Representations & Warranties, Fraud, and Risk Shifting: An Analytical Framework

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Abstract

Do violations of contractual representations and warranties ("R&Ws") merely shift risk by giving rise to contract-breach damages, or can they also give rise to fraud claims? This question is at the heart of numerous lawsuits, including billions of dollars of securitization-related litigation. Many agreements governing the issuance of securities in these transactions limit R&W breach claims to a sole contractual remedy—curing the violation or repurchasing nonconforming loans that caused the violation. Although parties making the R&Ws argue that this sole remedy should adequately shift risk, investor plaintiffs contend that it insufficiently shifts the risk if the violations are extensive. Plaintiffs also argue that extensive R&W violations should constitute fraud, and that in the presence of fraud, their remedies should not be limited. This Article seeks to resolve these issues and provide a more systematic framework for analyzing R&W breaches.

Table of Contents

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Introduction

Do violations of contractual representations and warranties ("R&W") merely shift risk by giving rise to contract-breach damages, or can they also give rise to fraud claims? That question is at the heart of billions of dollars of ongoing litigation, including lawsuits arising out of the 2008 financial crisis for which statutes of limitation were tolled. This Article seeks to answer that question.

Many contracts include R&Ws in order to reallocate risk between the parties and reduce information asymmetry—the common scenario where one party to a transaction, such as the seller of an asset, has greater information than the buyer or other parties to the transaction.[1] When used in asset-sale agreements, R&Ws are assertions by a seller to the buyer about the quality of the assets being sold.[2] When used in financing agreements, R&Ws are assertions by a borrower to the lender about the borrower's financial condition, its ability to repay the financing, and the quality of the collateral.[3] Whichever the context, this Article refers to the parties providing these assertions as "warrantors."

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1 *See* Negotiating and Drafting Contract Boilerplate § 10.08(2)(b) (Tina L. Stark et al. eds., 1st ed. 2003) (discussing R&Ws as contractual tools of risk allocation); Sean J. Griffith, *Deal Insurance: Representation and Warranty Insurance in Mergers and Acquisitions*, 104 Minn. L. Rev. 1839, 1840 (2020) (discussing R&Ws as a contractual solution to information asymmetry between sellers and buyers). R&Ws also reduce adverse selection, which in this context refers to the possibility that a seller—who has more information about its assets than the buyer—will sell the buyer its least desirable assets of the type on sale. *See* Patricia A. McCoy & Susan Wachter, *Representations and Warranties: Why They Did Not Stop the Crisis*, *in* Evidence and Innovation in Housing Law and Policy 289, 293 (Lee Anne Fennell & Benjamin J. Keys eds., 2017); *see also* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488, 489–94 (1970). R&Ws that reduce asymmetric information about the assets will necessarily reduce adverse selection. *See id.* at 490–92. The use of R&Ws to reduce adverse selection is well-established in other risk-shifting settings, like insurance. *See* Kenneth S. Abraham & Daniel Schwarcz, Insurance Law and Regulation 11 (7th ed. 2020).

2 *See* U.C.C. § 2-313 (Am. L. Inst. & Unif. L. Comm'n 2021) (discussing express warranties made by sellers of goods).

3 *See infra* notes 88–97 and accompanying text (discussing R&Ws in lending).

This Article analyzes contractual R&Ws, including their use to reallocate risk and reduce information asymmetry. It also builds a systematic framework for analyzing R&W violations or breaches—the terms being used herein synonymously.[4] To provide real world grounding, this Article takes into account actual R&Ws used in business and finance, including those used in securitization transactions ("securitizations"). Described in more detail in Part I,[5] securitizations exemplify the current controversy over the meaning of R&Ws.[6] Because they incorporate the types of R&Ws found in both asset sales and financings,[7] securitizations also broadly represent the problems.

A warrantor that breaches an R&W normally would be liable for contract-breach damages,[8] which are calculated as expectation damages.[9] Expectation damages can be an inefficient remedy for R&W breach, however, because they cannot always be calculated and awarded without cost.[10] Professor Miller explains why:

> [C]alculating the purchaser's expectation damages for a breach of the seller's representations would require courts to determine the difference in value between the loan as represented

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4 *Cf. Breach*, Merriam-Webster, https://www.merriam-webster.com/dictionary/breach [https://perma.cc/CKA5-DE4W] (defining "breach" as an "infraction or violation of a law, obligation, tie, or standard").

5 *See infra* notes 30–42 and accompanying text.

6 *See infra* notes 22–28 and accompanying text (discussing the extensive litigation generated by said controversy).

7 *See infra* notes 35–42 and accompanying text.

8 *See* Stephen L. Sepinuck, *The Virtue of "Represents and Warrants": Another View*, Bus. L. Today, Nov. 2015, at 1. A breach of R&Ws originally was considered a tort. *See* Lyon Fin. Servs., Inc. v. Ill. Paper & Copier Co., 732 F.3d 755, 762–63 (7th Cir. 2013) (discussing the historical evolution of warranty law). Over time, however, "the warranty gradually came to be regarded as a term of the contract of sale . . . for which the normal remedy is a contract action." William L. Prosser, Handbook of the Law of Torts 651 (3d ed. 1964); *see also* Sidney Kwestel, *Freedom from Reliance: A Contract Approach to Express Warranty*, 26 Suffolk U. L. Rev. 959, 969 (1992) (arguing that warranties should be guided "solely [by] general contract principles"); Indeck N. Am. Power Fund, L.P. v. Norweb plc, 735 N.E.2d 649, 658–59 (Ill. App. Ct. 2000) (agreeing with New York courts that "warranty is a creature of contract"); *Ex parte* Miller, 693 So. 2d 1372, 1376 (Ala. 1997) (holding that "[e]xpress warranties should be treated like any other type of contract and interpreted according to general contract principles"). Solely for perspective, the Author notes, based on his almost thirty-year experience interacting with economic scholars in a law-and-economic context, that economists sometimes emphasize the purpose of R&Ws as being more to reduce information-asymmetry-based incentives for misbehavior than to impose liability for breach.

9 Robert T. Miller, *The RMBS Put-Back Litigations and the Efficient Allocation of Endogenous Risk Over Time*, 34 Rev. Banking & Fin. L. 255, 290–91 (2014); Tina L. Stark, *Another View on Reps and Warranties*, Bus. L. Today, Jan.–Feb. 2006, at 8–9.

10 *See* Miller, *supra* note 9, at 290–91. Professor Miller observes that expectation damages can be an especially inefficient remedy "when the purchaser alleges breaches of representations about many loans, [because] the inquiry would have to be performed separately for each loan." *Id.* at 291.

> in the contract and the actual value of the loan as it really existed. The former would be extremely difficult to determine, and if the court actually undertook such an inquiry, the results would be highly unpredictable . . . . The value of the loan as it actually existed at the time of suit, however, would be even more difficult to determine, and given the relatively small value of an individual loan (generally no more than a few hundred thousand dollars), the transaction costs involved in determining its true value would be huge in relation to the amount in controversy. Moreover, when the purchaser alleges breaches of representations about many loans, the inquiry would have to be performed separately for each loan.[11]

Parties, therefore, have searched for alternative breach remedies, settling on a "cure-or-repurchase" remedy.[12] This remedy requires the warrantors either to correct—or "cure"—the violation or to repurchase nonconforming loans that caused the violation.[13] Many, if not most, securitization agreements now provide this remedy as the sole remedy for R&W breach.[14]

Warrantors argue that contracting parties—including investors, which at least in a securitization context are mostly large, and thus presumably sophisticated, financial institutions[15]—routinely agree to this

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11 *Id.*

12 *Id.* at 284.

13 *Id.* The New York Court of Appeals describes the cure-or-repurchase remedy as follows:

> [T]he remedy for breach of any of these imported representations and warranties and the remedy "with respect to any defective Mortgage Loan or any Mortgage Loan as to which there has been a breach of representation or warranty" under the Securitization Documents "shall be limited to the remedies specified" in the applicable Securitization Documents. In turn, the limited remedy provided in the Securitization Documents requires Countrywide [the applicable warrantor] to either repurchase [or] cure . . . nonconforming loans.

Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 106 N.E.3d 1176, 1180 (N.Y. 2018) (quoting insurance agreement). The quoted language also contemplated substituting conforming loans for nonconforming loans, but that option is very limited due to tax consequences. Howard Ro, *A Road Map of Tax Consequences of Modifying Debt*, Tax Adviser (June 1, 2012), https://www.thetaxadviser.com/issues/2012/jun/ro-jun2012.html [https://perma.cc/E96K-YMV2] ("[T]here could be adverse tax consequences to the borrower, lender, or purchaser of debt if there is a significant modification of the debt instrument.").

14 *See* Miller, *supra* note 9, at 293. The Author also observed this cure-or-repurchase remedy in his capacity as an expert witness in 20–30 mortgage-backed securities ("MBS") litigations, and many included R&W breaches among other claims. For more on the intricacies of R&W-breach litigations, see Tracy Lewis & Alan Schwartz, *Unenforceable Securitization Contracts*, 37 Yale J. on Regul. 164, 192–97 (2020).

15 *See, e.g.*, June Rhee, *Getting Residential Mortgage-Backed Securities Right: Why Governance Matters*, 20 Stan. J.L., Bus. & Fin. 273, 275 (2015) (stating that securitization investors were generally considered "sophisticated" market participants); *cf.* 17 C.F.R. § 230.144A(a)(1) (2022)

remedy.[16] Warrantors also contend that this remedy should adequately shift risk.[17] Investor plaintiffs counter, however, that this remedy insufficiently shifts risk if the violations are extensive because the costs necessary to establish the existence of extensive violations and to prove causation can be prohibitively expensive.[18] They also contend that extensive R&W violations should constitute fraud[19] and that, in the presence of fraud, their remedies should not be limited.[20] Fraud claims can go beyond contract-breach damages and can even give rise to punitive damages.[21]

These disputes are prevalent. In numerous securitizations—especially those predating the 2008 financial crisis—more than 50%, and in some cases more than 80%, of the underlying loans are estimated to have breached one or more R&Ws.[22] In response, investors and government agencies have filed hundreds of securitization-related lawsuits, alleging extensive R&W breaches.[23] Insurers of securitizations

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(requiring ownership or management of "at least $100 million [of] securities" for many definitions of "qualified institutional buyer").

16 *See, e.g.*, Brief for Defendant-Respondent/Cross-Appellant at 2–9, Nomura Home Equity Loan, Inc. v. Nomura Credit & Cap., Inc., 19 N.Y.S.3d 1 (App. Div. 2015) (No. 650337/13) (arguing that a remedies limitation in a contract represents the parties' agreement on the allocation of economic risk); Brief for Defendants-Respondents at 21–23, *In re* Part 60 Put-Back Litig., 93 N.Y.S.3d 269 (App. Div. 2019) (No. 652877/14) (arguing that the sole remedy provision provides an adequate remedy for R&W breaches).

17 *See* Brief for Defendant-Respondent/Cross-Appellant at 44 n.38, *Nomura Home Equity Loan, Inc.*, 19 N.Y.S.3d 1 (No. 650337/13).

18 *See infra* notes 179–97 and accompanying text (analyzing these arguments). This Article's use of the term "extensive" is intended to cover such synonymous terms as "widespread" and "pervasive."

