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Ambac Assur. Corp. v EMC Mtge. LLC
2013 NY Slip Op 50954(U)
Decided on June 13, 2013
Supreme Court, New York County
Ramos, J.
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<p>Ambac Assurance Corporation and THE SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION, Plaintiff,</p> <p>against</p> <p>EMC Mortgage LLC (formerly known as EMC MORTGAGE CORPORATION), J.P. MORGAN SECURITIES LLC (formerly known as BEAR, STEARNS & CO. INC.), and JPMORGAN CHASE BANK, N.A., Defendants.</p>
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For Plaintiffs: Nicolas Commandeur, Esq., of Patterson Belknap Webb & Tyler LLP

For Defendants: Sharon Nelles, Esq., of Sullivan Cromwell LLP

Charles E. Ramos, J.

Motion sequence numbers 02 and 03 are consolidated for disposition.

In motion sequence 02, defendants EMC Mortgage, LLC (EMC), J.P. Morgan Securities LLC and JPMorgan Chase Bank, N.A. (together, JP Morgan) move to dismiss the first amended complaint pursuant to CPLR 3211 (a) (1) and (7).

In motion sequence 03, defendants move by order to show cause to enjoin plaintiffs Ambac Assurance Corporation and the Segregated Account of Ambac Assurance Corporation (Segregated Account) (together with Ambac Assurance Corporation, Ambac) from taking any action in other jurisdictions that would interfere with this Court's jurisdiction to adjudicate the contract claims Ambac has brought in this action.

Background

The facts set forth herein are taken from the pleadings and are assumed to be true for the purposes of disposition.

This is the second lawsuit that Ambac, a monoline insurer, has filed in this Court relating to its issuance of financial guaranty insurance for residential mortgage-backed securities transactions (RMBS) after inquiry and investigation has purportedly revealed rampant fraud on the part of Bear Stearns and its affiliate, EMC.

*[*2]The Transactions*

This action involves seven RMBS transactions executed between March 2006 and November 2006: Greenpoint Mortgage Funding Trust 2006-AR2 (GPMF 2006-AR2), Greenpoint Mortgage Funding Trust 2006-AR3 (GPMF 2006-AR3), Structured Asset Mortgage Investments II Trust 2006-AR7 (SAMI 2006-AR7), Bear Stearns Mortgage Funding Trust 2006-AR2 (BSMF 2006-AR2), Bear Stearns Alt-A Trust 2006-R1 (BALTA 2006-R1), Structured Asset Mortgage Investments Trust 2006-AR8 (SAMI 2006-AR8), and Bear Stearns Mortgage Funding Trust 2006-AR4 (BSMF 2006-AR4) (together, the transactions).

Greenpoint originated all of the loans in the 2006-AR2 and GPMF 2006-AR3 transactions. Countrywide originated all of the loans in the SAMI 2006-AR7 transaction, and was a

significant originator of loans (52%) in the SAMI 2006-AR8 transaction.

The three remaining transactions are populated with loans originated in part by EMC affiliate, Bear Stearns Residential Mortgage Corporation (BSRMC). BSRMC originated 91% of the loans in the BSMF 2006-AR2 transaction, and approximately 52% of the loans in the 2006-AR4 transaction.

The Agreements

The transactions were effectuated through a series of inter-locking agreements executed by EMC and its affiliates that governed the rights and obligations of the various parties with respect to the RMBS. EMC purchased the underlying mortgage loans from the third party originators and then sold and assigned its entire interest in the loans to a "depositor," which then sold the mortgage loans into securitization trusts, pursuant to Mortgage Loan Purchase Agreements (MLPA).

Under section 7 the MLPAs, EMC made numerous representations and warranties pertaining to the underlying mortgage loans as of the closing date of the transactions. In section 8 of the MLPAs, EMC also represented that sections of the Prospectus Supplements (ProSupps) describing the mortgage loans did not include any untrue statement of a material fact.

