To be Argued by:
KEVIN REED
(Time Requested: 15 Minutes)

New York Supreme Court

Appellate Division—First Department

In the Matter of the Application of WELLS FARGO BANK,

(For Continuation of Caption See Inside Cover)

Appellate Case No.: 2020-02716

JOINT RESPONSIVE BRIEF FOR THE INSTITUTIONAL INVESTORS AND AIG PARTIES

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New York County Clerk's Index No. 657387/17

NATIONAL ASSOCIATION, U.S. BANK NATIONAL ASSOCIATION, THE BANK OF NEW YORK MELLON, THE BANK OF NEW YORK MELLON TRUST COMPANY, NA, 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

Appellants-Respondents

AEGON USA INVESTMENT MANAGEMENT, LLC, BLACKROCK FINANCIAL MANAGEMENT, INC., CASCADE INVESTMENT, LLC, FEDERAL HOME LOAN BANK OF ATLANTA, FEDERAL HOME LOAN MORTGAGE CORP., FEDERAL NATIONAL MORTGAGE ASSOCIATION, GOLDMAN SACHS ASSET MGMT L.P., VOYA INVESTMENT MGMT LLC, INVESCO ADVISERS, INC., KORE ADVISORS, L.P., METROPOLITAN LIFE INS. CO., PACIFIC INVESTMENT MGMT COMPANY LLC, TEACHERS INS. AND ANNUITY ASSOC. OF AMERICA, TCW GROUP, INC., THRIVENT FINANCIAL FOR LUTHERANS and WESTERN ASSET MGMT. CO.
(the “Institutional Investors”)

– and –

Appellants-Respondents

AMERICAN GENERAL LIFE INSURANCE COMPANY, AMERICAN HOME ASSURANCE COMPANY, LEXINGTON INSURANCE COMPANY, NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA., THE UNITED STATES LIFE INSURANCE COMPANY IN THE CITY OF NEW YORK and THE VARIABLE ANNUITY LIFE INSURANCE COMPANY
(the “AIG Parties”)

– and –

Appellants-Respondents

ELLINGTON MANAGEMENT GROUP, L.L.C. and DW PARTNERS LP
(the “Ellington and DW Parties”)

– and –

Appellants-Respondents

TILDEN PARK INVESTMENT MASTER FUND LP on behalf of itself and its advisory clients, TILDEN PARK MANAGEMENT I LLC on behalf of itself and its advisory clients and TILDEN PARK CAPITAL MANAGEMENT LP on behalf of itself and its advisory clients
(the “Tilden Park Parties”)

– and –

Appellants-Respondents

PROPHET MORTGAGE OPPORTUNITIES LP, POETIC HOLDINGS VI LLC, POETIC HOLDINGS VII LLC and U.S. BANK NATIONAL ASSOCIATION, solely in its capacity as Indenture Trustee for the Prophet and Poetic Trusts
(the "Prophet and Poetic Parties")

– and –

Appellant-Respondent

AMBAC ASSURANCE CORPORATION
("Ambac")

– and –

Appellants-Respondents

U.S. BANK NATIONAL ASSOCIATION, as NIM Trustee, U.S. Bank, solely in its capacity as Indenture Trustee for the HBK Trusts
(the "HBK Parties")

– against –

Respondent

NOVER VENTURES, LLC
("Nover")

– and –

Respondent

D.E. SHAW REFRACTION PORTFOLIOS, L.L.C.
("D.E. Shaw")

– and –

Respondent

STRATEGOS CAPITAL MANAGEMENT, LLC
("Strategos")

– and –

Respondents

OLIFANT FUND, LTD., FFI FUND LTD. and FYI LTD.
(the "Olifant Parties")

– and –

Respondents

GMO OPPORTUNISTIC INCOME FUND
and GMO GLOBAL REAL RETURN
(the "GMO Parties")

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The Institutional Investors[1] and AIG Investors[2] submit this Responsive Brief pursuant to the Briefing Schedule Stipulation dated September 24, 2020 (Dkt. 23)

PRELIMINARY STATEMENT

This Responsive Brief focuses on four aspects of the Decision from which various interested parties appealed, but which were correctly decided below: (i) the Settlement Agreement[3] does not override or supersede the PSAs in the event of a conflict between the two concerning the write-up method; (ii) the Settlement Payment cannot create temporary overcollateralization; (iii) the Retired Class provision should not be enforced if the Settlement Payment exceeds the realized losses suffered by the non-Retired classes; and (iv) for two Trusts in which the Institutional Investors appeared, Ambac, who insured certain certificates, is not entitled to receive the entire $31 million Settlement Payments, as Ambac sought.

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[1] The sixteen Institutional Investors are: AEGON USA Investment Management, LLC, BlackRock Financial Management, Inc., Cascade Investment, LLC, Federal Home Loan Bank of Atlanta, Federal Home Loan Mortgage Corp., Federal National Mortgage Association, Goldman Sachs Asset Mgmt L.P., Voya Investment Mgmt LLC, Invesco Advisers, Inc., Kore Advisors, L.P., Metropolitan Life Ins. Co., Pacific Investment Mgmt Company LLC, Teachers Ins. and Annuity Assoc. of America, TCW Group, Inc., Thrivent Financial for Lutherans, and Western Asset Mgmt. Co.

[2] The AIG Investors are: American General Life Insurance Company, American Home Assurance Company, Lexington Insurance Company, National Union Fire Insurance Company of Pittsburgh, Pa., The United States Life Insurance Company in the City of New York, and The Variable Annuity Life Insurance Company. The AIG Investors did not appear for the two trusts related to the Fourth Question Presented concerning a dispute with Ambac, a certificate insurer, and therefore only join Sections I-III of this Responsive Brief.

[3] Unless otherwise indicated, capitalized terms used herein have the meaning assigned to them in the Joint Opening Brief For The Institutional Investors, AIG Parties, And Ellington And DW Parties. (Dkt. 65.)

<u>COUNTERSTATEMENT OF QUESTIONS PRESENTED</u>

1. Where the Settlement Agreement conflicts with a PSA concerning the write-up method, does the Settlement Agreement override or supersede the PSA?

Answer: No. The IAS Court correctly held that the Settlement Agreement does not override or supersede the PSAs in the event of a conflict between the two concerning the write-up method. Tilden Park appealed from this ruling (Dkt. 58).

