Coronavirus and the Great Recession of 2008: Parallels in the ABS Market

This article explores the parallels of the 2008 Great Recession with the financial distress recently caused by the coronavirus crisis, in creating litigation investment opportunities in the asset-backed securities market – the former with respect to residential mortgage-backed securities, and the latter focusing on bonds backed by auto loans.

After the 2008 financial crisis, the world of residential mortgage-backed securities ("RMBS") was a well-spring of litigation. Over the last ten or so years, trustees, investors, and insurers brought scores of lawsuits – some involving billions of dollars – against the lenders whose shoddy mortgage practices led the economy into crisis.

Back in the early 2000s, a number of mortgage companies began issuing as many home loans as they could, as fast as they could, regardless of whether the borrowers could actually afford to repay them. This was catalyzed by the rapid expansion at the time of securitization in the mortgage industry. Through securitization, lenders were able to sell massive numbers of loans off their books for a profit immediately after originating them, while ostensibly shifting the risk of borrower default to the investors and monolines who insured these deals. This practice led to a flood of fraudulent and poorly-underwritten mortgage loans across the nation, fueling the rapid rise, and then precipitous collapse, of the housing market.

Investors and insurers had one key protection against these shoddy origination practices under the RMBS contractual framework: the "put-back" provision. In order to make their loan packages appealing to investors and insurers, mortgage companies sponsoring these transactions made certain promises about the quality and characteristics of the loans being securitized (representations and warranties or "R&Ws") – for example, that the loans on average had a particular FICO score, were tied to owner-occupied homes as opposed to secondary properties, or had an average appraisal value of a particular amount. And if any of the loans did not comply with those promises, the investors, their trustees, and insurers had the right to "put back" those loans, *i.e.*, demand that the sponsor repurchase them.

Virtually all RMBS litigation during the past decade was rooted in the enforcement of some form of put-back provision. In fact, RMBS put-back claims have been so prevalent that investing in that type of litigation became a market unto itself. But the time of RMBS litigation is coming to an end – previously-filed cases that have not already settled or otherwise been resolved are in the final stages of litigation.

Another wave of loan put-back litigation, however, could possibly be on the horizon, spurred by the onset of the coronavirus and ensuing financial distress of consumers: this time with respect to the auto loan asset-backed security ("ABS"). Like the mortgage lenders of the early 2000s, some auto lenders of today may have abandoned prudent underwriting in order to pump out more and more loans. After all, as was the case previously in the RMBS industry, approving more loans means that lenders can then bundle and sell those loans for a profit through securitization.

The growing securitization of auto loans has led to some of the same problems pervasive in the mortgage industry fifteen years ago: lenders are making as many loans as they can, regardless of the borrowers' ability to repay. As the Wall Street Journal reported last October:

Incomes have risen at a sluggish pace in the past decade, but car prices have grown rapidly . . . consumers are seeking bigger loans than ever to purchase a car. A lending machine has revved up in response, making it possible for more Americans to procure a vehicle by spreading the debt over longer periods. Wall Street investors snap up these loans, which are bundled into bonds. Dealers now make more money on the loans their customers take than on the cars they sell.

Ben Eisen & Adrienne Roberts, *The Seven-Year Auto Loan: America's Middle Class Can't Afford Its Cars*, Wall St. J. (Oct. 1, 2019), https://www.wsj.com/articles/the-seven-year-auto-loan-americas-middle-class-cant-afford-their-cars-11569941215.

