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.,	Index No. 657387/2017
	Friedman, J.
Petitioners,	
For Judicial Instructions under CPLR Article 77 on the Administration and Distribution of a Settlement Payment.	**OPENING BRIEF OF THE INSTITUTIONAL INVESTORS AND AIG CONCERNING THE PETITION**

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Pursuant to the August 15, 2018 Stipulation Regarding Merits Briefing Schedule and Trustee Substitutions (Dkt. No. 486), the Institutional Investors and the AIG Parties submit this Opening Brief addressing the issues raised in the Petition concerning the distribution of approximately $2.27 billion in settlement proceeds to 119 JPMorgan RMBS trusts identified in Exhibit 1 to the Affidavit of David M. Sheeren, filed herewith.[1] The aggregate current unpaid balance of the certificates held by the Institutional Investors and the AIG Parties in those trusts exceeds $7.3 billion. The Institutional Investors and the AIG Parties submit this Opening Brief only with respect to the trusts identified in Exhibit 1.

STANDARD OF REVIEW

Article 77 Proceedings are summary in nature. In an Article 77 proceeding, the Court must examine the Trustee's Petition (as well as any evidence filed), after which it "shall make a summary determination upon the pleadings, papers and admissions to the extent that no triable issues of fact are raised."[2] No triable issues of fact are raised here.

I. Introduction.

The two most consequential and disputed issues raised in the Petition are (i) whether the Trustees should employ the Pay First or Write Up First method, and (ii) whether, under the Pay First method, the settlement payment itself can *create* temporary overcollateralization. This Opening Brief focuses on those two issues.

[1] Unless otherwise defined herein, all capitalized terms have the meaning given to them in the Petition. Further, all exhibit references are to Exhibits to the Sheeren Affidavit filed herewith, unless otherwise specified. At least thirty-four additional trusts held by the Institutional Investors and/or the AIG Parties have become undisputed following the Court's standing decision, and the Institutional Investors and/or the AIG Parties will soon submit a proposed consensual judgment as to those undisputed trusts, which will reflect the arguments and distribution methodology set forth in this Opening Brief.

[2] N.Y.C.P.L.R. 409.

As to the first issue, the Settlement Agreement requires the Pay First method. Paragraph 3.06(a) of the Settlement Agreement provides for the distribution of the Settlement Payment, and Paragraph 3.06(b) provides for a certificate "write up" to occur after that distribution. The last sentence of Paragraph 3.06(b) removes any doubt: it states that the certificate "write up" provided for in Paragraph 3.06(b) "shall not affect" the distribution of the Settlement Payment set out in Paragraph 3.06(a). That final sentence rules out the Write Up First method, because the Write Up First method would necessarily alter the certificate balances before the settlement funds are distributed—impermissibly "affecting" which certificates will receive the settlement distribution.

Given that the Governing Agreements are silent as to the order of operations, all potential objections to this Pay First method were "overruled" and "deemed waived" by this Court's Final Order and Judgment in the prior Article 77 concerning the JPMorgan settlement.[3] The Court's Final Order and Judgment in that prior Article 77 bars certificateholders from raising objections to the Trustees' implementation of the Settlement Agreement, "so long as such implementation is in accordance with the terms of the Settlement Agreement."[4] The Pay First issue is therefore *res judicata* and certificateholders have waived any objection to the Pay First sequence set out in the Settlement Agreement.

As to the second issue, the Settlement Payment itself cannot create overcollateralization under the Pay First method because the definition of overcollateralization in the Governing Agreements prevents that from happening. In calculating the level of overcollateralization, the Governing Agreements direct the Trustees to "take into account" or "give effect to" both the write-down of certificate balances and the equivalent write-up of certificate balances associated with the

[3] *See* Ex. 2 (Final Order and Judgment, *In the matter of the application of U.S. Bank National Association, et al.*, Index No. 652382-2014, Docket No. 598 (August 23, 2016)), at ¶¶ 3 - 4.

[4] *Id.* at ¶ 5.

receipt of subsequent recoveries like the Settlement Payment. Those two operations necessarily cancel each other out for subsequent recoveries, keeping the trusts' assets and liabilities in balance, and preventing overcollateralization from being *created* by subsequent recoveries.

As to the other issues in the Petition, the Institutional Investors and the AIG Parties state the following:

With respect to the trusts included in Exhibit E to the Petition, the Trustees allege an ambiguity concerning whether senior certificates with prior losses in certain Bear Stearns trusts are "eligible" for a certificate write-up. No party, except Nover Ventures LLC ("Nover") and/or its CDO trustee, disputes that under the Settlement Agreement and the Governing Agreements, all classes of certificates, including senior certificates, are eligible for such a write-up. The Settlement Agreement (i) requires that the write-up be performed in the reverse order of previously allocated realized losses and (ii) does not restrict eligibility for such write-up to a particular class of certificates. The clear intent of the Governing Agreements was that senior certificates with losses are eligible for subsequent recovery write-ups. Absurd results would follow if they were not. Given that the Settlement Agreement expressly provides that all certificates are eligible to be written up, and that the Governing Agreements do not contravene this commonsense conclusion, all senior certificates should be treated as eligible for write-ups.

As to the trusts included in Exhibit F to the Petition, the Trustees allege a conflict between the write-up methodology in the Governing Agreements and in the Settlement Agreement. Most typically, many Governing Agreements for Exhibit F trusts provide for write-ups to be performed by order of *payment* priority, not the reverse order of previously allocated realized *losses*. Because that method directly conflicts with the Settlement Agreement, the Trustees should follow the Governing Agreement. The Trustees have been distributing subsequent recoveries for over a

decade for these trusts, and they should do so again now. In a small handful of the Exhibit F trusts, however, the Governing Agreements are *silent* as to the write-up methodology, so the Settlement Agreement methodology should control.

