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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

In the matter of the application of U.S. BANK NATIONAL ASSOCIATION, et al., Petitioners, For an order, pursuant to CPLR § 7701, seeking judicial instruction.	Index No: 652382/2014 Hon. Marcy S. Friedman

TRIAXX'S MEMORANDUM OF LAW IN SUPPORT OF ITS OBJECTION TO PETITIONERS' APPLICATION SEEKING JUDICIAL APPROVAL OF PROPOSED SETTLEMENT

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Preliminary Statement

Triaxx Prime CDO 2006-1, Ltd., Triaxx Prime CDO 2006-2, Ltd., and Triaxx Prime CDO 2007-1, Ltd. (together, "Triaxx") purchased approximately $1.5 billion of the least risky RMBS covered by the proposed settlement before the financial crisis and still hold it. *See* Affidavit of Mingsung Tang, sworn to November 3, 2014, at ¶¶ 2, 7 (hereinafter "Aff. at ¶ __"). Despite prudent investing, Triaxx has lost tens of millions, not only because of the market decline, but due to breaches of representations and warranties by JPMorgan Chase & Co. (with its affiliates, "JPMorgan"), as well as faulty loan servicing by JPMorgan, including improper loan modifications.[1]

Petitioners seek to resolve the claims of investors in approximately 300 RMBS trusts ("Covered Trusts") against JPMorgan for servicing failures and breaches of representations and warranties claims ("R&W Claims"). The proposed settlement provides for no monetary recovery for servicing failures. However, under the proposed settlement, the Trusts would have the option to accept a share of an allowed claim (the "Allowed Claim") of up to $4.5 billion in exchange for the release. The Allowed Claim would be allocated to each participating Trust *pro rata* according to its "estimated lifetime losses" (the "Allocation Formula") without any consideration of whether those losses were caused by breaches of representations and warranties or servicing failures by JPMorgan.

In reviewing Petitioners' exercise of discretion, courts may intervene in a proposed settlement where a trustee has not acted to further the purpose of the trust, or has acted unreasonably or beyond the bounds of reason. The proposed settlement fails these standards in three ways. *First,* the Allocation Formula ignores the fundamental principle that damages should

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[1] To resolve the loan servicing and other claims of residential borrowers, JPMorgan paid $1.08 billion to federal and state governments and $4.21 billion in relief to borrowers. *See* Aff. at ¶¶ 3-5.

be allocated based upon the breaches alleged and not losses caused by unrelated economic events. As the purpose of the Covered Trusts is to allocate risk through representations and warranties, rather than recompense investor losses, the Petition should be denied. *Second,* the $4.5 billion settlement amount does not take account of loan modifications and possible conflicts of interest on the part of JPMorgan. *Third,* the proposed settlement is premature, insofar as Triaxx does not have sufficient information to fully evaluate its terms.

I. THE ALLOCATION FORMULA IS IRRATIONAL

A. The Covered Trusts Hold Different Types of Loans

Before the financial crisis, there was a proliferation of RMBS backed by risky loans, and despite Triaxx's prudent investment in less risky Trusts, those Trusts lost hundreds of millions. *See id.* at ¶¶ 6-8. The Covered Trusts hold different types of residential mortgage loans, and the nature of the loans determines how likely defaults are to be due to a breach of a representation and warranty, which give rise to R&W Claims. *See id.* at ¶¶ 9-10. In contrast, economic or market factors do not. For example, whether a loan is fixed-rate or adjustable-rate ("ARM") is critical. If borrowers default because rising interest rates cause them to be unable to afford their payments, it does not give rise to R&W Claims. Interest rates rose quickly between 2004-2007, and the default rate for ARM loans closely followed that trend.

The different types of loans present different inherent risks. *See id.* at ¶¶ 11-15. Credit risk, the risk that a borrower will default on a loan, is greater with borrowers having subprime credit ratings than prime borrowers, irrespective of representation and warranty breaches. Different loans also present different "security risk," the risk that the collateral for the loan (the borrower's property) will be inadequate to repay the loan in full upon borrower default. For example, there is greater security risk with second lien loans. Properties with two liens may have had little equity at origination, so that if the property value decreases, the second mortgage may

be insufficiently collateralized. *See* Exhibit O. The security risk is also greater with POAs, because reverse amortization can increase the amount of the loan over time relative to the value of the underlying property.