2. Can the Settlement Payment create temporary overcollateralization (*i.e.*, whereby the trusts' assets exceed their liabilities), thereby causing portions of the Settlement Payment to flow through the "excess" cash flow waterfall to junior certificates, even though the trusts have suffered billions in losses, are generally not currently overcollateralized and will not be after the settlement is paid, and do not have excess cash flows?

Answer: No. The IAS Court correctly held that the plain language of the PSAs prevents the Settlement Payment from creating temporary overcollateralization, and appropriately noted that a holding to the contrary could cause settlement funds to be paid to junior certificates under the "excess" cashflow waterfalls, which nearly all investors considered an absurd result in light of the trusts' lack of overcollateralization and excess cash flows. The HBK Parties appealed from this ruling (Dkt. 59).

3. Where the Settlement Payment exceeds the realized losses suffered by the non-Retired classes in a trust with a Retired Class provision, can Retired Classes be written back up in a manner that makes them eligible to receive the benefits of the settlement?

Answer: Yes. The IAS Court correctly held that the PSAs permit Retired Classes to be written back up in this circumstance. The HBK Parties (Dkt. 59) and the Prophet and Poetic Parties (Dkt. 61) appealed from this ruling.

4. In two Trusts for which Ambac provided certificate insurance to senior-support, A-2 certificates, is Ambac entitled to bypass the principal distribution waterfalls in the PSAs in order to recover all Subsequent Recoveries received by the Trusts, including the entire Settlement Payment, to the detriment of the most senior certificates in the Trusts, the A-1 certificates, which Ambac did not insure?

Answer: No. The IAS Court correctly held that Ambac's entitlement to receive Subsequent Recoveries, including the Settlement Payment, is limited to Ambac's rights to receive funds pursuant to the distribution waterfalls in the PSAs, and that Ambac does not have a special right to all of the Trusts' Subsequent Recoveries, as Ambac argued below. Ambac appealed from this ruling (Dkt. 60).

RELEVANT BACKGROUND

The full factual background of the global $4.5 billion JPMorgan settlement at issue here is set out in the Opening Brief submitted by the Institutional Investors, AIG Investors, DW, and Ellington. (Dkt. 65.)

In sum, the Settlement Agreement resolving representation and warranty claims for over three hundred RMBS trusts was negotiated by the Institutional Investors with JPMorgan in 2013 (R.26-27), accepted by Petitioners,[4] with certain modifications, in August 2014 (*id.*), and approved by the New York Supreme Court (Friedman, J.) in August 2016.[5] As noted in the decision approving the settlement, the holdings of the Institutional Investors represented approximately 32.45% of the securities issued by the settlement trusts.[6] Immediately upon receiving the Settlement Payment from JPMorgan, Petitioners filed this Article 77 proceeding, seeking additional instructions concerning how to distribute the Settlement Payment to investors for 270 of the 300-plus settlement trusts. (R.359.)

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[4] Petitioners Wells Fargo Bank, NA, US Bank, NA, The Bank of New York Mellon, The Bank of New York Mellon Trust Company, NA, Wilmington Trust, NA, HSBC Bank USA, NA, and Deutsche Bank National Trust Company are variously trustees, indenture trustees, securities administrators, paying agents, and calculation agents for the RMBS trusts at issue.

[5] *See Matter of U.S. Bank N.A. v. Federal Home Loan Bank of Boston*, 2015 Slip Op. 32846 (U), 2016 WL 9110399, at *1 [Sup. Ct., NY Cty, Aug. 12, 2016] ("JPMorgan I").

[6] *JPMorgan I*, 2016 WL 9110399, at *1.

The Institutional Investors appeared in the proceeding below with respect to 249 of the 270 trusts at issue (R.2298), and the AIG Investors appeared with respect to 72 of the 270 trusts at issue. (R.2391.) The aggregate holdings of the Institutional Investors alone exceeded $11.8 billion. (R.2298.)

ARGUMENT

I. The IAS Court Correctly Held that the Settlement Agreement Does Not Override or Supersede the PSAs in the Event of a Conflict Between the Two Concerning the Write-Up Method.

One threshold issue raised in the Petition is whether Petitioners should follow the Settlement Agreement if its methodology for writing up the principal balances of classes of investors resulting from the Settlement Payment conflicts with the terms of the PSAs. (R.378.) The IAS Court correctly held that the Settlement Agreement does not supersede or override the PSAs in the event of a conflict between the two concerning the write-up method. (R.53) ("By its terms, the Settlement Agreement does not supersede or override the Governing Agreements."); (R.34) ("[T]he Governing Agreements control where they specify the order of operations, and the Settlement Agreement controls only where the Governing Agreements do not specify such order.")[7]

[7] Indeed, Petitioners themselves have long understood they are required to follow the PSAs if they conflict with the Settlement Agreement with respect to the write-up method. They stated in the Petition, for example, that "[f]or Settlement Trusts with [PSAs] that clearly specify a particular order of operations, … [Petitioners] are required and intend to follow the provisions of the [PSAs] for such Settlement Trusts." (R.370 [Petition ¶ 23].)

Though the Tilden Park Parties attempt to cloud the relationship between the Settlement Agreement and the PSAs (Dkt. 58), this interpretive issue is straightforward. To minimize duplicative briefing on this point, the Institutional Investors and AIG Investors join, and hereby incorporate by reference, the Responsive Brief of the GMO Funds, which explains why the PSAs must control over the Settlement Agreement in the event of a conflict concerning the write-up methodology. Two key points, however, bear emphasis.

First, Section 3.06(a) of the Settlement Agreement, by requiring the deposit of the Settlement Payment into the Settlement Trusts' "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" (R.418), reflects the parties' intent that the "distribution provisions" of the PSAs govern the "distribution" of the Settlement Payment. As the IAS Court observed, the Settlement Agreement "expressly elects to apply the existing distribution provisions in the [PSAs] for distribution of the Settlement Payment." (R.55.)

