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Court of Appeals

STATE OF NEW YORK

AMBAC ASSURANCE CORPORATION AND THE SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION,

Plaintiffs-Appellants-Cross Respondents,

—against—

COUNTRYWIDE HOME LOANS, INC., COUNTRYWIDE SECURITIES CORP., and COUNTRYWIDE FINANCIAL CORP.,

Defendants-Respondents-Cross Appellants,

—and—

BANK OF AMERICA CORP.,

Defendant.

BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS *AMICUS CURIAE*

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Pursuant to Rule 500.1(f), *amicus curiae* Securities Industry and Financial Markets Association states that it has no parents, subsidiaries, or affiliates.

Dated: April 19, 2018
New York, New York

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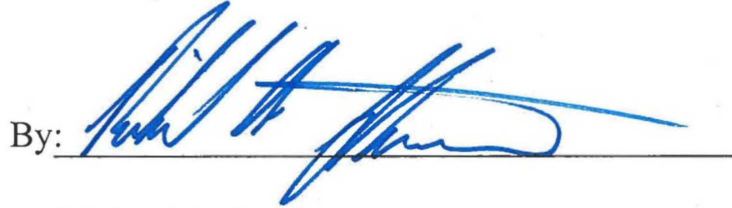
By: 

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I. STATEMENT OF INTEREST OF AMICUS CURIAE[1]

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's membership encompasses both sides of the securities industry – companies that sell securities, including issuers and sponsors, and those that purchase securities, including institutional investors and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. An important function of SIFMA is to represent the interests of its members in cases addressing issues of widespread concern in the securities and financial markets.

SIFMA is heard as amicus curiae in cases that raise important policy issues that impact the markets represented by SIFMA or otherwise affect common practices in the financial services industry. SIFMA's case selection is judicious to ensure that its advocacy focuses on the most significant and pressing industry interests. This is such a case.

II. PRELIMINARY STATEMENT

SIFMA supports the affirmance of the First Department's order because it upholds a century of clear New York law and interprets the contracts governing the

[1] No counsel for a party authored this brief in whole or in part, and no party or counsel for a party made a monetary contribution to fund the preparation or submission of this brief.

investments at issue consistent with the long-settled expectations of all participants in the multi-billion dollar securitization industry.

Residential mortgage-backed securitizations ("RMBS") involve certificates that entitle investors to payment of principal and interest according to underlying mortgage payments made by borrowers. Prior to the financial crisis, many RMBS transactions included a financial guaranty insurance policy issued by a monoline insurance company, which guaranteed that investors would receive the promised payment of principal and interest on their certificates even if borrowers failed to make payments on the underlying mortgages. Such financial guaranty policies were expressly "unconditional and irrevocable." Issuing irrevocable financial guaranties was the sole insurance business of monoline insurers such as Ambac.

Ambac's complaint, like complaints in the other actions brought in New York by monoline insurers involving RMBS, seeks money damages on common law claims of alleged fraudulent inducement and breach of contract. SIFMA takes no position here on the merits of these claims. SIFMA, however, takes serious issue with Ambac's attempt to create exceptions to the longstanding common law of fraud – exceptions solely applicable to fraud claims brought by insurers.

In the Appealed Order, the First Department correctly held that Ambac, like any other common law fraud plaintiff, is required to prove justifiable reliance in order to prevail on its claims. Before the First Department, Ambac argued that

"Insurance Law § 3105 dispenses with the common-law requirement of proving justifiable reliance," and the First Department correctly ruled that "[t]here is no merit to Ambac's contention." A10. Neither the Insurance Law nor the common law Ambac invokes before this Court creates any special cause of action that would allow insurers to obtain damages for alleged fraud without proving all the elements of a fraud claim.

The First Department also correctly held that Ambac's voluntary decision to issue an irrevocable insurance policy barred it from recovering rescissory damages or their equivalent, which would result in Ambac recovering the full amount of all claims payments it made under the policies. Expressly relying on SIFMA's amicus briefing, the First Department noted that "sound policy reasons" support this outcome because ruling otherwise "would inequitably allow Ambac to recoup the money it paid out for loans that complied with all warranties, and for which there were no misrepresentations, but which resulted in default due to the housing market collapse or other risks Ambac insured against." A13-14.