For all these reasons, that the riskier subprime, scratch and dent, Alt-A POA, and second lien Trusts have incurred greater losses than the safer prime and prime Alt-A fixed-rate RMBS does not justify the assumption that those losses arose from valid R&W Claims. The riskier Trusts would be expected to have greater losses, given the heightened risk profile of the loans they own. Exhibit G is a summary of losses among the Covered Trusts. It graphically illustrates the inherent risk characteristics of loans, from the least risky (the Trusts holding prime loans, with average percentage losses of 5% of original notional value) to most risky (the Trusts holding second lien loans, with average losses of 49%).

Moreover, Exhibit H graphically illustrates that the Institutional Investors have held riskier Trusts having greater losses than Triaxx. The Institutional Investors have not disclosed when they purchased their holdings, unlike Triaxx which purchased on or before November 2007. If they purchased their holdings during or after the financial crisis, the allocation formula produces a windfall for them. Exhibit I depicts how announcement of the proposed settlement corresponded with the sudden increase of a second lien Covered Trust that had experienced deep losses.

B. <u>The Trusts Are Subject to Different Representations and Warranties</u>

R&W Claims are contract claims, and depend on the contract terms: the representations and warranties. Another critical difference among the Covered Trusts is whether the PSA for a particular Trust allocate the risk of origination fraud, and if so, whether that risk was allocated to JPMorgan or the investors. During the period that the loans were originated (approximately 2004-2007), origination fraud was a substantial risk. *See* Exhibit K. Petitioners' Expert Reports

fail to assess adequately how the different Representations and Warranties among the Trusts are captured by Expected Lifetime Loss Rates.

However, the representations and warranties for fraud differ among the trusts. *See* Aff. at ¶¶ 19-24. Take, for example, one Sub-Prime Trust, one Scratch and Dent Trust, and three Prime Trusts. The Prime Trusts contain strong language concerning fraud by the mortgagor and mortgagee. For example, one representation and warranty re-stated by the Seller in all of the JPMMTs states:

> (hh) No fraud, error, omission, misrepresentation, negligence or similar occurrence with respect to the Mortgage Loan has taken place on the part of the Seller, the Servicer or any originator or servicer or the Mortgagor or on the part of any other party involved in the origination of the Mortgage Loan, . . .

Aff. at ¶ 21 & Exs. J1-J2. In contrast to language like this, the Sub-Prime and Scratch and Dent Trusts contain no language concerning fraud in their representations and warranties at all. *See id.* at ¶ 22. Furthermore, all of the Prime Trusts are clear that the "Seller . . . makes the representations and warranties contained" in the related purchase agreements, Exhibit J2, or the Seller directly makes the representations and warranties. Exhibit J3. In the other trusts such as BSMF 2007-AR2, this is not always the case. *See* Aff. at ¶ 23.

With respect to another type of Covered Trust, Scratch and Dent Trusts disclose the heightened risks the investors are taking in their prospectuses, while the Prime Trusts do not. For example, one Scratch and Dent Trust disclosure provides that loans in the trust were more than 30 days delinquent, violated underwriting guidelines or had defective loan documentation. Exhibit L.[2]

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[2] Moreover, as Exhibit G demonstrates, the losses for ARM and HELOC/2nd lien loans were largely the result of the economic downturn, as established by the credit support required by the rating agencies. It would be unfair to reward investors for market-driven losses with an R&W Claim recovery. Professor Fischel's Report highlights this inequity. He observes that there are "substantial outliers bordering on the absurd" for the market reaction of certain Subprime and Second Lien Trusts to announcement of the Proposed RMBS settlement. Fischel Report at ¶ 72. The