19 *See* Richard E. Gottlieb, Fredrick S. Levin, Amanda Raines Lawrence & A. Paul Heeringa, *Recent Developments in Residential Mortgage-Backed Securities Litigation*, 71 Bus. Law. 689, 691 (2016) (observing that the theories of liability in these lawsuits "primarily have been couched in . . . breach of contract" and fraud based on R&W breaches).

20 *See, e.g.*, Lone Star Fund V (U.S.), L.P. v. Barclays Bank PLC, No. 3:08-CV-0261-L, 2008 WL 4449508, at *9 (N.D. Tex. Sept. 30, 2008), *aff'd*, 594 F.3d 383 (5th Cir. 2010) (observing that the complaint asserts fraud claims which, under applicable law, cannot be limited by sole remedy provisions); Precision Castparts Corp. v. Schultz Holding GmbH & Co. KG, No. 20-cv-3029, 2020 U.S. Dist. LEXIS 125112, at *11–*13 (S.D.N.Y. July 15, 2020) (not enforcing a cap on indemnification in a sales agreement because the cap was fraudulently induced); Online HealthNow, Inc. v. CIP OCL Invs., LLC, No. 2020-0654, 2021 Del. Ch. Lexis 173, at *28–49 (Del. Ch. Aug. 12, 2021) (not enforcing a postclosing liability bar in a stock purchase agreement where the seller knowingly made false representations); *see also* 1 M & A Practice Guide § 14.04 (Stephen I. Glover, et al. eds., 2023) (discussing cases not enforcing a fraudulently induced cap on indemnification in merger and acquisition ("M&A") agreements).

21 *See* Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Tort Liability*, 64 Bus. Law. 999, 1017 (2009).

22 Mark Adelson, *Representations and Warranties in Mortgage-Backed Securities*, 23 J. Structured Fin. 98, 100–01 (2017).

23 *See, e.g.*, Emily Strauss, *Crisis Construction in Contract Boilerplate*, 82 L. & Contemp. Probs. 163, 167 (2019); *see also* John A. Ruddy, Murli Rajan & Iordanis Petsas, *A Study of RMBS*

have similarly filed numerous lawsuits, claiming "fraudulent inducement, breach of contract, and other violations."[24] Additionally, investors have sued indenture trustees on securitization contracts[25] for failing to require the warrantors to repurchase nonconforming loans.[26]

Settlements to date have ranged from a few million dollars to more than $15 billion.[27] "[T]he banking industry [alone] has [already] incurred $200 billion in [aggregate] fines, settlements[,] and related legal costs."[28] Many lawsuits remain ongoing and "[n]ew cases are still being filed, based on long-standing tolling agreements."[29] The outcome of billions of dollars of litigation thus turns on whether these R&W breaches merely contractually shift risk or could also constitute fraud. This Article seeks to resolve that issue as well as to provide a more systematic framework for generally analyzing R&W breaches.

This Article proceeds as follows. Part I reviews R&Ws used in securitizations and explains how R&Ws can reallocate risk and reduce information asymmetry. It also describes the cure-or-repurchase sole remedy for R&W breaches and discusses the resulting litigation. Part II provides a comparative overview of how R&Ws are used in other business and financial contexts, including sales of goods and services, lending, and merger-and-acquisition transactions. Finally, Part III analyzes the boundary between risk shifting and fraud, first historically and then normatively. That analysis also examines whether the existence of extensive R&W violations, even if unintended, should justify extracontractual claims that override sole remedy provisions.

Litigation Cases of Six Major U.S. Banks, 23 J. Structured Fin. 91, 91 (2017). For definitions of "MBS" and "RMBS," see *infra* note 31.

24 Jonathan Sablone, Troy K. Lieberman & Christopher E. Queenin, *RMBS Litigation: The Insurers as Victims?*, 26 J. Tax'n & Regul. Fin. Insts. 31, 33 (2013).

25 These contracts typically are called pooling and service agreements or indentures. Rhee, *supra* note 15, at 284; Houman B. Shadab, Note, *Interpreting Indentures: How Disequilibrium Economics and Financial Asset Specificity Support Narrow Interpretation*, 75 S. Cal. L. Rev. 763, 764 (2002).

26 Rhee, *supra* note 15, at 314.

27 Adelson, *supra* note 22, at 101–03 (providing tables of selected settlements).

28 Ruddy et al., *supra* note 23, at 98.

29 Donald Hawthorne, *NY Decision Does Not Mean the End of RMBS Litigation*, Law360 (June 9, 2022, 6:04 PM), https://www.law360.com/articles/1500620/ny-decision-does-not-mean-the-end-of-rmbs-litigation [https://perma.cc/D9PE-G4Z8] ("Cases continue to proceed against the banks that originated mortgage loans and created RMBS and against the trustees and servicers of those securitizations. . . . [T]here may be more to come. Hundreds of millions of dollars remain at stake."); *see also* Strauss, *supra* note 23, at 167 ("MBSs are creatures of contract, and much of the financial crisis litigation that remains is composed of contract claims, which typically have longer statutes of limitations.").

I. R&Ws Used in Securitization Transactions

Securitizations typify the R&Ws found in both asset-sale and financing agreements and also exemplify the R&W-breach controversy.[30] In these transactions, the sponsor of the securitization ("sponsor") purchases a pool, or large quantity, of mortgage loans or other rights to payment (collectively, "loans"[31]) from firms originating those loans ("originators") and then sells them to a special purpose entity ("SPE").[32] To this extent, securitizations represent asset sales—the sales of the loans.[33] The originators and the sponsor typically act as warrantors,[34] making customary asset-sale R&Ws in favor of the SPE and its investors.[35] Those R&Ws cover the quality of the loans being sold,[36] including maintenance of the loan-underwriting[37] standards,[38] the fact that there is no adverse selection, and the creditworthiness of the loans and their collateral.[39]

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30 *See supra* notes 6–8 and accompanying text.

31 Securitizations of mortgage loans are often referred to, in the securitization industry, by the MBS issued therein. Sec. Indus. & Fin. Mkts. Ass'n, MBS Fact Sheet 1 (2011), https://www.sifma.org/wp-content/uploads/2018/01/MBS_FactSheet.pdf [https://perma.cc/P69M-SXP3]. References to "RMBS" simply mean securitizations involving the issuance of residential mortgage-backed securities—that is, securities that are backed or secured by home mortgage loans. *Id.* at 1.

32 *See* Steven L. Schwarcz, *What Is Securitization? And for What Purpose?*, 85 S. Cal. L. Rev. 1283, 1292–93, 1295–98 (2012).

33 *Cf. supra* note 13 and accompanying text (observing that loans are the relevant assets being sold in a securitization).

34 In the Author's experience as a lawyer and expert witness for thirty-five years, the originators make R&Ws to the sponsor and its transferees when they sell the sponsor their loans; the sponsor then makes some or all of these R&Ws to the SPE and investors when it sells the SPE the loans it purchased from the originators.

35 Those investors are investors in the SPE's debt securities. *See infra* note 40 and accompanying text.

36 *See* U.C.C. § 2-313 *supra* note 2 and accompanying text (observing that R&Ws in asset-sale agreements are assertions by a seller to the buyer about the quality of the assets being sold); Adelson, *supra* note 22, at 98 (stating that R&Ws "[we]re essential elements of the transaction" and that "[t]here would be no private-label MBS without R&Ws").

37 Loan-underwriting guidelines are the guidelines under which a loan should be originated—that is, made. *See* FDIC, Div. Supervision & Consumer Prot., Risk Mgmt. Examination Manual for Credit Card Activities 40 (Mar. 2007), https://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch7.pdf [https://perma.cc/XL5P-8W3J]. The use of the term "underwriting" in this context should be distinguished from the term's use in connection with the sale of securities, in which "underwriting" refers to an investment bank facilitating that sale by either buying the securities and reselling them to investors or acting as the seller's agent in arranging that sale to investors. *See Underwriting the Offering: Overview of a Securities Offering Underwriting Process*, Bloomberg L., https://www.bloomberglaw.com/document/XE1RB1QS000000 [https://perma.cc/L74N-XF3A].

38 *See* Adelson, *supra* note 22, at 102.

39 *See* Miller, *supra* note 9, at 270–71. For RMBS, for example, the R&Ws about the quality of the loans and their collateral cover such matters as the loan-to-income and the debt-to-income

Securitization R&Ws also typify those found in financing agreements. Securitizations represent financings for two reasons: the SPE raises money to purchase the loans by issuing debt securities to investors, which are repayable from collections on the loans,[40] and the loan sales are actually priced as financings secured by the loans.[41] Accordingly, each warrantor makes customary financing-related R&Ws in favor of the SPE and its investors covering the warrantor's legal existence, the enforceability of the securitization agreements, and the absence of fraud or any violation of law or contract.[42]

A. Reallocating Risk and Reducing Information Asymmetry

The history of securitization shows that these customary asset-sale and financing-related R&Ws are intended to reallocate risk and reduce information asymmetry. Securitization began in the 1970s as a way to enable lenders, especially mortgage lenders, to multiply their financing capacity.[43] Traditionally, lenders held loans in their portfolio.[44] Securitization allows lenders to monetize—or securitize—those loans by effectively transforming them into securities sold to investors.[45] Lenders then can use the cash generated in the securitization to make new loans.[46]

Securitizations were originally arranged through a government-sponsored enterprise ("GSE"), like Fannie Mae[47] or Freddie

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ratios of the borrowers on those loans, the loan-to-value ratio of the mortgaged property, and the occupancy status of the mortgaged property. *See* Adelson, *supra* note 22, at 98; *see also* John Dunbar & David Donald, *The Roots of the Financial Crisis: Who Is to Blame?*, Ctr. for Pub. Integrity (May 6, 2009), https://publicintegrity.org/inequality-poverty-opportunity:the-roots-of-the-financial-crisis-who-is-to-blame/ [https://perma.cc/8CAW-MH7H].

40 Schwarcz, *supra* note 32, at 1295.

41 *See, e.g.*, Steven L. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 J. Corp. L. 1097, 1115 (2006) (explaining that all securitizations, economically, have loan-like pricing); *cf.* U.C.C. § 9-109 cmt. 4 (Am. L. Inst. & Unif. L. Comm'n 2021). Article 9 of the UCC (Secured Transactions) also covers sales of rights to payment in order to "avoid[] difficult problems of distinguishing between transactions in which a [right to payment] secures a[financing] obligation and those in which the [right to payment] has been sold outright. In many commercial financing transactions [alluding most especially to securitizations] the distinction is blurred." *Id*.

42 *See infra* note 91 and accompanying text.

43 *See* McCoy & Wachter, *supra* note 1, at 290; *see also* Aron M. Zuckerman, Note, *Securitization Reform: A Coasean Cost Analysis*, 1 Harv. Bus. L. Rev. 303, 307–08 (2011).

44 McCoy & Wachter, *supra* note 1, at 290.

45 *See id.* at 1.

46 *See, e.g.*, Zuckerman, *supra* note 43, at 306–08 (discussing the "[b]enefits of [s]ecuritization); Steven L. Schwarcz, *Securitization and Post-Crisis Financial Regulation*, 101 Cornell L. Rev. Online 115, 117 (2016) (explaining that securitization allows "originators to multiply their available funding by selling off their loans for cash").