As to the trusts included in Exhibit G to the Petition, the Trustees ask whether they should "apply" the Retired Class Provision and Class A Redirection Provision in the Governing Agreements. They should. The Settlement Agreement is silent on these issues, and the Trustees have not alleged these provisions are ambiguous, or that they conflict with the Settlement Agreement. The Trustees must therefore enforce these terms of the Governing Agreements.

II. The Trustees Must Employ the Pay First Method.

A. The Settlement Agreement Requires Pay First.

The Petition alleges the Trustees are uncertain whether the settlement funds should be distributed before the certificate balances are written up (the Pay First method), or whether the settlement funds should be distributed after the certificate balances are written up (the Write-Up First method).[5] There is no uncertainty: Paragraphs 3.06(a) and 3.06(b) of the Settlement Agreement require the Trustees to employ the Pay First method.

Paragraph 3.06(a) of the Settlement Agreement requires the Trustees to "distribute each Settlement Trust's Allocable Share" and further provides that the Allocable Share should be distributed "in accordance with the distribution provisions of the Governing Agreements" as though it were a subsequent recovery relating to principal proceeds. The next paragraph, Paragraph 3.06(b), states that "***[a]fter*** the distribution of the Allocable Share to a Settlement Trust

[5] *See* Petition at ¶¶ 21 - 23.

pursuant to Subsection 3.06(a)," the Trustees must write up the certificate balances by the amount of such subsequent recoveries.[6]

There is no doubt the Settlement Agreement requires the Pay First Method, because the last sentence of Paragraph 3.06(b) (i.e., the "write-up" paragraph) states plainly that:

> For the avoidance of doubt, this Subsection 3.06(b) is intended ***only*** to increase the balances of the related classes of securities, as provided for herein, and ***shall not affect the distribution of the Settlement Payment provided for in Subsection 3.06(a).***

This final sentence confirms that the Settlement Agreement prohibits the certificate write-up contemplated in Paragraph 3.06(b) from "affect[ing]" the distribution of the Settlement Payment provided for in Paragraph 3.06(a).

The Write-Up First Method would, by definition, "affect the distribution of the Settlement Payment" because it would increase certificate principal balances ***before*** the settlement distribution is made. If the certificate balances were altered ***before*** the settlement payment were distributed, that would necessarily shift which certificates receive the Settlement Payment—i.e., the write-up would impermissibly "affect the distribution of the Settlement Payment." Accordingly, the Settlement Agreement requires Pay First.

B. The Governing Agreements are Silent as to the Order of Operations.

In the Petition, the Trustees do not cite a single provision of any Governing Agreement bearing on whether Pay First or Write Up First should be employed. To the contrary, the Trustees concede that the Governing Agreements for the trusts included in Exhibit D to the Petition "do not clearly specify" the order of operations.[7] They are correct. The Governing Agreements are silent as to the order of operations. Because the Governing Agreements are silent as to the order of

[6] All emphasis is added, unless stated otherwise.

[7] Petition ¶ 23.

operations, there is no conflict between the Settlement Agreement's Pay First method and the terms of the Governing Agreements. Therefore, the Settlement Agreement's Pay First order of operations must control.

C. The Pay First Method is *Res Judicata* From the Prior Article 77

Before consummating the Settlement, the Trustee filed an Article 77 proceeding "to give Certificateholders an opportunity to be heard in opposition to, or in support of, the Settlement" and "to seek an order, among other things, concluding that the Trustees acted reasonably and in good faith in their evaluation of the settlement offer and their acceptance of the Settlement Agreement on behalf of the Accepting Trusts."[8]

In that prior Article 77, no objection was raised to the Pay First method in the Settlement Agreement, nor did any certificateholder assert that following this procedure would be inconsistent with or violate the terms of any Governing Agreement. As the Court knows, there were other objections to the distribution methodology in the Settlement Agreement, including an objection by W&L Investments, LLC ("W&L") that the characterization of the settlement proceeds as subsequent recoveries conflicted with the Governing Agreements.[9]

On August 23, 2016, this Court entered the Final Order and Judgment, which overruled all objections to the Settlement Agreement, including W&L's objection to the distribution methodology.[10] In that Final Order and Judgment, the Court ruled that "Certificateholders,

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[8] *See* JPMorgan Article 77 Verified Petition, Index No. 652382/2014, Dkt. No. 1, ¶ 20; *see also* JPMorgan Settlement Agreement, attached as Ex 6.

[9] *See* Ex. 3 (Dkt. No. 594, Decision, Aug. 12, 2016, *In the matter of the application of U.S. Bank National Association, et al.*, Index No. 652382/2014), at pp. 24-34.

[10] *See* Ex. 2 (Final Order and Judgment) at ¶ 3 (overruling W&L's objection) & Ex. 3 (Decision) at p. 32 ("The court does not find that it was an abuse of discretion for the Trustees to accept a Distribution Methodology that provides for the settlement payment to be treated as a Subsequent Recovery and distributed to certificateholders in accordance with the priorities set in the PSA section 6.01 waterfall provision.").

Noteholders, and any other parties claiming any rights in any Accepting Trusts are barred from asserting claims against any Trustee with respect to such Trustee's evaluation and acceptance of the Settlement Agreement and implementation of the Settlement Agreement, so long as such implementation is in accordance with the terms of the Settlement Agreement."[11]

The Final Order and Judgment resolves the order of operations issue raised by the Trustees. Under the doctrine of *res judicata*, the Final Order and Judgment bars certificateholders from asserting any claim that was or could have been litigated in the prior Article 77 proceeding pertaining to the Settlement Agreement, including any claim that the Trustee's use of Pay First method would violate its duties under the Governing Agreements for which the order of operations is not otherwise specified. As the Court of Appeals has explained:

> Under the doctrine of *res judicata*, a party may not litigate a claim where a judgment on the merits exists from a prior action between the same parties involving the same subject matter. The rule applies not only to claims actually litigated but also to claims that could have been raised in the prior litigation. The rationale underlying this principle is that a party who has been given a full and fair opportunity to litigate a claim should not be allowed to do so again. Additionally, under New York's transactional analysis approach to *res judicata*, once a claim is brought to a final conclusion, all other claims arising out of the same transaction or series of transactions are barred, even if based upon different theories or if seeking a different remedy.[12]

These principles "apply with equal force" to trust administration proceedings, such as the prior Article 77 proceeding, and are "conclusive and binding" against "all persons over whom the [court] obtained jurisdiction."[13]

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[11] Ex. 2 (Final Order and Judgment) at ¶ 5.