Second, Section 7.05 of the Settlement Agreement—entitled "No Amendments to Governing Agreements"—states that "[t]he Parties agree that this Settlement Agreement reflects a compromise of disputed claims and is not intended to, and shall not be argued or deemed to constitute, an amendment of any term of any Governing Agreement." (R.424.) On its face, then, the Settlement Agreement cannot "amend" any term of any PSA. The IAS Court correctly explained that this provision "would be rendered meaningless" if the Settlement Agreement altered the distribution or write-up provisions of the PSAs. (R.53.)

As set forth in the response of the GMO Funds, none of the responses to these two central points have any merit. The Court should affirm the IAS Court's holding that the PSAs control over the Settlement Agreement if they conflict concerning the write-up methodology.

II. The IAS Court Correctly Held that the PSAs Do Not Permit Temporary Overcollateralization Under the Pay First Order of Operations.

Another issue addressed in the Petition is whether, under the so-called Pay First order of operations, the Settlement Payment can create "temporary overcollateralization." (R.370-375.) The IAS Court properly held that it cannot, and only the HBK Parties appeal from this holding. (Dkt. 59.) Because the HBK Parties have only appeared with respect to twenty-one trusts (identified at R.5386), this issue is limited to just those trusts (the "HBK Trusts").

Importantly, because the IAS Court also held that Petitioners must employ the Write Up First order of operations for the HBK Trusts (at R.40-41)—which indisputably cannot lead to temporary overcollateralization—the Court need not reach the question of temporary overcollateralization if the Court affirms the Write Up First holding for the HBK Trusts.

If the Court reverses the Write Up First holding for the HBK Trusts, the Court should nonetheless affirm the IAS Court's holding that under the Pay First order of operations, the Settlement Payment cannot lead to temporary overcollateralization.

A. The Court Need Not Reach the Question of Temporary Overcollateralization if the Court Affirms the Write Up First Order of Operations for the HBK Trusts.

The first issue resolved by the IAS Court in the Decision and Order was the order of operations to be used in distributing the Settlement Payment. Specifically, the Court addressed whether Petitioners should employ the Pay First order of operations, under which the Settlement Payment is distributed to the trust's certificate holders prior to writing up the certificate principal balances of the trust's affected certificate classes, or the Write-Up First order of operations, under which the certificate principal balances are written up before the Settlement Payment is distributed. (R.369.)

Having found that the Settlement Agreement does not override or supersede the PSAs with respect to the write-up methodology, the IAS Court held that "the Trusts generally contain distribution provisions that specify the order of operations." (R.35.) The IAS Court analyzed the PSAs and held that some require Pay First, while others—including the HBK Trusts—require Write Up First. (R.35 – R.43.)[8]

[8] As to the HBK Trusts, the IAS Court reasoned that the definition of "Certificate Principal Balance" in the HBK Trusts' PSAs requires that all Subsequent Recoveries, including the Settlement Payment, must be added to the certificates' balances before the Settlement Payment is

The Institutional Investors and AIG Investors do not appeal from the IAS Court's order of operations holdings, including the IAS Court's holdings regarding which PSAs mandate Pay First and which PSAs mandate Write Up First.

If the Court affirms the IAS Court's order of operations holding that the HBK Trusts require Write Up First, the Court need not address the question of temporary overcollateralization, which will become moot. (R.43-44) (IAS Court explaining that temporary overcollateralization is an issue limited to Pay First trusts); (HBK Parties' Opening Brief (Dkt. 59), at p. 37 (conceding that the IAS Court's overcollateralization holding "does not matter" for Write Up First trusts).)

B. Under the Pay First Order of Operations, the Settlement Payment Cannot Create Temporary Overcollateralization.

As the IAS Court explained, for Pay First trusts with an overcollateralization structure, "a related issue is whether the Settlement Payment may cause the Trusts to be 'temporarily overcollateralized.'" (R.29 [Decision]); (R.372 [Petition ¶ 28].) The IAS Court correctly held that the plain language of the PSAs prevents the creation of temporary overcollateralization in Pay First trusts. (R.49-50.)

Only two parties below, the Tilden Park Parties and HBK Parties, argued that the Settlement Payment could create temporary overcollateralization. (R.47

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distributed. (R.38.) In so holding, the IAS Court rejected HBK's arguments below (at R.4960-4961) that the PSAs in question require Pay First. (*Id.)* Having lost that argument below, HBK has now reversed course, arguing instead that the HBK PSAs are silent as to the order of operations, and that the Pay First order of operations it seeks is found in the Settlement Agreement, not the PSAs. *See* HBK Opening Brief (Dkt. 59), at pp. 22-26.

[Decision].) All other investors addressing the issue argued that temporary overcollateralization was commercially absurd, prohibited by the PSAs, or both. (R.50 [Decision]); (R.5966 [Nover Brief]); (R.4682-4683 [Olifant Parties' Brief]); (R.5947 [GMO Funds' Brief].) Having lost below, the Tilden Park Parties have now abandoned the theory, leaving the HBK Parties alone in pursuing temporary overcollateralization.[9]

(i) Background on Overcollateralization.

Each of the HBK Trusts has an overcollateralization structure, meaning that when the trusts were originally issued, their assets (*i.e.*, the mortgage collateral) exceeded their liabilities (*i.e.*, the Trusts' Class A, Class M, and Class B certificates). (R.44 [Decision]); (R.364 & R.371 [Petition].) As the IAS Court explained, overcollateralization was "intended to insulate senior classes from realized losses." (R.50.) Effectively, the overcollateralization structure would allow a certain number of mortgages to default and go through foreclosures without causing losses to senior certificates—thereby providing a "cushion against loss" to senior certificates. (*Id.)*

Overcollateralization is calculated as the excess of the principal balances of the trust's mortgage collateral over the principal balances of the trust's certificates

[9] Notably, the Tilden Park Parties successfully argued below that the PSAs for the HBK Trusts require Write Up First. (R.3510 [Tilden Park Parties' Brief]).

and is referred to in the PSAs as "Overcollateralization Amount." The term "Overcollateralization Amount" is typically defined in the PSAs as follows:

> **<u>Overcollateralization Amount</u>**: With respect to any Distribution Date, the excess, if any, of (i) the aggregate Stated Principal Balance of the Mortgage Loans of a Group as of the last day of the related Due Period, over (ii) the sum of the Certificate Principal Balances of the Certificates of a related Group (after taking into account the payment of principal . . . on such Certificates) on such Distribution Date.