Despite the comparatively slow growth of incomes during the same period, the average auto loan "has grown by about a third over the past decade" and now "stretches for roughly 69 months, a record." *Id.* As a result, "U.S. consumers held a record $1.3 trillion of debt tied to their cars at the end of June [2019], according to the Federal Reserve, up from about $740 billion a decade earlier." *Id.* This has fueled massive profits for auto lenders who offload the risk of these loans through securitization. In 2018, alone, "investors bought a record $107 billion of bonds backed by cars." *Id.*

As of February 2019 – a year before the coronavirus became a household term and began putting financial stress on consumers – a record seven million Americans were at least 90 days delinquent on their auto loan payments, according to the Federal Reserve Bank of New York. And the major cause, University of Utah law professor Christopher Peterson argues, is tied to the subprime auto loan, and the fact that many auto dealerships and finance companies "are fully aware that they are making loans that have a high probability of defaulting." *Is a Subprime Auto Loan Crisis Brewing?*, Knowledge@Wharton Radio (Feb. 18, 2019), https://knowledge.wharton.upenn.edu/article/auto-loan-subprime-crisis/. According to Peterson, auto lenders "are really driving these high default rates. And my suspicion is that a lot of that has to do with . . . the fact that they are likely shedding off a lot of this risk by selling them into securitization pools that are sold on Wall Street." *Id.*

While the proportion of auto loans at least 90 days delinquent has continued to rise according to the Federal Reserve Bank of New York, the "market for securities backed by the riskiest U.S. car loans" as of November 2019 was still "booming." Robert Armstrong, *Yield-Crazed Investors Pile into U.S. Subprime Car Loans*, Financial Times (Nov. 25, 2019), https://www.ft.com/content/59f3a084-0d80-11ea-bb52-34c8d9dc6d84. The increase in risk of borrower default caused by this explosion of subprime auto loan ABS will only be exacerbated by the economic ramifications of the coronavirus in the coming months. *See* Chris Isidore, *More than Half of American Jobs are at Risk Because of Coronavirus*, CNN Business, (Mar. 16, 2020), https://www.cnn.com/2020/03/16/economy/job-losses-coronavirus/index.html.

In the words of Yogi Berra, it's like de ja vu all over again, except now the culprit may be some of the auto loan originators/securitization sponsors, as opposed to the originators/sponsors of residential mortgages. The similarities are striking – not just in the possible bad acts potentially causing another crisis, but also in the claims for recompense that would be sure to follow.

Indeed, the respective structures of RMBS and auto loan securitizations are essentially the same. An issuer takes thousands of loans it either originated or bought from another lender, and then packages them into a pool. That pool of loans is then transferred to a trust. The trust then uses the loans as collateral for corporate bonds that are sold to investors. The investors are then paid by the cash flow generated by the borrowers' monthly payments on the loans. As with RMBS, auto loan ABS investors do not get paid if the borrowers default on their loans.

Under this structure, RMBS and auto loan ABS "sponsors" alike make numerous R&Ws vouching for the quality and characteristics of the loans being securitized. At the heart of these R&Ws is the sponsor's promise that the loans were properly underwritten, *i.e.*, that each of the loans in the trust was approved based on the borrowers' ability to repay, as opposed to the sponsor's ability to sell the loans off its books.

RMBS sponsors typically do this by promising that the loans were approved in accordance with their underwriting guidelines. Similar promises are typically made in the auto loan context. One auto loan ABS sponsor, for example, promised that the loans at issue were originated in accordance with the sponsor's "credit policies."[1] Another auto loan ABS sponsor represented in the deal's prospectus that the loans at

[1] Sale and Servicing Agreement for AmeriCredit Automobile Receivables Trust 2017-1, at Schedule B-1 (Jan. 11, 2017), https://www.sec.gov/Archives/edgar/data/1347185/000119312517045280/d317641dex43.htm [hereinafter AmeriCredit 2017-1].

issue were approved based upon that sponsor's "origination guidelines," including those concerning "affordability."[2]

Auto loan ABS sponsors make a number of other R&Ws also typically included in RMBS deals that go to the quality of the loans being securitized. One sponsor, for example, promised that: (i) the auto loans at issue complied with "applicable federal, state and local laws," *e.g.*, they weren't approved as a result of predatory lending; and (ii) there was no "default, breach, violation or event permitting acceleration under the terms of" any auto loan, which could be argued constitutes a promise of no borrower fraud, to the extent borrower fraud was a default, breach, or violation of the relevant loan agreement.[3]

Auto loan ABS sponsors, like RMBS sponsors, typically promise to "repurchase" – again, often referred to as "put back" – any loan that breaches one or more of the sponsor's R&Ws, so long as the breach "materially and adversely" affects the interests of the investors.[4] These are commonly called "defective loans."