The First Department's decision echoes fundamental New York law, which has always prohibited a party, particularly a sophisticated party like Ambac, from claiming to have been defrauded when that party fails to use the reasonable means available to it to investigate the truth of the representations it claims are false – in other words, when the party's actual reliance on the alleged misrepresentation was

not justifiable. That bedrock common law principle promotes an important public policy: ensuring that commercial parties cannot turn a blind eye to discoverable risks, with the hope of using a fraud claim to avoid the consequences of those risks after they materialize. New York's requirement that parties identify important aspects of a transaction in advance and conduct due diligence into those aspects promotes predictability and stability between transacting parties and has been a fundamental reason why New York is a center for commercial transactions.

Here, Ambac knowingly accepted the risk that market turmoil or other events might cause the borrowers of securitized loans to miss their mortgage payments, which would lead to shortfalls in payments to certificateholders, triggering Ambac's duty to make the certificateholders whole. This is fundamentally the same risk taken by investors, some of whom have sued RMBS issuers for common law fraud, just as Ambac has done here. Again, SIFMA takes no position on the merits of those claims, but it is beyond dispute that those investors must prove justifiable reliance on the alleged misrepresentations to prevail. Ambac was exposed to those same losses, based on those same type of alleged misrepresentations. It offers no reason why its claims should receive special treatment merely because it was an insurer rather than an investor, particularly when monoline insurers were in a far better position than investors to

investigate and evaluate the transactions and collateral (and advertised as much to the market).

Excusing monoline insurers from their burden to prove justifiable reliance and causation in pursuing common law claims is further inappropriate because the monoline insurers touted their sophisticated diligence practices as a reason that investors could rely on their financial guaranties. The function of monoline insurance was to shift the credit risk of the investment to the insurer. Monolines carried "AAA" ratings, and their policies could convert a certificate that might by only "BBB+" without a guaranty into an investment bearing the monoline's "AAA" rating. Monolines touted to market participants that they conducted extensive due diligence into the credit characteristics of the bonds they insured to gain the comfort necessary to back a "BBB+" rated risk with an irrevocable and unconditional guaranty. Ambac identifies no good reason that monoline insurers, alone among sophisticated parties, should be freed from the common law requirements of establishing justifiable reliance and causation.

Adopting Ambac's position would create a moral hazard with significant detrimental effects on financial guaranty and insurance markets. Eliminating justifiable reliance would eliminate any incentive for monolines to engage in pre-transaction due diligence before providing billions of dollars in unconditional financial guaranties. Expending resources on diligence up front would only cost

monolines money and potentially weaken any fraud claim (should they uncover problems). Without the need to prove reliance or causation, insurers would be encouraged to make imprudent financial bets, blindly reaping larger premium payments while markets are high, and then litigating if those bets go south and they are called upon to pay claims. Enforcing the justifiable reliance element ensures that sophisticated parties do not turn a blind eye to risk and attempt to shift blame after those risks materialize.

Ambac's position on loss causation would also subvert RMBS industry expectations of the role of monoline insurance. The fundamental principle of those policies is that the insurer bears the risk of loss when loans that comply with contractual representations and warranties nonetheless fail to perform (for example, because of an intervening real estate collapse or any number of other market risks the monolines agreed to assume). The monolines explicitly accepted the risks that declining housing markets, recession, or changes in economic conditions could trigger payment obligations under the irrevocable guaranties they issued.

Yet now, as claims mount due primarily to the precise risk they insured against, monoline insurers seek to transfer that risk away from themselves. This result would allow a monoline insurer to recover from its counterparties the very claims payments they promised to make when they agreed to provide insurance.

The First Department correctly held that such a result would be contrary to the well-defined allocations of risk embodied in the contracts at issue and New York law. This Court should affirm.

