

## Regulation AB Forum

# Liability Provisions

- What are the legal implications of noncompliance with different provisions of the Regulation?
- What are the business implications of noncompliance?
- How do the liability provisions under the Sarbanes-Oxley certification relate to liability provisions elsewhere in the Regulation?
- Is compliance reporting under Item 1123 subject to liability provisions under Sarbanes-Oxley?

- Implications depend on party involved
  - Securitizers (“Sponsors”, “Issuers” and/or “Depositors”)
  - Loan Sellers (“Originators”)
  - Servicers
- Legal implications can be statutory and/or contractual

- In addition, these implications are affected by ambiguities arising from lack of SEC guidance in certain situations
  - For example, Originators and Servicers must confront inconsistent disclosure demands from purchasers who interpret Reg AB differently

- SECURITIZERS
  - “Sponsors”, “Issuers” and/or “Depositors”

- Liability under Sections 11 & 12 of the '33 Act
  - “Issuer” is required to sign the registration statement filed under the '33 Act.
    - The Depositor, acting solely in its capacity as depositor to the issuing entity, is the “issuer” for purposes of the asset-backed securities of that issuing entity.

- Section 11 imposes absolute liability on the Issuer for material misstatements and omissions in the registration statement, including information provided by third parties.
- Section 12(a)(2) imposes liability upon any person who offers or sells a security by means of a misstatement or omission of a material fact.

- Under Section 11, a successful plaintiff can recover losses on the security from time of purchase to time of sale of the investment
- Under Section 12(a)(2), a successful plaintiff can recover “the consideration paid for such security with interest thereon, less the amount of any income received thereon . . . or for damages if he no longer owns the security.”

- Liability under the '34 Act:
  - Issuers must make accurate and timely '34 Act reports, press releases and other information.
  - Also have liability due to the anti-fraud provisions of Section 10(b) of the '34 Act and rule 10b-5.
  - Did the issuer and its sponsors
    - Employ “any device, scheme, or artifice to defraud”
    - Make “any untrue statement of a material fact or [failed] . . . to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading.”

- Similar to the '33 Act, the Exchange Act Rule 3b-19 defines an “issuer” as the depositor for the asset-backed securities acting solely in its capacity as depositor to the issuing entity.
- Servicer or master servicer may sign Exchange Act reports on behalf of the issuing entity as an alternative to the depositor.

- Additional SEC Reg AB guidance:
  - Party signing the Exchange Act reports certify and disclose that all servicer attestation reports have been received and submitted as required except as disclosed in the annual report.
  - The signing party (whether the depositor or master servicer) is not required to assert to the accuracy of the content of the reports, or compliance with the rule by third parties
  - The signing party cannot include information in a report that it knows is false or is reckless in not knowing that the information is false.

- In addition, the SEC has advised that, similar to a dog owner where only the first bite by its dog is free, an issuer that contracts with third parties that make a habit of violating their contractual obligations to deliver these reports will assume responsibility for such failures.

- The executive signing the 10-K is also required by Reg AB to make a Sarbanes-Oxley 302 certification.
  - Providing a false certification could cause such person to be subject to SEC action for violating the Exchange Act and possibly to both the SEC and private actions for violating rule 10b-5 under the Exchange Act.

- Shelf registration issues:
  - Any issues, if not addressed properly, could impact the ability to access the markets with new issuances – including shelf registration.
    - Eligibility to use Form S-3 depends on compliance by the depositor and all affiliated depositors securitizing the same asset type with all Exchange Act reporting requirements for the preceding 12 months.

- Static pool issues:
  - For static pool information regarding (1) securitized pools of the sponsor established prior to January 1, 2006 and (2) the pool being offered, for periods before January 1, 2006, the information can be omitted if not known and not available to the registrant without unreasonable effort or expense.
  - Such information is only subject to rule 10b-5 liability.

- ORIGINATORS

- Liability is primarily contractual through ASF model Reg AB provisions
  - Originators generally required to provide 1105, 1108, 1117 and 1119 information for inclusion in Prospectus Supplement
  - Agree to indemnify “everyone” from and against any losses, damages, penalties, fines, forfeitures, legal fees and expenses and related costs, judgments, and any other costs, fees and expenses ***arising out of or based upon any untrue statement of a material fact or omissions of material fact***

- Other indemnification obligations:
  - General indemnification provision in “standard” Wall Street MLPAs:
    - Seller indemnifies Purchaser in any way related to the failure of the Seller to perform its obligations under this Agreement including but not limited to its obligation to service and administer the Mortgage Loans in strict compliance with the terms of this Agreement or any Reconstitution Agreement entered into . . .

