

**SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK IAS PART 60**

In the Matter of the Application of WELLS FARGO BANK, NATIONAL ASSOCIATION, U.S. BANK NATIONAL ASSOCIATION, THE BANK OF NEW YORK MELLON, THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., WILMINGTON TRUST NATIONAL ASSOCIATION, HSBC BANK USA, N.A., and DEUTSCHE BANK NATIONAL TRUST COMPANY (as Trustees, Indenture Trustees, Securities Administrators, Paying Agents, and/or Calculation Agents of Certain Residential Mortgage-Backed Securitization Trusts),

Petitioners,

For Judicial Instructions under CPLR Article 77 on the Distribution of a Settlement Payment.

Index No. 657387/2017
(Friedman, J.)

MEMORANDUM OF LAW OF U.S. BANK NATIONAL ASSOCIATION, AS TRUSTEE OF THE NIM TRUSTS HOLDING INTERESTS IN THE HBK SETTLEMENT TRUSTS REGARDING THE PAY FIRST, WRITE-UP SECOND ISSUE

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Respondent U.S. Bank National Association (“U.S. Bank”), solely in its capacity as Indenture Trustee for the NIM Trusts listed on Exhibit 10 hereto, and solely at the direction of Respondent HBK Master Fund LP (“HBK”), submits this memorandum of law, along with the Affirmation of Seth D. Allen, and the exhibits attached to it (“Allen Affirm.”), in support of HBK’s motion regarding the distribution of funds to the trusts listed in Exhibit 1 to the Allen Affirm. (the “HBK Settlement Trusts”) in this proceeding.¹ This memorandum addresses the issues raised in paragraphs 21 through 48 of the Petition (the “Order of Payment Issue”); other issues relating to the HBK Settlement Trusts are addressed in a separate Memorandum of Law regarding the retired class issue.²

PRELIMINARY STATEMENT

The dispute here is two-fold; first, certain Respondents seeking to pay first wish to rewrite the pooling and servicing agreements (the “PSAs”) governing the HBK Settlement Trusts (the “HBK Settlement Trust PSAs”) so that senior noteholders immediately receive the entirety of each trust’s Allocable Share by ignoring portions of the HBK Settlement Trust PSAs relating

¹ Pursuant to the Court’s order (Dkt. No. 471) (the “Substitution Order”) and at the direction of Respondent HBK, U.S. Bank, solely in its capacity as Indenture Trustee under the NIM Trusts referenced on Exhibit 10 hereto (which hold a direct interest in the HBK Settlement Trusts), has substituted into this proceeding in place of Respondent HBK. This memorandum of law addresses only the Order of Payment Issue and it reflects the position of HBK as set forth in its initial Answer (Dkt. No. 78). U.S. Bank, in its capacity as Indenture Trustee under certain other NIM Trusts, has also substituted into this proceeding on behalf of Respondents Poetic Holdings VI LLC, Poetic Holdings VII LLC (collectively, “Poet”) and Prophet Mortgage Opportunities Fund LLP (“Prophet”). At the direction of Poet and Prophet and jointly with Poet and Prophet, U.S. Bank will submit another memorandum of law with respect to these same issues (the “Poet/Prophet Memorandum of Law”). The Poet/Prophet Memorandum of law, in some respects may advance positions contrary to those asserted herein; however, as contemplated by the Substitution Order, U.S. Bank has taken appropriate measures to address any potential or actual conflicts of interest. Furthermore, U.S. Bank’s capacity in its role as NIM Trustee hereunder is a separate and distinct capacity from that of U.S. Bank in its role as Petitioner and Trustee of the Settlement Trusts.

² All capitalized terms in this memorandum have the meaning given to them in the Petition, unless otherwise specified.

to the Overcollateralization Release Amount and requiring payments to other noteholders; and second, certain Respondents seeking to write-up first wish to alter the order of operations set out in the HBK Settlement Trusts PSAs in order to increase the value of their own junior holdings. The Court should reject such invitations to rewrite unambiguous distribution language of the HBK Settlement Trust PSAs.