III. THE NATURE AND EVOLUTION OF UNCONDITIONAL, IRREVOCABLE FINANCIAL GUARANTY INSURANCE

A. Monoline Insurance Expands From Municipal Bonds to Asset-Backed Securities, Taking on Increased Risks in Exchange for Increased Premiums

Monoline insurance companies provide unconditional and irrevocable financial guaranties that insure payments of principal and interest on financial instruments. The industry dawned in the early 1970s, when monoline insurers began to guarantee principal and interest payments on municipal bonds.[2] Monoline insurers structured their business model on so-called "zero-loss" opportunities presented by the relatively placid municipal bond markets and other government-backed debt offerings. By their "zero-loss underwriting," monoline insurers "claimed to have confirmed that the insurance would not be necessary except in very extreme cases."[3] Financial guaranties reduced the cost of borrowing for municipalities and government entities, as investors were receptive to lower

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2 The State of the Bond Insurance Industry: Hearing Before the H. Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Entities, 110th Cong., Serial No. 110-91 at 3 (2008) (hereinafter "Bond Insurance").

3 "Bond Insurers Led into Temptation," Forbes/Investopedia, February 2, 2008 (available at http://goo.gl/zqrlVM).

interest rates in exchange for the security provided by a monoline financial guaranty of payment, sometimes called a "wrap."[4]

But bond insurance was relatively low reward in comparison to offering insurance in other securities markets. Beginning in the 1980s, monoline insurers extended their unconditional guaranties into private asset-backed securitizations.[5] By promising to make investors' certificate payments if there was a shortfall for any reason, monoline insurers could transform a lower-rated security into one of the highest credit quality. They were able to do this because of the core premise of the monoline business: their unconditional financial guaranties of payment cannot be revoked or rescinded.[6] The monolines' expansion into asset-backed securitizations featured an aggressive push to issue financial guaranties of RMBS.

In RMBS, a party (often called the "sponsor") first acquires a pool of residential mortgage loans, either through direct origination or by purchase from other originators. To create the RMBS, the sponsor transfers these pooled loans through another entity (a "depositor"), which in turn transfers the loans to a special

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[4] Bond Insurance, supra n. 2, at 66 (statement of Charles Chaplin, Chief Financial Officer, MBIA Inc.).

[5] See ABN Amro Bank, N.V. v. MBIA Inc., 17 N.Y.3d 208, 217 (2011); Gotham Partners Mgmt. Co., Is MBIA Triple A? A Detailed Analysis of SPVs, CDOs, and Accounting and Reserving Policies at MBIA, Inc. at 11-12 (Dec. 9, 2002), available at http://goo.gl/bgl9md.

[6] Assured Guaranty 2011 Annual Report, at p. 2, available at http://assuredguaranty.com/investor-information/by-company/assured-guaranty-ltd/sec-filings/ ("We guarantee timely payment of principal and interest when due. Irrevocably. Unconditionally. We back our promise with $12.8 billion of claims-paying resources and do not quibble.").

purpose trust, which issues securities to investors. The payments of principal and interest on these securities are funded by the underlying mortgage loan payments.

Monoline insurance on an RMBS reduces the credit risk to investors by guaranteeing payment on some or all of the securities. The insurer is paid a substantial premium, usually based on the aggregate amount insured. By design, these insurance policies are expressly irrevocable and noncancellable (a feature which increases their value to investors, and consequently, the insurance premium charged). In other words, in exchange for significant compensation, the insurer entered the transaction having knowingly and intentionally relinquished the right to rescind coverage for any reason.

For its part, the sponsor typically provides certain representations and warranties regarding the credit quality and underwriting guidelines and standards used in originating the underlying mortgage loans. RMBS transactions in general, and the transactions at issue here, contain sole remedies for representation and warranty breaches, called "repurchase protocols." When a loan in the pool breaches a representation or warranty and such breach "materially and adversely" affects the interests of the certificateholders or insurers, the repurchase protocols require the sponsor to repurchase the loan from the trust (or replace it with a non-breaching loan). This standard process reflects the agreed-upon allocation of risk

among the transaction parties, and the sole remedy available for nonconforming loans.