[12] *In re Hunter*, 4 N.Y.3d 260, 269 (2005) (emphasis added, citations and internal quotation marks omitted).

[13] *Id.* at 264, 270 ("In this case, we are required to decide whether the doctrine of res judicata applies to judicial proceedings settling an estate and a trust accounting .... These principles apply with equal force to judicially settled accounting decrees. As a general rule, an accounting decree is conclusive and binding with respect to all issues raised and as against all persons over whom [the court] obtained jurisdiction. ... [It is] self-evident that every decree whether upon an accounting or otherwise is binding upon all persons of whom

The purpose of a trustee instruction proceeding, such as this one, is to protect a trustee from a later suit regarding future conduct.[14] Here, the Trustees provided fulsome notice to all certificateholders that—if approved—the Settlement Agreement would obligate the Trustee to distribute the proceeds via the Pay First method. Under the terms of the Order to Show Cause issued in the prior Article 77 proceeding, a massive worldwide notice program was implemented to notify certificateholders of the relief the Trustees were seeking.[15] Under the terms of that Order to Show Cause, certificateholders were also notified that, "any potentially interested person who fails to object in the manner required herein shall be deemed to have waived the right to object (including any right of appeal) and shall forever be barred from raising such objection in this or any other action or proceeding, unless the Court orders otherwise."[16]

Any certificateholder who objected to the Settlement Agreement's Pay First order of operations had both the opportunity and the obligation to raise this claim in the prior Article 77 proceeding. Indeed, the central objection lodged by W&L in the prior Article 77 was that the distribution provisions in the Settlement Agreement, including the treatment of settlement proceeds as subsequent recoveries, violated the Governing Agreements.[17] In the Court's Decision, the Court analyzed the Settlement Agreements and Governing Agreements, and overruled W&L's

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jurisdiction was obtained. In accord with res judicata, an accounting decree is therefore conclusive as to issues that were decided as well as those that could have been raised in the accounting.") (citations and internal quotation marks omitted).

[14] *See City Bank Farmers' Trust Co. v. Smith*, 263 N.Y. 292, 295-96 (1934) (the purpose of a trustee instruction proceeding is "to protect trustees in the class of cases where the advice of competent lawyers is not sufficient protection, because of the doubtful meaning of the trust instrument, or because of uncertainty as to the proper application of the law to the facts of the case."); *BlackRock Fin. Mgmt. v. Segregated Account of Ambac Assur. Corp.*, 673 F.3d 169, 174 (2nd Cir. 2012) (Article 77 "proceedings are used by trustees to obtain instruction as to whether a future course of conduct is proper ….").

[15] Order to Show Cause, Index No. 652382/2014, Dkt. 40.

[16] *Id.* ¶ 7.

[17] *See* Ex. 3 at pp 24 - 35.

objection.[18] Any claim by a certificateholder in this or any other proceeding concerning the Trustee's implementation of the Pay First order of operations in the Settlement Agreement is therefore barred by the Final Judgment in the prior Article 77 under the doctrine of *res judicata*.

D. The Distribution Provisions of the Settlement Agreement Are Virtually Identical to Those of Four Other Global RMBS Settlement Agreements Negotiated By the Institutional Investors, Which Require Pay First

The Settlement Agreement's distribution provisions are virtually identical to those of the four other global RMBS settlements negotiated by the Institutional Investors and accepted by the Trustees. Each of them requires Pay First. The distribution provisions in these global settlements have the same basic sequence and structure: (1) the ***first*** distribution paragraph directs the trustees to distribute the settlement funds as though they were subsequent recoveries, in accordance with the terms of the Governing Agreements; (2) the ***second*** distribution paragraph then directs the trustees to write up the certificate balances after making the distributions provided for in the preceding paragraph; and (3) the last sentence of the second distribution paragraph (i.e., the certificate write-up paragraph), clarifies that the certificate write-up "***shall not affect***" the distribution of the settlement payment provided for in the previous paragraph.

The table below compares the relevant distribution provisions in each of these five global settlement agreements, including the JPMorgan Settlement Agreement. The Trustees have now distributed settlement proceeds to over 1,000 RMBS trusts on the basis of this clear Pay First sequence and structure. Notably, the Citigroup distribution provisions are nearly identical to the JPMorgan distribution provisions, but the Citigroup trustees did not file an Article 77 alleging any ambiguity concerning the order of operations in the Citigroup settlement agreement.

[18] *See* Exs. 2-3.

Global RMBS Settlement	First Distribution Paragraph In the Settlement Agreement	Second Distribution Paragraph In the Settlement Agreement
Countrywide[19] • 6/28/2011 • 530 Trusts • $8.5 Billion	¶ 3(d)(i): "After the Allocable Share for each Covered Trust has been deposited into the Certificate Account or Collection Account for each Covered Trust, **the Trustee shall distribute it to Investors in accordance with the distribution provisions of the Governing Agreements** . . . **as though it was a Subsequent Recovery** . . ."	¶ 3(d)(ii): "(ii) In addition, **after the distribution of the Allocable Share to Investors pursuant to Subparagraph 3(d)(i)**, the Trustee will allocate the amount of the Allocable Share for that Covered Trust in the reverse order of previously allocated Realized Losses, to increase the [certificate balances] . . . to which Realized Losses have been previously allocated . . . . **For the avoidance of doubt**, this Subparagraph 3(d)(ii) is intended only to increase [certificate balances], as provided for herein, and **shall not affect the distribution of the Settlement Payment provided for in Subparagraph 3(d)(i).**"
ResCap[20] • 5/14/2012 • 392 Trusts • $8.7 Billion Bankruptcy Claim	Ex. B, ¶ 2-3: "All distributions from the Estate to a Trust on account of any Allocated Allowed Claim **shall be treated as Subsequent Recoveries**, as that term is defined in the Governing Agreement for that trust . . . To the extent that as a result of the distribution resulting from an Allocated Allowed Claim in a particular Trust a principal payment would become payable to a class of REMIC residual interests . . ., such payment shall be maintained in the distribution account and the relevant Trustee shall distribute it on the next distribution date according to the provisions of this section."	Ex. B, ¶ 4: "In addition**, after any distribution resulting from an Allocated Allowed Claim pursuant to section 3 above**, the relevant Trustee will allocate the amount of the distribution for that Trust in the reverse order of previously allocated Realized Losses, to increase the [certificate balances] . . . to which Realized Losses have been previously allocated . . . **For the avoidance of doubt**, this section 4 is intended only to increase [certificate balances] . . . and **shall not affect any distributions resulting from Allocated Allowed Claims provided for in section 3 above.**

