agreement, or PSA, also typically included representations that "the mortgage loans were underwritten in accordance with the underwriting guidelines of the originators of the mortgage loans," "the information in the mortgage loan schedules was true and correct in all material respects," and "the lender made a reasonable determination that at the time of origination the borrower had the ability to make timely payments on each mortgage loan."[5] Since most parties to RMBS transactions did not have access to the loan files for each of the thousands of securitized loans, they generally relied on those representations and data in deciding whether to participate in the transactions.

Claims Asserted by Purchasers of RMBS Certificates

Investors who purchased RMBS certificates sued the loan originators, depositors, securities underwriters and related companies seeking to rescind their purchase of those certificates, as well as for compensatory and punitive damages, based upon allegations that the representations and data contained in the prospectus regarding the loans were materially false and misleading. Most investors asserted claims under federal securities laws — in particular Sections 11, 12(a)(2), and 15 of the Securities Act of 1933[6] and Sections 10(b) and 20(a) of the Exchange Act of 1934[7] — as well as under the analogous state securities laws.[8] They claimed that the depositors and the securities underwriters violated Section 11 by making misrepresentations in the prospectus, and that the securities underwriters, along with all others involved in the structuring, marketing, and selling of the certificates, violated both Section 12 of the Securities Act and Section 10 of the Exchange Act, along with its Rule 10b-5,[9] by making misrepresentations in connection with the purchase or sale of the certificates. In addition to these defendants, the investors sought to hold the corporate parents of the defendants (including financial giants such as Bank of America), vicariously liable pursuant to Section 15 of the Securities Act and Section 20 of the Exchange Act.

In addition to these statutory claims, purchasers of certificates also asserted common-law claims of fraud, fraudulent inducement, aiding and abetting fraud, negligent misrepresentation against the depositors and underwriters, and claims of vicarious liability against their corporate parents.[10]

Claims Asserted by Trustees and Trusts

A number of trustees, as well as the trusts themselves, sued the sponsors for breaching the representations in the PSA regarding the securitized loans.[11] Nearly all PSAs also required the sponsor to replace or repurchase loans that did not comply with these representations, and the trustees alleged that the sponsors failed to comply with that requirement.

Some trustees asserted a single claim for breach of contract,[12] while others asserted several claims, including breach of the representations, breach of the sponsor's duty to notify the trustee of the breach of representations, breach and anticipatory breach of contract of the obligation to replace or repurchase defective mortgage loans, and breach of the implied covenant of good faith and fair dealing.[13] Regardless of the number of claims asserted, most trustees were limited, under the terms of the PSA, to the sole remedy of requiring the sponsor to replace or repurchase defective mortgage loans.[14] This remedy is typically loan-specific, preventing the trustee from seeking global relief based solely on the volume of allegedly defective loans.[15]

Claims Asserted by Wrap Insurers

Some insurance companies that issued financial guaranty insurance sued the RMBS sponsors and depositors for damages, and sought declaratory judgment, based on alleged breach of written representations contained in the PSA. For example, in Assured Guaranty Municipal Corp. v. UBS Real Estate Securities Inc., Assured Guaranty, the wrap insurer, alleged that a significant number of securitized mortgage loans breached one or more of the representations in the PSA, and that UBS had breached its obligation to repurchase or replace the defective loans.[16] Assured Guaranty asserted claims for breach of the representations and repurchase obligations in the PSA and sought a declaratory judgment in its favor. However, because Assured Guaranty's insurance policies were, by their terms irrevocable, it did not seek to rescind its insurance policies.

Claims Asserted by and Against Mortgage Insurers

Insurance companies that issued mortgage insurance in connection with RMBS transactions sued both the loan originators and the trustees (who were the named insureds under many of the policies) for breach of representations regarding the mortgage loans contained in the policies and in related agreements.

