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

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 Administration and Distribution of a Settlement Payment,	Index No. 657387/2017 Hon. Marcy S. Friedman **REPLY MERITS BRIEF OF AMBAC ASSURANCE CORPORATION**

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Ambac Assurance Corporation ("Ambac"), the Certificate Insurer for certain classes of certificates issued by three trusts (GPMF 2006-AR2; GPMF 2006-AR3; and GPMF 2005-AR5) (the "Ambac Trusts") at issue in this proceeding, respectfully submits this reply memorandum of law concerning the distribution of payments under the Settlement Agreement.[1]

Preliminary Statement

In GPMF 2006-AR2 and GPMF 2006-AR3 (the "2006 Trusts"), the PSAs give Ambac a special, priority right to Subsequent Recoveries: Ambac receives Subsequent Recoveries ***first***, directly from the Custodial Account, ***before*** any remaining Subsequent Recoveries are transferred to the Distribution Account to become part of the "Principal Funds" distributed to certificates. Instead of confronting these special PSA provisions – which specifically address Subsequent Recoveries – the Institutional Investors focus on the later disposition of Subsequent Recoveries, after they flow into the principal distribution waterfall. This misses the point entirely. Moreover, it depends on a reading of the PSAs that ignores a portion of the definition of "Principal Funds," gives no effect to Section 6.02(b), and renders Section 6.02(c) entirely superfluous.

As for GPMF 2005-AR5 (the "2005 Trust"), Ambac adopts the arguments of other interested parties that senior certificates with Realized Losses should be written up before the Allocable Share is distributed to certificateholders or, in Ambac's case, to the Certificate Insurer due to Ambac's contractual right of subrogation.

[1] Capitalized terms not defined herein have the meanings given to them in the Petition for judicial instructions under Article 77 (NYSCEF No. 1), the relevant Pooling and Servicing Agreements, or Ambac's opening merits brief.

I. The PSAs Specify That Ambac is Entitled to the Full Allocable Shares for Insured Loan Groups in the 2006 Trusts

A. The Governing Documents Require Payment of Subsequent Recoveries First to Ambac, Directly From the Custodial Account

In its opening brief, Ambac described how Sections 6.02(b) and (c) of the PSAs control the disposition of Subsequent Recoveries immediately upon receipt: they are deposited into the Custodial Account from which they are paid "first" to Ambac to the extent of Ambac's unreimbursed claim payments for Realized Losses. *See* NYSCEF No. 528 at 3-6 ("Ambac Br."). Because these claim payments far exceed the amount of the Allocable Shares for the Insured Loan Groups, the PSAs require the full Allocable Shares for the 2006 Trusts to be paid from the Custodial Account to Ambac. *See id.*

The only response brief addressing Ambac's argument is that of the Institutional Investors and AIG. *See* NYSCEF No. 663 (the "II Br."). The Institutional Investors, however, largely ignore Ambac's argument, failing to dispute the following propositions advanced in Ambac's opening brief: (1) Section 6.02(b) requires Subsequent Recoveries to be deposited into the Custodial Account; (2) Section 6.02(b) specifies that Subsequent Recoveries are "first used to pay" Ambac the amounts described in Section 6.02(c) directly from the Custodial Account; (3) Section 6.02(c) allows Ambac to recover its unreimbursed claim payments for Realized Losses allocated to the Insured Certificates; and (4) such claim payments exceed $150 million, several times the entire Allocable Shares for the relevant loan groups of the 2006 Trusts. Ambac Br. at 3-6. Remarkably, the Institutional Investors never mention Section 6.02(b) at all.

B. The Principal Waterfall Is Irrelevant

Instead of discussing these special PSA provisions that specifically address the treatment of Subsequent Recoveries immediately upon receipt, the Institutional Investors focus on the later

flow of these funds through the principal distribution waterfall set forth in Section 6.01. II Br. at 19-21. This focus is misplaced because the general principal distribution waterfall is not what gives Ambac its priority right to Subsequent Recoveries.

As Ambac explained in its opening brief, Subsequent Recoveries are first deposited into the Custodial Account, from which they are paid to Ambac under Sections 6.02(b) and (c), and only *thereafter* do any *remaining* Subsequent Recoveries flow "to the Distribution Account for payment to holders through the [principal] waterfall." Ambac Br. at 4 n.6.[2] Here, there will be no remaining Subsequent Recoveries that become part of Principal Funds because the sum that Ambac is entitled to receive first exceeds the Allocable Shares.