- Reconstitution indemnification provision in standard “Wall Street” MLPA:
  - to deliver to the Purchaser for inclusion in any prospectus or other offering material ... information regarding the Seller’s underwriting standards, the Seller, its financial condition and its mortgage loan delinquency, foreclosure and loss experience and any additional information requested by the Purchaser including, without limitation, information on the Mortgage Loans and the Seller’s underwriting standards, ... or [any information] as is otherwise reasonably requested by the Purchaser and which the Seller is capable of providing without unreasonable effort or expense, ***and to indemnify the Purchaser and its affiliates for material misstatements or omissions or any alleged misstatements or omissions contained in such information.***

- Indemnification Agreement delivered in connection with Prospectus Supplement:
  - Scope of indemnity similar to AFS model provision, e.g. provide indemnification for any untrue statement of any material fact, or any omission to state a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances in which they were made, not misleading.

- SEC's opposition to indemnification for securities-law related liability is reflected in the contribution language often borrowed from underwriting agreements
  - Unclear if a court that holds such indemnification void as against public policy would allow contribution based on the same facts.

- Open Issue: Static Pool Information
  - Item 1105(c) provides that if the static pool data otherwise required by Item 1105 is not material, but alternative static pool information would provide material disclosure, the alternative information should be provided instead.
  - If disclosure of static pool information regarding parties other than the sponsor is appropriate to provide material disclosure to investors, such information may be provided in lieu of, or in addition to, the static pool information of the sponsor.
  - Model ASF provisions obligate Originators to provide static pool information upon request.

- Concern that market may punish those sellers unable to provide static pool information. What do Originators who sell their loans “servicing-released” do?
  - Such originators probably do not have access to loan performance information necessary to meet this requirement.

- In addition, how many “tiers” down does the sponsor have to go with respect to obtaining static pool information?
  - If more than one tier, the parties need to develop mechanisms to account for production by originators who sell to different sellers that are themselves part of a securitization

- Options for Originators with respect to ASF model provisions regarding static pool information:
  - Execute Reg AB amendment as proposed
    - In addition to indemnification obligations, this also raises the possibility of a fraud claim by investor since Originator knew when signing the amendment that it would be unable to meet such requirement

- Attempt to limit Investor’s ability to request static pool information, e.g., Seller only required to provide static pool information if Seller’s loans are more than 20% of the UPB of the pool
  - Limits likelihood that such information will be requested, but the bottom line is that the Originator still could be obligated to provide information it does not have.

- Attempt to cap Originator’s participation in any pool at 20% of UPB
  - Probably eliminates a lot of the risk but the SEC has not provided guidance on what level of involvement is “material” for purposes of static pool information, meaning that participation lower than 20% may be material (although the market appears to agree that 20-40% is material for purposes of static pool information)
  - Even if capped in this manner, there is the possibility that an originator’s static pool data may be material to a tranche of loans within a pool, etc.

- Eliminate obligation to provide static pool (at least until Originator is able to do so).
  - Investors who have been unwilling to cap an Originator's participation in a pool have preferred this approach, leaving them the discretion to determine the Originator's involvement in any given securitization.
  - Could limit investors who will buy the Originator's pools

- Provide static pool information to the extent the Originator can reasonably do so (similar to current requirement for pre-January 1, 2006 information)
  - Disclaim, disclaim, disclaim when providing static pool information to investors
  - Make sure to carve out from indemnification for omissions of material facts

- What we are seeing in the market:
  - The good news is that the market appears to be moving away from an outcome that punishes servicing-released Sellers with respect to their inability to provide static pool information.

- Aware of at least two investors that have taken the position in deals that, since they re-underwrite each loan to their underwriting criteria, no originator-related Reg AB information is required from the Seller.
- However, it all could (will?) go out the window after the first enforcement action or civil suit alleging that a registrant should have disclosed static pool information from an originator.