[19] *See* Ex. 4 at 11.

[20] *See* Ex. 5 at 36 of 39. The Original RMBS Settlement Agreement was expanded through the Chapter 11 Plan, but the order of operations was not modified. *See* Article IV.C. of the ResCap Chapter 11 Plan, *available at*: http://www.kccllc.net/documents/1212020/121202013121100000000009.pdf.

Global RMBS Settlement	First Distribution Paragraph In the Settlement Agreement	Second Distribution Paragraph In the Settlement Agreement
JPMorgan[21] • 11/15/2013 • 330 Trusts • $4.5 Billion	¶ 3.06(a): "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'** . . . **The related Accepting Trustee will distribute each Settlement Trust's Allocable Share** or, if any other transaction party is acting as paying agent under the related Governing Agreement, use reasonable commercial best efforts to cause such paying agent to do so pursuant to this Subsection 3.06(a)."	¶ 3.06(b): **After the distribution of the Allocable Share to a Settlement Trust pursuant to Subsection 3.06(a)**, the Accepting Trustee for such Settlement Trust will apply . . . the amount of the Allocable Share for that Settlement Trust in the reverse order of previously allocated losses, to increase the balance of each class of securities . . . to which such losses have been previously allocated losses . . . . **For the avoidance of doubt**, this Subsection 3.06(b) is intended only to increase the balances of the related classes of securities, as provided for herein, and **shall not affect the distribution of the Settlement Payment provided for in Subsection 3.06(a)**."
Citigroup[22] • 4/7/2014 • 68 Trusts • $1.125 Billion	¶ 3.05(a): "Each Settlement 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** . . . . The party responsible for making distributions to Investors under each Trust's Governing **Agreement shall distribute each Trust's Allocable Share** within that Trust **as though such Allocable Share was a subsequent recovery** . . . ."	¶ 3.05(b): "**After the distribution of the Allocable Share to Settlement Trusts pursuant to Subsection 3.05(a)**, to the extent permitted under each Trust's Governing Agreement, the party responsible for calculating certificate balances . . . will apply the amount of the Allocable Share for that Settlement Trust to increase the balance of securities within that Trust in the reverse order of previously allocated realized losses . . . **For the avoidance of doubt**, this Subsection 3.05(b) is intended only to increase the [certificate balances] . . . and **shall not affect the distribution of the Settlement Payment provided for in Subsection 3.05(a)."**

[21] *See* Ex. 6.

[22] *See* Ex. 7.

Global RMBS Settlement	First Distribution Paragraph In the Settlement Agreement	Second Distribution Paragraph In the Settlement Agreement
Lehman[23] • 4/3/2017 • 244 Trusts • $2.4 Billion Bankruptcy Claim	¶ 3.06(a): "Plan Payments on each Participating 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 in accordance with the distribution provisions of the Governing Agreements **as though such Plan Payments are a subsequent recovery** available for distribution on the related distribution date . . . ."	¶ 3.06(b): "In connection with the distribution of Plan Payments to Participating Trusts pursuant to Subsection 3.06(a), to the extent permitted under each Trust's Governing Agreement, the applicable Accepting Trustee . . . will apply the amount of the Plan Payment for that Trust to increase the balance of securities within that Trust . . . *in the reverse order of* previously allocated losses . . . **For the avoidance of doubt**, this Subsection 3.06(b) is intended only to increase the balances of the related classes of securities, as provided for herein, and **shall not affect the distribution of Plan Payments on the Net Allowed Claim provided for in Subsection 3.06(a)**."

E. The Countrywide Settlement Was Distributed on a Pay First Basis.

In a prior Article 77 brought by a trustee with respect to the distribution of the $8.5 billion Countrywide RMBS settlement, BNY Mellon raised a similar question concerning the order of operations.[24] As shown in the table above, the sequence and structure of the distribution provisions in the Countrywide settlement are virtually identical to those in the JPMorgan settlement. In the Countrywide Article 77, 515 of the 530 trusts were distributed on a Pay First basis by agreement among investors.[25] A dispute remained as to fourteen trusts with respect to certain contractual

[23] *See* Ex. 8 at 16.

[24] *See* Verified Petition, Index No. 150793/2016, Dkt. No. 1, at pp. 5-6 & 16.