(R.46 [Decision]); (R.5791 [compilation of the definitions of Overcollateralization Amount in the PSAs for each of the HBK Trusts].)

Trusts with an overcollateralization structure also generally have a class of certificates, the "Class C" certificates, whose initial certificate principal balance equaled the initial Overcollateralization Amount when the trusts were created. (R.371 [Petition].) If losses on the mortgages began to accrue, the initial Overcollateralization Amount in the trusts could be depleted, with the associated loss borne only by the Class C certificates—the certificates specifically designed to mirror the level of overcollateralization in the trusts over time. (*Id.)*

As described in the Petition, "[t]he overcollateralization amount, along with the corresponding Class C certificates, 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." (*Id.)* Thus, if overcollateralization was depleted through losses on the mortgages, all of those losses would be suffered by the Class C certificates until the losses exceeded the initial Overcollateralization Amounts.

Petitioners calculate the Overcollateralization Amounts on each monthly Distribution Date by subtracting the Class A, Class M, and Class B certificate balances from the aggregate balances of the mortgage collateral "after taking into account the payment of principal . . . on such Distribution Date." (R.46.) In other words, Petitioners assess on each monthly Distribution Date whether a trust's assets still exceed its liabilities and, if so, by how much.

The HBK Trusts also have a specified "Overcollateralization Target," which represents a set "target" dollar amount for the Overcollateralization Amount in the trusts over time. (R.44-45 [Decision]; R.371 [Petition].) Importantly, if the Overcollateralization Amount exceeds the Overcollateralization Target for a given distribution period, then any excess overcollateralization over and above the Overcollateralization Target is distributed as "Overcollateralization Release Amount" through the "excess" cashflow waterfall, rather than the primary distribution waterfall through which regular principal payments are distributed. (*Id.)*

(ii) HBK's Temporary Overcollateralization Theory Seeks a Commercially Absurd Windfall.

If the HBK Trusts had performed well, and the Overcollateralization Amount exceeded the Overcollateralization Target Amounts over time, the "excess" overcollateralization could have been distributed through the "excess" cashflow waterfall to junior certificates, including even the Class C certificates, instead of the senior certificates. That is the commercially absurd result the HBK Parties seek when the Settlement Payment is disbursed. (R.45-51 [Decision]); (R.371-374 [Petition]); (HBK Opening Brief (Dkt. 59), at p. 30.)

That result is commercially absurd because the HBK Trusts have not performed well and have not had "excess" cash flows. Rather, they have had large cash flow deficits and have suffered staggering losses of approximately $5 billion, for an average of $230 million in losses for each of the twenty-one HBK Trusts. (R.5386 [HBK Trusts]); (R.5884-5887 [trust losses].) While the HBK Trusts stand to receive approximately $350 million in settlement proceeds (R.5867-5870), that will leave approximately $4.5 billion in unreimbursed losses. Because the Overcollateralization Targets have not been met or exceeded for many years, "there have been no recent overcollateralization release amounts and no excess cashflow distributions." (R.50 [Decision]); (R.372 [Petition].)

Even though the HBK Trusts have suffered billions in losses and have fallen far short of their Overcollateralization Targets for many years now, and will continue to fall short after the settlement funds are distributed, Petitioners expressed a concern that the Pay First order of operations could cause the Trusts to "appear to be temporarily overcollateralized" (R.372) at some fleeting moment during the distribution itself. That could, in turn, cause significant portions of the Settlement

Payment to be distributed as Overcollateralization Release Amount under the excess cashflow waterfall to junior certificates (the position the HBK Parties urge now), instead of to senior certificates through the primary distribution waterfall. (R.45 [Decision]); R.371 [Petition].) The basis for the Petitioners' concern is as follows.

It is undisputed that two operations are required when Petitioners distribute the Settlement Payment: (1) the distribution of the Settlement Payment to Certificateholders, which has the effect of reducing the certificate balances by the amount of the Settlement Payment[10]; and (2) the writing up of certificate principal balances by the same amount.[11] (R.369 [Petition]); (R.30 [Decision].) The second operation is essential to the distribution of Subsequent Recoveries such as the Settlement Payment, because the write-up reverses reductions in certificate balances that occurred when the realized losses being reversed by the Subsequent Recovery

[10] The distribution of the settlement funds is set forth both in Section 3.06(a) of the Settlement Agreement and in the PSAs, which generally provide that Subsequent Recoveries are to be distributed to investors as principal. (R.418 [Settlement Agreement Section 3.06(a)] (stating that the Settlement Payment is to be distributed "as though" it were subsequent recoveries relating to principal)); (R.47-48 [Decision] (PSAs require subsequent recoveries to be distributed to investors through the distribution waterfalls as principal).)

[11] The certificate "write-up" is found in Section 3.06(b) of the Settlement Agreement and in the PSAs, which generally provide for certificate write-ups at the end of the distribution waterfall section. (R.418 [Settlement Agreement]); (R.36-40 & R.47-48 [Decision] (describing PSA write-up provisions).)

were allocated to the certificates—thereby keeping the trusts' assets and liabilities in balance. (R.28-29 [Decision].)[12]

Without a certificate write-up, Subsequent Recoveries would cause the trusts' assets to exceed their liabilities, as the trusts' unchanged mortgage collateral would exceed the trusts' reduced certificate balances—an absurd result that the PSAs contemplated and prevented through the write-up. The write-up is so integral to the payment of Subsequent Recoveries that it appears in the section of the PSAs entitled "Distributions"—the same section that specifies which certificates are entitled to receive Subsequent Recoveries when distributed. (R.36-40 [Decision citing Section 5.04 of the PSA for BSABS 2005-AQ2, one of the HBK Trusts]); (R.3532 & R.3537 [full excerpt of Section 5.04 of that PSA, entitled "Distributions"].)

