Contract in Crisis

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Emily Strauss, Crisis Construction in Contract Boilerplate, 82 L. & Contemp. Probs. 163 (2019).

Oddly enough, contract law may help quell at least some of the panic that comes with a pandemic. Sure, contract doctrine can't tell us about the spread of the COVID-19 virus. But Emily Strauss' article Crisis Construction in Contract Boilerplate shows how courts adeptly and quietly helped the economy recover during the 2008 financial crisis. She tracks the surprising outcomes and rationale of cases allocating risk among loan originators, investors in residential mortgage backed securities (RMBS), and insurers in those transactions, and reports that they followed a method of contract interpretation she dubs "crisis construction." Faced with "sole remedy" contract clauses in asset securitization contracts that simply could not remedy the magnitude of losses that investors and insurers suffered, courts abandoned the plain language of those standard clauses in favor of a plaintiff-proposed equitable alternative. That method, Strauss contends, helped restore investor confidence and right the economy.

Those of us who value predictability of contract law—and the rule of law more generally—will be relieved to hear that the judicial rejiggering only lasted a few years. As the economy was getting back on track in 2015, courts quietly reverted to the ordinary course of judicial business by enforcing those "sole remedy" allocation-of-risk clauses.

In short, Strauss demonstrates that common law injected equity in a crisis. To this reader, that displacement of the plain meaning of the risk allocation clauses is not as inconsistent with the parties' intent as it may initially appear. Instead, the judiciary's equitable revision of the written provision arguably followed the prime directive of contract law to enforce the parties' intent by inserting a reasonable substitute for the plain meaning when circumstances stray so far from foreseeability and practicality that reasonable parties would intend an alternative remedy.

Hotels, restaurants, airlines, retail businesses, and manufacturers who are just beginning to absorb the shock of widespread business shut-downs, event cancellations, and interruptions in supply chains will comb through their contracts hoping that a force majeure clause protects them. Regardless of how that boilerplate reads, we should all take heart that the doctrine and practice of contract law provide a model for equitably allocating the risks of losses that occur in an unprecedented—and thus unforeseeable—crisis.

The Problem: Unusable "Sole Remedy" Clauses

Here's the problem. One key way that governments counter economic crises such as the Great Depression, the Great Recession, and the 2020 COVID pandemic is to lower interest rates near zero. When that didn't do the job to counter the Great Recession, the judicial branch quietly used its own tool of crisis construction to ease investor fears. Strauss's article give us an insider's view, gleaned from her time as a lawyer in litigation that allocated losses in the wake of the 2008 financial crisis.

Strauss efficiently explains the transactions at the heart of the financial meltdown (P. 167):

- Loan originators or "sponsors" bundle mortgages as assets;

- Special Purpose Entitles (“SPEs”), often trusts, acquire the bundle and sell shares in a Mortgage Loan Purchase Agreement and Pooling and Service Agreement;
- Investors buy the shares; and
- Insurers pay investors if mortgages don’t pay a certain amount.

The contracts between the sponsors and the SPEs have the sponsor represent and warrant that the mortgages conform to specific guidelines such as property appraisal and no default or delinquencies, and that all information in the mortgage paperwork is true. (P. 168.) The contracts also specify three possible remedies for breach of those representations and warranties such as failing to appraise the property. The sponsor can cure the breach, can substitute a compliant loan for the non-compliant one, or repurchase the loan. (P. 168.) The party demanding that the sponsor repurchase the loan must show that the loan “materially and adversely” breached a representation and warranty. (P. 170.) The contracts unambiguously designate these as the “sole remedy” for breach.

The Solution: Instead use Equitable Sampling Remedy

Enter cases like *Syncora Guaranty Inc. v. EMC Mortgage CorP.* The court balked at examining nearly 10,000 loans one-by-one to identify breaches such as missing verification of a debtor’s employment, the materiality of each breach, and an appropriate repurchase price. The judge emphatically refused to use the boilerplate remedy in a footnote:

> The repurchase protocol . . . is appropriate for individualized breaches. . . . That is not what is alleged here. . . . Accordingly [the sponsor] cannot reasonably expect the Court to examine each of the 9,871 transactions to determine whether there has been a breach, with the sole remedy of putting them back one by one. [1]

Strauss tells us that this fact-intensive inquiry could take about two to three hours of an expert’s time, at a cost of between $300-$400 for each loan. (P. 171.) No wonder Strauss calls this court’s refusal “blistering.” (P. 184.)

Contract law had two options. Plan A would be to follow the plain meaning rule and enforce the “sole remedy” clause, which could result in impossibly time-consuming and onerous analyses and vastly inadequate remedies for plaintiffs. Plan B would be to find another way to match the breach to the losses suffered.

Strauss says this “blistering” footnote along with other cases explained why the court instead allowed plaintiffs to use a statistical sampling method to determine breach and damages by extrapolation from the sample. (P. 164.) The written agreements neither allowed nor mandated that method and the defendants strenuously objected. But court after court essentially exercised its equity powers to replace the agreed-upon remedy with one provided by the court in crisis conditions. The early decisions, Straus contends, lacked rationale or support in precedent, but created what she calls an “echo chamber” in which the later decisions could cite the earlier ones as precedential authority. By 2013 and 2014, courts justified the swap of the sole remedy clause for court-provided statistical sampling in terms of commercial reasonableness. (P. 174.)