The Institutional Investors nonetheless argue that the principal distribution waterfall (Section 6.01) governs because it controls the flow of "Principal Funds," which include "Liquidation Proceeds" and "Subsequent Recoveries." II Br. at 20. But in making this argument, the Institutional Investors omit an important qualification in the definition of "Principal Funds" that supports Ambac's position. *Id.* at 20, n.32. This qualification clarifies that Principal Funds do not include those Subsequent Recoveries paid directly from the Custodial Account before reaching the Distribution Account. Subpart (g) of the definition of "Principal Funds" is set forth below in full – with emphasis on the portion omitted by the Institutional Investors:

[2] *See* GPMF 2006-AR2 PSA § 4.02(d) ("No later than 3:00 p.m. New York time on each Distribution Account Deposit Date, the Servicer will transfer all Available Funds on deposit in the Custodial Account with respect to the related Distribution Date to the Trustee for deposit in the Distribution Account."). *See also id.* § 6.01(a) ("On each Distribution Date, an amount equal to the Interest Funds and Principal Funds for such Distribution Date shall be withdrawn by the Trustee from the Distribution Account to the extent of funds on deposit therein and distributed for such Distribution Date . . . .").

> **Principal Funds**: With respect to each Loan Group and each Distribution Date . . . (g) all Liquidation Proceeds collected during the related Prepayment Period (or, in the case of Subsequent Recoveries, during the related Due Period) on the Mortgage Loans in the related Loan Group, to the extent such Liquidation Proceeds relate to principal, ***in each case to the extent remitted by the Servicer to the Distribution Account pursuant to this Agreement***

This definition contemplates that there are some Subsequent Recoveries that are not remitted to the Distribution Account.[3] Here, those are the Subsequent Recoveries paid "first" to Ambac from the Custodial Account under Sections 6.02(b) and (c).

C. The Institutional Investors Misconstrue Section 6.02(c) in a Manner that Would Render It Mere Surplusage

Ignoring Section 6.02(b) entirely, the Institutional Investors read Section 6.02(c) in isolation, characterizing it as a subrogation clause providing merely that "Ambac must receive subsequent recoveries before the [Insured Holders] can receive them." II Br. at 22. This construction is incorrect for two reasons.

First, this interpretation ignores the function that Section 6.02(c) actually serves – describing the *amount* of Subsequent Recoveries that Ambac can recover first, before all others. Section 6.02(b) makes this clear, stating that Subsequent Recoveries will first be used to pay "any amounts owed to the Certificate Insurer as set for[th] in Section 6.02(c)." With this lead-in, Section 6.02(c) provides:

> Subsequent Recoveries will be allocated first to the Certificate Insurer for payment on any Reimbursement Amounts for such Distribution Date in respect of any Deficiency Amount described in clauses (a)(2) or (b)(y) of such definition, but only to the extent of the portion of Subsequent Recoveries that were paid by the Certificate Insurer for Realized Losses that were allocated to Class I-A-2 Certificates or II-A-2 Certificates

GPMF 2006-AR2 PSA § 6.02(c). The Institutional Investors never explain why this reference to Subsequent Recoveries going "first" to Ambac should be construed to mean "before the A2

[3] None of the other components of Principal Funds contains a similar carve-out.

certificates, but after the A1 certificates." Moreover, the remainder of this provision defines the *amount* of Subsequent Recoveries Ambac receives "off-the-top." First, the upper limit on Ambac's recovery is its Reimbursement Amount in respect of claim payments for Realized Losses allocated to the Insured Certificates. *See* Ambac Br. at 4-6. Second, Ambac can only apply against that upper limit the portion of Subsequent Recoveries associated with Realized Losses allocated to the Insured Certificates for which Ambac paid claims.[4]

Second, this interpretation attributes a meaning to Section 6.02(c) that is not supported by its text. Nothing in Section 6.02(c) speaks to Ambac's right to stand in the shoes of holders of Insured Certificates or to whether such holders should be paid twice for Realized Losses, as the Institutional Investors contend. *See* II Br. at 22. Nor should it, because an entirely different section of the PSA already does so. Specifically, Section 4.07(d) grants Ambac subrogation rights, providing that to the extent Ambac pays any "Insured Amount" to any holder of Insured Certificates, Ambac is "subrogated to any rights of such Holder to receive the amounts for which such Insured Amount was paid . . . ." GPMF 2006-AR2 PSA § 4.07(d); *see also* GPMF 2006-AR3 PSA § 4.07(d). The Institutional Investors' construction of Section 6.02(c) would render it entirely superfluous in light of the subrogation provision, Section 4.07(d). *See Matter of Viking Pump, Inc.*, 52 N.E.3d 1144, 1154 (N.Y. 2016) (a construction that renders a clause surplusage "cannot be countenanced under our principles of contract interpretation"); *FCI Grp., Inc. v. City of N.Y.*, 54 A.D.3d 171, 177 (1st Dep't 2008) ("[A] court should not adopt an interpretation