Ambac and other monoline insurers recognized the irrevocability of their obligations and their inability to avoid payments under them. As Ambac alleged: "Under its irrevocable Policies, Ambac guaranteed that it would cover certain payments to purchasers of the securities regardless of whether Countrywide's representations proved false and the mortgage loans did not generate the anticipated cash flow." A66. And Ambac touted to investors that its insurance "provides an unconditional and irrevocable guarantee that protects the holder of a fixed income obligation against non-payment of principal and interest when due." Ambac 2006 10-K, at 2.[7]

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[7] Other monoline insurers include MBIA Insurance Corporation ("MBIA"), Assured Guaranty Corp. ("Assured"), Financial Guaranty Insurance Company ("FGIC"), and Syncora Guarantee Inc. ("Syncora"). They commonly underscored this same understanding in statements made in their public filings and marketing materials:

- From MBIA's 2011 10-K, at 29: "The financial guarantees issued by [MBIA] insure the financial performance of the obligations guaranteed over an extended period of time, in some cases over 30 years, under policies that we have, in most circumstances, no right to cancel . . . . Moreover, although the second-lien RMBS obligations we insure typically include contractual provisions obligating the sellers/services to cure, repurchase or replace ineligible loans . . . we are required to pay losses on these securities irrespective of any proceeding we initiate to enforce our contractual rights." (emphasis added).
- From Syncora's 2006 10-K, at 37: "Because our financial guarantee insurance and reinsurance policies are unconditional and irrevocable, we may incur losses from fraudulent conduct relating to the securities that we insure or reinsure . . . . Financial guarantee insurance and reinsurance provided by us is unconditional and does not provide for any exclusion of liability based on fraud or other misconduct" (emphasis added).
- From Assured's 2007 10-K, at 48: "The financial guaranties issued by us insure the financial performance of the obligations guaranteed over an extended period of time, in some cases over 30 years, under policies that we have, in most circumstances, no right to cancel." (emphasis added).

B. Monoline Insurers Claim to Have Performed Sophisticated Analyses of the Loans in the RMBS Pools They Insured

Monoline insurers aggressively and successfully marketed their unconditional financial guaranty product to the RMBS industry by touting their depth of knowledge and sophistication in the mortgage markets. Ambac told investors in its SEC filings that its underwriting guidelines were "developed . . . with the intent that Ambac Assurance guarantees only those obligations which, in the opinion of [its] underwriting officers, are of investment grade quality with a remote risk of loss."[8] Ambac's Chairman, President, and Chief Executive Officer, Robert Genader, publicly described Ambac's "very conservative risk limits"[9] and its "disciplined and rigorous . . . scrutiny" of RMBS risks.[10] He stated in 2006 that Ambac's "passion . . . is trying to find the minute detail that can cause a transaction to go – not necessarily to pay a claim, but to get downgraded."[11]

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[8] Ambac 2006 10-K at 9-10 (emphasis added); see also In re Ambac Fin. Grp., Inc. Sec. Litig., 693 F. Supp. 2d 241, 248 (S.D.N.Y. 2010) ("Ambac's business model has always been based on establishing underwriting guidelines and procedures that enable the company to guarantee only those obligations that were 'of investment grade quality with a remote risk of loss.'").

[9] "Ambac Financial Group at Piper Jaffray Financial Services Conference - Final," FD Wire, Mar. 21, 2006 (available via Westlaw).

[10] Ambac 2006 Annual Report, available at http://ir.ambac.com/financial-information/annual-reports, at 4.

[11] March 21, 2006 Piper Jaffray transcript, supra n. 9, at p. 3.

Monoline insurers also touted that they obtained "additional rights, special protections . . . and information access beforehand as the senior creditor."[12] As MBIA's CEO testified in one of its cases:

> [B]ecause we insured the whole thing, we were like the owner of that debt issue. And we had clout and bargaining chips that weren't available for the average schmo in the marketplace . . . . [B]ecause of our reputation, and our structure, and our expertise, we basically turned the BBB market into an A market on average. And that's why the rating agencies allowed us to do it.[13]

Similarly, Tom Gandolfo, head of Ambac's Global Structured Credit Group, told investors in mid-2007 "[w]e believe our credit-risk analysis goes far beyond that which a typical CDO investor would perform."[14] Ambac's CEO, Genader, expounded: "We, the larger participants, really lead the industry. We lead the rating agencies. We are looking for pinhole risks, where the rating agencies are looking for ratings migration."[15] In other words, far from being an "average schmo" at the mercy of large banks, monoline insurers filled a key role in RMBS,

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12 See "Fixed Income Investor Presentation, 3rd Quarter – 2006" by MBIA, at 3, available at http://library.corporate-ir.net/library/88/880/88095/items/217914/FixedQ306.pdf.