47 Fannie Mae is a portmanteau of the Federal National Mortgage Association.

Mac,[48] but over time, private securitizations became the principal funding mechanism.[49] Although the shift to private securitizations expanded lending capacity, it also increased investor risk.[50] Private securitizers, unlike the GSEs, were not subject to regulatory oversight and constraints, and they allegedly did not always bear credit risk on the loans being sold.[51] Information asymmetry became an issue because, "know[ing] more about the quality of the loans . . . than investors," originators "ha[d] incentives to conceal negative information when selling th[e] loans."[52] Adverse selection also became a concern because investors feared that sponsors and "originators would retain their best loans and securitize the rest."[53]

Because of the high cost of verifying information, investors needed assurances about the quality of the loans underlying the securitizations.[54] To provide those assurances, sponsors and originators began providing R&Ws along the lines previously discussed.[55]

B. Sole Remedies for R&W Breach and Resulting Litigation

Because expectation damages cannot always be calculated and awarded without cost,[56] parties to securitizations began using cure-or-repurchase as the sole remedy for an R&W breach.[57] Most securitization agreements now provide this sole remedy.[58]

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48 Freddie Mac is a portmanteau of the Federal Home Loan Mortgage Corporation.

49 *See* Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 Geo. L.J. 1177, 1182–83 (2012).

50 *Id.* at 1183.

51 *See* McCoy & Wachter, *supra* note 1, at 289; *cf.* Levitin & Wachter, *supra* note 49, at 1189.

52 McCoy & Wachter, *supra* note 1, at 293. Concealing that information would not violate Rule 10b-5 or other provisions of federal securities law because the loans themselves are not securities. *See, e.g.*, Kirschner v. JPMorgan Chase Bank, N.A., No. 17 Civ. 6334, 2020 WL 2614765, at *10 (S.D.N.Y. May 22, 2020) (finding that a syndicated bank loan is not a security).

53 McCoy & Wachter, *supra* note 1, at 293; *cf.* Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru & Vikrant Vig, *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans*, 125 Q.J. Econ. 307, 311 (2010); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2039, 2057 (2007) (explaining that securitization "investors . . . demand a . . . premium . . . for the risk of adverse selection").

54 *See* McCoy & Wachter, *supra* note 1, at 290.

55 *See supra* notes 37–42 and accompanying text; *see also* Strauss, *supra* note 23, at 168 ("[R]epresentations and warranties are designed to help address the information asymmetries inherent in the securitization process . . . ."); Adam B. Ashcraft & Til Schuermann, Understanding the Securitization of Subprime Mortgage Credit 7 (Fed. Rsrv. Bank N.Y. Staff Reps. No. 318 2008) ("[T]he information advantage of the arranger creates a standard lemons problem."); Engel & McCoy, *supra* note 53, at 2057 (describing securitizations as possessing a "lemons problem").

56 *Supra* notes 10–11 and accompanying text.

57 *Supra* notes 13–14 and accompanying text.

58 *Supra* notes 13–14 and accompanying text.

The 2008 financial crisis led to widespread defaults on the mortgage loans underlying many securitizations, causing massive investor losses.[59] To try to recover these losses, investors filed hundreds of lawsuits—many of which remain ongoing—arguing that widespread defaults on the mortgage loans must be caused by extensive R&W violations and that such violations should justify overriding the cure-or-repurchase sole remedy.[60] "The theories of liability in th[e]se [cases] primarily have been couched in terms of breach of contract based on breaches of representations and warranties and common law fraud."[61]

Under the limited authorities to date, some courts and commentators would disallow fraud claims based on R&W violations, even if extensive.[62] Their rationale is that sophisticated parties should have "freedom of contract . . . to allocate" their respective "risks and responsibilities."[63] Others suggest, to the contrary, that R&W violations, even if unintentional,[64] might justify a fraud-like rescission remedy if such violations are "so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract."[65]

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59 *See* William Constantine, Developments in Banking and Financial Law, *Justice or Retribution: The S&P Downgrade and Lawsuit*, 33 Rev. Banking & Fin. L. 504, 510 (2014).

60 *See supra* notes 22–29 and accompanying text.

61 Gottlieb et al., *supra* note 19. Plaintiffs in several cases use a fraud-related theory to try to obtain greater damages than they would from sole remedy provisions. *See, e.g.*, Assured Guar. Mun. Corp. v. Flagstar Bank, FSB, 920 F. Supp. 2d 475, 477 (S.D.N.Y. 2013); CMFG Life Ins. Co. v. UBS Sec., 30 F. Supp. 3d 822, 824 (W.D. Wis. 2014); MBIA Ins. Corp. v. Countrywide Home Loans, Inc., 928 N.Y.S.2d 229, 231 (App. Div. 2011); Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc., 104 F. Supp. 3d 441, 453 (S.D.N.Y. 2015).

62 *See* Frederick R. Fucci, *Arbitration in M&A Transactions: Laws of New York and Delaware, Part III*, 71 Disp. Resol. J. 1, 11–12 (2016); *cf.* DynCorp v. GTE Corp., 215 F. Supp. 2d 308, 324 (S.D.N.Y. 2002) (explaining that, under New York law, fraud claims for breaching R&Ws can only be sustained if the plaintiff "can . . . demonstrate a legal duty separate from the . . . contract" or "a fraudulent misrepresentation . . . extraneous to the contract").

63 Fucci, *supra* note 62, at 12; *see also* E. River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 873 (1986) (commenting that courts should not "intrude into the [sophisticated] parties' allocation of risk"); Koch Indus., Inc. v. Aktiengesellschaft, 727 F. Supp. 2d 199, 216 (S.D.N.Y. 2010) (ruling that the sophistication of the plaintiffs weighed against them bringing a fraud claim to escape the sole remedy provision in their contract).

64 Intentional R&W violations do constitute fraud. *See, e.g.*, Graham v. James, 144 F.3d 229, 237 (2d Cir. 1998).

65 *Id.* (quoting Septembertide Publ'g, B.V. v. Stein & Day, Inc., 884 F.2d 675, 678 (2d Cir. 1989)); *cf.* Richard R.W. Brooks & Alexander Stremitzer, *Remedies On and Off Contract*, 120 Yale L.J. 690, 693 (2011) (arguing that "a . . . liberal right [to] rescission" would incentivize counterparties "to enhance the quality of performance" and improve contract efficiency); Lummus Co. v. Commonwealth Oil Refin. Co. 280 F.2d 915, 925 (1st Cir. 1960) (a party fraudulently induced to enter into a contract may elect to rescind the contract instead of seeking damages).

II. R&Ws Used in Other Business Contexts

To place these issues into a comparative context as well as to ensure completeness, Sections II.A, II.B, and II.C next examine how R&Ws are used in other business—including financial—contexts. That examination also explores similarities and differences in these uses of R&Ws. Thereafter, Section II.D summarizes the comparative insights, showing that R&Ws are widely used to reallocate risk and reduce information asymmetry regardless of the business context.

A. Sales of Goods and Services

1. Sales of Goods

Information asymmetries commonly arise in the sale of goods, epitomized by the classic "lemons problem" of selling a used car.[66] To assure buyers, sellers typically must make R&Ws about the condition of the car, including whether it has been in an accident or has a tendency to break down.[67]

The Uniform Commercial Code ("UCC") provides a comprehensive legal framework for using R&Ws to facilitate the sale of goods. Besides permitting express R&Ws,[68] it provides, "[u]nless excluded or modified" by the parties, that every sales contract by a merchant contains an implied warranty of merchantability, meaning that the goods "are fit for the ordinary purposes for which [they] are used" and satisfy other minimum quality standards.[69] This reflects the commercial reality that "the seller is generally in a better position than the buyer to control and evaluate the quality of the goods."[70]

The UCC's R&W framework applies to all transactions in goods "regardless of the dollar amount involved, the complexity . . . of the goods sold," or the sophistication "of the contracting parties."[71] Courts nonetheless consider buyer sophistication when assessing whether to enforce contractual limitations on R&Ws. For example, a court is more likely to find that a disclaimer of an implied warranty of merchantability

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66 *See* Akerlof, *supra* note 1, at 489–92.

67 *See id.* at 489, 499 (discussing R&Ws and other forms of seller guarantees as a market mechanism to help solve the problem of asymmetric information when selling used cars).

68 U.C.C. § 2-313 (Am. L. Inst. & Unif. L. Comm'n 2021).

69 *Id.* § 2-314.

70 Ellen Taylor, *Applicability of Strict Liability Warranty Theories to Service Transactions*, 47 S.C. L. Rev. 231, 262–63 (1996); *cf.* Curtis R. Reitz, *Manufacturers' Warranties of Consumer Goods*, 75 Wash. U. L.Q. 357, 359 (1997).

71 Edith Resnick Warkentine, *Article 2 Revisions: An Opportunity to Protect Consumers and "Merchant/Consumers" Through Default Provisions*, 30 J. Marshall L. Rev. 39, 44 (1996).

is "conspicuous,"[72] and thus enforceable, if the buyer is sophisticated.[73] R&Ws used in the sale of goods and those used in securitizations have important similarities but, for purposes of this Article's analysis, unimportant differences. As is standard, both types of R&Ws are intended to reallocate risk and reduce information asymmetry.[74] Also, both types of R&Ws can be expressly agreed to.[75]

Another similarity is that contracts for the sale of goods, like securitization contracts, sometimes limit buyers to a sole remedy for an R&W breach. The UCC allows sellers to limit the buyer's remedies by "expressly agree[ing]" that a certain remedy is "exclusive, in which case it is the sole remedy."[76] A sole remedy provision will be respected unless it "fail[s] of its essential purpose."[77] Courts often consider the sophistication of a buyer when deciding whether a remedy has failed its essential purpose;[78] other things being equal, the more sophisticated the buyer, the less likely a court is to find that the remedy has failed its purpose.[79]

As mentioned, the differences between R&Ws used in the sale of goods and those used in securitizations are unimportant. One difference is that R&Ws used in the sale of goods, unlike those used in securitizations, need not always be expressly agreed to.[80] This difference is irrelevant to this Article's analysis. The other difference is likewise

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72 *See* U.C.C. § 2-316(2) (Am. L. Inst. & Unif. L. Comm'n 2021) (requiring any exclusion or modification of an implied warranty of merchantability to "be conspicuous").

73 *See* Warkentine, *supra* note 71, at 61–65; *cf.* Meredith R. Miller, *Party Sophistication and Value Pluralism in Contract*, 29 Touro L. Rev. 659, 679 (2013) ("For sophisticated parties, . . . a rules-driven and a-contextual approach . . . lends itself to efficiency, predictability, and certainty.").

74 *Supra* Section I.A; *see also supra* notes 69–71 and accompanying text.

75 U.C.C. § 2-313 (Am. L. Inst. & Unif. L. Comm'n 2021); *see* McCoy & Wachter, *supra* note 1, at 293 (observing that because R&Ws in securitizations are negotiated, they can vary significantly).

76 U.C.C. § 2-719(1)(b) (Am. L. Inst. & Unif. L. Comm'n 2021).

77 *Id.* § 2-719(2); *see also id.* § 2-719 cmt. 1 ("[I]t is of the very essence of a sales [of goods] contract that at least minimum adequate remedies be available . . . . Thus any clause purporting to modify or limit the remedial provisions of this [UCC] Article [2] in an unconscionable manner is subject to deletion . . . ."); *cf.* Sunny Indus., Inc. v. Rockwell Int'l Corp., Nos. 98-2824, 98-2875, 1999 U.S. App. LEXIS 7001, at *30 (7th Cir. Apr. 12, 1999) (explaining that "the UCC merely seeks to provide a buyer with the substance for which it bargained"). Unconscionability alone should not apply to securitizations because the traditional elements determining unconscionability—bargaining power, inequality, unsophistication of one party, and surprise in the inclusion of limited remedy—are inapplicable to those transactions. *See* Telecom Int'l Am., Ltd. v. AT&T Corp., 280 F.3d 175, 195 (2d Cir. 2001).