The Pooling and Servicing Agreements (PSA) govern the sale of the interest in the mortgage loans from the depositor to the securitization trust. The trusts issued various classes of mortgage-backed securities, which were registered with the SEC and underwritten and marketed to investors by Bear Stearns. The mortgage loans served as collateral for the issuance of the securities.

The MLPAs and the PSAs create a repurchase protocol (Repurchase Protocol) pursuant to which certain parties to the agreements, including the trustee, can compel EMC to repurchase loans that breach the representations and warranties (MLPA § 7; PSA § 2.03 [b]). The agreements state that the Repurchase Protocol is the "sole and exclusive" remedy available to certain [*3] parties for breaches under the agreements (*id.*) [\[FN1\]](#)

Ambac issued financial guaranty insurance policies (policies) for each of the transactions and is subrogated to the rights of the insured certificate holders. Ambac is not a

direct signatory to any of the agreements, although it is expressly named in the PSAs as a third-party beneficiary with respect to the rights of the certificate holders. Ambac maintains that it is also a third-party beneficiary of the MLPAs with the direct right to enforce breaches of the MLPAs.

Alarming Rate of Defaults

As nationwide housing prices began a precipitous decline, the mortgage loans underlying the transactions began defaulting at alarming rates. According to Ambac, approximately 85% of the mortgage loans in the trusts have defaulted or are seriously delinquent, which has caused massive shortfalls in the cash flows required to pay down the securities. As a result, Ambac has suffered enormous losses and has paid more than \$300 million to certificate holders under the policies.

Ambac alleges that prior to commencing this action, it conducted re-underwriting of more than 5,000 individual mortgage loans included in the transactions. It discovered that approximately 80% to 90% of the mortgage loans breach the representations and warranties contained in sections 7 and 8 of the MLPAs. Based upon the staggeringly high breach rate, Ambac alleges that Bear Stearns and EMC have perpetrated a massive fraud that deceived investors and financial guarantors, such as itself, into believing that the mortgage loans were originated pursuant to established underwriting guidelines and were of good quality.

Claims

In addition to its rights in subrogation and as a third party beneficiary, Ambac maintains that it would not have issued the policies on the same terms had it known that the majority of the mortgage loans in the transactions were plagued by pervasive defects (the fraud claim).

Ambac asserts a claim for fraudulent inducement with respect to all seven of the transactions. Ambac also asserts claims for breach of contract, based upon sections 7 and 8 (viii) of the MLPAs, for each of the transactions except for BALTA 2006-R1, and breach of the Repurchase Protocol with respect to two of the transactions. Ambac seeks monetary damages, including rescissory and punitive damages.

Wisconsin Rehabilitation Proceeding

In March 2010, Ambac's regulator, the Commissioner of [*4]Insurance of the State of Wisconsin approved the establishment of the Segregated Account and commenced a court-supervised statutory rehabilitation proceeding in that state. Ambac allotted the policies and claims at issue in this action to the Segregated Account.

The Wisconsin rehabilitation court imposed a temporary cessation of policy claims payments (Wisconsin Injunction). The Wisconsin Injunction also precludes counter parties to the transactions from terminating contracts, claiming breach, or otherwise impairing Ambac's contract rights based on the rehabilitation proceeding and the cessation of claim payments. As of September 2012, Ambac has, with court approval, resumed certain payments to policyholders.

Discussion

I. Contract Claims

Defendants move to dismiss all of Ambac's contract claims on the ground that they are barred by the sole remedy provisions of the relevant agreements. In addition, defendants maintain that Ambac cannot directly enforce the Repurchase Protocol, but may instead act through the trustee. Finally, defendants assert that Ambac's third-party beneficiary rights under the agreements are suspended because it is in default of its insurance obligations for failing to make claims payments due under the policies (insurer default defense).