[25] *See* Ex. 9 (Partial Severance Order and Partial Final Judgment as to 512 Uncontested Trusts) & Ex. 10 (Severance Order and Partial Final Judgment as to Three Uncontested Trusts).

language not present in any of the JPMorgan trusts.[26] Moreover, even as to those fourteen disputed trusts, the Court held that the Countrywide settlement agreement required the Pay First method.[27]

F. The Lehman Settlement Agreement Requires Pay First.

Likewise, the trustees involved in the Lehman proceeding have raised a similar question concerning the order of operations in an Article 77 proceeding filed in this Court.[28] As the Court knows, the Institutional Investors sought to enjoin the Article 77 proceeding because the bankruptcy court had retained exclusive jurisdiction over the settlement agreement. Though the Bankruptcy Court declined to enjoin the Article 77 proceeding, Judge Chapman issued an order stating that "the terms of the RMBS Settlement Agreement shall be strictly enforced, including without limitation Sections 3.06(a)-(c) of the RMBS Settlement Agreement [i.e., the distribution provisions]."[29]

Judge Chapman's Order further stated that in light of the Bankruptcy's Court retention of exclusive jurisdiction in the Settlement Agreement, "the Court respectfully requests of the Supreme Court, New York County (*per* Friedman, J.) that if issues arise during the Article 77 Proceeding regarding the interpretation of the RMBS Settlement Agreement, such issues be referred to this Court for determination."[30] Notably, at the oral argument on the Institutional Investors' motion to enjoin the Article 77 proceeding, Judge Chapman highlighted the last sentence of the certificate write-up paragraph—the same sentence that appears in the JPMorgan settlement agreement, which unambiguously prohibits the Write Up First method:

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[26] *See* Ex. 11 at pp.10-11 (describing the differing interpretations of the defined term "Principal Distribution Amount" in the fourteen Countrywide trusts at issue).

[27] *Id.* at p. 18.

[28] *See* Petition, Index No. 651625/2018, Dkt. No. 1, at pp. 12-13.

[29] *See* Ex. 12 at p. 3.

[30] *Id.* at p. 2.

> [Judge Chapman:] So, Mr. Siegel, I'll go back to you. I clearly can order and direct that the settlement agreement's terms be enforced, including without limitation that payments shall be made in accordance with **Section 3.06(a) (b) and (c), which in sum and substance say pay first, write up second?** . . . You can go – right? I mean, I can say that. **That's obvious.** […]
>
> [S]ir, you're ignoring the language about that it cannot affect the distribution of plan payments. **And if you did write up first, that would affect the distribution of the plan payments.**[31]

III. The Settlement Payment Cannot Create Overcollateralization.

The second most consequential and disputed issue in the Petition is whether, under the Pay First method, the settlement payment itself can create overcollateralization. It cannot.

Many of the trusts included in Exhibit D of the Petition have an overcollateralization structure, meaning that when the trusts were originally issued, the trusts' assets (i.e. the mortgage loans) exceed the trusts' liabilities (i.e. the trusts' certificates). Like subordination, which protects senior certificates at the expense of more junior ones, overcollateralization is a form of "credit enhancement" meant to absorb the first losses experienced by the trusts and to protect the certificates from the risk of loss.[32] Because of the significant collateral losses the trusts have suffered since their original issuance, however, the original overcollateralization in the trusts has been substantially or completely exhausted, leaving the trusts generally *not* overcollateralized.

The Petition suggests that the Pay First Method may cause the trusts to "appear to be temporarily overcollateralized" because the trusts' liabilities (i.e. the certificate balances) would be reduced by the amount of the settlement payment, but the trusts' assets (i.e. the mortgages) would remain unchanged.[33] In other words, the Petition suggests that the settlement payment itself

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[31] *See* Ex. 13 at 45:24 - 46:19.

[32] *See* Petition ¶ 25 ("The overcollateralization amount . . . essentially functions as a first-loss position intended to insulate Class A, Class M, and Class B certificates from realized losses and operates as credit enhancement for such classes.").

[33] *See* Petition ¶¶ 28 - 29.

can create overcollateralization. If, as the Trustees suggest, the temporary overcollateralization allegedly created by the Settlement Payment exceeds a threshold typically defined as an overcollateralization "target," then such excess would be distributed under the trusts' "excess cashflow" waterfall, which may result in much of the Settlement Payment flowing to entirely different certificates than if the settlement payment was not deemed to have created such transitory overcollateralization.[34]

The Trustees' alleged concern is unfounded. As the Trustees note, the trusts are not overcollateralized before the settlement payment is made, and they will not be overcollateralized after the Settlement Payment is made. Rather, the trustees suggest that the trusts may "temporarily appear" overcollateralized at some point during the distribution itself, even though the balances of the underlying mortgages never exceed the balances of the outstanding certificates.

The definition of overcollateralization in the Governing Agreements, however, does not allow the calculation of overcollateralization *during* a distribution. Rather, it requires the Trustees to *look through* the distribution and "take into account" or "give effect to" not only the reduction of certificate balances associated with the receipt of subsequent recoveries, but also an equal and offsetting increase in certificate balances required upon the receipt of subsequent recoveries. The level of overcollateralization in the trusts would remain unchanged by the Settlement Payment, because overcollateralization cannot be assessed at some fleeting moment during the distribution itself. Put simply, the Settlement Payment cannot create overcollateralization.

[34] *See* Petition ¶¶ 24 - 37.

A. Overcollateralization is Calculated After Taking Into Account Both the Write-Down and the Equivalent Write-Up of the Certificate Balances

Each of the Governing Agreements for the Exhibit D overcollateralization Trusts requires the Trustees to calculate overcollateralization after "giving effect to" or "taking into account" the ***full*** distribution of principal proceeds to be distributed in a given distribution—which involves both the paydown of certificate balances by the amount of the subsequent recoveries, and an equal, completely offsetting increase of certificate balances associated with the receipt of subsequent recoveries. Thus, "temporary" overcollateralization cannot be created by the Settlement Payment.

Given the voluminous number of trusts at issue, the Institutional Investors and the AIG Parties have attached a compendium of trust language with respect to disputed Exhibit D trusts with an overcollateralization structure. A summary of this language is attached as Exhibit 14, and trust-by-trust excerpts from each such trust are attached as Exhibit 15. The underlying Governing Agreements from which this compendium was extracted have been submitted by the Trustees to the Court in electronic form.[35] Though there are four variants in the definitions of overcollateralization in the trusts, each variant requires the Trustees to assess the level of overcollateralization only after giving effect to the entire distribution to be made—***not*** at some moment during the distribution itself, as the Petition alleges.

