

## Southern District Civil Practice Roundup

## Expert Analysis

# In 'Ambac,' Judge Attempts to Make Sense of New York's Economic Loss Rule

New York's economic loss rule, which acts as a check on asserting tort claims for purely economic damages, has long confounded practitioners. The rule, intended to preserve the distinction between contract and tort law and to protect defendants from disproportionate damages, has its most straightforward application in products liability and construction cases, but has been applied in a broad array of cases. The resulting body of case law is both complicated and confusing. In his recent decision in *Ambac Assurance v. U.S. Bank National Association*, 2018 WL 3212456 (S.D.N.Y. June 29, 2018), Judge William H. Pauley III attempts to make sense of the economic loss rule in the context of litigation arising out of the collapse of the residential mortgage-backed securities (RMBS) market, exploring a split in authority within the Southern District of New York on the question of whether a plaintiff



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in an RMBS case seeking recovery for purely economic loss may assert claims for breach of fiduciary duty as well as for breach of contract. We discuss that decision below.

### 'Ambac v. U.S. Bank'

In broad strokes, the litigation before Judge Pauley involved claims by Ambac, as the insurer for a series of RMBS trusts, against U.S. Bank, the trustee of those trusts, for failing to take various actions against the originator of the underlying mortgages (Countrywide Home Loans, Inc. (Countrywide)) or the sponsor (Greenwich Capital Financial Products, Inc. (Greenwich)) who pooled and then transferred those loans ultimately to the trusts. During the loan securitization process, Countrywide made various representations and warranties to Greenwich about the

quality of the underlying loans, backed by Countrywide's obligation to cure or repurchase any beaching loan. Greenwich assigned those rights to U.S. Bank as trustee, which took on the obligation to enforce those rights for the benefit of the trust beneficiaries, and assumed certain contractual, common law and statutory obligations to protect trust assets.

As the insurer of the trusts, Ambac was an express trust beneficiary, and asserted claims for breach of contract and breach of fiduciary duty (as well as certain statutory breaches) against U.S. Bank for violation of those obligations. The essence of those claims was that because of its own shortcomings in originating, underwriting and servicing residential mortgage loans, U.S. Bank as trustee of the RMBS trusts composed of Countrywide loans, failed to enforce Countrywide's obligations in order to avoid scrutiny of its own practices and to maintain good relationships with its own counterparties. Ambac asserted that U.S. Bank's abdication of its responsibilities depleted the trust assets and deprived the trusts of recoveries resulting in Ambac paying more than \$300

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million in insurance claims.

U.S. Bank moved both to stay Ambac's claims under the *Colorado River* abstention doctrine based on what it claimed were parallel state proceedings, and alternatively to dismiss certain claims as time-barred, and on the merits, including under the economic loss rule. Judge Pauley rejected U.S. Bank's abstention argument, finding that the state proceedings in favor of which U.S. Bank sought the stay were not sufficiently parallel, despite significant overlap of issues, because Ambac was not a party to either action.

U.S. Bank's motion to dismiss on the merits turned on the extent of the overlap between Ambac's breach of contract and breach of fiduciary duty claims. It argued both that those claims were impermissibly duplicative, and that the breach of fiduciary duty claims were barred by New York's economic loss rule.

### Duplicative Contract and Fiduciary Duty Claims

Ambac asserted that U.S. Bank had breached its fiduciary duties to the trusts and their beneficiaries in two ways related to its failure to investigate the extent of Countrywide's breach of its representations and warranties, its failure to provide required notice to Countrywide of those breaches, and its failure to sue Countrywide to enforce its rights to have Countrywide cure or repurchase the breaching loans. Specifically, Ambac asserted that U.S. Bank breached its duty to act prudently and

in good faith to preserve trust assets after an event of default, as well as its duty to act with undivided loyalty to the trusts and their beneficiaries. Judge Pauley examined whether those claims could stand in light of New York law barring fiduciary duty claims that merely duplicate contract claims. That question turned on whether Ambac had alleged the breach of an independent legal duty that "spring[s] from circumstances extraneous to, and not constituting elements of, the contract," even

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if that duty was "connected with and dependent on the contract," (quoting *Clark-Fitzpatrick v. Long Island Railroad*, 70 N.Y.2d 382, 389 (1987) (alteration in original)). Under this analysis, Judge Pauley found that the claims based on U.S. Bank's duty to act prudently and in good faith were impermissibly duplicative of Ambac's breach of contract claims, but that the claims that U.S. Bank had breached its duty to act with undivided loyalty were sufficiently independent of the contract to survive.