For example, United Guaranty Mortgage Indemnity Company, or UGI, issued mortgage insurance policies in connection with a number of securitizations of loans originated by Countrywide Home Loans for which The Bank of New York Trust Company, or BNY, acted as trustee. UGI sued both parties, alleging that in both the insurance policies and in separate agreements, Countrywide and BNY represented that all the loans were underwritten in accordance with Countrywide's underwriting guidelines and that the data regarding those loans provided to UGI were true and correct,[17] as well as that each mortgage loan "was accurately and completely described in all material respects" and that the loans were "underwritten in accordance with prudent underwriting judgment."[18] UGI denied insurance claims, or rescinded insurance coverage, for loans which allegedly did not comply with these representations and sued Countrywide and BNY to recover damages for breach of contract, breach of the covenant of good faith and fair dealing, fraud, and to rescind the insurance policies due to Countrywide's and BNY's alleged fraudulent or negligent misrepresentations.

Countrywide, in turn, sued UGI, alleging that it breached the insurance policies by denying claims or

rescinding coverage for loans and sought damages for breach of contract, breach of the implied covenant of good faith and fair dealing, and a declaratory judgment in its favor.

Which RMBS-Type Claims Can We Expect if the Auto Loan Securitization Market Crashes?

Since nearly all claims asserted in actions involving RMBS transactions were based on alleged misrepresentations regarding the origination and quality of the securitized mortgage loans, it is likely that claims asserted in any future actions involving auto loan securitizations will be based on similar allegations. The question, then, is what potentially actionable representations are made regarding the auto loans in the prospectuses and other transaction agreements.
While the representations made in connection in various RMBS transactions were generally consistent in nature, the representations made in connection with auto loan securitizations are less uniform and have changed over time. For example, in a 2007 auto loan securitization, the representations regarding each auto loan in the prospectus included:

- There was "no material misrepresentation by any obligor on his credit application …"
- Each loan "satisfies in all material respects the requirements under the originator's credit and collection policy in effect …"
- The "originator, the depositor and the issuing entity have duly fulfilled all obligations to be fulfilled on the lender's part in connection with the origination" of each loan.
- Each loan "complied at the time it was originated or made and complies at the closing date in all material respects with all requirements of applicable federal, state, and local laws and regulations thereunder …"
- Each loan is a "legal, valid, and binding payment obligation in writing of the obligor … and no obligor has any right of action against the depositor, the servicer or the issuing entity or any right to any offset, counterclaim or rescission."[19]

However, in a securitization issued in 2018 by the same company, the representations are far narrower:

- The loan "complied at the time it was originated or made in all material respects with all requirements of applicable federal, state, and local laws, and regulations thereunder."
- The "records of the Servicer do not reflect any facts which would give rise to any right of rescission, offset, claim, counterclaim or defense with respect to such [loan] or the same being asserted or threatened with respect to such [loan]."
- The loan was either "originated by a dealer … and has been purchased by Santander Consumer in accordance with the terms of a dealer agreement between Santander Consumer and that dealer", "originated by Santander Consumer", or "acquired by Santander Consumer in accordance with the terms of a purchase agreement between the applicable originator and Santander Consumer."[20]

In order for an investor to assert similar statutory and common law claims as those asserted in connection with RMBS transactions, the investor must allege that the representations were materially false or misleading. While the ability to do so depends on a number of factors, it is likely that an investor

can more readily allege a violation of a broader representation, such as that no obligor has "any right to … rescission" of the auto loan, than to allege a violation of the narrower representation that "the records of the servicer do not reflect facts which would give rise to any right of rescission …" Similarly, a trustee will more likely be able to allege a breach of the broader representations. However, as with the trustees in RMBS transactions, the trustee's relief for any breach of those representations will be limited to enforcing a replace-or-repurchase remedy.

One major difference with auto securitizations is that it is unlikely that insurers will assert claims against other parties, or will have claims asserted against them. Wrap insurance was sometimes used as a credit enhancement in earlier auto loan securitizations, but has not been used in recent transactions. For example, the 2007 auto loan securitization mentioned above included a wrap insurer, but the 2018 securitization did not. However, if a wrap insurer was involved in a transaction, it is likely that the sponsor made the broader representations to it upon which claims could be based. Furthermore, auto loan securitizations do not include an insurer similar to the mortgage insurance companies in the RMBS transactions. Although each auto loan borrower is required to obtain collision insurance, that insurance is generally obtained by the borrowers. Trustees typically do not obtain auto loan default insurance for their or the trust's benefit.