Strauss explains the courts’ Plan B approach, suggesting that the decisions

> appear to reflect the sentiment that perilous economic times called for unusual measures, and that judges should produce decisions that would make investors whole, increase investor confidence and thus stabilize and ultimately help stimulate the battered economy. (P. 179.)

That choice, often made in pretrial motions, set the stage for cases to settle in the "millions, even billions" of dollars. (P. 175.) This judicial resort to an equitable remedy in the financial crisis, Strauss argues, helped shore up investor confidence and thus the wider economy.

Paths not Taken

Strauss reviews alternative routes courts could have taken, such as opting for a different kind of Plan B. The doctrines of impracticality and frustration of purpose immediately come to mind, yet Strauss explains that those defenses typically seek to excuse non-performance. Here, the investors sought to make the sponsors meet their contractual obligations of providing high-quality loans in the bundle to be securitized. (P. 183.) Likewise non-enforceability on the grounds of public policy typically would avoid a contract instead of provide a different remedy for its breach. But if it did, the public policy of protecting public welfare could certainly justify refraining from enforcing the sole remedy clause if not the entire contract. (P. 183.)

Strauss convincingly contends that the judicial swap of statistical sampling for a loan-by-loan remedy better served the end of quieting an economic panic. A decision based on impracticability, or more likely interference with public policy, could generate headlines, provide grounds for a public and drawn-out appeal process and perhaps reversal, as well as criticism from scholars and other commentators. Instead these trial courts quietly substituted an equitable remedy for the plain language of a contract. The sub rosa quality of the approach, Strauss explains, "provided a quiet, flexible medium for judges to stabilize investor confidence." (P. 186.)

Once the economy and culture were safely on track toward ordinary life, courts became more explicit in their rationale for setting aside the sole remedy clauses in favor of statistical sampling. For example, cases in 2017 and 2018 justified their reliance on sampling on the public policy against enforcing exculpatory clauses in cases involving gross negligence. (P. 187.)

After the Crisis Passes

Among the most fascinating patterns that Strauss reveals is that courts only applied the sampling remedy for a few years. Once the economy began to recover in late 2015, courts began to revert to the "sole remedy" of loan-by-loan repurchase.[2] Strauss tells us that these cases returned to the conventional approach of enforcing contracts as written without commenting on the earlier decisions that allowed sampling.

She sees this as a pattern of courts using "crisis construction" to fashion an appropriate remedy in cataclysmic circumstances that make the usual approach unusable.

That's hardly surprising. As Strauss also explains, courts likewise construed contracts to account for major changes in the economy such as the departure from the gold standard during the Depression.[3] (P. 178.)

But it did surprise me that the defects in that sole remedy and the financial collapse apparently did not make the parties edit their remedial clauses in subsequent transactions. Strauss surmises that the stickiness of these default provisions is due to the costs of revising them, and the reduced likelihood of them coming up again en mass given the protections in the Dodd-Frank Act that require lenders to assess each borrower in detail. (Pp. 190-91.)

But what really matters today—in the spring of 2020 as businesses and whole states shelter in place, borders are closed, conferences and building projects postponed or cancelled, and workers laid off—is that "crisis construction" lies at the ready for courts to resolve the many disputes that will arise from the COVID-19 pandemic. As I write in April 2020, hotels, airlines, schools, construction companies, and buyers and sellers of goods in supply chains are doubtless pulling out their written agreements and puzzling whether a force majeure clause that specifies "bacterial infection" also applies to a viral pandemic. While they puzzle over that legalese, they should read Emily Strauss' important *Crisis Construction* article to find out how judges and the doctrine and practice of common law retain the flexible, quiet tools of equity to steer parties as well as the economy and wider culture back toward normalcy.

1. 2011 WL 1135007, *6 (S.D.N.Y. Mar. 25, 2011). *See also* MBIA Ins. CorP. v. Countrywide Home Loans, 2010 WL 5186702 (N.Y. SuP. Ct. Dec. 22, 2010); MBIA Ins. CorP. v. Credit Suisse Sec. (USA), LLC, 927 N.Y.S.2d 517 (N.Y. SuP. Ct. 2011); Assured Guaranty Mun. CorP. v. Flagstar Bank, 2011 WL 5335566 (S.D.N.Y. Oct. 31, 2011); Assured Guaranty Mun. CorP. v. DB Structured Prods., Inc., 2014 WL 3282310 (N.Y. SuP. Ct. July 3, 2014).
2. *See, e.g.*, MASTR Adjustable Rate Mortgages Trust 2006-OA2 v. UBS Real Estate Sec., Inc. (MARM-20060OA2), 2015 WL 797972 (S.D.N.Y. Feb. 25, 2015); Homeward Residential, Inc. v. Sand Canyon Corp., 2017 WL 5256760 (S.D.N.Y. Nov. 13, 2017).
3. David Glick, *Conditional Strategic Retreat: The Court's Concession in the 1935 Gold Clause Cases*, 71 J. Pol. 800 (2009).

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