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CLIENT ALERT

CMBS Litigation Redux: The First COVID Crisis Claims

APRIL 7, 2020

On March 25, 2020, affiliates of AG Mortgage Investment Trust—a publicly traded mortgage real estate investment trust (mREIT)— sued Royal Bank of Canada (RBC) for breach of contract, challenging margin calls by RBC that plaintiffs claim were based on an erroneous valuation of a portfolio of commercial mortgage-backed securities (CMBS) and seeking a temporary restraining order and preliminary injunction blocking the auction of those assets into a "frozen" market.[1] While the complaint names only RBC and an affiliate as defendants (and suggests that most banks have exercised forbearance in light of the COVID-19 crisis), it alleges that certain "other banks have [also] taken advantage of" market illiquidity "by applying opportunistic (and unfounded) markdowns . . . in order to trigger widespread margin calls against their counterparties" and warns that RBC's actions could "precipitate a chain reaction" and "jeopardize the viability of the entire mREIT industry . . . ."

While the requested TRO was denied as moot (since the filing was made after the auction was scheduled to begin and there were no other auctions of plaintiffs' assets scheduled), plaintiffs have since agreed to defer service of the complaint to allow the parties to explore a consensual resolution, and the CMBS market has eased somewhat, the *AG MIT v. RBC* case could nevertheless represent the leading edge of a new wave of mortgage-related litigation arising out of the COVID-19 pandemic. With the effects of the virus rippling across the economy, fears of systemic retail and commercial lease and mortgage defaults reportedly stalled the markets for mortgage-backed securities (MBS), as the Federal Reserve stepped in with emergency bond buying, including $200 billion of MBS. Falling prices and resulting illiquidity (as traditional buyers exit the market) led several mortgage REITS to announce that they will be unable to meet the growing number of margin calls issued by their lenders and prompted calls by some for a moratorium on margin calls and additional Federal Reserve buying. Relatedly, the Mortgage Bankers Association has written to the SEC and FINRA formally soliciting immediate guidance on interaction between securities firms and mortgage lenders.

An Overreaction Based on "Temporary" Market Conditions?

In *AG MIT v. RBC*, plaintiffs claim that RBC undervalued their CMBS portfolio by determining market value based on what the complaint characterizes as "an artificially (and temporarily) depressed market that is not a reliable or reasonable means of calculating the true value of the underlying securities," in breach of the parties' master repurchase agreements. Plaintiffs concede that debt markets have declined precipitously in recent weeks, but

assert that this “did not reflect a decline in the fundamental value of the debt securities as opposed to the absence of liquidity in the marketplace,” and that the margin calls and threatened auction of the CMBS—a presumably objective means of determining market value—rest on temporary dislocations and do not account for recent governmental intervention, including by the Federal Reserve, to restore liquidity and maintain the flow of capital.

Plaintiffs also claim that, under the master repurchase agreements, even if the margin calls and threatened liquidation were permissible, the asset sale must take place “in a recognized market (or otherwise in a commercially reasonable manner),” which cannot be done given that the market for MBS is allegedly frozen. Finally, plaintiffs claim that RBC breached the implied covenant of good faith and fair dealing by refusing to exercise forbearance with respect to any contractual remedies in light of New York Governor Cuomo’s March 21, 2020 Executive Order No. 202-9, declaring the denial of forbearances to a business “who has a financial hardship as a result of the COVID-19 crisis” to be an “unsound and unsafe business practice.”

An MBS Litigation Relapse?

It is early days with regard to the potential fallout of the COVID-19 crisis from a securities and financial services litigation perspective. Whether the economic impact of the pandemic will spawn anything approximating the magnitude of mortgage- and asset-backed securities litigation touched off by the 2008 financial crisis remains to be seen. But a substantial increase in defaults, as many predict, will inevitably trigger litigation by investors, trusts, swap counterparties, and other securities holders against the financial services firms involved in underwriting, securitizing, marketing, or selling those securities.

Already, certain similarities with claims asserted in the wake of the last financial crisis can be seen. For example, in 2011, the bankruptcy trustee of REIT Thornburg Mortgage, Inc., sued several major banks challenging the issuance of margin calls based on the banks’ alleged unilateral calculation of market value in breach of the applicable repurchase agreement.[2] Although new issues will undoubtedly arise out of the unique economic conditions created by the COVID-19 outbreak, some lessons can nevertheless be gleaned for financial institutions by comparing and contrasting CMBS margin-call litigation in the current financial crisis with such litigation during the last one.

