New York Court Of Appeals Roundup

Decision Clarifies Contract Issue Regarding Grossly Negligent Conduct

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January 19, 2021

The Court of Appeals recently clarified the ability of parties to limit their liability for grossly negligent conduct in a breach of contract action. In Deutsche Bank National Trust Company v. Morgan Stanley Mortgage Capital Holdings, the court held that the public policy rule prohibiting parties from insulating themselves for damages resulting from grossly negligent conduct only applies to contractual provisions that either completely immunize a party or provide for solely nominal damages. It does not apply to other provisions that simply limit, but do not eliminate, the remedies available to a plaintiff for breach.

Plaintiff is the trustee for a residential mortgage-backed security (RMBS) trust for which defendants served as sponsor and depositor. In essence, defendants purchased 5,337 residential mortgage loans and pooled them into a trust which then issued certificates that were sold to investors. In connection with these transactions, defendants made a series of representations and warranties concerning the mortgage loans. The governing documents contained a "sole remedy" clause providing that if a mortgage loan in the pool breached a representation or warranty in a material manner, the plaintiff's sole remedy is to require defendants to cure the breach or repurchase the loan at a contractually defined price.

Plaintiff sued defendants alleging widespread breaches of the representations and warranties and asserted that defendants were grossly negligent in failing to notify plaintiff of the breaches and in failing to cure or repurchase the loans at issue. Plaintiff sought specific performance, compensatory, consequential and punitive damages, and attorney fees. Relying in part on the sole remedy provision, defendants moved to dismiss the claims for compensatory, consequential and punitive damages and for attorney fees. Plaintiff opposed the motion and argued that the sole remedy provision was unenforceable as a matter of public policy because the complaint alleges that defendants acted with gross negligence. Defendants countered that this public policy is only applicable where the provision at issue completely exculpated a defendant or provided for just nominal damages.

The trial court granted defendants' motion and dismissed the breach of contract claim to the extent that it sought punitive damages, attorney fees and compensatory damages beyond those provided for in the sole remedy clause. Plaintiff appealed and the Appellate Division, First Department, reversed. The First Department reinstated the claims for punitive damages and attorney fees and ruled that the allegations of gross negligence rendered the sole remedy clause unenforceable. The First Department granted leave to appeal.

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In a majority decision written by Judge Eugene M. Fahey and joined by Judges Stein, Wilson and Feinman, the Court of Appeals reversed the First Department and reinstated the trial court's order dismissing the damages claims. Judge Jenny Rivera dissented in a lengthy opinion. Chief Judge DiFiore and Judge Garcia took no part in the decision.

The majority noted that contractual exculpatory clauses insulating a party from liability for its own negligence are disfavored in New York but are nevertheless enforceable, particularly when the contract at issue is entered into at arm's length and by sophisticated parties. Public policy, however, generally prevents a party from contractually insulating itself from liability for damages arising out of its own gross negligence. The court had previously applied this public policy to cases in which the contractual clause at issue either completely exculpated the party or limited damages to a nominal amount, but it had not addressed a case—like this—where the clause imposed limitations on the liability or remedies available to the non-breaching party but did not bar them outright or limit them to nominal damages.

The majority focused on the importance of enforcing the bargain freely made by contracting parties and specifically noted that freedom to contract, particularly at arm's length and between sophisticated parties, is "deeply rooted in public policy" (quoting J.P. Morgan Sec. v. Vigilant Ins. Co., 21 N.Y.3d 324, 334 (2013)). In the view of the majority, in situations where the limiting provision provides for more than nominal damages and does not wholly exculpate the breaching party, the rationales supporting the gross negligence public policy exception do not outweigh the public policy favoring freedom of sophisticated parties to contract. Accordingly, in causes of action for breach of contract, grossly negligent conduct by the breaching party will only render unenforceable exculpatory or nominal damages clauses. The sole remedy clause at issue here did not exculpate defendants or limit plaintiff's damages to a nominal sum, but rather provided a mechanism for defendants to correct the breach that was intended to make the trust whole.

The majority also found that punitive damages are unavailable to plaintiff because it is merely seeking to enforce its bargain and has not alleged tortious conduct separate and apart from defendants' failure to fulfill their contractual obligations. Finally, the majority rejected the claim for attorney fees on the grounds that, absent statutory authority or a court rule, a prevailing party can only recover its fees where it is expressly and unmistakably provided for in the parties' contract, but there is no such clear and unmistakable intent in the governing documents here.

Judge Rivera issued a long dissent in which she agreed with the majority with respect to the unavailability of attorney fees but disagreed with their conclusions regarding punitive damages and the scope of the public policy restriction on parties' ability to limit contractual damages for gross negligence. Judge Rivera's dissent starts with a thorough discussion of the economic impact of the financial crisis of 2008 and the role played in that crisis by participants in the RMBS markets. Judge Rivera's dissent is animated by this concern with the effect on the public. While she does not dispute that parties are free to enter into agreements to further their respective interests, she disagrees with a rule that does not sufficiently disincentivize parties from engaging in gross negligence or reckless conduct—particularly when it puts the public at risk. Judge Rivera similarly disagrees with the majority's conclusion that punitive damages are unavailable because plaintiff has not alleged tortious conduct independent of defendants' breach of their contractual obligations. Judge Rivera finds that plaintiff has alleged a violation of a separate duty of care not to mislead the public about defects in the mortgage loans and that this is sufficiently independent of the contract breaches to justify the imposition of punitive damages.

While Judge Fahey's majority opinion acknowledges the seriousness of the 2008 financial crisis and the suffering that it inflicted, that decision focuses on the losses suffered by the trust rather than the public in general. And, because the sole remedy cause does not exculpate defendants or limit the trust to nominal damages but rather was intended to make the trust whole with respect to any defective loans, the majority would hold the parties to the benefit of their bargain and enforce the contract as written.