78 Meredith R. Miller, *Contract Law, Party Sophistication and the New Formalism*, 75 Mo. L. Rev. 493, 511–12 (2010).

79 *Id.* Also, the failure of a sole remedy to provide relief in certain situations does not mean it fails in its essential purpose because "the whole point of limiting remedies is to make some remedies unavailable." S. Fin. Grp., LLC v. McFarland State Bank, 763 F.3d 735, 741 (7th Cir. 2014).

80 *See supra* note 69 and accompanying text (discussing the UCC's implied warranty of merchantability).

unimportant: R&Ws used in the sale of goods may warrant both their quality at the time of sale as well as their "output" quality—the latter meaning that the goods will function in a certain manner going forward.[81] In contrast, R&Ws used in securitizations typically warrant only the quality of the loans at the time of their sale.[82] This difference is unimportant to this Article's analysis because it merely reflects that goods are tangible assets whereas loans are intangible rights to payment.[83]

2. Sales of Services

R&Ws are sometimes used in connection with the sales of services.[84] Most service-related R&Ws are express warranties as courts generally refuse to extend UCC-like implied warranties to services contracts.[85]

There are two arguments for not extending implied warranties to services. In the case of professional services, the "buyers" of such services

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81 Lewis & Schwartz, *supra* note 14, at 172.

82 This observation is based on the Author's experience as a lawyer, a scholar of securitizations, and an expert witness for almost forty Years. *Cf.* Phillip Wm. Lear, *Representations, Warranties, Covenants, Conditions, and Indemnities: Stitching Them Together in the Purchase Agreement*, *in* 37 Rocky Mountain Mineral Law Foundation Annual Institute § 3.02 (1991) (quoting *Representation*, Black's Law Dictionary (abr. 5th ed. 1983)) (explaining that R&Ws generally relate to past or existing facts that were given "before or at the time of making the contract").

83 Under the old adage that "possession is nine-tenths of the law," the physical transfer of goods strongly evidences their sale. *See* K-Sue Park, *The History Wars and Property Law: Conquest and Slavery as Foundational to the Field*, 131 Yale L.J. 1062, 1121 (2022). Because loans are intangible rights that are not physically transferred, a complex body of jurisprudence surrounds whether or not they are sold. *See* Benedict v. Ratner 268 U.S. 353, 362 (1925) (Justice Brandeis observing that in the "transfer" of rights to payment, "there is nothing which corresponds to the delivery of possession of chattels"). A key factor in that jurisprudence is the degree of recourse that the buyer of the loan has against the seller if the loan fails to pay out according to its terms. *See, e.g.*, Steven L. Schwarcz, Structured Finance, A Guide to the Principles of Asset Securitization § 4:2 (Adam D. Ford ed., 3d ed. 2002) ("The most significant factor in the true sale determination [of rights to payment] appears to be the nature and extent of recourse that the transferee of the [rights to payment] has against the transferor."). "As the degree of recourse increases, the likelihood that a court will find a true sale decreases." *Id.* R&Ws as to the "output" quality of a loan, warranting that the loan will pay out going forward, are thus rarely used because they would introduce a degree of recourse that could undermine the loan's sale. For example, in the leading case of *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 449 F. Supp. 538 (E.D. Pa. 1978), *aff'd*, 602 F.2d 538 (3d Cir. 1979), the court analyzed the recourse provisions in an accounts receivable financing agreement to determine whether the transaction should be considered a sale or a secured loan. In holding the transaction to be a secured loan, the court reasoned that Castle attempted to shift all risks to Major's and incur none of the risks or obligations of ownership. *Id.* at 543.

84 *E.g.*, Stacy-Ann Elvy, *Hybrid Transactions and the INTERNET of Things: Goods, Services, or Software?*, 74 Wash. & Lee L. Rev. 77, 117 (2017).

85 *Id.* Service buyers still may have negligence claims based on an implied duty of care. *Id.* at 116 n.152 (citing Cargill, Inc. v. Ron Burge Trucking, Inc., No. 11-2394, 2013 WL 608520, at *3 (D. Minn. Feb. 19, 2013)).

are often unqualified to evaluate the quality of the services.[86] Furthermore, buyers of professional services do not buy a result but merely the diligence, care, and skill of a professional, which lends itself better to a noncontractual negligence claim.[87] These arguments are largely irrelevant to the types of R&Ws generally discussed in this Article.

B. Lending

In lending transactions, R&Ws help to reallocate risk and reduce information asymmetry by assuring the lender that it will be repaid in full, with interest, on a timely basis. To this end, the borrower of an unsecured loan typically makes R&Ws that it is legally bound under the loan agreement and any promissory notes;[88] its performance of those documents will not violate law or contract;[89] there has been no material adverse change in the borrower's financial condition or results of operations since a given reference date; no litigation is pending or threatened that would result in such a material adverse change;[90] and the information provided by the borrower in connection with the loan is true, complete, and accurate in all material respects.[91] These R&Ws sometimes also cover the borrower's creditworthiness.[92] For secured

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86 Taylor, *supra* note 70, at 263.

87 *See* Dana Shelhimer, Comment, *Sales-Service Hybrid Transactions and the Strict Liability Dilemma*, 43 Sw. L.J. 785, 793 (1989); David Crump & Larry A. Maxwell, *Should Health Service Providers Be Strictly Liable for Product-Related Injuries? A Legal and Economic Analysis*, 36 Sw. L.J. 831, 836 (1982). Some also argue that sellers of services usually "lack the large . . . pool necessary to spread their losses effectively," in contrast to sellers of goods who may be better situated to spread the risk of losses. Shelhimer, *supra*, at 792.

88 These usually state that the borrower is duly organized and validly existing under the law of the jurisdiction of its organization, that it has duly authorized, executed, and delivered the loan agreement and any promissory notes, and that such loan agreement and promissory notes are the borrower's legal, valid, and binding obligations, enforceable against the borrower in accordance with their terms. *See infra* note 91.

89 These usually state that the execution and delivery by the borrower of such loan agreement and promissory notes do not, and the performance by the borrower of its obligations thereunder will not, result in a violation of the borrower's organizational documents or any contract to which the borrower is a party or any law, rule, or regulation applicable to the borrower. *See infra* note 91.

90 These usually state that there are no actions, suits, proceedings, or investigations pending or threatened against the borrower that would, individually or in the aggregate, be reasonably expected to result in any such material adverse change. *See infra* note 91.

91 The above R&Ws, *see supra* notes 88–90 and accompanying text, reflect the Author's extensive experience as a lawyer, partner, and practice group chair at two of the world's leading law firms, whose practice included securitizations and other financings. *Cf.* The TriBar Opinion Committee, *Third-Party "Closing" Opinions*, 53 Bus. Law. 591, 667–68 (1998) (illustrating a representative third-party legal opinion for a lending transaction, which substantively parallels many of the R&Ws delivered by the borrower itself).

92 Loan agreements more usually include assertions about a borrower's creditworthiness as ongoing covenants, rather than fixed-in-time R&Ws. *See infra* note 93.

loans, the borrower typically makes additional R&Ws covering the perfection, priority, enforceability, and value of the collateral.[93]

In securitizations, the warrantors typically make these same kinds of R&Ws. The kinds of R&Ws covering unsecured loans assure the SPE and its investors that the warrantors will validly perform their securitization obligations;[94] the kinds of R&Ws covering secured loans assure the SPE and its investors of the perfection, priority, enforceability, and value of the loans underlying the securitization.[95] The only R&W not typically included in a securitization regards the warrantors' creditworthiness;[96] this R&W is not needed because, in a securitization, the primary source of investor repayment is the underlying loans.[97]

C. Mergers and Acquisitions and Private Equity

Merger-and-acquisition and other private-equity (collectively "M&A") transactions are simply asset sales where the relevant asset is all or a substantial part of a business.[98] Like other asset sales, they face asymmetric information problems because sellers know more about the quality of their business, and the assets used therein, than buyers.[99] Contracting parties customarily use R&Ws to reduce that information asymmetry.[100]

R&Ws also reallocate risk because an R&W breach may entitle the buyer to cancel the transaction[101] and possibly also to claim damages.[102]

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93 These additional R&Ws also reflect the Author's extensive experience, described *supra* note 91.

94 *See infra* note 95.

95 Again, these observations reflect the Author's extensive experience, described *supra* note 91. *Cf. supra* note 54 and accompanying text (observing that investors needed assurances about the quality of the loans underlying the securitizations).

96 *See supra* note 92 and accompanying text.

97 *See supra* note 40 and accompanying text.

98 An M&A transaction that is not formally structured as an asset sale—such as a stock purchase or statutory merger—is still an asset sale in economic effect. *Cf.* Cooper Indus. LLC v. City of South Bend, 899 N.E.2d 1274, 1288 (Ind. 2009) (observing that "*de facto* mergers" and asset sales have similar economic consequences).

99 *Compare* Griffith, *supra* note 1, at 1840, Andrae J. Marrocco, *Negotiating Critical Representations and Warranties in Franchise Mergers and Acquisitions—Part I*, 36 FRANCHISE L.J. 107, 108 (2016), *and* Will Pugh, Note, *Getting What You Bargained for: Avoiding Legal Uncertainty in Survival Clauses for a Seller's Representations and Warranties in M&A Purchase Agreements*, 12 J. BUS., ENTREPRENEURSHIP & L. 1, 3 (2019), *with* Strauss, *supra* note 23, at 167–68.

100 Griffith, *supra* note 1, at 1851. Private deals usually contain more R&Ws because the lack of public information creates a greater information asymmetry. *Id.* at 1849–51.

101 *Id.* at 1856. Whether the deal is public or private, M&A agreements usually make the accuracy of the R&Ws an essential element for closing the transaction—that is, consummating the asset sale. *Cf. id.* at 1851.

102 *See, e.g.*, CBS Inc. v. Ziff-Davis Publ'g Co., 553 N.E.2d 997, 1000–01 (N.Y. 1990) (providing damages for a breach of a warranty).

Sophisticated sellers usually include sole remedy provisions that limit the amount of damages for R&W breaches to a specified percentage of the purchase price.[103]

R&Ws, therefore, play a role in M&A transactions that is similar to their role in securitizations. There is, however, one critical difference: sellers in M&A transactions usually can make accurate R&Ws about what is being sold.[104] In contrast, sellers in securitizations sometimes lack full information about the loan pool.[105] This suggests that R&W breaches are more likely to be unintentional in securitizations than in M&A transactions.

D. Comparative Insights

The foregoing comparisons confirm that, regardless of the business context and notwithstanding their similarities and differences, R&Ws are widely used to reallocate risk and reduce information asymmetry. That insight also helps to inform an analysis of sole remedy provisions for an R&W breach.