Ambac maintains that it is entitled to pursue all of its contract claims and remedies, and has standing to enforce the Repurchase Protocol. Ambac also argues that defendants are not entitled to assert the insurer default defense because the Wisconsin court overseeing the Segregated Account's rehabilitation has expressly enjoined RMBS counter parties from attempting to use the claims payment moratorium to strip Ambac of its rights under the relevant agreements.

At the outset, the Court rejects Ambac's interpretation of the relevant contractual language. Section 7 of the MLPA states that the Repurchase Protocol is the "sole and exclusive remedy" "**under this Agreement or otherwise respecting a breach of representation or warranties hereunder with respect to the Mortgage Loans**" (emphasis added) (Exhibit A-1, annexed to the Cafasso Aff., MLPA § 7). The "sole and exclusive" remedy language of the MLPAs is repeated in section 2.03 of the PSAs, which states that the Repurchase Protocol shall be the trustee's and certificate holders' "sole remedy for any breach

thereof" (Exhibit A-5, annexed to the Cafasso Aff., PSA § 2.3).

Thus, the sole remedy of the Repurchase Protocol is not limited to breaches of section 7 representations and warranties, as Ambac urges, but rather, applies to any breach of warranty pertaining to mortgage loans in the transactions.

As a third-party beneficiary of the PSAs with the same rights as the certificate holders under the transaction documents, Ambac has no greater rights or remedies than the [*5] direct parties to the agreements (*compare Syncora Guarantee Inc. v EMC Mortg., LLC*, 39 Misc 3d 1211[A], *3-4 [Sup Ct, NY County 2013, Ramos, J., in which case that plaintiff possessed direct rights under a separate insurance contract]). Therefore, Ambac's damages for breaches of representations and warranties pertaining to the mortgage loans are limited to the Repurchase Protocol (*accord Assured Guar. Corp. v EMC Mortg., LLC*, 39 Misc 3d 1207[A], *4-5[Sup Ct, NY County 2013, Ramos, J.]; *Assured Guar. Mun. Corp. v DLJ Mortg. Capital, Inc.*, 37 Misc 3d 1212[A], *9 [Sup Ct, NY County 2012, Kornreich, J.]).

The [MLPAs] section 8 warranties that Ambac attempts to premise its additional claim for breach of contract largely relate to, and overlap with, the [MLPAs] section 7 warranties. However, the relevant contractual language of the MLPAs and the PSAs is unequivocal that the Repurchase Protocol is the "sole and exclusive" remedy for any breach of representations and warranties pertaining to the mortgage loans, whether arising under MLPA section 7, section 8 or otherwise.

Finally, to the extent that Ambac seeks to enforce the Repurchase Protocol on its own behalf, the Court concludes that the transaction documents do not confer upon Ambac such a right. The agreements do not explicitly bar Ambac from enforcing the Repurchase Protocol, but they do not confer upon Ambac such a right.^[FN2] Nonetheless, the parties to the agreements agreed to certain procedures for noticing, resolving and enforcing claims under the Repurchase Protocol.

Under section 2.03 (a) of the PSAs, the depositor assigned all of its rights under the MLPA to the trustee, "on behalf of the Trust for the benefit of the certificateholders and the Certificate Insurer [Ambac]" (Exhibit C-1, annexed to the Cafasso Aff.). Further, the relevant provisions expressly name the trustee as the party with authority to act with respect to providing notice and enforcement of the Repurchase Protocol.

Ambac is not listed among those parties authorized to enforce the Repurchase Protocol, but is named as a party on whose behalf the trustee enforces the Repurchase Protocol (PSA § 2.03 [a], Exhibits A-4, C annexed to the Cafasso Aff.). The provision states:

The Depositor [affiliate of EMC] hereby assigns to the Trustee, on behalf of the Trust for the benefit of the certificateholders and the Certificate Insurer, all of its right, title and interest in the Mortgage Loan Purchase Agreement. The obligations of the sponsor [EMC] to substitute or repurchase, as applicable to a Mortgage Loan, shall be the Trustee's and the Certificateholders' sole [*6]remedy for any breach thereof. **At the request of the Trustee, the Depositor shall take such actions as may be necessary to enforce the above right [Repurchase Protocol], title and interest on behalf of the Trust and the Certificateholders or shall execute such documents as the Trustee may reasonably require in order to enable the Trustee to carry out such enforcement** (emphasis added).