[4] This provision should be read with the drafters' understanding that Subsequent Recoveries reversed previously allocated Realized Losses. Although the Institutional Investors misconstrue this provision, they acknowledge its underlying logic: "[i]f Ambac makes an insurance payment to the A2 certificates associated with a realized loss on a liquidated loan, and then at some point in the future, the trust receives a Subsequent Recovery, that Subsequent Recovery should be paid to Ambac, not the A2 certificates." II Br at 22. Where the Institutional Investors err is in failing to give effect to the command that Ambac receive Subsequent Recoveries first, before all others.

which will operate to leave a provision of a contract without force and effect.") (internal quotation marks and citation omitted).[5]

Indeed, the Institutional Investors' construction of Section 6.02(c) would leave Ambac with no greater rights in the 2006 Trusts than it has in the 2005 Trust, which PSA contains the same general subrogation clause in Section 4.07(d),[6] but lacks language later included in the 2006 Trusts creating a right to receive Subsequent Recoveries first. No interested party has disputed that Section 4.07(d) alone is sufficient to place Ambac into the shoes of holders of Insured Certificates in the 2005 Trust. The very different provision that was added to the 2006 Trusts must be given a different effect.

D. Ambac Would Not Receive a Windfall If It Receives the Allocable Shares

Having failed to grapple with the plain language of the PSA, the Institutional Investors argue the equities, complaining of a supposed "windfall" for Ambac. II Br. at 5. To the contrary, the equities favor Ambac. There is no dispute that Ambac has made in excess of $150 million in unreimbursed claim payments. *See* Ambac Br. at 6. Even after receiving the entire applicable Allocable Shares, Ambac still will have made more than $100 million in unreimbursed claim payments, with no significant recoveries on the horizon.

[5] Section 4.07(d) also illustrates another omission by the Institutional Investors. They describe the principal distribution waterfall as providing that principal funds are distributed "first to each class of Class II-A Certificates" and "second, to the Certificate Insurer" as reimbursement only after the Class II-A certificates are paid down to zero. II Br. at 19-20 (quoting GPMF 2006-AR2 PSA § 6.01). But this description ignores the fact that, in addition to having the direct reimbursement right that the Institutional Investors acknowledge, Ambac is also subrogated to the rights of the insured Class II-A Certificates to receive principal funds. Thus, focusing solely on what would occur within the principal distribution waterfall (which is not relevant here, for the reasons explained above), Ambac would share pro rata in principal distributions to the Class II-A Certificates *as subrogee* before the Class II-A Certificates are paid down to zero.

[6] *See* GPMF 2005-AR5 PSA § 4.10(d) ("[T]o the extent the Certificate Insurer pays any Insured Amount, either directly or indirectly . . . to the Holder of a [sic] Insured Certificates, the Certificate Insurer will be entitled to be subrogated to any rights of such Holder to receive the amounts for which such Insured Amount was paid . . . .").

Unlike Ambac, holders of the most senior certificates have suffered minimal, if any, losses. In GPMF 2006-AR2, the I-A-1 and II-A-1 certificates have no realized losses at all. *See* GPMF 2006-AR2 Remittance Report (NYSCEF No. 666) at 1. In GPMF 2006-AR3, the II-A-1 certificates, with an original face amount of approximately $492 million, have been allocated approximately $6.6 million in realized losses. *See* GPMF 2006-AR3 Remittance Report (NYSCEF No. 667) at 1-2. These paper losses pale by comparison to Ambac's nearly $150 million in claim payments. *See* Ambac Br. at 6.

At bottom, the Institutional Investors complain that it is unfair for Ambac "to leapfrog" A1 certificates because the insured A2 certificates are subordinate to them for purposes of loss allocation. II Br. at 22. But the fact remains that Ambac secured a priority right to Subsequent Recoveries reversing Realized Losses for which it has paid claims. There is nothing unfair about Ambac obtaining this partial and entirely inadequate recovery. *See One Step Up, Ltd. v. Webster Bus. Credit Corp.*, 87 A.D.3d 1, 14 (1st Dep't 2011) (contracting party entitled to "the benefit of its bargain"); *see also Matter of Bank of N. Y. Mellon*, 51 N.Y.S.3d 356 (N.Y. Sup. Ct. N.Y. Cnty. 2017) ("[I]t is neither an absurd or unenforceable result that the principal distribution amount calculated under the governing agreements may be small in proportion to the entire amount of the allocable share, resulting in the majority of the allocable share to be distributed to certificates with realized losses, particularly because the parties anticipated that this result might occur . . . .").