R&Ws used for the sale of goods are governed by the UCC, which does not specifically address extensive R&W violations per se.[106] Nonetheless, it provides that a sole remedy provision will be respected unless it "fail[s] of its essential purpose."[107] Courts often consider the buyer's sophistication when deciding whether a remedy has so failed.[108]

R&Ws used in securitizations and other business transactions not involving the sale of goods are not governed by statute.[109] Nonetheless, given that R&Ws are used the same way—to reallocate risk and reduce information asymmetry—regardless of whether or not they are governed by statute, the UCC concept that a sole remedy will be respected unless it "fail[s] of its essential purpose"[110] should be sensible in both contexts. Furthermore, that concept is functionally similar to, if not the same as, the previously observed test for rescission: that the R&W breaches are "so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract."[111] It also

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103 *See* West & Lewis, *supra* note 21, at 1019–20.

104 *See* Griffith, *supra* note 1, at 1840, 1848–49.

105 *See* Lewis & Schwartz, *supra* note 14, at 169–70.

106 *See* U.C.C. §§ 2-313 to -314 (Am. L. Inst. & Unif. L. Comm'n 2021).

107 *See supra* note 77 and accompanying text.

108 *See supra* note 79 and accompanying text.

109 Even though securitizations involve asset sales, the UCC does not apply because the relevant assets are loans or other rights to payment, not "goods." *See supra* notes 30–32 and accompanying text.

110 *See supra* note 77 and accompanying text.

111 *See* Graham v. James, 144 F.3d 229, 237 (2d Cir. 1998) (quoting Septembertide Publ'g, B.V. v. Stein & Day, Inc., 884 F.2d 675, 678 (2d Cir. 1989)); *see also supra* note 65 and accompanying text. This rescission test might have some parallel in the contract-law doctrine of commercial

is somewhat analogous to the contract law doctrine of impossibility: contracts that are impossible to fulfill are void.[112] Similarly, it is sensible that sole remedy provisions should be more likely to be respected if the contracting parties are sophisticated.[113]

Applying these concepts, the fact that securitization parties are typically all sophisticated[114] suggests that courts should enforce contractual cure-or-repurchase provisions in securitization agreements unless they fail of their essential purpose. Such a failure would mean that the cure-or-repurchase provisions prevent the R&Ws from reallocating risk and reducing information asymmetry. This Article later examines whether the existence of extensive R&W violations would cause that failure.[115]

III. R&W Breach: The Boundary Between Risk Shifting and Fraud

Section III.A next examines, from a historical perspective, the boundary between risk shifting and fraud for R&W breaches. Section III.B then analyzes, more normatively, what that boundary

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impracticability; rescission might become available when, for reasons unrelated to the excused party, performance of a contract becomes unrealistically difficult or costly to perform. *See* MASTR Asset Backed Sec. Tr. 2006-HE3 *ex rel.* U.S. Bank Nat'l Ass'n v. WMC Mortg. Corp., No. 11-2542, 2012 WL 4511065, at *6 n.10 (D. Minn. Oct. 1, 2012) (considering an impracticability theory concerning extensive R&W breaches, but denying rescission because plaintiff already foreclosed on the mortgage loans). The above rescission test might also appear to have some parallel to the doctrine of mutual mistake:

> Where a mistake of both parties at the time a contract was made as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances, the contract is voidable by the adversely affected party unless he bears the risk of the mistake . . . .

RESTATEMENT (SECOND) OF CONTS. § 152 (AM. L. INST. 1981). To succeed in an action for rescission based on mutual mistake, however, the alleged mistake must go to the subject of the parties' exchange and not merely to mistaken valuation; R&Ws backing the creditworthiness of investor certificates would appear to go to valuation, not to the subject of the exchange. *See, e.g.*, IKB Deutsche Industriebank AG v. Credit Suisse Sec. (USA) LLC, 135 N.Y.S.3d 396, 398 (App. Div. 2020) (ruling that "once the true nature of the credit risk materialized, the market value of the certificates declined, all of which goes to valuation, not to whether [plaintiff] received the agreed upon certificates").

112 *See, e.g.*, MASTR Asset Backed Sec. Tr. 2006-HE3 *ex rel.* U.S. Bank Nat'l Ass'n v. WMC Mortg., LLC, 983 F. Supp. 2d 1104, 1112 (D. Minn. 2013) (denying trustee of MBS trust monetary damages when sole remedy provision is impossible to perform); *cf. In re* Part 60 Put-Back Litig., 165 N.E.3d 180, 189 (N.Y. 2020) (citing a lower court's "conclusion that where specific performance of cure or repurchase is impossible, a plaintiff in an RMBS case may pursue monetary damages in lieu of specific performance").

113 *See supra* notes 76–79 and accompanying text.

114 *See supra* note 15 and accompanying text.

115 *See infra* notes 177–78 and accompanying text (examining whether extensive R&W breaches should cause sole remedy provisions to fail of their essential purpose).

should be, taking into account the possible existence of intentional R&W breaches. Thereafter, Section III.C analyzes whether the existence of unintentional, but extensive, R&W violations should justify extracontractual claims that override sole remedy provisions.

A. Risk Shifting and Fraud: A Historical Perspective

The boundary between risk shifting and fraud for R&W breaches has a murky origin. In part, the murkiness reflects that warranty law initially developed from tort law and was recognized "as an action in deceit"[116]—a type of fraud claim.[117] Over time, courts began to view warranty law as more grounded in contract than tort law, prompting Professor Prosser to colorfully characterize warranty law as a curious "hybrid born of the illicit intercourse of tort and contract."[118]

In Britain, this muddling remains, persisting—at least partly—from the belief that there is a distinction between "representations" and "warranties."[119] British lawyers ostensibly view a "representation" as "a statement of fact or opinion which induces another party to enter into a contract," but view a "warranty" merely as "a contractual term, secondary to the main purpose of a contract, which in effect gives the other party to the contract a right to an indemnity if the warranty is not true."[120] A breach of a representation is considered deceitful, the remedy for which "can include rescission of the contract as well as damages."[121] In contrast, the remedy for breaching a warranty is "usually limited to damages."[122]

English lawyers recognize, though, "that it is sometimes difficult to establish exactly what statement belongs in one category or the other."[123] Accordingly, British contracts, like American contracts, refer

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116 Matthew J. Duchemin, Comment, *Whether Reliance on the Warranty Is Required in a Common Law Action for Breach of an Express Warranty*, 82 Marq. L. Rev. 689, 690 (1999) (quoting Samuel Williston et al., Williston on Sales § 15:1 (5th ed. 1994)); *see also* William L. Prosser, *The Assault upon the Citadel (Strict Liability to the Consumer)*, 69 Yale L.J. 1099, 1126–27 (1960).

117 *See* Brown v. Underwriters at Lloyd's, 332 P.2d 228, 232 (Wash. 1958) (observing that misrepresentation with deceit is fraud).

118 Prosser, *supra* note 116, at 1126; *see also* Lyon Fin. Servs. Inc. v. Ill. Paper & Copier Co., 732 F.3d 755, 762 (7th Cir. 2013) (discussing the tort and contract origins of warranty law and concluding that "[w]arranty thus blurred the distinction between contract and tort").

119 *See* West & Lewis, *supra* note 21, at 1008–10.

120 *Subscription Finance Loan Agreement Series, Part 14: Representations and Warranties*, Cadwalader (Nov. 15, 2019), https://www.cadwalader.com/fund-finance-friday/index.php?eid=444&nid=61 [https://perma.cc/C4HG-UZJA].

121 *Id.*; West & Lewis, *supra* note 21, at 1008 n.49.

122 Cadwalader, *supra* note 120.

123 *Id.*

collectively to representations and warranties without purporting to distinguish the two.[124]

American lawyers, in contrast, normally view "representations" and "warranties" as nearly synonymous.[125] Nonetheless, as in Britain, some American commentators regard a "representation" as a factual assertion.[126] To that extent, a breach arguably should expose the breaching party to a tort-based deceit—that is, fraud[127]—claim.[128]

These conflicting viewpoints provide an opening for parties to assert extracontractual fraud claims for an R&W breach. In the *Nomura Home Equity Loan Inc.* case,[129] for example, the dissent observed that "allegations of serious and pervasive misrepresentations regarding the level of risk in an investment with widespread, massive failures [would] support a claim . . . of fraud."[130]

Even in the United States, therefore, the issue of whether R&W breaches—and certainly the issue of whether widespread R&W breaches—would constitute fraud is unsettled.[131] Unsettled law creates uncertainty, which can increase the cost and availability of credit: The National Bureau of Economic Research has found that "uncertainty has a direct effect on investment" and that "greater uncertainty tends to make investment less desirable" and "exerts a strong negative influence

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124 *Id.*

125 *See, e.g.*, Kenneth A. Adams, *A Lesson in Drafting Contracts: What's Up with 'Representations and Warranties'?*, 15 Bus. L. Today, Nov.–Dec. 2005, at 33, 33–35 (arguing that "representations" and "warranties" are near synonyms that play a similar legal function).

126 *See, e.g.*, Simon M. Lorne & Joy Marlene Bryan, 11 Acquisitions & Mergers: Negotiated & Contested Transactions § 3:57 (2023) (arguing that representations assert the truth of the represented statements, whereas warranties "allocate financial responsibility" for the warranted statement's accuracy); Marialuisa S. Gallozzi & Eric Phillips, *Representation and Warranties Insurance*, 14 Env't Claims J. 455, 455 (2002) ("[A] representation is a statement of fact about the current state of the business made by a seller to the buyer or by the buyer to the seller in a purchase agreement."); Irwin A. Kishner, *The Changing Legal Landscape and Matters Affecting M&A Documentation*, *in* Mergers and Acquisitions Law 2016, at 17–18 (Aspatore 2016) ("Representations are statements of facts existing at the time the purchase agreement is executed . . . .").

127 *See supra* note 117 and accompanying text (explaining why a tort-based action in deceit is a type of fraud claim).

128 *Cf.* Stark, *supra* note 9, at 8–9 ("If a representation is intentionally false, a plaintiff can make a common law claim of deceit (a tort) . . . ."); Sepinuck, *supra* note 8, at 2 (setting forth false representations as torts).

129 Nomura Home Equity Loan, Inc., Series 2006-FM2 by HSBC Bank USA, N.A. v. Nomura Credit & Cap. Inc., 92 N.E.3d 743 (N.Y. 2017).

130 *Id.* at 759 (Rivera, J., dissenting) (quoting Morgan Stanley Mortg. Loan Tr. 2006-13ARX v. Morgan Stanley Mortg. Cap. Holdings LLC, 36 N.Y.S.3d 458, 463 (App. Div. 2016)). Apparently, though, any such extracontractual claim would have to be pleaded with particularity. In *In re Part 60 Put-Back Litigation*, the court did not rule on whether there should be an extracontractual claim—in that case, for gross negligence—due to the alleged pervasive misrepresentations because the plaintiff had not formally pleaded that claim. *In re* Part 60 Put-Back Litig., 165 N.E.3d 180, 190–91 (N.Y. 2020).

131 *See supra* note 61 and accompanying text.

on investment."[132] Federal courts likewise have found that uncertainty "would both impair bank financing and increase the costs of obtaining such financing."[133] Uncertainty also creates a deleterious impact on "households' access to small credit"[134] and "leads to higher loan interest rates and default probabilities."[135]

This Article next strives to reduce that uncertainty by analyzing what the boundary should be between R&W breaches that support a fraud—including tort-based deceit[136]—claim and those that merely shift risk contractually.