The Institutional Investors and AIG Investors argued below that Petitioners are required to take into account both of these operations when assessing overcollateralization, because the definition of Overcollateralization Amount plainly states that it is calculated "after taking into account the payment of principal . . . on such Distribution Date," and because the plain meaning of the phrase "taking into account the payment of principal" requires Petitioners to account for everything inherent in a payment of principal, *i.e.*, both the distribution of the payment and the

[12] *See also* Opening Brief of the Institutional Investors, AIG Investors, DW, and Ellington (Dkt. 61), at pp.4-10 (describing realized losses and certificate write-up mechanics in detail).

certificate write-up. (R.46.) Doing so renders temporary overcollateralization impossible. As the Institutional Investors and AIG Investors argued (and the IAS Court ultimately held), Petitioners' concern about temporary overcollateralization assumes that Petitioners would assess the Overcollateralization Amount by considering the distribution to investors, while ignoring the certificate write-up. (R.45.) If Petitioners only considered the certificate reduction associated with the distribution of the settlement funds, but ignored the equal and offsetting certificate write-up that follows, a trust could "temporar[ily] appear" to be overcollateralized because its unchanged mortgage collateral would exceed its reduced certificate balances—an appearance that would vanish once the required certificate write-ups are made, and which the write-up itself is designed to avoid.

(iii) The IAS Court Rejected HBK's Commercially Absurd Overcollateralization Theory.

The IAS Court agreed with the Institutional Investors and AIG Investors and correctly held that the Settlement Payment cannot create temporary overcollateralization under the Pay First order of operations. The IAS Court held that the definition of "Overcollateralization Amount" was dispositive. That term, the IAS Court explained, requires Petitioners to "take into account" the payment of the settlement funds as subsequent recoveries relating to principal, which includes "account[ing]" for both (i) the reduction of certificate balances caused by the Settlement Payment, and (ii) the corresponding certificate write-ups. (R.49-50) ("As

Overcollateralization Amount must be calculated based on Certificate Principal Balances that have not only been reduced by the Settlement Payment but have also been written up, overcollateralization will not occur.")

The HBK Parties alone appeal from this holding, as Tilden Park has abandoned it. The HBK parties concede that the dispute turns on the definition of "Overcollateralization Amount." (HBK Opening Brief (Dkt. 59), at pp. 35-36.) As the IAS Court noted, the HBK Parties "focus solely on the requirement in the definition of Overcollateralization Amount that the amount be calculated 'after taking into account the payment of principal,' and contend that 'payment' of principal is taken into account merely by reducing the certificate balance" and ignoring the required certificate write-ups. (R.49.) The IAS Court correctly rejected HBK's implausible and self-serving reading (at R.49-50):

> [HBK's] interpretation fails to apply the settled precept that a contract must be read as a whole so as to give meaning to all of its terms. The [HBK] interpretation ignores or reads out the write-up provision of the PSAs, which requires Subsequent Recoveries to be accounted for not just by payment of the amount of the Subsequent Recoveries, but also by write-up of certificate balances in the corresponding amount. Both accounting operations are required to take place upon distribution of Subsequent Recoveries. The court accordingly holds that "taking into account the payment of principal" [. . .] encompasses both a reduction of the balance in the amount of principal to be paid out, and an increase of the balance in the amount of the Subsequent Recovery to be distributed. As Overcollateralization Amount must be calculated based on Certificate Principal Balances that have not only been reduced by the Settlement Payment but have also been written up, overcollateralization will not occur.

(iv) The IAS Court Correctly Held that the Definition of Overcollateralization Amount Precludes Temporary Overcollateralization.

The IAS Court's thorough textual analysis was correct, and the HBK Parties offer no new arguments on appeal.

The only plausible reading of the operative phrase "taking into account the payment of principal" is that Petitioners must take into account each of the two operations inherent in the payment of Subsequent Recoveries: a reduction in the certificate balances in the amount of the Subsequent Recovery, and an equal and offsetting increase caused by the certificate write-up. The IAS Court summed this up by explaining that "[b]oth accounting operations are required to take place upon distribution of Subsequent Recoveries" and therefore both must be taken into account. (R.49-50.)

The HBK Parties ask that Overcollateralization Amount be assessed at a fictitious moment, half-way through the distribution: after the certificates have been reduced by the Settlement Payment, but just before they have been written back up by the same amount. At that ephemeral half-way point, HBK claims the trusts become overcollateralized and that the fictitious overcollateralization must be distributed to junior certificates under the "excess" cash flow waterfalls. But nothing in the definition of Overcollateralization Amount plausibly allows Petitioners to assess Overcollateralization Amount half-way through, or to otherwise embrace the absurd fiction that the HBK Trusts are overcollateralized, even though it is undisputed that they are generally not overcollateralized now and will not be after the Settlement Payment is made.

Rather, the definition of Overcollateralization Amount requires Petitioners to "tak[e] into account the payment of principal," including subsequent recoveries, when assessing the level of overcollateralization in the trusts on the distribution date in question. (R.46.) As the IAS Court correctly held, the phrase "taking into account the payment of principal" "encompasses both a reduction of the balance in the amount of principal to be paid out, and an increase of the balance in the amount of the Subsequent Recovery to be distributed." (R.49-50.)

Reflecting the centrality of the certificate write-up to the "payment" of Subsequent Recoveries, each operation is found in the same section of the PSAs, entitled "Distributions." (R.36-40 [Decision citing Section 5.04 of the PSA for BSABS 2005-AQ2, one of the HBK Trusts]); (R.3532 & R.3537 [full excerpt of Section 5.04 of that PSA, entitled "Distributions"].) That makes sense, because each of the two operations is an essential feature of the "payment" of subsequent recoveries that the trustees must "tak[e] into account." The IAS Court accurately held that HBK's interpretation "ignores or reads out" the certificate write-up from the "Distribution" Section of the PSAs, rendering that term meaningless. (R.49-50.)

(v) The IAS Court Correctly Highlighted the Commercially Unreasonable Consequences of Temporary Overcollateralization.

In addition to correctly applying the contractual text, the IAS Court's holding is consistent with the seniority structure of the trusts and the reasonable commercial expectations of the parties. As described above, Overcollateralization Release Amounts are only paid to junior certificates through the excess cash flow waterfalls when the Overcollateralization Amounts exceed the Overcollateralization Targets over time—a sign of healthy, well-performing trusts. Yet, the trusts have generally not met those targets, do not have "excess" cash flows, and have instead suffered large cash flow deficits—exceeding $5 billion in the twenty-one HBK Trusts and over $60 billion in all of the Settlement Trusts. *See* § II(B)(ii), *supra*.

