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

In the matter of the application of

WELLS FARGO BANK, NATIONAL ASSOCIATION, *et al.,* Petitioners, For Judicial Instructions under CPLR Article 77 on the Administration and Distribution of a Settlement Payment.	Index No. 657387/2017

ELLINGTON MANAGEMENT GROUP L.L.C.'S ANSWER AND MEMORANDUM OF LAW IN RESPONSE TO PETITION

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Interested Person[1] Ellington Management Group L.L.C. ("Ellington"), on behalf of certain funds and accounts it manages and advises, respectfully submits this Answer and Memorandum of Law in Response to the Petition (the "Submission"). The Submission is supported by the accompanying Affirmation of Daniel R. Margolis ("Margolis Aff.").

PRELIMINARY STATEMENT

Ellington is an owner of certificates in Covered Settlement Trusts, as well as of non-Covered Trusts, whose interests are directly impacted by an issue raised in the Petition at Paragraphs 53-57—the Retired Class Provision. Ellington purchased its certificates in the secondary market in reliance on plain and unambiguous language found in the Settlement Agreement and the Covered Settlement Trusts' Governing Agreements, including the PSAs, as well as similar language found in governing agreements of Non-Covered Trusts.

In particular, Ellington, like many other investors, reviewed the specific waterfall of recovery set forth in these documents and purchased tranches in the capital structure based on its understanding of its risk, which was limited by the Retired Class Provision. Pursuant to the Retired Class Provision, certificates of Zero Balance Classes were retired, and the Zero Balance Classes were precluded from any further distribution, once the Certificate Principal Balances were reduced to zero. The Retired Class Provision contains no exceptions for subsequent recoveries.

Ellington and other investors were entitled to rely on that language when they purchased tranches that would be entitled to distributions after the Zero Balance Classes' certificates had been retired. Petitioner U.S. Bank National Association, the Paying Administrator for many of the Trusts, even confirmed to Ellington in writing after it was clear that the Settlement Payment

[1] All undefined capitalized terms have the definitions ascribed to them in the Petition (ECF 1) and Order to Show Cause (ECF 10).

was to flow through the waterfall specified in the PSAs, that once Zero Balance Classes had been retired, they were entitled to no further distributions.

The Petition suggests that the Retired Class Provision is unclear. It is not. The language plainly and unambiguously states that certificates whose principal balance has been reduced to zero must be retired and are no longer entitled to distributions. Interpreting the provision any other way would be equivalent to adding an exception to the provision that is not there, thus constructively amending the PSAs and upending the premise on which Ellington and other investors purchased their certificates. The Court should find that the Zero Balance Classes cannot be "revived" in order to obtain distribution of the Settlement Payment.

BACKGROUND

A. The Zero Balance Class Question

Ellington owns tranches in three Covered Settlement Trusts: BSABS 2007-AC4, PRIME 2006-CL1, and SACO 2005-5 (the "Ellington Covered Trusts"). *See* Margolis Aff. ¶ 2; Petition Ex. A at A-2, A-3, A-6. Accordingly, Ellington is an Interested Person with respect to the relief requested in the Petition. *See* Order to Show Cause ¶ 1.

The Ellington Covered Trusts are each subject to a PSA that contains a Retired Class Provision with substantially the following terms:

> In addition, notwithstanding the foregoing, on any Distribution Date after the Distribution Date on which the Certificate Principal Balance of a Class of Class A, Class B or Class M Certificates has been reduced to zero, that Class of Certificates *will be retired and will no longer be entitled to distributions*, including distributions in respect of Prepayment Interest Shortfalls or Basis Risk Shortfall Carry Forward Amounts.

See Petition ¶ 54 and *id.* Ex. G. The Petition observes that the Retired Class Provision "appears to preclude any further distributions to any Class A, Class B, or Class M certificates if the

aggregate certificate principal balance of such class has been reduced to zero ('Zero Balance Classes')…" Petition ¶ 55. The Petitioners admit that the Retired Class Provision states that "Zero Balance Classes 'will be retired' when the aggregate certificate principal balances thereof have been reduced to zero." *Id.* ¶ 57. The Petitioners also concede that the Retired Class Provision "arguably prevent[s] Zero Balance Classes from receiving any distribution of the Settlement Payment or any application of the Settlement Payment Write-Up…" *Id.* ¶ 56.