Conclusion

The collapse of the real estate market in 2007 saw a flood of lawsuits filed by investors, trustees and insurers in RMBS transactions, all alleging that the representations made to them regarding the quality and underwriting of the securitized mortgage loans were false. Billions of dollars were at stake, and the lawsuits dragged on for years. Now there are rumblings that the auto loan market may be headed for a similar fate. While we cannot predict whether that will happen, the industry can better prepare itself for that potential outcome by learning from the tidal wave of RMBS litigation and by keeping the pertinent claims and defenses in mind.

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[1] Joe Rennison, Securitised auto loans hit post-financial crisis high, Financial Times (Dec. 29, 2017), available at https://www.ft.com/content/37390b14-ec86-11e7-8713-513b1d7ca85a.

[2] Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit 2018:Q1 (May 2018).

[3] Settlement Agreement between United States et al. and Bank of America Corporation, et al., Annex 1, p. 1, available at https://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading

[4] Federal Housing Finance Agency, as conservator for the Federal Nat'l Mortgage Assoc. and the Federal Home Loan Mortgage Corp. v. HSBC North America Holdings, Inc., No 11-cv-06189 (S.D.N.Y.), Amended Complaint, ¶¶ 80, 81, 84, available at 2012 WL 3601028.

[5] Assured Guaranty Municipal Corp. v. UBS Real Estate Securities, Inc., No. 12-cv-1579 (S.D.N.Y.), Complaint, ¶ 3, available at 2012 WL 692680.

[6] 15 U.S.C. §§77k, 77l(a)(2), 77o.

[7] 15 U.S.C. §§ 78j(b), 78(a).

[8] See, e.g. Federal Housing Finance Agency v. HSBC North America Holdings Inc., No 11-cv-06189 (S.D.N.Y.), Amended Complaint, available at 2012 WL 3601028; Dodona I LLC v. Goldman Sachs & Co., No. 10 Civ. 7497 (VM) (S.D.N.Y.), Amended Class Action Complaint, available at 2011 WL 1297951.

[9] 17 C.F.R. 240.10b-5.

[10] See, e.g. In re Countrywide Financial Corp. Mortgage –Backed Securities Litigation Cases, Nos. 12-cv-08317-MRP (MANx), 11-ML-02265-MRP (MANx) (C.D. Cal.), First Amended Complaint, available at 2013 WL 9775035.

[11] Some trustees did not voluntarily commence these actions but instead were compelled to do so by the purchasers of the trust certificates. Bank of New York Mellon v. WMC Mortgage LLC, 41 Misc.3d 1230(A) (S.Ct. NY Cty. 2013), aff'd,136 AD3d 1 (1st Dept. 2015), aff'd, 28 N.Y.3d 1039 (2016).

[12] See, e.g. U.S. Bank, NA v. UBS Real Estate Securities Inc., 205 F.Supp.3d 386 (S.D.N.Y. 2016)

[13] See, e.g. Federal Housing Finance Agency v. Morgan Stanley ABS Capital I Inc., 59 Misc.3d 754 (S.Ct. NY Cty. 2018).

[14] US Bank, N.A., 205 F.Supp.3d at 402.

[15] Id.

[16] Assured Guaranty Municipal Corp. v. UBS Real Estate Securities Inc., Complaint, ¶ 3.

[17] United Guaranty Mort. Indemn. Co. v. Countrywide Financial Corp., No. 09-cv-01888 MRP (JWJx) (C.D. Cal.), Amended Complaint, ¶ 48, available at 2009 WL 2129544.

[18] Id., ¶¶ 51-52.

[19] Santander Drive Auto Receivables Trust 2007-1 Prospectus, pp. 32-34 (March 19, 2007), available at https://www.sec.gov/Archives/edgar/data/1383094/000095014407002927/g06129b5e424b5.htm

[20] Santander Drive Auto Receivables Trust 2018-1 Prospectus, p. 90 (January 18, 2018), available at https://www.sec.gov/Archives/edgar/data/1383094/000119312518016038/d518419d424b5.htm; Purchase Agreement between Santander Consumer USA Inc. and Santander Drive Auto Receivables LLC, Section 3.3 and Schedule II, available at https://www.sec.gov/Archives/edgar/data/1383094/000119312518015988/d515169dex101.htm