13 MBIA Ins. Corp. v. Credit Suisse Sec. (USA) LLC, Index No. 603751/09, Dkt. 997, Exhibit 2 to the Affirmation of Paul Rugani (Dunton Dep. Tr.) at 202:18-203:4.

14 Mr. Gandalfo made this statement during Ambac's July 25, 2007 conference call; the transcript was publicly filed in In re Ambac Securities Litigation, Case No. 08-cv-00411-NRB (S.D.N.Y.), Doc. No. 60-6, Exhibit 48, at 5.

15 March 21, 2006 Piper Jaffray transcript, supra n. 9, at p. 2.

transforming BBB risks into A-rated investment grade collateral to make deals more attractive to investors.

Because of this unique role in credit enhancement, monoline insurers played a significant role in the RMBS market before the financial crisis. For example, at the end of 2007, Ambac was obligated on more than $31 billion in insured balances on RMBS transactions issued between 1998-2007.[16]

C. Monoline Insurers Admit They Irrevocably Assumed the Risk of Loss for Loans that Meet Representations and Warranties, but Nevertheless Default as a Result of Market Volatility or for Any Other Reason

Financial guaranty insurance in RMBS transactions protects investors not only from individual loan defaults, but more importantly, guarantees investment returns against the risk of systemic underlying loan defaults caused by a housing market decline, recession, widespread unemployment, and the like. The monoline insurer, not the other transaction participants, contracted to assume such risks in exchange for substantial compensation. In its 2006 Form 10-K, Ambac summarized the nature of the risks it retained:

> Changes in general economic conditions can impact our business. Recessions; increases in corporate, municipal, and/or consumer bankruptcies; changes in interest rate levels; changes in domestic and international law . . . could adversely affect the performance of our insured portfolio and our investment portfolio.

[16] Ambac 2007 10-K at 56.

Ambac 2006 10-K, p. 29 (emphasis added). One year later, Ambac acknowledged the "near record volumes of delinquencies and losses" occurring in the loans underlying its insured RMBS, and that "[c]ontinued increases in RMBS defaults . . . could adversely impact residential real estate values and the probability of default and severity of loss for our transactions." Ambac 2007 10-K, p. 51.

Accordingly, in pleadings in RMBS lawsuits filed in the wake of the worst real estate meltdown since the Great Depression, monoline insurers admit (as they should) that they – not their RMBS counterparties – assumed the risk that loans satisfying representations and warranties might nevertheless fail to perform. As Ambac admitted in its complaint, "Ambac as the insurer bore the risk and the burden of evaluating whether loans bearing the attributes represented by Countrywide would perform after the closing of the Transactions." A109-11. These admissions acknowledge the basis of the financial guaranty bargain – monoline insurers, in exchange for premiums, assume the risk that economic decline, market forces, or other systemic risks will cause delinquencies, even among properly underwritten loans.

Unfortunately, the risks that monoline insurers acknowledged in their disclosures occurred. As Ambac acknowledged in a court filing in October 2008, it faced "losses and writedowns in the wake of this extraordinary market-wide

downturn" because its business was "based upon taking on credit risk in exchange for premium payments."[17] Now, faced with having to make good on its policies covering the precise risks that it (and other monolines) insured against, Ambac seeks to evade the unconditional and irrevocable obligations it agreed to by shifting the full amount of those risks to transaction counterparties.

IV. THE APPEALED ORDER CORRECTLY HELD THAT THE INSURANCE LAW DOES NOT ABROGATE COMMON LAW REQUIREMENTS OF JUSTIFIABLE RELIANCE AND CAUSATION

The Appealed Order, in accordance with long-settled New York law, holds that Ambac must prove justifiable reliance and causation as elements of its common law claims for damages. On appeal here, Ambac would have this Court craft a special rule for insurers that absolves them of the burden to prove justifiable reliance and proximate cause. Neither the law nor public policy supports such a drastic alteration to well-established common law.

A. The Appealed Order Correctly Held that Common Law Fraud Claims Require a Showing of Justifiable Reliance

As the First Department held, the element of justifiable reliance is "essential" to any fraud claim. A9 (citing Basis Yield Alpha Fund Master v. Morgan Stanley, 136 A.D.3d 136, 140 (1st Dep't 2015); Danann Realty Corp. v.