Despite their admissions concerning the plain terms of the Retired Class Provision, Petitioners contend that "it is not clear whether or how such provision should apply in this circumstance." Petition ¶ 56. The Petitioners then proclaim that "[n]othing on the face of the Retired Class Provision or in the applicable Governing Agreements appears to expressly preclude Zero Balance Classes from being written up in connection with subsequent recoveries" (*id.* ¶ 57)—notwithstanding the plain language *on the face of* the Retired Class Provision that certificate principal balances "will be retired and will no longer entitled to distributions," with no exception for "subsequent recoveries." Most of the PSAs expressly anticipate the prospect of subsequent recovery, yet contain no provision for "un-retiring" a certificate or reversing a certificate's reduction to zero to participate in a subsequent recovery. *See id.* ¶¶ 7-8. Petitioners thus contend that the plain language, that a retired certificate "will no longer be entitled to distributions" —which contains no exceptions—is "unclear" as to "whether a 'retired' certificate is entitled to write-ups or distributions in any circumstance." *Id.* In effect, they ask the Court to determine whether the PSAs may be judicially amended to permit a certificate that has been reduced to zero and retired to be un-retired and then provided with a write-up or distribution.

The Court's resolution of this issue has implications for owners of tranches entitled to receive waterfall payments once the Principal Balance Certificates for Zero Balance Classes have

been reduced to zero and retired. This Court is also the first in New York to address the issue and similar issues are present in trusts not covered by this proceeding, as well.

For example, Ellington also owns a tranche in SACO I Trust Mortgage Backed Securities Series 2007-2 ("SACO 07-2"), which is the subject of a separate RMBS litigation and settlement agreement with JPMorgan Chase (the "SACO Trust JPM RMBS Settlement"), and which is governed by a PSA that contains the identical Retired Class Provision language at issue here:

> In addition, notwithstanding the foregoing, on any Distribution Date after the Distribution Date on which the Certificate Principal Balance of a Class of Class A, Class M or Class B Certificates has been reduced to zero, that Class of Certificates *will be retired and will no longer be entitled to distributions*, including distributions in respect of Prepayment Interest Shortfalls or Basis Risk Shortfall Carry Forward Amounts.

See Margolis Ex. A § 6.04(a) at 76 (emphasis added); *compare* Petition ¶ 54.

Petitioner Wilmington Trust, National Association ("Wilmington Trust") is the Trustee for SACO 07-2 and a party to the SACO Trust JPM RMBS Settlement. *See* Margolis Aff. Ex. B. On January 17, 2018, Wilmington Trust and Petitioner U.S. Bank National Association ("U.S. Bank"), which is the Securities Administrator for SACO 07-2, filed a petition in Minnesota state court seeking judicial guidance concerning the Retired Class Provision in connection with the SACO Trust JPM RMBS Settlement, raising similar issues that they raise here.

B. Ellington Invested Based On Its Understanding That The Plain Text Of The Retired Class Provision Precludes Write-Ups or Distributions To The Zero Balance Classes, And Petitioner U.S. Bank, National Association Confirmed That Understanding

Ellington and other investors in the Covered Trusts had a right to rely on the plain language of the Retired Class Provision when making investment decisions, including which tranches to purchase. Investors purchased tranches based on their understanding, derived from the plain text of the Retired Class Provision, that the Zero Balance Classes were retired, and

would be unable to receive any write-ups or distributions, *i.e.,* based on their understanding that their ability to recover under the Settlement Agreement would be unimpeded by classes whose Certificate Principal Balances had been reduced to zero. That understanding was reinforced by the fact that the Settlement Agreement requires that the terms of the PSA govern and override the Settlement Agreement when in conflict. *See* Petition Ex. B § 7.05. It was further reinforced by the fact that the Settlement Agreement requires the Allocable Shares to be treated as if they were a "subsequent recovery"—a circumstance that many PSAs define and anticipate, but for which the Retired Class Provision makes no exception. *Compare id.* § 3.06(a) *with* Petition ¶ 54.

Ellington's understanding of the Retired Class Provision, and the provision's application notwithstanding the Settlement Agreement, was confirmed in the context of its purchase of tranches of SACO 07-2 by Petitioner U.S. Bank, which is the Securities Administrator for SACO 07-2 and the Payment Administrator for several of the Covered Trusts. *See* Margolis Aff. ¶ 7 and Ex. C; Petition ¶ 1 n.5 and Ex A. U.S. Bank is a key actor whose role both here and with respect to SACO 07-2 included understanding and interpreting the PSAs to determine how the waterfall operates—including with respect to the Retired Class Provision. When Ellington asked U.S. Bank in September 2017, "Can you confirm that in 'SACO I Trust Mortgage-Backed Certificates Series 2007-2', the II-A tranche has been 'retired and will no longer be entitled to distributions' as per the PSA [pooling and service agreement] language?", U.S. Bank responded affirmatively, stating, "Yes, that is correct." Margolis Aff. Ex. C.