Though the IAS Court based its holding on the plain text of the PSAs and the definition of Overcollateralization Amount—which are dispositive—the IAS Court also appropriately highlighted the commercially unreasonable consequences of temporary overcollateralization. (R.50.) In this regard, the IAS Court stated that it "bears noting" that the overcollateralization feature of the trusts was "intended to insulate senior classes from realized losses and operates as a credit enhancement for such classes—i.e., a 'cushion against loss'" and that permitting temporary overcollateralization could divert the Settlement Payment through the excess cash flow waterfalls to junior certificates, including to the "first-loss" Class C Certificates, as sought by the HBK Parties. (R.50-51.)

It is well settled in New York that contracts "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). Embracing the fiction of temporary overcollateralization in these circumstances would be just such an absurd, commercially unreasonable result. The other investors addressing this issue besides the Tilden Park and HBK Parties agreed below that such a result would be commercially unreasonable. *See* § II(B), *supra*.

Notably, the HBK Parties do not offer any commercial rationale for the outcome they seek. Nor could they; there is no conceivable commercial justification for permitting overcollateralization release in trusts that are not overcollateralized, much less permitting such release to the "first-loss" Class C certificates, while allowing senior certificates to continue to suffer from billions of dollars in unreimbursed realized losses.

Reflecting the broad consensus among investors that temporary overcollateralization is a commercially unreasonable result, out of the twenty-eight separate severance orders that have been entered by agreement since Petitioners filed this case approximately three years ago—which allowed approximately $2 billion of the escrowed settlement funds to be released—not a single one has permitted the Settlement Payment to create temporary overcollateralization. (R.72—342 [severance orders]); (R.5866-5881 [Settlement Payments]). Instead, each of the severance orders providing for a Pay First order of operations contained terms that instructed Petitioners to measure the level of overcollateralization after taking into account the certificate write-ups associated with the distribution of the Settlement Payment, thereby preventing temporary overcollateralization—precisely as the IAS Court held in the Decision.[13]

For these reasons, if the Court reverses the IAS Court's holding that the Write Up First order of operations must be employed for the HBK Trusts, the Court should nonetheless affirm the IAS Court's holding that under the Pay First order of operations, the Settlement Payment cannot create temporary overcollateralization.

[13] *See, e.g.*, Partial Severance Order and Partial Final Judgment for 91 Trusts (R.92) (instructing Petitioners to "account for both the distribution of the Subject Allocable Shares and accompany Settlement Payment Write-Up when performing the Overcollateralization Amount Calculation," which would "prevent [those] Trusts from being overcollateralized as a result of the receipt, administration, and/or distribution of the Subject Allocable Shares"). Though these twenty-eight severance orders were entered without prejudice to the ongoing disputes over temporary overcollateralization (*see, e.g.*, R.95, providing that the severance order for 91 trusts was without prejudice to other trusts or the ongoing disputes), that they have permitted billions of dollars in settlement proceeds to be distributed in this manner confirms that temporary overcollateralization is inconsistent with the parties' reasonable, commercial expectations.

III. The IAS Court Correctly Held that Retired Classes With Realized Losses Are Eligible For Certificate Write-Ups.

The IAS Court also addressed trusts containing a "Retired Class" provision providing that once their certificate balances have been reduced to zero, they will be "retired" and "will no longer be entitled to distributions." (R.60 [Decision].) Petitioners sought instructions concerning whether such zero-balance classes in trusts with such a provision were eligible to be written up by the amount of the Settlement Payment. (R.382-384.)

As noted in the Decision, the Institutional Investors and AIG Investors argued that this provision should be enforced, unless the Settlement Payment exceeds the realized losses of the non-Retired certificates, in which case the Trustees should write up zero balance certificates in order to keep the Trusts' assets and liabilities in balance. (R.62 [Decision].)[14]

On this issue, the IAS Court held that, notwithstanding the Retired Class provision, the write-up sections of the PSAs and the Settlement Agreement permit Retired Classes to be written back up by the amount of subsequent recoveries, and

[14] The Institutional Investors' and AIG Investors' position in this regard was stated in their submission before the IAS Court (R.5414): "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. They should. . . . 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 [and AIG Investors] support this structural adjustment."

that these certificate write-up provisions authorize the write-up of such certificates. (R.62-63.)

In effect, the IAS Court's holding permits Retired Classes to be written back up from zero if the Settlement Payment exceeds the realized losses of the then-outstanding certificates. As the Institutional Investors and AIG Investors noted below, this structural adjustment is important to keeping the Trusts' assets and liabilities in balance. (R.5414.) The IAS Court appropriately reconciled the Zero Balance provision with the write-up provisions in the Settlement Agreement and PSAs in a manner that preserves the balance between the trusts' assets and liabilities.

IV. The IAS Court Correctly Held that Ambac Is Not Entitled to The Entire $31 Million Settlement Payments In Two Trusts By Bypassing the Principal Distribution Waterfalls

The IAS Court also addressed an issue that was not raised in the Petition but was raised by Ambac, a certificate insurer for GPMF 2006-AR2 and GPMF 2006-AR3 (the "Ambac Trusts"). (R.65.) The Institutional Investors appeared with respect to the Ambac Trusts, but the AIG Investors did not.

Ambac argues that the entirety of the Settlement Payments for the Ambac Trusts, exceeding $31 million, should bypass the Trusts' distribution waterfalls entirely and should instead be paid to Ambac directly from the Trusts' Custodial Account, to which Ambac claims "special" access rights. (Ambac Opening Brief (Dkt. 60), at pp. 10-14.) The IAS Court correctly rejected Ambac's arguments and directed Petitioners to enforce the PSAs' distribution waterfalls as written. (R.68 [Decision at 43].) To be sure, the IAS Court confirmed that Ambac is entitled to stand in the shoes of the specific certificates that Ambac actually insured and on which Ambac covered certificateholders' losses pursuant to that insurance. But Ambac's argument that it is entitled to all of the Trusts' Settlement Payments is directly contrary to the PSAs for two key reasons. First, Ambac's rights to Subsequent Recoveries are limited to subrogation rights for the A-2 certificates that it actually insured, payable exclusively through the distribution waterfall set out in Section 6.01 of the PSAs. And second, Ambac has no right to direct payment from the trusts' Custodial Accounts; the flow-of-funds provisions in the PSAs confirm that all Subsequent Recoveries must be distributed pursuant to Section 6.01.