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[17] In re Ambac Fin. Grp., Inc. Sec. Litig., Case No. 08-cv-00411-NRB, Dkt. 59, Memorandum in Support of Ambac and Individual Defendants' Motion to Dismiss the Consolidated Amended Class Action Complaint, at p. 1.

Harris, 5 N.Y.2d 317, 322 (1959) (it is a "fundamental precept" that reliance must be justifiable in order to state a cause of action for fraud). "A plaintiff suing for fraud (and particularly a sophisticated plaintiff . . .) must establish that it 'has taken reasonable steps to protect itself against deception.'" Basis Yield, 23 N.Y.S.3d at 55.

Indeed, in a 2015 ruling fully applicable here, this Court held that a financial guaranty insurer must have "justifiably relied on the alleged misrepresentations" in order to assert a fraud claim. ACA Fin. Guar. Corp. v. Goldman, Sachs & Co., 25 N.Y.3d 1043, 1044 (2015). The justifiable reliance requirement protects against moral hazard in transactions. Parties without a duty to investigate will have no incentive to undertake any investigation, and instead will be encouraged to turn a blind eye to risks, safe in the knowledge that they can capitalize on the upside of a transaction and avoid the downside after the fact through a claim that they were defrauded. That hazard is doubly present here, where Ambac is not merely making an investment for its own benefit, but providing the imprimatur of its AAA rating to assure other investors of the creditworthiness of their investment in exchange for millions of dollars in premiums.

The Appealed Order simply applies one hundred years of tort law in New York by holding that sophisticated insurers can recover damages only when they perform the same reasonable investigations required of sophisticated parties in any

other fraud action. Ambac acknowledged as much when it recited reasonable reliance as an element of its claim, and expressly pled that it completed this reasonable investigation. A108-11, A164.

B. The Appealed Order Correctly Held that Common Law Fraud Claims Require a Showing of Causation

It is beyond dispute that causation is a bedrock element of any claim for fraud. The Appealed Order thus correctly held that a fraud plaintiff must "demonstrate that a defendant's misrepresentations were the direct and proximate cause of the claimed losses" by proving the fundamental elements of transaction causation and loss causation. A9-10 (collecting cases).

Other RMBS cases also consistently state the same controlling rule in addressing claims of fraud by monoline insurers. See Assured Guar. Mun. Corp. v. DLJ Mortg. Capital, Inc., No. 652837/2011, 2014 WL 3288335, at *9 (Sup. Ct. N.Y. Cnty. July 3, 2014) (Kornreich, J.) ("Even though Assured does not have to parse out losses caused by non-conformance from losses caused by market forces, it still must prove that its losses were caused by non-conforming, as opposed to conforming loans."); Fin. Guar Ins. Co. v. Countrywide Home Loans, Inc., Index No. 650736/2009 (Sup. Ct. N.Y. Cnty. June 15, 2010) (Bransten, J.) ("To establish causation, plaintiff must show both that defendant's misrepresentation induced plaintiff to engage in the transaction in question (transaction causation) and that the misrepresentations directly caused the loss about which plaintiff complains (loss

causation).") (emphasis in original) (quoting Laub v. Faessel, 297 A.D.2d 28, 31 (1st Dep't 2002)).

C. The New York Insurance Law Is Not The Source of the Justifiable Reliance and Causation Elements of Ambac's Claims

Before the First Department, Ambac urged that Sections 3105 and 3106 of the Insurance Law should be viewed as "informing" Ambac's common law claims. Specifically, Ambac argued to the First Department that those sections of the Insurance Law provide a private right for insurers to seek damages without proving justifiable reliance or causation.

The Appealed Order correctly rejected that argument, holding that those sections of the Insurance Law address only two situations that are not present here or in any of the other actions brought by monoline insurers against RMBS issuers in the wake of the financial crisis: (i) where an insurer seeks rescission – that is, seeks to "avoid an insurance contract" ab initio, or (ii) seeks to avoid payments under a policy – that is, "defeat recovery thereunder." A10-11. In so doing, the First Department did not, as Ambac now contends, construe Sections 3105 and 3106 as precluding or limiting Ambac's common law damages claims. Ambac Br. at 32-33. It instead correctly concluded that those sections have nothing to do with common law fraud claims for damages. Accord MBIA Ins. Corp. v. J.P. Morgan Sec. LLC, 2014 WL 4797010, at *10 (Sup. Ct. Westchester Cnty. Sept. 18, 2014) ("There is nothing in Insurance Law Section 3105 that dispenses with, or alters, the