In the RMBS context, courts have held that a defective loan need not actually default for the breach to be material and thus require repurchase, so long as the breach increases the risk of default.[5] Because of this, RMBS plaintiffs have been able to seek repurchase of materially defective loans even if the borrowers have not defaulted, which has significantly broadened the scope of RMBS put-back claim recovery. The same standard for repurchase could govern auto loan ABS, given their similarities to RMBS.

As with prior RMBS precedent, investors may be able to purchase ABS bonds backed by auto loans at discounted prices, and then sue the sponsors for repurchase of all loans that violate their R&Ws. The suits would be contract based and the statute of limitations would depend on the state, but many states have a six-year statute of limitations for breach of contract, which would likely begin to run from the time the securitization closed. The complaints may best be filed in the states where the sponsors are located, unless a forum selection clause in the contract dictates another jurisdiction. And while auto loans tend to be much smaller than mortgages, the number of auto loans in each trust still are very substantial, often approaching $1 billion in the aggregate for a given trust.

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Concerns about the coronavirus thrusting our economy into a trough similar to that of the Great Recession continue to grow. The likelihood of that prospect occurring appears to increase with each passing day and with every new announcement of the world in a health crisis. Indeed, proclamations that the market has had its worst days since 2008 are rampant.

During the Great Recession, shrewd hedge funds, investment managers, and others took the plunge and wisely invested in RMBS bonds, betting that when the economy inevitably rebounded, the bonds would either come back in value or they could exercise legal recourse against the RMBS originators and sponsors who made and sold the defective mortgage loans that backed the bonds. That strategy was wildly successful for many who followed it. The same may be true today with respect to auto loan ABS.

In short, there is strong potential for a tidal wave of auto loan put-back litigation. Like their RMBS counterparts, auto loan ABS sponsors are obligated to repurchase defective loans, and tens of billions of

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[2] Prospectus for Santander Drive Auto Receivables Trust 2017-1, at 39 (Feb. 23, 2017), https://www.sec.gov/Archives/edgar/data/1383094/000119312517058266/d345750d424b5.htm#rom345750_45 [hereinafter Santander 2017-1].

[3] *See, e.g.*, Purchase Agreement for Santander 2017-1, at Schedule II(b), (e) (Feb. 28, 2017), https://www.sec.gov/Archives/edgar/data/1383094/000119312517058229/d315860dex101.htm.

[4] *See, e.g.*, Sale and Servicing Agreement for Santander 2017-1, at Section 3.6 (Feb. 28. 2017), https://www.sec.gov/Archives/edgar/data/1383094/000119312517058229/d315860dex102.htm; Sale and Servicing Agreement for AmeriCredit 2017-1, at Section 3.2 (Jan. 11, 2017), https://www.sec.gov/Archives/edgar/data/1347185/000119312517045280/d317641dex43.htm.

[5] *See Home Equity Mortg. Trust Series 2006-1 v. DLJ Mortg. Capital, Inc.*, 175 A.D.3d 1175, 1177 (1st Dep't 2019); *Wilmington Tr. v. MC-Five Mile Commercial Mortg. Fin. LLC*, 171 A.D.3d 591, 592 (1st Dep't 2019).

dollars' worth of auto loans have been securitized in just the past several years. To the extent these loans suffer from the same rampant R&Ws breaches that plagued RMBS deals, the potential for plaintiff-side recovery could be substantial. At the very least, the recent news reports and the financial distress caused by the coronavirus suggest that this is a topic worth exploring further.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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