The distribution of funds received by the HBK Settlement Trusts is governed by the HBK Settlement Trust PSAs. The HBK Settlement Trust PSAs and the Settlement Agreement—both explicitly by their terms and implicitly by their structure—require that each trust’s Allocable Share be distributed to certificateholders as provided by Section 5.04(a) of the HBK Settlement Trust PSAs before writing up certificate balances as provided by Section 5.04(b) of the HBK Settlement Trust PSAs (the “Pay First, Write-Up Second Method”).

The Payment Waterfall

The structure of the payment waterfall shows that a trustee should follow that Pay First, Write-Up Second Method. The Settlement Agreement requires the Allocable Share to be treated as a Subsequent Recovery. The payment waterfall for the HBK Settlement Trust PSAs provides in Section 5.04(a) that Subsequent Recoveries are included in Principal Funds, which are used to pay down principal owed on Class A, M and B certificates and to constitute the Overcollateralization Release Amount, which is in turn used to pay down Applied Realized Loss Amounts on nonretired senior certificates, make other distributions and then pay Class C (or economically equivalent) certificates. After those distributions are made, under Section 5.04(b), affected classes of bonds are written up to account for Subsequent Recoveries.

The Settlement Agreement

The Settlement Agreement reinforces that the order of payment is pay first, write-up second. Section 3.06(a) of the Settlement Agreement requires a trustee to **deposit** a trust's Allocable Share into the trust's collection or distribution account for further distribution to Investors and then to **distribute** the Allocable Share. Only after these distributions are made—that is, after the trustee pays first—does Section 3.06(b) discuss the **write-up** of certificates.

The Respondents who oppose the payment methods prescribed by the Settlement Agreement and the HBK Settlement Trust PSAs ask the Court to rewrite complex agreements negotiated by sophisticated parties and their counsel because funds paid pursuant to the Settlement Agreement—also negotiated by sophisticated parties and their counsel—will flow in a way to which such Respondents object. That a certificateholder might now wish that the Settlement Agreement and the HBK Settlement Trust PSAs provided for a different result is no grounds for declaring any of these agreements to be ambiguous or for ignoring or rewriting their terms. This is particularly true for the argument that the trustee should pay first but then ignore Section 5.04(a) relating to the Overcollateralization Target Amount. Such a result would amount to a rewriting of the HBK Settlement Trust PSAs.

Indeed, the same appeal to vague notions of fairness or expectations was rejected in litigation over the Pay First, Write-Up Second Method in *In re Bank of New York Mellon*, 56 Misc. 3d 210, 225 (N.Y. Sup. 2017), (the “BoNYM Article 77 Proceeding”). The Court (Scarpulla, J.) rejected all such appeals, holding, “[u]pon careful examination of the plain language of the settlement agreement and governing agreements, I find that their objective meaning is to direct the Trustee to distribute the allocable shares for the 14 trusts using the pay first, write up second method . . .” *Id.* This Court should do the same and apply the

unambiguous terms of the HBK Settlement Trust PSAs as written and consistent with the Settlement Agreement, following the Pay First, Write-Up Second Method.

FACTUAL BACKGROUND

A. The Settlement Agreement.

The Settlement Agreement requires the distribution of each HBK Trust's share of the Settlement Payment (the "Allocable Share") for distribution by Petitioners "as though such Allocable Share was a 'subsequent recovery' relating to principal proceeds available for distribution on the immediately following distribution date." (Settlement Agreement § 3.06(a) Allen Affirm. Ex. 2) (emphasis added).) It provides a specific order of payment and write-up.

First, "[e]ach 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." (*Id.* (emphasis added).)

Second, the trustee "will **distribute** each Settlement Trust's Allocable Share" to certificateholders. (*Id.* (emphasis added).)

Third, "[a]fter the distribution of the Allocable Share to a Settlement Trust pursuant to Subsection 3.06(a)," the Allocable Share is to be applied "to increase the balance of each class of securities . . . to which . . . losses have been previously allocated" "in the reverse order of previously allocated losses" (the "**Write-Up**"). (*Id.* § 3.06(b).)

B. The HBK Settlement Trusts.

The HBK Settlement Trust PSAs all use the defined term "Subsequent Recoveries," (Allen Affirm. Ex. 3) and provide that Subsequent Recoveries are part of "Principal Funds." (*Id.* Ex. 4.) The "Distributions" provision, a term in all HBK Settlement Trust PSAs at Section 5.04, governs both the distribution of Principal Funds (which include Subsequent Recoveries), as well

as the write-up of classes of certificates to reflect Subsequent Recoveries. (*Id.* Ex. 5.)