A. Ambac's Rights To Subsequent Recoveries Are Exclusively Set Out in the Section 6.01 Distribution Waterfalls.

Ambac insured the Trusts' A-2 senior-support certificates, which are junior to the senior-most A-1 certificates held by the Institutional Investors.[15] (R.4607-4647 [certificate insurance policies].) As insurer for A-2 certificates, Ambac reimbursed significant Realized Losses allocable to those A-2 certificates. (Ambac Opening

[15] The A-2 certificate is "junior" to the A-1 certificates in the sense that all losses must be allocated first to the A-2 certificates, until the A-2 certificates are written down to zero, before losses are allocated to the A-1 certificates. (R.3641 [PSA for GPMF 2006-AR2 allocating losses first to the A-2 certificates until they are written off, and only then to the A-1 certificates]); (R.4109 [PSA for GPMF 2006-AR3 allocating losses first to the A-2 certificates until they are written off, and only then to the A-1 certificates].)

Brief at 4 n. 4.) But the more senior A-1 certificates have not been immune from losses. For instance, in the GPMF 2006-AR3 trust, the II-A-1 senior certificate held by the Institutional Investors had suffered $6.6 million in Realized Losses as of September 2018—an amount that has increased significantly since then. (R.10879 [Sept. 2018 monthly report for GPMF 2006-AR3].) And Ambac, who does not insure the II-A-1 certificates, has naturally not paid a dime to cover those losses.

The PSAs and related agreements provide Ambac with subrogation rights[16] that mirror its role as an insurer of a specific group of certificates: Ambac is entitled to receive any Subsequent Recoveries otherwise payable to the A-2 certificates, but not those payable to other certificates, much less the Trusts' senior-most certificates.[17] Several related provisions of the PSAs confirm that analysis.

[16] (R.4610-4612 [insurance policy for GPMF 2006-AR2] ("[Ambac] shall be subrogated to the rights of each Holder [of an insured A-2 certificate] to the extent of any payment by [Ambac] under the policy"]); (R.4626-4628 [identical insurance policy provisions for GPMF 2006-AR3].)

[17] This subrogation structure is typical of insurance arrangements. A leading insurance treatise describes subrogation as follows:

[F]rom the perspective of the insurer, it has been stated that subrogation has the objective of reimbursing the insurer for the payment which it has made. When the insurer has made payment for the loss caused by a third party, it is only equitable and just that the insurer should be reimbursed for its payment to the insured, because otherwise either the insured would be unjustly enriched by virtue of a recovery from both the insurer and the third party, or in the absence of such double recovery by the insured, the third party would go free notwithstanding the fact that he or she has a legal obligation in connection with the damage.

(16 COUCH ON INS. § 222:8)

Section 6.02(b) and 6.02(c) of the PSAs, which address distributions and certificate write-ups, describe Ambac's subrogation rights to receive Subsequent Recoveries that would otherwise be payable to the A-2 certificates:

> Section 6.02(b):
>
> In the event that the Servicer receives any Subsequent Recoveries, the Servicer shall deposit such funds into the Custodial Account pursuant to Section 4.01(a)(ii). Subsequent Recoveries will first [be] used to pay any amounts owed to the Certificate Insurer as set for[th] in Section 6.02(c).
>
> Section 6.02(c):
>
> 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.

(R.3708.)

These Section 6.02 subrogation provisions provide that any Subsequent Recoveries payable to the A-2 certificates must "be allocated first to [Ambac] for payment on any Reimbursement Amounts." But that allocation right is far more limited than Ambac claims. The key term "Reimbursement Amounts" is defined by the related insurance policies as the "the sum of (i) all [insurance payments] paid by [Ambac], but for which [Ambac] has not been reimbursed prior to such Distribution Date pursuant to Section 6.01 of the Agreement"—that is, payments Ambac made to the A-2 holders but has not gotten back. (R.4611.) And importantly, the definition of "Reimbursement Amounts" also states that Ambac is "reimbursed" for such amounts "pursuant to Section 6.01 of the Agreement"—the distribution waterfalls.

The Section 6.01 distribution waterfalls, in turn, specify who receives which cash flows, and in what priority:

> Section 6.01 Distributions on the Certificates. (a) On each Distribution Date, an amount equal to the Interest Funds and Principal Funds for such Distribution Date shall be [. . .] distributed for such Distribution Date, in the following order of priority: [. . .] to pay as principal on the Class A, Class M, and Class B Certificates, in the following order of priority: (A) For each Distribution Date [. . .], from the Principal Funds [. . .]: (b) An amount equal to the Group II Principal Distribution Amount[18] will be distributed first to each class of Class II-A Certificates[19] on a pro rata basis until the Current Principal Amount of each such Class is reduced to zero and second, to the Certificate Insurer, any accrued and unpaid Reimbursement Amounts payable to the Certificate Insurer for that 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 with respect to the Mortgage Loans with respect to which

[18] The Group II Principal Distribution Amount is simply Group II's share of the Principal Funds, excluding overcollateralization release, which is not relevant here. The full definitions in the GPMR 2006-AR3 Trust are as follows:

> Group II Principal Distribution Amount: "The product of the Principal Distribution Amount and a fraction, the numerator of which is the Principal Funds for Loan Group II for such Distribution Date and the denominator of which is the Principal Funds of all Loan Groups for such Distribution Date." (R.3651.)

> Principal Distribution Amount: "With respect to each Distribution Date, an amount equal to the excess of (i) sum of (a) the Principal Funds for all Loan Groups on such Distribution Date and (b) any Extra Principal Distribution Amount for such Distribution Date over (ii) any Overcollateralization Release Amount for such Distribution Date." (R.3658.)

[19] Class II-A Certificates include both the uninsured, super-senior II-A-1 certificate and the insured, senior-support II-A-2 certificate insured by Ambac. (R.3642.)

> Realized Losses were paid by the Certificate Insurer would otherwise be payable to the Class II-A-2 Certificates;

(R.3705 [GPMF 2006-AR2]); (*see also* R.4153 [equivalent 6.01 terms for GPMF 2006-AR3].)