B. Toward a Normative Boundary Between Risk Shifting and Fraud

Because the R&Ws discussed in this Article are contractual, a threshold question is whether courts should simply respect freedom of contract and enforce R&W agreements in accordance with their terms. In principle, voluntary bargaining should lead to an economically efficient outcome for the contracting parties.[137] Freedom of contract, however, should be subject to three limitations: paternalism, externalities, and public policy.[138]

Paternalism, the idea "that there may be certain extreme situations when, as a matter of equity, a contracting party must be protected

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132 John V. Leahy & Toni M. Whited, *The Effect of Uncertainty on Investment: Some Stylized Facts* 2–3 (Nat'l Bureau of Econ. Rsch., Working Paper No. 4986, 1995).

133 Worldwide Sugar Co. v. Royal Bank of Can., 609 F. Supp. 19, 26–27 (S.D.N.Y. 1984) (ruling that allowing "recovery from an advising bank on the basis of a terminated letter-of-credit arrangement would impose" uncertainty and increase financing costs); *cf.* Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990) ("Any attempt to add an overlay of 'just cause' . . . to the exercise of contractual privileges would reduce commercial certainty and breed costly litigation."); John C. McCoid, II, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 Va. L. Rev. 249, 267–68 (1981) (observing that uncertainty whether creditors who receive a potentially preferential transfer may have to return it imposes "costs to their debtor-customers by increasing the cost of credit").

134 Xiang Li, Bibo Liu & Xuan Tian, Policy Uncertainty and Household Credit Access: Evidence from Peer-to-Peer Crowdfunding 28 (2018) (reporting on the peer-to-peer lending market).

135 *Id.*; *cf.* Diana Olick, *Here's Why It's Suddenly Much Harder to Get a Mortgage, or Even Refinance*, CNBC (Apr. 13, 2020, 5:08 PM), https://cnbc.com/2020/04/13/coronavirus-why-its-suddenly-much-harder-to-get-a-mortgage-or-even-refinance.html [https://perma.cc/EPD7-XPN8] (reporting that economic uncertainty arising from the coronavirus pandemic made mortgage loans more expensive and difficult to get).

136 *See supra* note 117 and accompanying text.

137 *See* Michael J. Trebilcock, The Limits of Freedom of Contract 7 (1993) (observing that "if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it").

138 *See* Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Tex. L. Rev. 515, 535–39 (1999).

against his own weakness,"[139] should not apply in this Article's context of business contracting. This is especially true for securitizations, given the sophistication of the relevant investors.[140]

The extent to which freedom of contract should be limited by a contract's externalities—its potential harm to noncontracting parties—is unclear; "many contracts create externalities, yet they are [still] enforced."[141] From the standpoint of externalities, R&W agreements should be enforced because only contracting parties have the right to rely on contractual R&Ws.[142] R&W breaches should not, therefore, directly cause externalities. Although R&W breaches might indirectly cause externalities by causing systemically important contracting parties to fail, thereby harming third parties, that likelihood appears too remote and indirect to constrain freedom of contract.[143]

Freedom of contract should also be limited by public policy.[144] To the extent R&W breaches are fraudulent, freedom of contract should be constrained by the public policy against fraudulent conduct: "The public policy against fraud is a strong and venerable one that is largely founded on the societal consensus that lying is wrong."[145] Sole remedy provisions should not protect deceitful parties from extracontractual claims for fraud.[146]

On that basis, R&W breaches should merely shift risk, in accordance with the contract, unless such breaches are themselves fraudulent. Traditionally, fraud requires intent.[147] Willful or otherwise intentional

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139 *Id.* at 548.

140 *See supra* note 15 and accompanying text.

141 Schwarcz, *supra* note 138, at 552.

142 Even though originators in securitizations make R&Ws to the sponsor and its transferees, *see supra* note 34, those transferees are the SPE and its investors—which are all contracting parties. *See supra* text accompanying notes 31–32.

143 *See, e.g.*, Deborah Zalesne, *Enforcing the Contract at All (Social) Costs: The Boundary Between Private Contract Law and the Public Interest*, 11 Tex. Wesleyan L. Rev. 579, 606–07 (2005) (arguing that "[c]ontract law is . . . ill equipped to recognize . . . remote externalities" and that indirect externalities are typically tolerated).

144 *Cf.* Schwarcz, *supra* note 138, at 536 (observing that the public policy limitation would not permit waivers that thwart a statute's legislative policies).

145 Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1035 (Del. Ch. 2006).

146 *Cf.* United Guar. Mortg. Indem. Co. v. Countrywide Fin. Corp., 660 F. Supp. 2d 1163, 1181 (C.D. Cal. 2009) (arguing that contracting should not allow parties to escape extracontractual duties); R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, Note, 41 Wm. & Mary L. Rev. 1789, 1833–34 (2000) (same); Vincent R. Johnson, *The Boundary-Line Function of the Economic Loss Rule*, 66 Wash. & Lee L. Rev. 523, 584 (2009) (same).

147 *See, e.g.*, 37 Am. Jur. 2d *Fraud and Deceit* § 24 (2024) ("The five traditional elements of fraud, each of which must be established by evidence that is not equally consistent with either honesty or deceit include: (1) a false representation; (2) in reference to a material fact; (3) made with knowledge of its falsity; (4) *with the intent to deceive*; and (5) on which an action is taken in justifiable reliance upon the representation." (emphasis added)).

R&W breaches should, therefore, justify fraud claims.[148] Being extracontractual, fraud claims could override contractual sole remedy provisions, such as the cure-or-repurchase remedy.

Integrating these concepts, this Article's proposed normative rule follows: R&W breaches should shift risk strictly according to the contractual terms, including any cure-or-repurchase or other sole remedy provision; however, intentional breaches should also justify extracontractual fraud claims.

This proposed normative rule makes sense on many levels. From an economic standpoint, the goal of R&Ws and remedy limitations is to more efficiently allocate risk between parties.[149] Freely contracting sophisticated parties are believed to efficiently allocate risk among themselves unless some parties are deceiving other parties.[150] The proposed normative rule additionally makes sense because it would operate to correct market failures: in this case, information asymmetry resulting from fraud.[151] The primary purpose of economic and financial regulation is to help correct market failures.[152]

The proposed normative rule would also be consistent with the Economic Loss Rule, sometimes known as the Economic Loss Doctrine, which generally prevents tort, including deceit-based, remedies for economic losses where parties contractually allocate their risk.[153]

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148 *Cf. Abry Partners*, 891 A.2d at 1035 (observing that "parties may allocate the risk of factual error freely as to any error where the speaking party did not consciously convey an untruth").

149 *See supra* note 74 and accompanying text (concluding that R&Ws are intended to reallocate risk and reduce information asymmetry).

150 *See, e.g.*, Robinson Helicopter Co. v. Dana Corp., 102 P.3d 268, 275 (Cal. 2004) (explaining that "[a] breach of contract remedy assumes that the parties to a contract can negotiate the risk of loss occasioned by a breach," except that a party "cannot rationally calculate the possibility that the other party" will be deceitful); Budgetel Inns, Inc. v. Micros Sys., Inc., 8 F. Supp. 2d 1137, 1148 (E.D. Wis. 1998) (stating that when a seller intentionally lies, "the party best situated to assess the risk of economic loss and allocate the risk is not the buyer, who cannot possibly know which of several statements may be a lie, but rather the seller, who clearly knows"); *see also* Steven C. Tourek, Thomas H. Boyd & Charles J. Schoenwetter, *Bucking the "Trend": The Uniform Commercial Code, the Economic Loss Doctrine, and Common Law Causes of Action for Fraud and Misrepresentation*, 84 Iowa L. Rev. 875, 908–10 (1999).

151 Any further information asymmetry should be mitigated by the fact that the contracting parties are all sophisticated, as well as by the fact that the proposed rule would respect a risk-shifting measure of damages.

152 *See, e.g.*, David Gowland, The Regulation of Financial Markets in the 1990s 21 (1990) (characterizing regulating markets to correct market failure as the "public interest theory"); Richard A. Posner, *Theories of Economic Regulation*, 5 Bell J. Econ. & Mgmt. Sci. 335, 335 (1974) ("[Economic] regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices."); *cf.* Paul A. Samuelson & William D. Nordhaus, Economics 756 (Michael J. Mandel ed., 15th ed. 1995) (defining "[m]arket failure" as "[a]n imperfection in a price system that prevents an efficient allocation of resources").

153 The rule is often said to serve the purpose of maintaining the fundamental distinction between tort and contract law. Miller, *supra* note 78, at 510.

The Economic Loss Rule does not prevent a tort law remedy to discourage fraud, however, because parties cannot efficiently allocate the risk of fraud—and any attempt to do so would result in additional transaction costs.[154]

Other possible versions of a normative rule for an R&W breach might be theoretically possible but not pragmatic. For example, such a rule could require lawyers to clearly distinguish between a "representation" and a "warranty" in future contracts, thereby triggering different remedies depending on which is breached.[155] However, lawyers might not always remember to document that distinction and, as the British experience shows, even if they remembered, lawyers could not always "establish exactly what statement belongs in one category or the other."[156]

One also might propose a "constructive" fraud rule that presumes fraud unless, for example, the warrantor engages in appropriate due diligence or takes other reasonable steps to try to establish the reasonableness of its R&Ws.[157] Due diligence could be costly, however, and warrantors should not incur that cost unless, under the circumstances, it adds net value.[158] In general, due diligence would not appear to add net value because liability for breach already should discourage warrantors from making unreasonable R&Ws. This Article later examines whether due diligence might nonetheless add net value if a warrantor should have known that extensive R&W violations could occur.[159]

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154 *See* Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, 1035 (Del. Ch. 2006); *Robinson Helicopter* Co., 102 P.3d at 274–75; All-Tech Telecom, Inc. v. Amway Corp., 174 F.3d 862, 867 (7th Cir. 1999).

155 *See supra* notes 119–28 and accompanying text (discussing whether an R&W assertion provides factual assertions or merely enables indemnification if the assertion is breached).

156 *Cf.* Cadwalader, *supra* note 120 (observing that even British lawyers recognize that "it is sometimes difficult to establish exactly what statement belongs in one category or the other").

157 *Cf.* Miller, *supra* note 9, at 290; Adelson, *supra* note 22, at 100–01; Joseph Philip Forte, *Representations and Warranties—The Capital Markets Context*, *in* 1 ALI-ABA Course of Study Materials: Commercial Securitization for Real Estate Lawyers 219, 222 (2002); Thomas J. Holdych & Bruce D. Mann, *The Basis of the Bargain Requirement: A Market and Economic Based Analysis of Express Warranties—Getting What You Pay for and Paying for What You Get*, 45 DePaul L. Rev. 781, 839–40 (1996) (arguing that even where warrantors have incomplete information about the loans they are warrantying, they still have better information than investors and could detect defects at a lower cost).

158 The question of warrantor due diligence should be distinguished from a superficially related, but fundamentally different, question: Should investors engage in due diligence? In other contexts, this Author has argued that although it would be inefficient for investors individually to engage in due diligence if each has a relatively small investment, due diligence becomes especially compelling when a monoline insurer or other financial institution guarantees all or substantially all of the investor risk and can cost-effectively perform diligence through statistical sampling. *See generally* Steven L. Schwarcz, *Marginalizing Risk*, 89 Wash. U. L. Rev. 487 (2012).