As shown in Exhibit 14, the definitions of overcollateralization in the Governing Agreements for the trusts generally provide that overcollateralization is calculated as the trust's aggregate collateral balance, minus the trust's aggregate certificate balances "after taking into account" or after "giving effect to" the payment of principal. Though these four variants are not materially different, the most common variant of the definition of Overcollateralization Amount,

[35] *See* Petition at 3 n.8.

which is included in 74 of the 93 disputed trusts included in Exhibit D to the Petition, generally states as follows[36]:

> **Overcollateralization Amount**: With respect to any Distribution Date, the excess, if any, of (a) the aggregate Stated Principal Balance of the Mortgage Loans for such Distribution Date over (b) the aggregate Certificate Principal Balance of the Offered Certificates and the Class B-3 Certificates on such Distribution Date (after taking into account the payment of principal other than any Extra Principal Distribution Amount on such Certificates).[37]

As this definition makes clear, the Overcollateralization Amount is defined as the excess of the trust's assets (i.e. the balance of the outstanding mortgage loans) over the trust's liabilities (i.e. the certificate balances). Importantly, however the definition requires that this excess be calculated "after taking into account the payment of principal . . . on such Certificates."

It is undisputed that the Settlement Agreement dictates that the settlement distributions be characterized as "'subsequent recoveries' relating to principal proceeds available for distribution."[38] Thus, in calculating the Overcollateralization Amount, the trustees must "tak[e] into account" the settlement payment itself. There are two steps the trustees must take into account.

The ***first*** step the Trustees must take into account is that, like the payment of any other principal proceeds, the distribution of settlement funds would result in a reduction of certificate balances. The Petition focuses exclusively on this first step, by explaining how the receipt of

[36] *See* Ex. 16 (Governing Agreement for BALTA 2005-1).

[37] The Stated Principal Balance is generally defined as the mortgage loans' original principal balance, less principal paydown and realized losses. The Certificate Principal Balance is generally defined as the certificates' original balances, less principal receipts and realized losses allocated to such certificates. The Extra Principal Distribution Amount is generally defined as the excess interest received on the mortgage loans, which can be paid out as principal. Because the settlement funds are characterized as principal payments, not interest payments, the settlement payments do not constitute Extra Principal Distribution Amounts. *See* Ex. 16 (Governing Agreement for BALTA 2005-1 containing all defined terms).

[38] Settlement Agreement ¶ 3.06(a) (emphasis added).

principal funds like subsequent recoveries would reduce the trusts' liabilities (i.e., the trusts' certificate balances).[39]

The ***second*** step the Trustees must take into account, however, is the equal and offsetting write-up of certificate balances associated with the receipt of subsequent recoveries. As explained in Section II, above, Section 3.06(b) of the Settlement Agreement provides for such a write-up. The Governing Agreements provide for them, too. For example, Section 6.02(b) of the Governing Agreement for BALTA 2005-1 states that whenever a subsequent recovery is received, the certificate balances are increased by the amount of such subsequent recovery:

> (b) In addition, in the event that the Master Servicer receives any Subsequent Recoveries from the Servicer, the Master Servicer shall deposit such funds into the Master Servicer Collection Account pursuant to Section 4.01(c)(ii). 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 Subordinate Certificates with the highest payment priority to which Applied Realized Loss Amounts have been allocated, but not by more than the amount of Applied Realized Loss Amounts previously allocated to that Class of Subordinate Certificates.

Accordingly, in employing the Pay First method for trusts with an overcollateralization structure, the Trustees should be instructed to assess overcollateralization only after "taking into account' both the write-down and write-up of certificate balances by the amount of the Settlement Payment—and not by taking into account ***only*** the write-down. If overcollateralization is correctly calculated in this way, the Settlement Payment will not, and cannot, create overcollateralization.

B. Temporary Overcollateralization is an Absurd, Commercially Unreasonable Result.

"[A] contract should not be interpreted to produce a result that is absurd, commercially unreasonable or contrary to the reasonable expectations of the parties" *Luver Plumbing and*

[39] *See* Petition ¶ 29 (suggesting that the trusts' receipt of subsequent recoveries would only decrease certificate balances, and not increase them).

Heating, Inc. v Mo's Plumbing and Heating, 144 A.D.3d 587, 588 (1st Dept 2016). "The ultimate aim" of these interpretive rules, of course, "is to realize the parties' reasonable expectations through a practical interpretation of the contract language." *Gessin Elec. Contractors, Inc. v. 95 Wall Assocs., LLC*, 74 A.D.3d 516, 518 (1st Dep't 2010).

The Olifant Funds,[40] DE Shaw,[41] and Nover agree with the Institutional Investors that permitting the Settlement Payments to "temporarily" create overcollateralization in the trusts would be an absurd, commercially unreasonable result.[42] Only HBK and Tilden Park argue in favor of temporary overcollateralization—and only as to 36 of the 93 disputed Exhibit D trusts in which the Institutional Investors and/or the AIG Parties hold direct certificates.[43]

The trusts have experienced massive losses since the financial crisis, and their initial overcollateralization, meant to absorb the first losses suffered by the trusts, was long ago depleted. The trusts have since suffered tens of billions of dollars of realized losses, and the basic allocation methodology in the settlement distributes the settlement payment across trusts according to their past and future losses.[44] Though the final settlement payment exceeds $4 billion, it will not come close to reimbursing the trusts for the full amount of their prior and future losses, which the trustees' expert has estimated to exceed $60 billion.[45] In that context, the trustees' allegation that the Settlement Payment could lead to the creation of "temporary" overcollateralization is an absurd

[40] Dkt. 89 at p. 6 (citing Paragraphs 28-34 of the Petition as a "commercially unreasonable result").

[41] Dkt. 67 at p. 5 (identifying "temporary overcollateralization" as a commercially unreasonable result).

[42] Dkt. 165 at p. 5 (noting absurdity of temporary overcollateralization and stated that "the OC Trusts receiving the Settlement Payment are not, in fact, overcollateralized and ***no one will claim to the contrary***").