If the Depositor, the Servicer, or the Trustee discovers a breach of any of the representations and warranties set forth in the Mortgage Loan Purchase Agreement [MLPA] ... the party discovering the breach shall give prompt written notice of the breach to the other parties. The Sponsor [EMC], within 90 days if its discovery or receipt of notice that such breach has occurred, shall cure the breach in all material respects.

As stated above, Ambac is a third-party beneficiary who has no greater rights than the direct parties to the inter-locking agreements, and to this extent, its rights are limited to those of the certificateholders. On this basis, this Court concludes that the relevant contractual language of the PSAs do not confer upon Ambac the direct right to enforce the Repurchase Protocol, and the trustee must act on Ambac's behalf (*accord Assured Guar. Mun. Corp. v UBS Real Estate Securities, Inc.*, 2012 WL 3525613, *4 [SD NY 2012]; *CIFG Assur. N. America, Inc. v Goldman, Sachs & Co.*, 2012 WL 1562718 [Sup Ct, NY County 2012, Sherwood, J.], *modified on other grounds* 106 AD3d 437 [1st Dept 2013]). Finally, to the extent that the Court has dismissed all of Ambac's contract claims, the issue of defendants' assertion of the insurer default defense in the Rehabilitation Proceedings need not be addressed, as that defense is only relevant to Ambac's breach of contract claims.

II. Fraudulent Inducement

In support of its claim for fraudulent inducement, Ambac alleges that defendants made material misrepresentations by touting their own due diligence and quality control while ignoring and condoning severe defects in the mortgage loans in order to induce Ambac to insure the transactions. Assuming the complaint's allegations are true, the pivotal issue is

whether Ambac justifiably relied on those misrepresentations.

Defendants argue that Ambac cannot demonstrate justifiable reliance as a matter of law. Defendants point out that Ambac does not dispute that it failed to conduct loan-level due diligence in advance of the transactions, despite possessing contractual rights to request and access information relating to the loans before issuing the policies. Moreover, defendants maintain that Ambac was advised, and the ProSupps applicable to each transaction warned, that the mortgage loans in the trusts [*7] were risky, adjustable rate, negative amortization loans originated by third parties under reduced documentation programs, and thus particularly sensitive to a downturn in home prices. Defendants rely primarily upon [*HSB Nordbank AG v UBS AG* \(95 AD3d 185 \[1st Dept 2012\]\)](#).

In opposition, Ambac maintains that it insisted on written representations and warranties that certain facts relating to the mortgage loans were true, and that it was justified in relying upon those representations as they pertained to the facts that due diligence would have examined. In support of this argument, Ambac cites to [*DDJ Mgmt., LLC v Rhone Group LLC* \(15 NY3d 147, 154-56 \[2010\]\)](#).

Generally, in determining whether a sophisticated plaintiff could justifiably rely upon representations and warranties made as part of a transaction, the Court of Appeals has explained:

[I]f the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of ordinary intelligence, the truth or the real quality of the subject of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter the transaction by misrepresentations

(*DDJ Mgmt., LLC*, 15 NY3d at 154; [*see also Centro Empresarial Cempresa S.A. v America Movil, S.A.B. de C.V.*, 17 NY3d 269, 278-79 \[2011\]](#)). Nonetheless, that Court went on to state that "where a plaintiff has gone to the trouble to insist on a written representation that certain facts are true, it will often be justified in accepting that representation rather than making its own inquiry," while admonishing that the question of what constitutes justifiable reliance is fact-intensive (*DDJ Mgt., LLC*, 15 NY3d at 154-56). In this Court's view, this reasoning requires a denial of this motion.