159 *See infra* notes 200–05 and accompanying text.

C. Should Extensive but Unintentional R&W Violations Override Sole Remedy Provisions?

Under the normative rule proposed in Section III.B, the existence of intentional R&W violations—which would include, of course, the existence of extensive intentional violations—should justify extracontractual fraud claims that override sole remedy provisions. This Section examines whether the existence of extensive *unintentional* R&W violations should also justify such extracontractual claims.

As a matter of freedom of contract, unintentional R&W violations, even if extensive, should not override contractually agreed sole remedy provisions. Absent intentional violations, none of the limitations to freedom of contract—paternalism, externalities, and public policy—should apply.[160]

This view is consistent with the few cases that have considered sole remedy provisions concerning extensive R&W violations. In *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*,[161] for example, the highest court in New York upheld cure-or-repurchase sole remedy provisions negotiated between sophisticated parties.[162] Ambac had insured several securitizations, on behalf of the investors.[163] Countrywide, the sponsor of the securitizations, made certain R&Ws to Ambac regarding the quality of the underlying loans.[164] In each transaction, Ambac's recourse for an R&W breach was contractually limited to the cure-or-repurchase sole remedy.[165]

As a result of extensive defaults on the underlying loans, Ambac had to pay the investors much more than it anticipated for insurance claims.[166] Ambac alleged that the high default rate corresponded to extensive R&W violations, claiming that Countrywide fraudulently induced Ambac to insure the transactions.[167] Ambac sued Countrywide for breach of contract and fraud.[168] Rejecting the fraud claim, the court held that "courts must honor contractual provisions that limit liability or damages because those provisions represent the parties' agreement

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160 *See supra* notes 138–45 and accompanying text; *cf. supra* note 147 and accompanying text (explaining that fraud requires intent).

161 106 N.E.3d 1176 (N.Y. 2018). This Article's discussion of this case is partly informed by the excellent article by David B. Saxe, Danielle C. Lesser & Michael Mix, *From 'Nomura' to 'Ambac': Where Does the Law on Sole Remedy Clauses Stand?*, LAW.COM: N.Y.L.J. (Aug. 20, 2018, 1:30 PM), https://www.law.com/newyorklawjournal/2018/08/20/082118saxe/ [https://perma.cc/FZX5-CASU].

162 *Ambac Assurance Corp.*, 106 N.E.3d at 1183–85.

163 *Id.* at 1179.

164 *Id.* at 1180.

165 *Id.*

166 *Id.*

167 *Id.* at 1181.

168 *Id.* at 1179.

on the allocation of the risk of economic loss in certain eventualities."[169] It reasoned that

> [c]ontract terms providing for a sole remedy are sufficiently clear to establish that no other remedy was contemplated by the parties at the time the contract was formed, for purposes of that portion of the transaction . . . especially when entered into at arm's length by sophisticated contracting parties.[170]

Similarly, in *Nomura Home Equity Loan Inc.*, New York's highest court ruled that extensive R&W violations do not allow a plaintiff to escape a sole remedy provision.[171] Although the plaintiff had agreed to a sole remedy provision, it argued that it should not be bound to that provision because there were extensive R&W violations.[172] The court rejected the plaintiff's argument, finding no support in the agreement that the sole remedy provision only applied to occasional breaches and not extensive breaches.[173]

Clearly, though, courts should not respect a sole remedy provision that is, effectively, meaningless.[174] This view parallels the UCC's rejection of a remedies limitation that fails in its essential purpose[175] and the judicial rejection of remedies limitations that are "so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract."[176] Some R&W beneficiaries have thus argued that the existence of extensive violations makes a cure-or-repurchase

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169 *Id.* at 1184 (quoting Nomura Home Equity Loan, Inc., Series 2006-FM2 by HSBC Bank USA, N.A. v. Nomura Credit & Cap., Inc., 92 N.E.3d 743, 748 (N.Y. 2017)); *cf.* Warkentine, *supra* note 71, at 67–78 (discussing the enforceability of remedies limitations in transactions for goods); Ralph A. Anzivino, *The False Dilemma of the Economic Loss Doctrine*, 93 Marq. L. Rev. 1121, 1129–33 (2010) (discussing the contract limitations available to sellers and manufacturers); *see also supra* note 63 and accompanying text (citing similar sources).

170 *Ambac Assurance Corp.*, 106 N.E.3d at 1184 (quoting *Nomura Home Equity Loan, Inc., Series 2006-FM2 by HSBC Bank USA, N.A.*, 92 N.E.3d at 748). *But cf.* Clark v. Int'l Harvester Co., 581 P.2d 784, 798 (Idaho 1978) (holding that, under UCC section 2-719(2), "an exclusive remedy, which may have appeared fair and reasonable at the inception of the contract, as a result of later circumstances operates to deprive a party of a substantial benefit of the bargain").

171 *Nomura Home Equity Loan, Inc., Series 2006-FM2 by HSBC Bank USA, N.A.*, 92 N.E.3d at 745.

172 *Id.* at 750.

173 *Id. But see supra* notes 129–30 and accompanying text (discussing the dissent).

174 *Cf.* Rocanova v. Equitable Life Assurance Soc'y. of the U.S., 634 N.E.2d 940, 943–44 (N.Y. 1994) (contract breach damages ordinarily will be limited to those necessary to redress the wrong).

175 *See supra* note 77 and accompanying text.

176 *See* Graham v. James, 144 F.3d 229, 237 (2d Cir. 1998); *cf. supra* note 65 and accompanying text. For a discussion of what other remedies should apply if a remedy fails in its essential purpose, see Robert J. Williams, *Getting What You Bargained For: How Courts Might Provide a Coherent Basis for Damages That Arise When Remedies Fail of Their Essential Purpose*, 5 Va. L. & Bus. Rev. 131, 146 (2010).

sole remedy prohibitively expensive, if not impossible, to enforce.[177] The New York Court of Appeals, however, has rejected that argument: "Plaintiff's contention that that [sic] the pervasive nature of the [R&W] breaches will make it impossible for plaintiff to prove its case on a loan-by-loan basis has previously been considered and rejected by this Court as a basis to render the sole remedy provision unenforceable."[178]

This Article agrees that the existence of extensive R&W violations should not make a cure-or-repurchase sole remedy prohibitively expensive to enforce. As next shown, the scholarship purporting to demonstrate that prohibitive expense is flawed.

Some scholars claim that the verification costs necessary to establish the existence of extensive violations can be prohibitively expensive. Professors Lewis and Schwartz contend, for example, that it can be costly to establish whether any given loan violated an R&W at the time of its sale if, as was especially common during the 2008 financial crisis, the inquiry occurs years after that time.[179] Professors McCoy and Wachter illustrate this by suggesting that R&W-breach inquiries "alleging false loan-to-value ratios or appraised values [would] require reconstructing the actual appraised value at [the time of the sale], which is subject to debate and difficult to do."[180]

Debate and difficulty do not, however, necessarily make those inquiries prohibitively expensive.[181] Moreover, R&W-breach inquiries "alleging false loan-to-value ratios or appraised values" do *not* always "require reconstructing the actual appraised value at" the time of the sale.[182] Often, R&Ws regarding appraised value are assertions about the appraisal procedure, not about the accuracy of the appraisal itself.[183]

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177 *See, e.g.*, *In re* Part 60 Put-Back Litig., 165 N.E.3d 180, 189 (N.Y. 2020) ("This Court . . . has not yet considered, let alone overruled, the Appellate Division's conclusion that where specific performance of cure or repurchase is impossible, a plaintiff in [a securitization] case may pursue monetary damages in lieu of specific performance."); *cf. infra* note 179 and accompanying text (citing scholars who argue that the existence of extensive breaches can make a cure-or-repurchase sole remedy prohibitively expensive to enforce).

178 *In re* Part 60 Put-Back Litig., 165 N.E. 3d at 190; *accord Nomura Home Equity Loan, Inc., Series 2006-FM2 by HSBC Bank USA, N.A.*, 92 N.E.3d at 751 (holding that the plaintiff "is expressly limited to the more specific Sole Remedy Provision . . . however many defective loans there may be"); Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 106 N.E.3d 1176, 1184–85 (N.Y. 2018) (upholding a sole remedy provision despite extensive R&W breaches).

179 *See* Lewis & Schwartz, *supra* note 14, at 192–97; Strauss, *supra* note 23, at 171 (discussing the cost of proving causation and damages on a loan-by-loan basis).

180 McCoy & Wachter, *supra* note 1, at 301.

181 *Cf.* Strauss, *supra* note 23, at 171 n.39 ("The cost and difficulties of re-underwriting a portfolio of MBS to determine liability and damages, though immense, do not render [the cure-or-repurchase sole remedy] *unenforceable*. It is more accurate to say that such [remedy is] expensive and cumbersome to enforce as written in events of mass breach . . . .").

182 *Contra supra* note 180 and accompanying text (making that allegation).

183 *See* Don Coker, *Repurchase & Buyback Demands, Representations and Warranties Claims in Residential Mortgage-Backed Securities*, HGExperts.com (2012), https://www.hgexperts.

For R&Ws that make assertions about the appraisal procedure, R&W-breach inquiries would be relatively trivial: to confirm whether the required procedures were followed. R&W-breach inquiries regarding possible alleged "false loan-to-value ratios"[184] would then also be easy: the amount of the loan is clearly documented, and the "value" would simply be the appraised value as determined by the required procedure.

It also should be noted that the cure-or-repurchase remedy can be pursued if *any* R&W is violated.[185] In the unlikely event that proving breach of an R&W about a loan's loan-to-value ratio or the collateral's appraised value could be prohibitively expensive, the warrantors still would be obligated to cure or repurchase that loan if any other R&Ws were violated.[186] Violations of most of the other R&Ws—including no adverse selection, the creditworthiness of the loans, the loan-to-income and debt-to-income ratios of the borrowers, and the occupancy status of the mortgaged properties[187]—should be easier to prove.[188]

Scholars also argue that enforcing a cure-or-repurchase sole remedy would be prohibitively expensive because it would require proof of causation: Professors Lewis and Schwartz write, for example, that a "portfolio buyer who could prove a[n] [R&W] breach must also prove causation: that the breach, rather than exogenous factors, caused the buyer's loss,"[189] and the portfolio buyer bears "the burden of proof in"

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com/expert-witness-articles/repurchase-and-buyback-demands-representations-and-warranties-claims-in-residential-mortgage-backed-securities-24951 [https://perma.cc/6KEQ-4SYL] (describing the "Misrepresentation of Appraised Value" as follows, "This potential problem typically is one with the appraiser rather than a problem with the borrower since the borrower does not generate the appraisal or contribute towards the data used by the appraiser in formulating the value of the property . . . . My experience has been that Originators make sure that the appraisal is performed by an appropriately certified licensed appraiser, and rely upon the expertise of the appraiser."). Fannie Mae and Freddie Mac likewise contemplate procedural R&Ws regarding appraised value. *See, e.g.*, *MBS Disclosure Enhancement: Property Valuation Method*, Fannie Mae (Jan. 13, 2020), https://capitalmarkets.fanniemae.com/mortgage-backed-securities/single-family-mbs/mbs-disclosure-enhancement-property-valuation-method [https://perma.cc/33CA-NYH9] ("The property value was obtained through an appraisal that was completed by a licensed or certified appraiser.").