[43] *See* Ex. 15 (identifying the 36 trusts for which any investor advocates temporary overcollateralization).

[44] *See* Settlement Agreement at §3.05 (allocation of settlement proceeds across trusts *pro rata* according to realized and anticipated loss).

[45] *See* Ex. 17 (Final Expert Calculation dated December 19, 2017) at p. 19 of 38.

result that is neither a "reasonable" or a "practical" interpretation of the Governing Agreements. *Gessin*, 74 A.D.3d at 518.

C. The Countrywide Trusts Were Distributed on Pay First Basis, with No Temporary Overcollateralization.

An order directing the Trustees to employ the Pay First Method in a way that prevents the creation of "temporary overcollateralization" would be consistent with the result in the Countrywide Article 77. There, the sole trustee, BNY Mellon, was directed, by agreement among the parties, to distribute the settlement payment for the 512 Initial Release Trusts on a Pay First basis and in a manner that avoided any "temporary" overcollateralization during the distribution itself.[46] Specifically, the Order directed BNY Mellon to "***account[] for both the pay down of certificate balances and the write up of certificate balances*** in an amount equal to such trust's Allocable Share" and further ordered BNY Mellon "***not [to] measure such Overcollateralization Amount during the distribution between the pay down and write up steps*** as described in paragraph 26 of the Verified Petition").[47]

In the same Countrywide Article 77, a separate dispute arose concerning fourteen trusts as to whether the amount available for distribution to the senior certificates under the Governing Agreements – i.e., the "Principal Distribution Amount" – was limited by an express "cap" equivalent to a much smaller amount called the Overcollateralization Target Amount.[48] Justice Scarpulla ultimately held that the definition of Principal Distribution Amount was indeed capped in this way.[49] Justice Scarpulla's ruling as to the fourteen "Principal Cap" trusts in that proceeding

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[46] *See* Ex. 9 at pp. 7 - 8.

[47] *Id.* (emphasis added).

[48] *See* Ex. 11 at pp. 10 - 12.

[49] *Id.* at p. 13 of 19 ("[T]he Governing Agreement provides a straightforward directive regarding the amounts that need to be gathered, added together, and subtracted in order to calculate the Principal Distribution Amount . . . As the Governing Agreements expressly indicate how to calculate the Principal

is not relevant here, a conclusion borne out by the fact that not a single investor appearing in this Article 77 has argued that the definition of Principal Distribution Amount in any of the JPMorgan Governing Agreements is subject to the kind of "cap" that was at issue with respect to those fourteen Countrywide trusts. Therefore, that Decision is irrelevant to the disputed issue here of whether the Settlement Payment can *create* overcollateralization.

IV. All Classes of Certificates in the Exhibit E Trusts Are Eligible For a Write-Up

With respect to the trusts in Exhibit E to the Petition, the Trustees allege they are uncertain whether all classes of certificates are "eligible" for a write-up. All investors except Nover and/or its CDO trustee agree that all certificates, including senior certificates, are eligible for a subsequent recovery write up. Nover's and/or its CDO trustee's objection is limited to the 26 trusts identified in Exhibit 18. As to all other Exhibit E trusts, no investor disputes that senior certificates are eligible for a write-up.

Section 3.06(b) of the Settlement agreement requires the certificate write-up to occur in reverse order of previously allocated losses. Because of the massive losses experienced by the trusts, many of the senior certificates have experienced substantial losses, and have been written down to reflect those losses. The Settlement Agreement requires that the senior-most certificates, which are generally last to suffer losses within the trusts' waterfall, are eligible to be written up ***first*** to the extent they have previously suffered losses.

In the Petition, however, the Trustees point to an isolated provision in the Governing Agreements for certain Bear Stearns trusts which the Trustees allege may prevent the senior certificates from receiving a subsequent recovery write-up.[50] That provision typically appears in

Distribution Amount, the Trustee must follow this definition to calculate what portion of the Allocable Share must be distributed to certificateholders as the Principal Distribution Amount.").

[50] *See* Petition ¶ 45 - 48.

Section 6.02(h) of the relevant Bear Stearns Governing Agreements, and provides that if subsequent recoveries are applied to reduce prior realized losses, "the amount of such Subsequent Recoveries will be applied to increase the Current Principal Amount of the Class of Subordinate Certificates with the highest payment priority to which Applied Realized Loss Amounts have been allocated."[51] The Trustees narrowly focus on the reference to "Subordinate Certificates" in this provision to suggest that *only* Subordinate Certificates may be written up. The Trustees' focus on this isolated reference to Subordinate Certificates is misplaced, for two key reasons.

First, the Trustees ignore the definition of "Realized Losses" in the Governing Agreements for which senior certificates are allocated realized losses, which make clear that the Subsequent Recovery write-up was not intended to be limited to subordinate certificates. That definition generally provides that "the amount of the Realized Loss with respect to that Mortgage Loan will be reduced to the extent such recoveries are applied to reduce the Current Principal Amount of any Class of Certificates on any Distribution Date."[52] This definition of Realized Loss contains no limitation on which classes of certificates are eligible for subsequent recovery write-ups, and necessarily includes senior certificates. Exhibit 19 compiles the definitions of Realized Loss in each of the 26 disputed Exhibit E trusts for which Nover and/or its CDO trustee has appeared.[53]

Second, absurd results would follow if only the subordinate certificates were eligible for subsequent recovery write-ups, as such an interpretation would in effect favor junior certificates at the expense of senior ones, and would result in the false appearance of overcollateralization in

[51] *See* Petition ¶ 45 (citing 6.02(h) of Governing Agreement for BSARM 2005-11) (emphasis added).

[52] Governing Agreement, BSARM 2005-11, Definition of Realized Loss.