- *Contractual terms governing the procedure for margin calls may be critical*. For example, in the *Thornburg* litigation, one disputed issue (the case survived cross-motions for summary judgment) was whether the bank provided the requisite notice prescribed in the repurchase agreement to meet the margin call and whether the notice of default was premature. Banks should therefore scrupulously examine and adhere to the agreements’ procedural requirements to minimize exposure.
- *A supportable valuation methodology will be critical*. A key allegation in these cases is that the banks allegedly unilaterally undervalued the securities collateralizing the agreement and sought to liquidate (or, as occurred in *Thornburg*, in fact liquidated) them outside the context of a true market. Accordingly, in addition to adhering to contractually prescribed or permitted valuation and liquidation methodologies, banks should give consideration to third-party/independent valuation and market analyses to corroborate their valuation and related determinations.
- *The role of the implied covenant remains to be seen*. Claims for breach of the implied covenant of good faith and fair dealing are a common “tack on” in breach of contract cases and can often be batted away as wholly duplicative of the contract claim. In *AG MIT v. RBC*, plaintiffs attempt to avoid that result by tying their implied covenant claim to Governor Cuomo’s forbearance order. However, a subsequent New York State Department of Financial Services emergency regulation clarified that the order does not apply to commercial mortgages.[3] Nonetheless, financial institutions should closely track the extent to which plaintiffs attempt to leverage governmental intervention, orders, exceptions, and rulemaking into private claims. Meanwhile, defendants will likely point to the same governmental intervention as proof positive that asset prices were widely recognized to be in free fall. It will be left to the courts to determine the extent to which these often hastily drafted pieces of emergency legislation and regulation may have the effect of redefining privately ordered contractual relationships under the circumstances—which would presumably have been an unintended consequence in many instances.

Leaving aside the impact that further governmental intervention affecting the markets and seeking to guide or (re)define the relationships between market participants may have, it seems certain that prolonged volatility and illiquidity will continue to stress the relationships between lenders and borrowers in the MBS markets, leading to additional litigation.

If you have additional questions or need further assistance, please reach out to James Smith (jpsmith@winston.com), Joe Motto (jmotto@winston.com), Thomas Weber (tgweber@winston.com), Linda Greene (lgreene@winston.com), or your Winston relationship attorney.

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[1] *AG MIT CMO, LLC v. RBC (Barbados) Trading Corp.*, Case No. 1:20-cv-02547 (S.D.N.Y.) (filed Mar. 25, 2020) (*AG MIT v. RBC*).

[2] *See, e.g., Sher v. Barclays Capital Inc.*, Case No. 11-00329 (D. Md.) (*Thornburg*).

[3] On March 24, 2020, the NY DFS issued an emergency regulation implementing the directives of Executive Order 202.9, which clarified that the required forbearance measures do not apply to transactions other than *residential mortgages* of properties located in New York.

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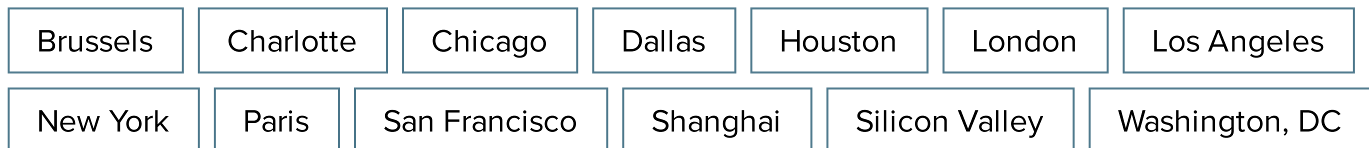

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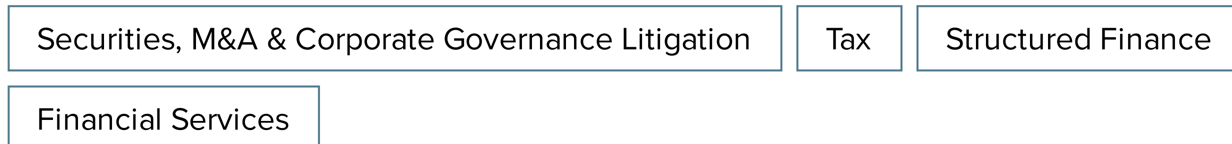

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