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New York's Top Court Backs HHR Position on Key Provision in RMBS

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January 26, 2021 — Hughes Hubbard represented the Securities Industry and Financial Markets Association (SIFMA) as an amicus curiae that contributed to an appellate victory for Morgan Stanley in a lawsuit by Deutsche Bank National Trust over a residential mortgage-backed securitization (RMBS).

On Dec. 22, the New York Court of Appeals reversed a lower court's decision holding that Deutsche Bank's allegations of gross negligence by Morgan Stanley were sufficient to render a key provision in the RMBS unenforceable.

Deutsche Bank served as trustee for investors in an RMBS trust created by Morgan Stanley in 2007 after purchasing over \$1.05 billion of mortgage loans at a bankruptcy auction. The trust was one of the last ones formed before the 2008 financial crisis.

Deutsche Bank sued Morgan Stanley in 2014, accusing the bank of putting defective loans in the trust and saddling investors with nearly \$300 million in losses after the U.S. Securities and Exchange Commission found that Morgan Stanley had made "misleading public disclosures regarding the number of delinquent loans" in the trust that operated as a "fraud or deceit" on investors.

Morgan Stanley sought to trigger the "sole remedy" provision, which would allow the trustee to hold Morgan Stanley liable only for breaches that could be proved on a loan-by-loan basis. Deutsche Bank argued that the provision was unenforceable due to Morgan Stanley's gross negligence. It also claimed punitive damages based on the SEC's finding of "fraud or deceit."

After a trial court dismissed both of Deutsche Bank's claims, the trustee appealed. In January 2019, the New York Appellate Division's First Department reversed the trial court's decision and ruled that "sole remedy" provisions may not apply to claims for breaches of loan-related representations and warranties. The court also reinstated the punitive damages claim.

On Oct. 31, 2019, HHR filed an amicus curiae brief on behalf of SIFMA, urging the appeals court to reverse the Appellate Division’s decision and reconfirm that the standard “sole remedy” provision will be respected by New York courts. The brief noted that the provision provides each party with a predictable outcome in the event of a breach.

“The sponsor, the trustee and the certificate-holders know exactly what is required in the event of a breach of the representations and warranties that materially and adversely affects the interests of the certificate-holders – cure or repurchase of the offending loan or loans,” the brief stated. “That certainty allows the parties to control the costs of securitization. Permitting pool-wide damages claims against sponsors based on alleged ‘pervasive breaches’ and extrapolated ‘breach rates’ would drive up the costs of securitization and have the concomitant impact of increasing the costs of borrowing for consumers.”

The appeals court adopted HHR’s position and found that the “sole remedy” provision in the RMBS must be enforced as written and that it is not subject to the gross negligence exception applicable to exculpatory clauses. The ruling clarified that the exception only applies to provisions that immunize a party from liability or only allow for nominal damages. The appeals court also dismissed Deutsche Bank’s claim for punitive damages.

Founded in 1912 with offices in New York and Washington, D.C., SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets.

Shahzeb Lari, Hannah Miller and Grace Ha worked on the amicus brief.

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