[53] Out of the 26 disputed Exhibit E trusts, there are five Bear Stearns trusts for which the Senior Certificates are not allocated Realized Losses at all, and therefore would not receive a subsequent recovery write-up even if they were eligible for such a write-up. These five Bear Stearns trusts are identified as "Variant 2" in Exhibits 18 and 19: BSABS 2005-AC3, BSABS 2005-AC5, BSABS 2005-AC6, BSABS 2006-AC1, and BSABS 2006-AC2.

the trusts. "[A] contract should not be interpreted to produce a result that is absurd, commercially unreasonable or contrary to the reasonable expectations of the parties" *Luver Plumbing and Heating, Inc. v Mo's Plumbing and Heating*, 144 A.D.3d 587, 588 (1st Dept 2016).

If subsequent recoveries received by the trusts exceed the realized losses incurred by the subordinate certificates, an absurd result would follow if the senior certificates are not eligible for a subsequent recovery write-up: the trust would falsely *appear* to be overcollateralized (i.e. the trusts' assets would exceed its liabilities), even though it would not be. That absurd result cannot be squared with the structure and intent of the trusts' seniority and subordination structure. To avoid that absurd result, senior certificates with losses must be eligible to be written up.

"Courts should read a contract 'as a harmonious and integrated whole' to determine and give effect to its purpose and intent." *Nomura Home Equity Loan, Inc., Series 2006-FM2, by HSBC Bank USA, N.A. v. Nomura Credit & Capital, Inc.*, 30 NY.3d 572, 581 (2017). "[C]onflicting contract provisions should be harmonized, if reasonably possible, so as not to leave any provision without force and effect ..." *Natixis Real Estate Capital Tr. 2007-HE2 v Natixis Real Estate Holdings, LLC*, 149 A.D.3d 127, 134 (1st Dept 2017). Here, the Governing Agreements can and should be harmonized with the Settlement Agreement by making senior certificates eligible for subsequent recovery write-ups.

V. Among Exhibit F Trusts With Unambiguous Write-Up Provisions That Conflict With the Settlement Agreement, The Governing Agreements Should Control.

As to the Exhibit F trusts, the Trustees generally allege that the write-up methodology in the Settlement Agreement conflicts with the write-up methodology in the Governing Agreements. Specifically, the Trustees generally allege the Settlement Agreement instructs them to perform the subsequent recovery write-up in reverse order of previously allocated realized losses, but the

subsequent recovery write-up method in the Governing Agreements is based on some other order. Most typically, many Exhibit F trusts require the write-up to be performed in order of the certificates' "***payment priority***"—not in the order of their previously allocated realized losses.[54] The Trustees also allege that some Exhibit F trusts simply do not specify a write-up methodology.

There are 72 disputed Exhibit F trusts in which the Institutional Investors and/or the AIG Parties hold direct certificates, and in 62 of those 72 trusts, the Governing Agreements allocate subsequent recoveries by "payment priority" or "seniority." Exhibit 20 summarizes three variants of these methodologies, and Exhibit 21 provides a trust-by-trust compendium of the Governing Agreement provisions. In 10 of those 72 trusts, the Governing Agreements are silent as to the write-up methodology.

Unlike the Exhibit E trusts, for which the Governing Agreements can and should be harmonized with the Settlement Agreement, the Governing Agreements for most Exhibit F trusts set out a clear scheme for subsequent recovery write-ups that conflicts with the Settlement Agreement's provisions. The Settlement Agreement provides that it "is not intended to, and shall not be argued or deemed to constitute, an amendment of any term of any Governing Agreement."[55] Therefore, the Trustees should simply follow the Governing Agreements. The Trustees have been distributing subsequent recoveries for over a decade for these trusts on the basis of the cited provisions in the Governing Agreements, and they should do so again here. Where the Governing Agreements are silent, however, the Trustees should follow the Settlement Agreement.[56]

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[54] *See* Petition ¶ 49 - 52. The Trustees give two examples of such conflicts between the Governing Agreements and Settlement Agreement as to Exhibit F trusts: (1) trusts where realized losses are allocated *pro rata* among Class A certificates, but where principal is distributed on a sequential basis; and (2) trusts where realized losses are allocated sequentially, but subsequent recovery write-ups are applied *pro rata*.

[55] Settlement Agreement at ¶ 7.05.

[56] Variant 1, 2, and 3 Governing Agreements identified in Exhibits 20 and 21 conflict with the Settlement Agreement methodology. Variant 4 Governing Agreements are silent as to the write-up methodology.

VI. For Exhibit G Trusts, The Trustees Should Enforce the Retired Class Provision and the Class A Redirection Provision

As to the trusts included in Exhibit G to the Petition, the Trustees ask the Court whether to "apply" the Retired Class Provision and Class A Redirection provision.[57] They should. The Trustees do not allege that these provisions are ambiguous or conflict in any way with the Settlement Agreement. Moreover, the Settlement Agreement is silent as to the treatment of retired classes or class redirection. The Trustees should therefore "apply" the unambiguous provisions of the Governing Agreements they have identified.[58]

CONCLUSION

In sum, with respect to the Exhibit D trusts, the Trustees should be instructed to employ the Pay First method in a manner that avoids the creation of "temporary" overcollateralization. With respect to the Exhibit E trusts, the trustees should be instructed to harmonize the Settlement Agreement with the Governing Agreements by making all Classes of certificates eligible for a subsequent recovery write-up. With respect to the majority of Exhibit F trusts, the Trustees should be instructed to follow the write-up methodology in the Governing Agreements, because it is unambiguous and conflicts with the Settlement Agreement. With respect to a handful of Exhibit F trusts for which the Governing Agreements are silent as to the write-up methodology, the Settlement Agreement should control. Finally, with respect to the Exhibit G trusts, the Trustees should be instructed to apply the Retired Class Provision and Class A Redirection Provision.

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[57] Petition ¶ 53 - 62.

[58] The one caveat to this rule is based on a structural limitation in the trusts. Namely, if the Settlement Payment exceeds the realized losses of the then-outstanding certificates, the Trustees may be required to write-up a written off certificate in order to keep the Trust's assets and liabilities in balance. This structural requirement is reflected in the consensual judgment for 91 undisputed trusts entered on March 30, 2018 (Dkt. 289). The Institutional Investors support this structural adjustment.

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