Subsection (a) of Section 5.04 contains the rules for the distribution of such funds. (*Id.*

§ 5.04(a).) **Only after the distribution of such funds are accounted for** can the accounting for those funds be addressed in subsection (b) of Section 5.04. (*Id.* § 5.04(b).)

C. Section 5.04(a): The Distribution of Funds.

Section 5.04(a) of the HBK Settlement Trust PSAs requires that “on each Distribution Date, an amount equal to the Interest Funds and **Principal Funds** for each Loan Group for such Distribution Date shall be withdrawn by the Trustee from the Distribution Account and **distributed** in the following order of priority. . . .” (*Id.* (Emphasis added).) In other words, the Principal Funds, which include the Subsequent Recoveries, flow into the payment waterfall of Section 5.04(a) and are distributed.

The first step of the waterfall does not involve the Principal Funds; rather, under Section 5.04(a)(1), the Interest Funds are first used to make various payments for interest. Next, Section 5.04(a)(1) provides that “Excess Spread to the extent necessary to meet a level of overcollateralization equal to the Overcollateralization Target Amount shall be the Extra Principal Distribution Amount and shall be included as part of the Principal Distribution Amount.” In other words, the Excess Spread (*id.* Ex. 6), up to the Overcollateralization Target Amount, is used to constitute the Extra Principal Distribution Amount, which flows back into the waterfall at Section 5.04(a)(2). (*Id.* Ex. 5 § 5.04(a)(2).)

Next, Section 5.04(a)(1) provides that “[a]ny Remaining Excess Spread, **together with the Overcollateralization Release Amount** shall be applied as Excess Cashflow and distributed pursuant to clauses 5.04(a)(4)(A) through (H).” (*Id.* § 5.04(a)(1) (emphasis added).) In other words, the Remaining Excess Spread (*i.e.*, the Excess Spread over the Extra Principal Distribution Amount (*id.* Ex. 7)) and the Overcollateralization Release Amount (**paid from**

Principal Funds (*id.* Ex. 8) **skip** the parts of the waterfall in 5.04(a)(2) and 5.04(a)(3) and are distributed lower down, in 5.04(a)(4), in the provisions regarding the distribution of Excess Cashflow.

After possibly making payments for Relief Act Interest Shortfalls and Prepayment Interest Shortfalls, the waterfall moves to 5.04(a)(2), which is the distribution of principal. (*Id.* Ex. 5 § 5.04(a)(2).) At Section 5.04(a)(2), the trustee pays the Principal Distribution Amount. The Principal Distribution Amount has three components: the Principal Funds and any Extra Principal Distribution Amount **minus** the Overcollateralization Release Amount created in Section 5.04(a)(1). (*Id.* Ex. 9 (emphasis added).) This definition reinforces that the Overcollateralization Release Amount is **not** paid under Section 5.04(a)(2) with other principal payments, but rather is distributed further down the waterfall, in Section 5.04(a)(4).

In Section 5.04(a)(2), the Principal Distribution Amount is used to pay down certificates, until the certificate balance is paid to zero, in payment priority. (*Id.* Ex. 5 § 5.04(a)(2).) Section 5.04(a)(3) is the Class A Redirection Provision discussed below. (*Id.* Section 5.04(a)(3).)

Finally, in Section 5.04(a)(4), Excess Cashflow (including the Remaining Excess Spread and the Overcollateralization Release Amount discussed above) is used to pay various distributions, including paying down any Applied Realized Loss Amounts on non-retired senior certificates in order of seniority. (*Id.* at Section 5.04(a)(4).) At the end of the waterfall, at Section 5.04(a)(4)(G), is where distributions are made to Class C certificates.

D. Section 5.04(b): The Write-Up of Certificates.

Section 5.04(b) of the HBK Settlement Trust PSAs provides: “If, after taking into account such Subsequent Recoveries, the amount of a Realized Loss is reduced, the amount of such Subsequent Recoveries will be applied to increase the Certificate Principal balance of the Class of Certificates with the highest payment priority to which Realized Losses have been

allocated, but not by more than the amount of Realized Losses previously allocated to that Class of Certificates” (*Id.* § 5.04(b).)