184 *Contra* McCoy & Wachter, *supra* note 1, at 301; *see also supra* note 180 and accompanying text (raising that type of inquiry).

185 Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 106 N.E.3d 1176, 1180 (N.Y. 2018) (observing that cure-or-repurchase is "the remedy for breach of *any* of these imported representations and warranties and the remedy 'with respect to *any defective Mortgage Loan or any Mortgage Loan as to which there has been a breach of representation or warranty*'" (emphasis added)).

186 *Supra* notes 12–14 and accompanying text.

187 *Supra* notes 36–39 and accompanying text (discussing these R&Ws).

188 *Cf.* McCoy & Wachter, *supra* note 1, at 300 ("Some breaches of representations and warranties are easily proven because they turn on commonly available evidence using objective standards.").

189 Lewis & Schwartz, *supra* note 14, at 192.

showing causation.[190] They contend that causation could not be proved "at acceptable cost."[191]

Proving causation—for example, that an R&W violation at the time of a loan's sale has caused the loan to default years later—could indeed be expensive, if even feasible. However, the premise of the proof-of-causation argument is *erroneous*. Enforcing the cure-or-repurchase remedy does not necessarily require proof of causation;[192] it merely requires proof that a loan violated an R&W at the time of its sale[193]—in which case the warrantors are obligated to either cure that violation or repurchase that loan.[194] As discussed, proving that a loan violated an R&W at the time of its sale should not be prohibitively expensive.[195]

For these reasons, the existence of extensive violations should not make a cure-or-repurchase sole remedy prohibitively expensive to enforce. In the unlikely event, though, that extensive R&W violations would make such enforcement prohibitively expensive, courts should consider allowing statistical sampling to approximate the sole remedy damages without incurring full-review expenses.[196] Professor Miller

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190 *Id.* at 197.

191 *Id.*

192 *Cf.* ACE Sec. Corp. v. DB Structured Prods., Inc., 36 N.E.3d 623, 629–30 (N.Y. 2015) ("[The warrantor] represented and warranted certain facts about the loans' characteristics as of March 28, 2006, when the MLPA and PSA were executed, and expressly stated that those representations and warranties did not survive the closing date. DBSP's cure or repurchase obligation was the Trust's remedy for a breach of *those* representations and warranties, not a promise of the loans' future performance."); Mastr Adjustable Rate Mortgs. Tr. 2006-OA2 v. UBS Real Est. Sec. Inc., 12-cv-7322, 2015 WL 797972, at *1, *3 (S.D.N.Y. Feb. 25, 2015) (finding that where a cure-or-repurchase remedy was dependent on the R&W breach "materially and adversely affect[ing] the interests of the Certificateholders" in the relevant loan, explaining that materiality merely "require[s] proof of a significant increase in the risk of [the] loan's default" and "reject[ing] the notion that the plaintiffs must prove an actual loss or default" (quoting the contracts at issue)). *But cf.* Strauss, *supra* note 23, at 170 (observing that whereas R&W beneficiaries "argue that any [R&W] breach increasing the risk of loss is material and adverse" and thus does not require proof of causation, sponsor-warrantors "maintain that [a R&W] breach is material and adverse [and thus actionable] only if it results in an actual loss on the loan").

193 *Cf. supra* note 13 and accompanying text (quoting a cure-or-repurchase provision).

194 *See* Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 106 N.E.3d 1176, 1180, 1184–85 (N.Y. 2018). The Author's thirty-five years of extensive experience as a lawyer and as an expert witness with securitization transactions, including cure-or-repurchase provisions documented therein, supports this conclusion: a cure-or-repurchase provision simply requires the warrantors either to correct, or "cure," the breach or to repurchase the breaching loan; there is no requirement to also show that the R&W breach caused the loan to default.

195 *See supra* notes 179–84 and accompanying text.

196 Statistical sampling might be less directly relevant, however, to a cure-or-repurchase provision that contemplates curing or repurchasing specific actually nonconforming loans. *See* Homeward Residential, Inc. v. Sand Canyon Corp., No. 12 Civ. 5067, 2017 WL 5256760, at *7 (S.D.N.Y. Nov. 13, 2017) (denying a motion for statistical sampling because cure-or-repurchase provision required proof of actual breaches); Royal Park Invs. SA/NV v. HSBC Bank USA,

notes, for example, that a "court could allow the plaintiff to prove its damages by taking a sample of the non-conforming loans and compute its damages for the sample and then extrapolate to its total damages in the suit."[197]

The foregoing analysis has shown that the existence of extensive unintentional R&W violations should not justify extracontractual fraud claims that can override sole remedy provisions. One might nonetheless ask whether the existence of those R&W violations should justify some type of *constructive* fraud rule; federal bankruptcy law, for example, provides a statutory precedent for a constructive fraud rule.[198] Should warrantors be liable for extracontractual claims for constructive fraud, or perhaps gross negligence,[199] if they should have known that extensive R&W violations could occur?[200]

Because the use of constructive fraud or gross negligence to override contractual provisions is not the norm, any such use should require a compelling policy basis.[201] In the context of R&W violations, where the contract itself provides a negotiated remedy, there does not appear to be such a compelling basis. Moreover, on a cost-benefit basis, this Article already has argued against a presumption of fraud which the warrantor could rebut by engaging in appropriate due diligence to try to establish the reasonableness of its R&Ws.[202] The costs likewise would not appear to justify the benefits if warrantors feel compelled to engage in due diligence simply because they fear that investor-plaintiffs could allege, ex post, that they should have known that extensive

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N.A., No. 14-CV-08175, 2017 WL 945099, at *5 (S.D.N.Y. Mar. 10, 2017) (involving cure-or-repurchase sole remedies); *MASTR Adjustable Rate Mortgs. Tr. 2006-OA2*, 2015 WL 764665, at *11 (finding that cure-or-repurchase sole remedies "foreclose the 'pervasive breach' theory"); W&S Life Ins. Co. v. Bank of N.Y. Mellon, No. A1302490, 2017 WL 3392855, at *10–13 (Ohio Ct. Com. Pl. Aug. 4, 2017) (finding that statistical sampling was inappropriate where cure-or-repurchase provision required proof of actual breaches).

197 Miller, *supra* note 9, at 291–92 n.137. For a source discussing the possibility of the parties using sampling techniques, Professor Miller references ACE Securities Corporation v. DB Structured Products., 965 N.Y.S.2d 844, 851 (N.Y. Sup. Ct. 2013), *rev'd on other grounds*, 977 N.Y.S.2d 229 (N.Y. App. Div. 2013). *Id. But see* Strauss, *supra* note 23, at 175–76 (observing that some courts have not yet allowed statistical sampling).

198 *See* 11 U.S.C. § 548(a) (imposing liability for certain constructively fraudulent actions); *accord* Cal. Civ. Code § 1573(1) (Deering 2024) (defining constructive fraud to include "any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault . . . by misleading another to his prejudice").

199 *Cf. supra* note 130 (discussing whether to allow an extracontractual claim for gross negligence due to alleged pervasive misrepresentations).

200 Due diligence might provide, for example, a defense against this constructive fraud claim. *Cf.* Therese H. Maynard, *The Affirmative Defense of Reasonable Care Under Section 12(2) of the Securities Act of 1933*, 69 Notre Dame L. Rev. 57, 91 (1993) (explaining that section 11(b) of the Securities Act of 1933 has a "'due diligence defense'" for loan underwriters).

201 *See supra* note 130 and accompanying text.

202 *See supra* notes 157–58 and accompanying text.

R&W violations could occur. Such a constructive fraud rule would invite litigation—and thus compel costly due diligence to avoid that litigation—any time there is even a remote chance of extensive R&W violations occurring.[203]

Furthermore, in the rare case, such as the lead-up to the 2008 financial crisis, where publicly available information indicates that there could be extensive R&W violations,[204] the plaintiffs—including sophisticated securitization investors—arguably should know that, too. Such knowledge by plaintiffs should be a defense to any claim of constructive fraud against warrantors.[205] It, therefore, is highly questionable whether the benefits of a constructive fraud rule for extensive R&W violations would exceed its costs.

Conclusion

This Article provides a systematic framework for analyzing R&W breaches. Its framework helps to resolve whether such violations, if extensive, should give rise to fraud claims in addition to contract-breach damages. These issues are not only jurisprudentially important; they also are at the heart of billions of dollars of ongoing litigation.[206]

The boundary between contract-breach damages and fraud for an R&W breach has a murky origin. Initially developing from tort law, under which an R&W breach would justify an action in deceit, warranty law is now viewed as more grounded in contract law. Nonetheless, continuing ambiguity provides an opening for parties to assert extra-contractual fraud claims for an R&W breach, creating legal uncertainty.

Analyzing an R&W breach from the perspective of freedom of contract helps to reduce that uncertainty. Freedom of contract is not absolute. Its limitations include the public policy against fraudulent conduct. Although R&W breaches should generally shift risk strictly according to the contractual terms, including any cure-or-repurchase

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203 The very occurrence of extensive R&W breaches could, rightly or wrongly, create the impression that the warrantor should have known that such breaches could occur.

204 The rate of securitization issuance had risen so rapidly prior to the 2008 financial crisis that warrantors would have lacked the information necessary to truly "represent" the quality of the loans, suggesting that they should have known there *could* be extensive breaches. *Cf.* Lewis & Schwartz, *supra* note 14, at 167–70 (observing that the parties would be using R&Ws as a way to reallocate the risk of defective loans on the sponsor/originator); Miller, *supra* note 9, at 258 n.6, 264, 297 (same); McCoy & Wachter, *supra* note 1, at 289 (same).

205 *Cf.* Joseph Cioffi, *How Subprime RMBS Can Prepare Us for Subprime Auto Litigation in the Time of COVID-19*, Westlaw: Prac. Insights Comments. (June 3, 2020), https://www.dglaw.com/wp-content/uploads/2021/09/Westlaw_Subprime_RMBS_Cioffi.pdf [https://perma.cc/PFQ5-HH3H] (noting that investor fraud claims that were brought in New York in 2013 were thrown out as untimely because "the plaintiff should have known . . . of [the] claims by 2010" due to "the widespread reports of subprime mortgage issues").

206 McCoy & Wachter, *supra* note 1, at 299.

or other sole remedy provisions, the policy against fraudulent conduct should subject intentional R&W breaches to extracontractual fraud claims.

A related issue is whether the existence of unintentional, but extensive, R&W violations should justify extracontractual "constructive" fraud claims. Litigants argue that such extensive violations can make contract-breach damages prohibitively expensive to enforce and thus meaningless. In other contexts, there are precedents that allow rescission where contract-breach remedies fail in their essential purpose or strongly "defeat the object of the parties in making the contract."[207]

The Article shows, however, that the existence of extensive R&W violations should not make contract-breach damages—or at least, the typical cure-or-repurchase sole remedy damages—prohibitively expensive to enforce. In the unlikely event that extensive violations would otherwise make such enforcement prohibitively expensive, courts should consider allowing plaintiffs to more efficiently—and cost-effectively—enforce sole remedy provisions by using statistical sampling to approximate the damages.[208]

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207 Graham v. James, 144 F.3d 229, 237 (2d Cir. 1998) (quoting Septembertide Publ'g, B.V. v. Stein & Day, Inc., 884 F.2d 675, 678 (2d Cir. 1989)).

208 *See supra* notes 196–97 and accompanying text (discussing statistical sampling and its possible limitations).