common law requirement that an insurer must show reliance upon the claimed misrepresentation in a fraud action."), rev'd in part on other grounds, 144 A.D.3d 635 (2d Dep't 2016); Ambac Assur. Corp. v. First Franklin Fin. Corp., No. 651217/2012, 2015 WL 5578267, at *4 (Sup. Ct. N.Y. Cnty. Sept. 17, 2015) (Section 3105 does not relieve a monoline insurer of its duty to prove justifiable reliance where the insurer "is seeking damages for fraud").

D. Abrogating Long-Standing Elements of Fraud and Contract Claims Would Contradict Settled Expectations of the Parties and Investors

1. Requiring Sophisticated Monoline Insurers to Prove Justifiable Reliance on Fraud Claims Meets Market Expectations

Under New York law, the contours of the monoline insurer's required investigation must be analyzed in light of the specific factual context. See CIFG Assur. N. Am., Inc. v. Goldman, Sachs & Co., 106 A.D.3d 437, 437-38 (1st Dep't 2013) (reasonableness of insurer's reliance involved "a question of fact" not resolvable at the pleading stage). But there can be no doubt that prudent due diligence is necessary for insurers unconditionally and irrevocably assuming billions of dollars of risk in complex financial products.

Ambac claims that it is entitled to rely on an RMBS sponsor's representations without making any investigation at all. Ambac Br. at 22. This may be true as a matter of contract – regarding a claim for breach of representation

and warranty – but it is directly contrary to longstanding New York law governing fraud claims, which requires sophisticated parties to investigate potential risks. HSH Nordbank AG v. UBS AG, 95 A.D.3d 185, 195 (1st Dep't 2012) (holding that parties have a duty to exercise ordinary diligence when the nature of a risk can be ascertained). Monoline insurers cannot have it both ways. When a party chooses not to perform any reasonable investigation at all, it cannot pursue a common law fraud claim in New York.

By contrast, an insurer offering conditional and rescindable policies can use Sections 3105 and 3106 to rescind a policy or deny claims. Certain rescindable life insurance policies are offered without requiring the insurer to conduct physical examinations or elaborate reviews of medical records. Certain rescindable property insurance policies are offered based on promises to maintain functioning fire safety measures like sprinkler systems or smoke detectors without requiring the insurer to conduct constant inspections. For these rescindable policies offered to consumers in high volumes at lower margins, not requiring reasonable investigations benefits the public by keeping investigation costs – and corresponding premiums – low and proportional to the risk assumed.

No such benefit would flow to the public if exceptions to longstanding common law were extended to insurers asserting damages claims, rather than rescission or avoidance claims, in connection with low-volume, high-value non-

rescindable RMBS guaranties.[18] The effect would be the opposite. Monoline insurers made extensive, repeated representations that they adopted prudent, conservative risk underwriting practices. The investors who purchased RMBS securities in reliance on the monoline insurers' vote of confidence are harmed if the insurers' refusal to perform a reasonable review of the collateral they blessed receives judicial sanction.[19]

2. Requiring Monoline Insurers to Prove Loss Causation Comports with the Contractual Risk Allocation

Permitting monoline insurers to recover damages on conforming loans – loans on which they admittedly assumed the risk of default – turns the allocation of risk in RMBS contracts on its head.

The representations and warranties ubiquitous in RMBS securitizations are generally part of a "repurchase protocol," which in many cases provides the "sole remedy" available to certain transaction participants. See, e.g., Ambac Assur. Corp. v. EMC Mortg. LLC, 121 A.D.3d 514, 515-516 (1st Dep't 2014). Monoline insurers commonly assert repurchase claims and aggressively pursue those contractual rights. See, e.g., A131 (alleging Ambac's demand that Countrywide

[18] In one action, an RMBS sponsor has offered expert testimony that the cost of a review of 400 loan files would have been $80,000 in 2007, and that some monoline insurers did conduct reviews of selected loan files in the 2003-2007 time period. MBIA v. Credit Suisse, Index No. 603751/09, Dkt. No. 1043, Affidavit of Charles Grice, ¶¶ 3-4.