ARGUMENT

I. THE HBK SETTLEMENT TRUST PSAS REQUIRE THE TRUSTEE TO PAY FIRST, WRITE-UP SECOND

Because the order of payment and write-up is not unaddressed in the HBK Settlement Trust PSAs, the Court should simply apply the PSAs as written, and direct Petitioners to make distributions (including distributions of Principal Funds, of which the Allocable Share is a part) as provided by Section 5.04(a) of the HBK Settlement Trust PSAs before writing up certificate balances as provided by Section 5.04(b).

A. The Structure of the HBK Settlement Trust PSAs Require Payment First, Write-Up Second.

First, the structure of Section 5.04, which governs the distribution of funds (including Subsequent Recoveries) and the write-up of certificates, shows why the distribution of the Settlement Payment must be made using the Pay First, Write-Up Second Method. The order of distributions is clear: Subsequent Recoveries, including the Settlement Payment, must first be distributed in accordance with the waterfall (5.04(a)). Only after those distributions are complete are any certificates written up (5.04(b)).

The HBK Settlement Trust PSAs include Subsequent Recoveries in Principal Funds which are used in turn: first, in Section 5.04(a)(1) to constitute the Overcollateralization Release Amount; then in Section 5.04(a)(2) to pay down principal; and finally, if there are any Principal Funds left, in Section 5.04(a)(4) (along with the Overcollateralization Release Amount) to pay down Applied Realized Loss Amounts on nonretired senior certificates, make other distributions, and then pay Class C certificates.

Indeed, if a trustee processed the write up under Section 5.04(b) before distributing Principal Funds under Section 5.04(a), the trustee would have to ignore the introductory clause of Section 5.04(b), requiring certificates to be written up only if, “**after** taking” Subsequent Recoveries “**into account**,” “the amount of a Realized Loss is reduced.” (Emphasis added). Realized Losses are reduced through the payment of distributions under Section 5.04(a)(4). A trustee cannot determine whether the condition precedent represented by the introductory clause of Section 5.04(b) is met except by paying distributions first, under Section 5.04(a). There is nothing suggesting that Section 5.04(b) should be applied before Section 5.04(a). Thus, the trustee should follow the payment and write-up instructions sequentially.

Second, some Respondents contend in their Answers that the Settlement Agreement calls for a write-up first, arguing that while it unambiguously discusses the distribution of the Allocable Shares first and the write-up second, the Settlement Agreement somehow envisions a three-step process: (1) distribution of the Allocable Share to the trust; (2) write-up; and (3) distribution to certificateholders. This interpretation not only would impermissibly rewrite the Settlement Agreement, but further would bootstrap the rewritten Settlement Agreement to rewrite the PSA, something Settlement Agreement explicitly forbids.

Section 3.06(a) of the Settlement Agreement requires that “[e]ach Trust’s Allocable Share” be deposited in the trust’s “collection or distribution account.” (Ex. 2, Settlement Agreement § 3.06(a)). Section 3.06(a)’s first sentence provides that the deposit shall be “for further distribution to Investors” (*id.*), while its last sentence requires the trustee to “distribute each Settlement Trust’s Allocable Share.” (*Id.*). Thus, Section 3.06(a) requires not just the deposit of the Allocable Share into a trust’s accounts but also the Allocable Share’s distribution to certificateholders “in accordance with the distribution provisions of the Governing

Agreements . . . as though” the payment “was a Subsequent Recovery.” (*Id.*) Only after these distributions are made—that is, after the trustee pays first—does Section 3.06(b) provide for the write-up of certificates.

B. Payments to the Class C Certificates Should Be Processed Regardless of The Payment Status of Senior Certificates.

Consequences of the payment flow generated by the Pay First, Write-Up Second Method are referenced in the Petition (Pet. ¶¶ 24 – 51) and by certain Respondents in their answers (*see, e.g.*, Dkt. No 117, 136, 141), particularly payments being made to Class C certificates before higher certificates are paid in full. The questions raised in paragraphs 32 through 34 of the Petition are not issues of contractual ambiguity, but rather reflect a preference by certain noteholders that the HBK Settlement Trust PSAs distribute the money in a way that benefits their holdings. The Court should reject this invitation to ignore the unambiguous terms of the HBK Settlement Trust PSAs.