C. The Proposed Settlement Does Not Meet the Applicable Legal Standard

In determining whether a trustee has abused its discretion, the Court must consider whether discretionary power was exercised with "absolute singleness of purpose." *Dabney v. Chase,* 196 F.2d 668, 671 (2d. Cir. 1952). Therefore, it is settled that courts may intervene in a proposed settlement where a trustee has not acted to further the purpose of the trust, or has acted unreasonably or beyond the bounds of reason. *See* Restatement (Third) of Trusts § 87 cmt. c. In *In re the Application of The Bank of New York Mellon,* 42 Misc. 3d 1237A, at *18 (Sup. Ct. N.Y. County 2014), the Court denied in part a similar proposed settlement, holding that when the trustee settled the loan modification claims "without investigating their potential worth or strength," it acted "unreasonably or beyond the bounds of reasonable judgment." Nothing in record shows that the Petitioners adequately investigated the use of losses as a proxy for R&W Claims[3] or even adequately examined distinguishing features of applicable PSAs. Furthermore, judicial intervention is warranted when a trustee "acts in good faith but for a reason other than to further the purpose of the trust. . . ." Here, recompensing investor losses from economic circumstances is not a purpose of the Covered Trusts.[4]

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market reaction was not absurd; rather, the reaction shows certain market participants opportunistically taking a windfall by buying into Trusts with high rates of loss and weak representations and warranties. *See* Exhibit I.

[3] In opining upon the proposed settlement, Petitioners' experts did not assess whether estimated losses was an adequate proxy for R&W Claims. The Reports of Judge Carpinello, Professor Schwartz, and Mr. Reifsnyder do not touch upon the matter. Dr. Sabry, who does, merely states, "I have been asked by counsel for the Trustees to calculate the lifetime Net Losses for the 330 Trusts at issue and apply the Allocation Formula set out in the Settlement Agreement to estimate the Allocable Share of the Gross Settlement Amount for each Trust." Sabry Report at ¶ 11. Professor Fischel concedes that "this [Allocation] formula does not take into account, among other things . . . the Material Breach Rate for the Trust . . . ." Fischel Report at ¶ 25. Although Professor Fischel repeatedly refers to Material Breach Rate to argue the proposed settlement is reasonable, *see, e.g.*, ¶¶ 106-21, he did not consider (or at least explain) whether "estimated lifetime losses" are a proxy for Material Breach Rates.

[4] Petitioners cannot claim that a comparison of a statistically significant sample of loan files to actual representations and warranties is not feasible. *In re Residential Capital, LLC*, Chapter 11 Case No. 12-12020 (Bankr. S.D.N.Y.) [Docket No. 2833 at ¶ 10]. (such methodology "sufficiently accounts for the differences among the characteristics of each Settling Trust.").

II. THE PROPOSED SETTLEMENT DOES NOT ACCOUNT ADEQUATELY FOR LOAN MODIFICATIONS

In reviewing JP Morgan's apparent failures with respect to loan modifications, it became apparent that Petitioners did not take account of the variations among PSAs governing the loan modifications. *See* Exhibit M. More troubling, JPMorgan may have engaged in improper conflicts of interest in passing loan modification losses to the Covered Trusts while protecting its interests in second lien mortgages, and the record shows no investigation by the Trustees of that matter. *See* Exhibit N.

III. DISCLOSURE IS NECESSARY TO FULLY EVALUATE THE PROPOSED SETTLEMENT

Finally, (i) a complete set of PSAs and Pro Supps for the Covered Trusts, (ii) facts as to the possible conflicts of interest regarding loan modifications by JPMorgan and (iii) facts as to the timing and pricing of purchases by the Institutional Investors warrant disclosure before the proposed settlement receives judicial approval.

Conclusion

For the reasons set forth above, the proposed settlement should not be approved.

Dated: New York, New York
November 3, 2014

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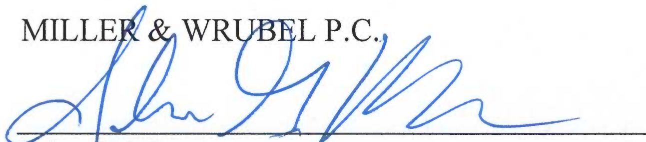

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