With respect to U.S. Bank's duty to act prudently and in good faith, Judge

Pauley held that this duty was expressly incorporated into the operative contracts, which required U.S. Bank, upon an event of default, to exercise its contractual rights and powers with the "same degree of care and skill ... as a prudent man would exercise or use under the same circumstances in the conduct of his own affairs." Based on this contractual language, Judge Pauley concluded that U.S. Bank's duties to act prudently and in good faith were "essentially subsumed within the language of the [contracts] or else implied within their terms," and for that reason could not stand, (citing *Phoenix Light SF v. Bank of New York Mellon*, 2015 WL 5710645 (S.D.N.Y. Sept. 29, 2015) (Caproni, J.); *Fixed Income Shares: £Series M v. Citibank*, 130 F. Supp. 3d 842 (S.D.N.Y. 2015) (Furman, J)).

By contrast, Judge Pauley found that U.S. Bank's duty of undivided loyalty existed "separate and apart" from its duties memorialized in the contract, and that even though the same underlying conduct "undergirded" both Ambac's contractual and breach of the duty of loyalty claims, the latter were not subject to dismissal as duplicative.

### Economic Loss Rule

U.S. Bank also relied on New York's "economic loss rule" as a "second, distinct barrier" to Ambac's breach of fiduciary duty claims. The economic loss rule provides that "a tort action for economic loss will not lie where the parties' relationship is governed by an express contract." Judge Pauley

noted a split in authority in the Southern District of New York as to whether this rule bars breach of fiduciary claims against RMBS trustees. He cited two prior decisions, including his own opinion in *Commerzbank AG v. U.S. Bank National*, 277 F. Supp. 3d 483 (S.D.N.Y. 2017) and Judge John G. Koeltl's decision in *Phoenix Light SF v. Deutsche Bank National Train*, 172 F. Supp. 3d 700 (S.D.N.Y. 2016) holding that the economic loss rule did not bar such claims, and four decisions by Judges Katherine B. Forrest and Naomi Reice Buchwald dismissing such claims under the economic loss rule (*Phoenix Light SF v. U.S. Bank National*, 2016 WL 1169515 (S.D.N.Y. Mar. 22, 2016) (Forrest, J.); *Triaxx Prime CDO 2006-1, Ltd. v. Bank of N.Y. Mellon*, 2018 WL 1417850 (S.D.N.Y. Mar. 8, 2018) (Buchwald, J.); *Blackrock Core Bond Portfolio v. U.S. Bank National*, 165 F. Supp. 3d 80 (S.D.N.Y. 2016) (Forrest, J.); and *National Credit Union Administration Board v. U.S. Bank National*, 2016 WL 796850 (S.D.N.Y. Feb. 25, 2016) (Forrest, J.). Judge Pauley observed that "this schism centers on whether a defendant's alleged breach of extra-contractual legal duties is independently sufficient to foreclose application of the economic loss rule, or whether a plaintiff must also allege damages flowing from the tort claims that are independent of the damages flowing from the contract claims."

Judge Pauley adhered to his earlier decision in *Commerzbank* after an extended discussion of both the traditional "economic loss rule" and the

related "economic loss doctrine." He explained that the economic loss "rule" arose in the context of products liability cases and "precludes a recovery in tort for purely economic losses—without personal injury or property damage—against a manufacturer," whereas under the economic loss "doctrine" "a defendant is not liable in tort for purely economic loss unless the plaintiff demonstrates that the defendant owed a

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duty to protect against the risk of harm to plaintiff. He concluded that under either approach, Ambac's surviving claims for breach of the duty of undivided loyalty survived.

He noted first that under the economic loss "doctrine," Ambac had sufficiently alleged the requisite special duty of undivided loyalty to the trusts and their beneficiaries. Observing that such claims have faltered in other RMBS cases under the economic loss "rule," which focuses on the nature of the defect, the injury and the damages sought, Judge Pauley expressed doubt that the rule had application outside the products liability context. He went on to reason that even if the rule was applied in the RMBS context, the allegation that U.S. Bank had breached its extra-contractual duty of undivided

loyalty "suffice[d] to foreclose application of the economic loss rule."

By focusing on the existence of an independent duty rather than requiring independent damages, Judge Pauley parted company with those courts that have found that the economic loss framework barred breach of fiduciary claims in RMBS cases because separate damages were not alleged. He concluded that New York courts applying the economic loss framework in cases not involving products liability claims "have appeared to eschew a rigid damages-based rule in favor of a ... duty-focused analysis," and declined "to require Ambac to disaggregate the damages arising from its breach of contract and breach of fiduciary duty claims at this stage in the proceedings."

## Conclusion

Although Judge Pauley's decision in *Ambac v. U.S. Bank* arises in the context of an RMBS case, it provides an interesting and informative lens for viewing the interplay between contract and breach of fiduciary duty claims under New York law.