[19] For these reasons, the fire, burglary, health, and life insurance cases cited by Ambac are inapposite. Ambac Br. at 22-26.

repurchase 8,029 purportedly defective loans). Ambac's complaint in this very action acknowledges the risk retention and allocation that underlies the repurchase protocols. A110-11 ("Countrywide accepted the risks that its broad and extensive representations were false, while Ambac accepted the risk that mortgage loans that conformed to Countrywide's representations and warranties would not perform as expected.").

The recognition of the risk allocation implemented by repurchase protocols is reflected in the American Securitization Forum's ("ASF") model representations and warranties. The ASF includes Ambac and other monoline insurers among its participants.[20] In 2009, the ASF surveyed practices in the RMBS industry and published Model Representations and Warranties for future RMBS transactions. The ASF "continues to advocate that risk retention or skin in the game for originators and issuers of RMBS be implemented through the representations and warranties that originators and issuers provide with respect to the mortgage loans sold into the securitization trust coupled with meaningful remedial [repurchase] mechanisms designed to ensure their enforcement." ASF Model Reps, supra n. 20, at 4. If permitted to stand, however, the Appealed Order marginalizes this regime

[20] American Securitization Forum, "ASF Model RMBS Representations and Warranties" at 1, Dec. 15, 2009, available at https://www.scribd.com/document/376527487/ASF-Model-RMBS-Representations-and-Warranties (hereinafter, "ASF Model Reps"). Monoline insurers Ambac, MBIA, Assured, CIFG, and Syncora all are or were members of the ASF.

in favor of a hybrid legal/equitable remedy that is flatly inconsistent with the parties' contractual rights.

Monoline insurers admit that perfectly underwritten collateral will nevertheless incur some default. See, e.g., Financial Security Assurance (now Assured), "A Guide to Insured Asset-Backed Securities," October 1999, at 9 ("Asset risk is present because some losses are expected to occur in any large pool of receivables.").[21] Similarly, the securitization industry recognizes that not all origination defects result in defaults and, consequently, in losses.

The Appealed Order was thus precisely correct when it agreed with SIFMA's position, and limited Ambac's remedies to those losses actually caused by misrepresentations, holding:

> Ruling otherwise would inequitably allow Ambac to recoup the money it paid out for loans that complied with all warranties, and for which there were no misrepresentations, but which resulted in default due to the housing market collapse or other risks Ambac insured against. By issuing the irrevocable insurance policies, Ambac accepted the risk that an economic downturn could cause the loans to default and trigger its obligation to pay.

A14.

Ambac argues here that it can recover all of its claims payments, regardless of whether those payments are attributable to the allegedly breaching loans. This

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[21] Available at https://goo.gl/Zgf8WG.

would constitute the exact rescissory damages that New York courts consistently reject in these circumstances, and shift the risks Ambac agreed to assume onto other counterparties.

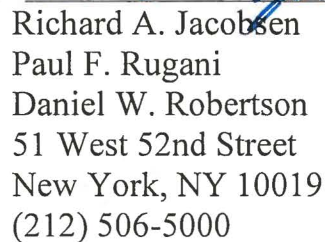
SIFMA respectfully submits that "defeat[ing] recovery thereunder" must be construed to mean what it says. An insurer may rely on that provision to rescind or deny payments under an insurance policy – the opposite of the facts here. Nothing in the Insurance Law supports an affirmative cause of action for damages in the amount of payments already made. The statute does not provide an alternative to the core proximate causation analysis for damages claims. Nor does it specify what might be required for any alleged "statutory" cause of action, even assuming one existed. The Appealed Order comports with New York common law, the Insurance law, and the expectations of transaction counterparties. Because the Appealed Order has import not only in this case but across the securitization industry, SIFMA respectfully requests that the Court sustain longstanding common law by an affirmance on this appeal.

CONCLUSION

For the reasons and upon the authorities set forth above, this Court should affirm the Appealed Decision insofar as it holds that a monoline insurer is required to prove justifiable reliance and loss causation as elements of a common law fraud claim for damages.

Dated: April 19, 2018
New York, New York

ORRICK, HERRINGTON & SUTCLIFFE LLP



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