However, further, on occasion, New York appellate courts have determined that this

very issue of justifiable reliance with respect to a claim for fraudulent inducement may be decided as a matter of law on a pre-answer motion to dismiss (*see e.g. HSH Nordbank AG*, 95 AD3d 185 [undisputed documentary evidence established that the sophisticated plaintiff was not relying on any advice from defendant, was explicitly warned of the risks it was undertaking in the highly leveraged and complex transaction, and could have uncovered any misrepresentation of the risk of the transaction through the exercise of reasonable due diligence]).

The distinguishing element between *HSH Nordbank AG* (95 AD3d 185) and *Centro Empresarial Cempresa S.A.* (17 NY3d at 279), where the element of justifiable reliance was found to be lacking at the pleading stage, and *DDJ Mgmt., LLC* (15 NY3d at 154), where issues of fact warranted a denial of the motion to dismiss, was the presence of written assurances as to the accuracy of the information in the relevant transaction documents.

[*8]The First Department recently reinstated a claim for fraudulent inducement asserted by a monoline insurer against the sponsor of RMBS transactions (*see CIFG Assur. of N. America, Inc.*, 106 AD3d 437, citing *DDJ Mgmt., LLC*, 15 NY3d at 154). The First Department reasoned that where the insurer conducted its own due diligence concerning the underlying loans which were the subject of written representations not demonstrably known to be false when made, there remained a question of fact as to whether the insurer reasonably relied upon the representations.

Here, Ambac does not allege, as the insurer alleged in *CIFG Assur. of N. America, Inc.* (106 AD3d 437), that it conducted its own independent due diligence in advance of the transactions. Moreover, there were numerous hints from which Ambac, or any insurer for that matter, would have been put on guard with respect to the inherent risk involved in these transactions. For instance, the ProSupps that Ambac alleges it relied upon to its detriment disclose that the majority of the mortgage loans were originated by third parties based upon limited or no documentation and certain borrower information was not verified (Exhibit A-11, annexed to the Cafasso Aff.).

It is arguable to conclude, as Ambac urges, that the matters allegedly misrepresented were "peculiarly within the [defendants'] knowledge" (*DDJ Mgmt., LLC*, 15 NY3d at 154), but, Ambac could have learned the truth of the quality of the loans it was insuring by exercising its contractual right to access loan-level information and by conducting its own re-

underwriting in advance of the transactions, at least by sampling (Exhibit A-13, annexed to the Cafasso Aff.). To this point, the only excuse Ambac alleges is that it did not have a reasonable opportunity to review individual loan files *pre-closing* given the rapid pace of defendants' securitization (Complaint, ¶¶ 144, 206-08). These considerations raise triable issues of fact on the question of justifiable reliance.

For these reasons, the Court is constrained to deny the motion to dismiss the claim for fraudulent inducement.

III. Successor Liability

Defendants move to dismiss Ambac's claims for successor liability against JPMC as the purported successor to Bear Stearns and against JPMC Bank as the purported successor to EMC. The motion to dismiss this claim is denied.

Accordingly, it is hereby

ORDERED that defendants' motion (02) to dismiss is granted, in part, and denied, in part, and the second and third claims are hereby severed and dismissed; and it is further

ORDERED that defendants are directed to serve an answer within 20 days after service of a copy of this order with notice of entry; and it is further

ORDERED that defendants' motion (03) is denied as moot.

Dated: June 13, 2013

ENTER: [*9]

J.S.C.

Footnotes

Footnote 1: The relevant contract provisions of the transaction documents differ slightly from one transaction to another, although not in any material respect (*see* Exhibits A-1-A-4,

annexed to the Cafasso Aff.).

Footnote 2: Ambac has brought repurchase claims with respect to two transactions only: GPMF 2006-AR3 and BSMF 2006-AR2.

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