- However, with respect to liability issues and static pool information, there is more!
  - In order to provide static pool information, Sellers that sell on a servicing-released basis need Purchasers to provide static pool information back to them on such loans at least quarterly
  - Such sellers then will aggregate information received from all investors to be able to provide static pool information when requested

- Some investors are refusing to provide such static pool information back to sellers while insisting on the AFS model approach, which allows such investors to demand static pool information from the seller upon request.
  - Other investors will only provide it to the extent the loans are serviced by an affiliated servicer

## Originators – Static Pool Information (continued)



- Other investors will agree to provide static pool information back to Sellers but will not represent that it is accurate or provide any related indemnification.
  - Could result in crazy outcome where an investor provides erroneous static pool information back to a seller, which that seller aggregates with information it receives from other investors. Once aggregated, this static pool information may be sent back to the same investor who provided the erroneous information in the first place. The Seller would then have an indemnification obligation to the investor if the information contained a misstatement of a material fact.

- Other investors will represent that the information provided back to the seller is accurate (and provide indemnification), but only to the extent an affiliated servicer services the loans.

- Other potential liability for Originators:
  - **Originators do not appear to have direct private liability.** Originators have no (1) section 11 liability since such person is not the issuer, underwriter, officer/director or expert, (2) Section 12 liability since originator is not a “seller”, and (3) Rule 10b-5 damages since the originator is not the maker of a misrepresentation in a prospectus to create a direct violation and, under the ***Central Bank of Denver*** decision, there is no aider and abettor liability in private civil actions under rule 10b-5.
  - **Originators still at risk from SEC enforcement.** The SEC remedies are broader and reach persons who directly or indirectly "cause" a violation. See e.g., Section 20 of the '33 Act and Sections 21(d)(3) and 21C of the Exchange Act.

- Possibility that an originator is deemed to engage in a “rent-a-shelf” transaction, thereby taking on sponsor-related liability.
  - A typical ABS “rent-a-shelf” transaction is one where the sponsor of the transaction transfers the pool assets to an unaffiliated depositor for a takedown off of a registration statement filed by the unaffiliated depositor, usually for a fee.

- **SERVICERS**

- Similar to Originators, Servicers also have significant contractual liability under the model ASF Reg AB provisions and servicing agreements
  - Servicers generally required to provide Item 1110, 1117 and 1119 information for inclusion in Prospectus Supplement
  - Also have obligations under Items 1121, 1122 and 1123
  - Agrees to indemnify “everyone” for untrue statements of material fact or omissions of material fact, as well as failure to deliver applicable reports, certifications, accountants’ letters, etc.
- Also have similar indemnification obligations under the MLPA and/or the applicable servicing agreement.

- Certain failures are also considered to be events of default under the ASF model provisions and give the investor the ability to terminate the servicer “without payment . . . of any compensation . . . .”

- The servicing certification and attestation reports require that all material instances of servicing non-compliance must be identified in the report and disclosed in the related Form 10-K. The final regulations do not include a specific line item requirement to disclose any material impact or effects as a result of material instances of noncompliance. The SEC has, however, adopted a requirement that material instances of noncompliance during the reporting period, even if such noncompliance was subsequently corrected during the reporting period, must be disclosed.
- The servicer will be required to provide documentation to evidence compliance with all servicing criteria included in management's assertion, even if Servicer is willing to take responsibility for servicing functions it outsources to third parties.

- All parties that participate in the servicing function must make a statement of compliance with the applicable servicing criteria.
- Servicers who sign Exchange Act reports on behalf of the issuing entity can also take on that liability.
- Servicers responsible for Exchange Act filings should develop procedures to assure compliance with these requirements, including with respect to Forms 8-K, 10-D and 10-K.

- Other potential liability:
  - Securitizers pushing down to servicers indemnification obligations for providing inaccurate static pool data back to Originators
  - Costs for tracking such static pool information

- Open Issue:
  - If you service more than 20% of the pool assets as of the cut-off date, Regulation AB disclosure may conflict with your compliance with the Exchange Act.
    - Regulation AB may require disclosure of litigation that you are not otherwise required to disclose.
    - Regulation AB disclosure requirements may trip you up on your Regulation FD compliance.

- Open Issue:
  - Interim Servicing Transfer Date occurs after the securitization date:
    - Is the interim servicer “participating in a servicing function”?
    - If so, how will such “interim servicers” without a true servicing platform comply with the Item 1122 certification and attestation requirements?

- Open Issue:
  - Managing third-party requirements

- Questions or Comments?

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