ARGUMENT

I. The Retired Class Provision Unambiguously Precludes The Zero Balance Classes From Receiving Write-Ups Or Distributions

The Retired Class Provision is clear and unambiguous that the Zero Balance Classes are not entitled to distributions or write-ups under any circumstance. The plain language of the

provision suffers from no ambiguity: once the Principal Certificate Balance on a Class A, Class B, or Class M tranche has been "reduced to zero," then "that Class of Certificates *will be retired and will no longer be entitled to distributions*…" Petition ¶ 54 (emphasis in original).

Petitioners acknowledge that the language in the Retired Class Provision providing that a retired certificate shall "will be retired and will no longer be entitled to distributions" is clear, in that it "appears to preclude any further distributions to any Class A, Class B, or Class M certificates if the aggregate certificate principal balance of such class has been reduced to zero ('Zero Balance Classes'), no matter [what the reason for the reduction]…." Petition ¶ 55. The Retired Class Provision contains no exceptions for subsequent recoveries. *Id.* ¶ 54. It likewise contains no exception if the Principal Certificate Balance has been reduced to zero as a result of realized losses. *Id.* Nonetheless, ignoring this plain language, Petitioners contend that "it is not clear whether or how such provision should apply in this circumstance" and that "[n]othing on the face of the Retired Class Provision or in the applicable Governing Agreements appears to *expressly* preclude Zero Balance Classes from being written up in connection with subsequent recoveries." *Id.* ¶¶ 56, 57 (emphasis added). The only question, therefore, is whether the Court should read into the Retired Class Provision an exception for subsequent recoveries, such as the Settlement Payment. It should not.

First, reading an exception into the Retired Class Provision would conflict with the generally understood method by which tranches are paid in a waterfall. Unless otherwise specified, tranches are paid in sequence *until* they are retired, after which the tranche is no longer outstanding and thus no longer entitled to payment.[2] *See* Petition ¶¶ 3-4. Neither the Retired

[2] *See, e.g.,* http://www.nasdaq.com/article/what-is-the-difference-between-treasury-shares-and-retired-shares-cm581930 (Feb. 19, 2016); https://thelawdictionary.org/retirement/ (retirement is "1. The removal of any asset after its sale. 2. Forced or voluntary withdrawal from the job market. 3. Withdrawing a document from circulation. 4. The discharge or satisfaction of an obligation."). Further, the common or plain meaning of retirement, relied on

Class Provision nor any other provision of the PSAs provides for resuscitation of a retired certificate or tranche, under any circumstance. The PSAs include instruction for write-ups in the face of subsequent recovery of realized losses, yet the Retired Class Provision requires retirement of certificates whose balances have been reduced to zero regardless of circumstance. Indeed, the finality of retirement, and the additional language in the Retired Class Provision stating categorically and without exception that upon reduction of the Certificate Principal Balance to zero, no distributions will be made, necessitates the conclusion that once a certificate is retired, it may not be revived.

Second, if parties to a contract omit specific terms, "the inescapable conclusion is that the parties intended the omission." *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 23 N.Y.3d 549, 560 (2014) ("The maxim *expressio unius est exclusio alterius,* as used in the interpretation of contracts, supports precisely this conclusion (*see generally* Glen Banks, New York Contract Law § 10.13 [West's N.Y. Prac. Series 2006]; *see also In re Ore Cargo, Inc.,* 544 F.2d 80, 82 (2d Cir.1976) (where sophisticated drafter omits a term, *expressio unius* precludes the court from implying it from the general language of the agreement)"). The parties to the PSAs declined to include an exception to the Retired Class Provision even though many of the PSAs define the term "subsequent recovery", mention it multiple times, and specify the circumstances under which subsequent recoveries are permitted (typically for write-ups of realized losses). *See, e.g.*, Petition ¶¶ 7, 21. The parties to the PSAs thus anticipated that subsequent recoveries would be made in the context of write-ups of realized losses—but declined to provide an exception in the

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generally by RMBS investors, is that once a tranche is retired, the certificate holder is no longer entitled payment of any kind, because "the principal payments are paid to the first tranche alone, until it is completely retired. Once the first tranche is retired, principal payments are applied to the second tranche until it is fully retired, and the process continues…" SIFMA, http://www.investinginbonds.com/learnmore.asp?catid=5&subcatid=17&id=35.