E. This Issue is Appropriate For Judicial Instruction

Finally, the Institutional Investors' argument that "the issues raised by Ambac are not properly before this Court" should be rejected. *See* II Br. at 18-19. Ambac's timely response to the Petition squarely raised this question regarding the proper distribution of the Allocable

Shares in the 2006 Trusts. *See* NYSCEF No. 76 at 1-3. Not only is it appropriate to consider the issues raised in Ambac's response, but the Petition itself seeks "any other instruction from this Court concerning the distribution or administration of the Allocable Shares." Petition (NYSCEF No. 1) at 36; *see also id.* at 33 (seeking instruction that Court has exclusive jurisdiction "for the purposes of rendering such additional instructions as are necessary and/or appropriate in the administration of the Settlement Trusts"). No one – including the Institutional Investors – can claim any prejudice from addressing an issue that Ambac raised back in January.

Moreover, the *res judicata* argument advanced by the Institutional Investors demonstrates that if Ambac had failed to raise these issues here, the Institutional Investors would later claim Ambac was barred from doing so elsewhere. *See* Institutional Investors and AIG Opening Br. (NYSCEF No. 576) at 6-9 (arguing that certain interested parties are precluded from advocating a "write-up first" approach here because there was an "opportunity and obligation" to raise this issue in the prior Article 77 even though it was not mentioned in the petition). The Institutional Investors cannot have it both ways, and it is more efficient for all involved, including the Court, for these issues be decided here, instead of in yet another Article 77 proceeding.[7]

II. For the 2005 Trust, All Certificates That Were Written Down by Realized Losses Should Be Written Up Before Distribution.

While Ambac has no priority right to Subsequent Recoveries in the 2005 Trust, it is subrogated to the rights of holders of Insured Certificates that received claim payments. No one challenges Ambac's right to receive through subrogation distributions of the Allocable Share that the Insured Certificates would otherwise receive, placing Ambac in the shoes of its insureds.

[7] Notably, the Court allowed another financial guaranty insurer, Assured, to be heard on issues not raised in the Petition even though it missed the deadline for appearing. The Institutional Investors did not dispute Assured's right to do so, and have no basis to take a different positon as to Ambac. *See* Aug. 20, 2018 Tr. at 21-22 (counsel for Institutional Investors stating that "[a]s a certificate [insurer], we believe that they would have had standing had they timely appeared").

The Institutional Investors contend that the Pay First method should be used in the 2005 Trust. In support of its argument that the Write-Up First method is appropriate, Ambac adopts and respectfully refers the Court to the responses that the Olifant Funds and Tilden Park made to the arguments of the Institutional Investors and AIG. *See* Olifant Funds Responsive Br. (NYSCEF No. 651) at 2-17; Tilden Park Responsive Br. (NYSCEF No. 668) at 5-13.[8]

Nover remains the only interested party contending that senior certificates that have been written down by Realized Losses should not be written up. As to this issue, Ambac adopts and respectfully refers the Court to the responses of DW and Ellington, the Institutional Investors and AIG, and Tilden Park. *See* DW/Ellington Responsive Br. (NYSCEF No. 708) at 2-11; II Br. (NYSCEF No. 663) at 16-17; Tilden Park Responsive Br. (NYSCEF No. 668) at 20-22.

III. Conclusion

For the foregoing reasons, the Court should instruct Wells Fargo, as Trustee, to pay the entire Allocable Shares for loan group II of GPMF 2006-AR3 and loan groups I and II of GPMF 2006-AR2 directly to Ambac. The Court also should instruct Wells Fargo to distribute the Allocable Shares for loan groups II and III of GPMF 2005-AR5 using the Write-Up First Method, and to write up all certificates that were written down for Realized Losses by the amount of the Allocable Shares, in the reverse order that Realized Losses were allocated as required by the Settlement Agreement, and then to pay to Ambac, as holder by subrogation of the GPMF 2005-AR5 Insured Certificates, the portion of the Allocable Shares that would be payable to holders of such certificates in the absence of Ambac's claim payments.

[8] Tilden Park misconstrues Ambac's argument, stating that Ambac contends that the Settlement Agreement dictates use of the Write-Up First method for all Settlement Trusts. Tilden Park Responsive Br. (NYSCEF No. 668) at 5. While Ambac advocates for Write-Up First in the 2005 Trust, it takes no position on trusts in which it has no interest.

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