First, the Settlement Agreement and HBK Settlement Trust PSAs are unambiguous and under well-settled law must be enforced as written.³ Any appeal by Respondents to “fairness” is exactly what Justice Scarpulla rejected in the BoNYM Article 77 Proceeding. Justice Scarpulla recognized that she could “not look beyond the four corners of the relevant agreement to determine the parties’ intent, when the contract language is clear.” 56 Misc. 3d at 224.⁴

³ *See, e.g., R/S Assoc. v. New York Job Dev. Auth.*, 98 N.Y.2d 29, 32 (2002) (“[W]hen parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms.”); *Greenfield v. Philles Records, Inc.*, 98 N.Y.2d 562, 569 – 570 (2002) (“[I]f the agreement on its face is reasonably susceptible of only one meaning, a court is not free to alter the contract to reflect its personal notions of fairness and equity”).

⁴ The appeals of the BoNYM Article 77 Proceeding pay-first, write-up second decision were withdrawn. The Notice of Appeal filed October 25, 2017, related to a different aspect of Justice Scarpulla’s decision (*i.e.*, the application of *res judicata* regarding one specific trust), an issue that is irrelevant here.

Second, concerns about accounting anomalies (Pet. ¶ 34), if every active certificate is paid off before the Principal Distribution Amount is exhausted (Pet. ¶¶ 38 – 40), are theoretical concerns: there is **no** evidence that there is any danger of this happening or if it did, that it would make any practical difference to the rights of certificateholders. “When examining [a] contract for ambiguity, a court must look to the situation before it, and not to other possible or hypothetical scenarios.” *Bishop v. Nat'l Health Ins. Co.*, 344 F.3d 305, 308 (2d Cir. 2003) (applying Connecticut law); *see also In re Fontainebleau Las Vegas Contract Litig.*, 716 F. Supp. 2d 1237, 1252 (S.D. Fla. 2010) (applying New York law) (“[C]ontract law is clear insofar as a court must look to the situation before it, and not to other possible or hypothetical scenarios when considering a contract in order to determine whether an ambiguity exists.”) (internal quotations omitted). Even if these are real rather than hypothetical issues, the solution would be to determine what to do, for example, with the excess Principal Distribution Amount, not to ignore the unambiguous distribution rules of Section 5.04(a).

Third, just as the Court should not rewrite the HBK Settlement Trust PSAs to address theoretical problems with the implementation of the payment waterfall as written, nor should it ignore waterfall provisions or rewrite the waterfall because a Respondent does not like the result of the waterfall as written. Thus, for example, there is no basis for ignoring the parts of the waterfall in Section 5.04(a) relating to the Overcollateralization Target Amount because a Respondent would like to see the money go to them rather than as required by the HBK Settlement Trust PSAs. Similarly, just because a pay-first methodology results in payment going to holders of Class C certificates or insurers (Pet. ¶ 33.) is not a basis for using a write-up first methodology.

Fourth, there is nothing unfair about the order of distribution required by the Settlement Agreement and the HBK Settlement Trust PSAs. The purpose of the Settlement Agreement is to benefit a trust as a whole and then rely on the trust's PSA to determine how to distribute the Allocable Share to specific classes of certificateholders. The Court's decision should thus reflect the Settlement Agreement's agnosticism toward specific classes of holders. Distribution of the Overcollateralization Release Amount in accordance with the waterfall of Section 5.04(a)(4) respects the senior certificateholders' position in the payment waterfall: to the extent holders of non-retired senior certificateholders have suffered realized losses, Section 5.04(a)(4) compensates them for those losses before the holders of more junior non-retired certificateholders. And, of course, the Principal Funds—other than the Overcollateralization Release Amount—will still flow into Section 5.04(a)(2) and be used to pay the existing Certificate Principal Balance of each non-retired certificate down to zero by order of seniority.

CONCLUSION

For the foregoing reasons, the Court should direct the trustees of the HBK Settlement Trusts to make distributions as provided by Section 5.04(a) of the HBK Settlement Trust PSAs with the distribution of Overcollateralization Release Amount before writing up certificate balances as provided by Section 5.04(b) of the HBK Settlement Trust PSAs (*i.e.*, Pay First, Write-Up Second)

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