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Retired Class Provision. They were well aware of how to provide such an exception and chose not to do so. Thus, the omission from the Retired Class Provision of language exempting write-ups of realized losses and distributions of subsequent recoveries leads to the inescapable conclusion that the parties intended no exemption. That conclusion is reinforced further by the omission from the PSAs of any mechanism for un-retiring a retired certificate to enable it to participate in a subsequent recovery.

Third, reading such an exception into the Retired Class Provision now, to permit payment of the Settlement Payment to the Zero Balance Classes, would require a constructive amendment of the PSA. Yet, as Petitioners acknowledge, the Settlement Agreement "provides that the Settlement 'shall not be argued or deemed to constitute, an amendment of any term of any Governing Agreement". Petition ¶ 42 (quoting Settlement Agreement § 7.05).

Further, the sophisticated parties who negotiated the Settlement Agreement made clear their intent to treat the Settlement Payment as a "subsequent recovery" as defined in the Governing Agreements, and to abide by, rather than override or amend, the terms of those Governing Agreements. The Settlement Agreement provides,

> Each Trust's Allocable Share shall be deposited into the related Trust's collection or distribution account pursuant to the terms of the Governing Agreements, for further distribution to Investors in accordance with the distribution provisions of the Governing Agreements ….as though such Allocable Share *was a subsequent recovery available for distribution on the related distribution date*…

Petition Ex. B § 3.06(a) (emphasis added). Thus, the Settlement Agreement itself instructs the Court to abide by the Governing Agreements' distribution terms for subsequent recoveries, and it plainly does not permit the Court to amend, alter, or override those distribution terms, even where the Retired Class Provision precludes such recovery. Just as the parties to the PSAs

included no exceptions to the Retired Class Provision for subsequent recoveries, the parties to the Settlement Agreement included no exceptions to the prohibition on amending the terms of the PSAs and in particular the distribution waterfalls.

The only "inescapable conclusion" is that the parties, which could have excluded subsequent recoveries from the general prohibitions in the broad Retired Class Provision, and could have written the Settlement Agreement to override the Retired Class Provision, intended not to do either. Further, the Zero Balance Classes had ample opportunity to negotiate for different settlement terms or to object to and/or opt out of the Settlement Agreement if they had had any concerns about the Retired Class Provision. If the Zero Balance Classes objected during the settlement negotiations, then that objection was rejected by the court in approving the settlement and this Court should not revisit that decision. If they did not object during settlement negotiations, then they should not be permitted to do so now, as they should have known that the plain language of the PSAs shut them out of the Settlement Payment. Neither circumstance creates an after-the-fact ambiguity in the PSAs or the Settlement Agreement, or justifies amending the PSAs to provide a right that does not exist, at the expense of certificate holders entitled to rely on the plain language of both the PSAs and the Settlement Agreement.

The Court should therefore find that the Retired Class Provision must be applied according to its unambiguous terms: the Zero Balance Classes' certificates have been retired; there is no provision anywhere in the PSA for "reviving" them after retirement (even in the context of a subsequent recovery); and the Zero Balance Classes are entitled to no distributions.

II. One Of The Petitioners Has Already Confirmed Its Agreement That The Zero Balance Classes Are Precluded From Receiving Write-Ups or Distributions

Petitioner U.S. Bank's prior written statement demonstrates its understanding of the intent and meaning of identical language to that used in the Retired Class Provision.

Specifically, following its purchase of certain tranches in SACO 07-2, Ellington sent an email to U.S. Bank, which serves as Securities Administrator for the SACO 07-2 Trust, whose PSA included a provision with language identical to that in the Retired Class Provision, asking it to confirm that the II-A tranche of SACO 07-02 had been "'retired and will no longer be entitled to distributions' as per the PSA language". Margolis Aff. ¶ 7 and Ex. C. U.S. Bank affirmed that it understood the identical language to preclude any further distributions. *See id.* Ex. C. Further, U.S. Bank provided this confirmation *after* Wilmington Trust entered into the SACO Trust JPM RMBS Settlement, and, thus, was in full agreement that the Retired Class Provision precluded recovery for the Zero Balance Classes under the SACO Trust JPM RMBS Settlement. *Compare* Margolis Aff. Ex. C *with id.* Ex. B.

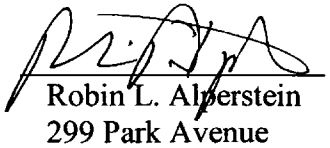
Conclusion

For the foregoing reasons, the Court should find that the Retired Class Provision bars writing up the Zero Balance Classes or distributing any Settlement Payment to them.

Dated: New York, NY
January 29, 2017

Respectfully submitted,

BECKER, GLYNN, MUFFLY, CHASSIN AND HOSINSKI LLP

By: 

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