The Settlement Payment is distributed "as though it were a Subsequent Recovery allocable to principal." (R.418 [Settlement Agreement Section 3.06(a)].) And the Section 6.01 distribution waterfall unambiguously governs the distribution of Subsequent Recoveries, which are part of "Principal Funds."[20]

Ambac's argument that it is entitled to a first-priority payout is directly at odds with that express language. The Section 6.01 distribution waterfall provides that Subsequent Recoveries are "first" paid "pro rata" to the A-1 and A-2 certificates, until their certificate balances are reduced to zero. "Second," once the certificate balances of the A-1 and A-2 certificates are reduced to zero, any "accrued and unpaid Reimbursement Amounts" are paid to Ambac—but "only to the extent of the portion of Subsequent Recoveries with respect to the Mortgage Loans with respect to which

[20] "Principal Funds" is defined as follows, in relevant part: "the sum, without duplication, of (a) . . . all scheduled principal collected on the Mortgage Loans in the related Loan Group during the related Due Period, [. . .] (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 . . . ." (R.3658-3659.)

"Liquidation Proceeds," which are part of "Principal Funds," is defined as follows: "Cash received in connection with the liquidation of a defaulted Mortgage Loan, whether through trustee's sale, foreclosure sale, Insurance Proceeds, condemnation proceeds or otherwise and Subsequent Recoveries." (R.3653.)

Realized Losses were paid by [Ambac] would otherwise be payable to the Class II-A-2 Certificates." (R.3706.)

As such, Ambac is entitled to a portion of Subsequent Recoveries under those subrogation provisions. "[F]irst," Ambac receives whatever portion of Subsequent Recoveries that are allocable to the A-2 Certificates that Ambac has already made whole. "[S]econd," once the A-1 and A-2 certificates are paid down to zero, Ambac is entitled to "Reimbursement Amounts" to the same extent. But there is no basis for Ambac's far broader claim that it is also entitled to receive all of the Trust's Subsequent Recoveries, including those that would otherwise be payable to the senior-most, A-1 certificates under Section 6.01, which Ambac did not insure. (Ambac Opening Brief (Dkt. 60), at pp. 6-10.)

B. The IAS Court Correctly Rejected Ambac's Meritless Construction of the PSAs, Which Vastly Overstates Ambac's Rights to Subsequent Recoveries.

The IAS Court agreed with the analysis set out above, correctly rejecting Ambac's argument that Section 6.02 of the PSAs provides Ambac a top-of-the-waterfall entitlement to all of the Trust's Subsequent Recoveries, ahead of even the A-1 certificates. The IAS Court also held that Section 6.02 merely confirms Ambac's subrogation rights to receive Subsequent Recoveries that would otherwise be payable to the A-2 certificates, thereby preventing a "double recovery" by the A-2 certificates. (R.68.)

But the IAS Court also correctly held that these subrogation provisions "do[] not modify or contradict section 6.01 [the principal distribution waterfall] to the extent that it provides that A1 certificates are entitled to payment of Subsequent Recoveries through the principal distribution waterfall on a pro rata basis until the certificate principal balances are zero." (*Id.*)

In other words, Ambac cannot bootstrap its Section 6.02 subrogation rights into a top-of-the waterfall right to all Subsequent Recoveries, even ahead of the super-senior A-1 certificates that Ambac did not insure.

C. Ambac Does Not Have a Special Right to Take All of the Trust's Subsequent Recoveries From the Custodial Account.

In its Opening Brief, Ambac additionally claims that Section 6.02 of the Ambac Trusts is "a special provision that governs the distribution of Subsequent Recoveries" and that one of Ambac's "special" rights is to take all Subsequent Recoveries directly from a bank account called the "Custodial Account"—essentially an all-purpose collection account maintained by the Trust's Servicer—before they ever make their way to the Section 6.01 distribution waterfall. (Ambac Opening Brief (Dkt. 60), at pp. 6-10.) This argument completely ignores the plain terms of the PSAs, which channel all Subsequent Recoveries—without exception—from (1) the Custodial Account to (2) the Distribution Account to (3) the Section 6.01 distribution waterfall. The PSA terms below set out this clear path.

First, Section 4.01 of the PSAs describes the Servicer's duty to create a "Custodial Account": "The Servicer shall segregate and hold all funds collected and received pursuant to each Mortgage Loan separate and apart from any of its own funds and general assets and shall establish and maintain one or more Custodial Accounts held in trust for the Certificateholders." (R.3691.) In other words, the Servicer, who handles monthly collections from borrowers, must deposit all the cash it receives, including Subsequent Recoveries, into the Custodial Account, which is "held in trust for the Certificateholders." (*Id.*)

Second, Section 4.02(d) of the PSAs requires the Servicer to make a monthly transfer of all "Available Funds" from its Custodial Account to the Trustee's Distribution Account for distribution to investors under the Section 6.01 distribution waterfall. The "Available Funds" the Servicer must transfer from the Custodial Account to the Distribution Account include "Principal Funds," which, as set out above, expressly include "Subsequent Recoveries." (*Supra* n.20 and R.3641.) Thus, Section 4.02(d) of the PSA requires the Servicer to make a monthly transfer of all Subsequent Recoveries from its Custodial Account to the Trustee's Distribution Account. There is no carve-out for any Subsequent Recoveries; each and every Subsequent Recovery must be transferred to the Distribution Account.

Third, the Trustee's Distribution Account is described in Section 4.03 of the PSAs: "The Trustee shall establish and maintain in the name of the Trustee, for the benefit of the Certificateholders and the Certificate Insurer, the Distribution Account as a segregated trust account or accounts. The Trustee shall deposit into the Distribution Account all amounts in respect to Available Funds received by it from the Servicer." (R.3691.)

Fourth, Section 4.04(c) of the PSAs provides that the Trustee "shall distribute the Available Funds to the extent on deposit in the Distribution Account to the Holders of the related Certificates in accordance with Section 6.01 [the distribution waterfall]." (R.3693.)

Through these four steps in the PSAs, the flow of Subsequent Recoveries goes from the Custodial Account (per Section 4.01), to the Distribution Account (per Section 4.02(d), as part of "Available Funds" that must be transferred monthly to the Distribution Account), and then onto investors pursuant to the Section 6.01 distribution waterfall. In attempting to reach into the proverbial Custodial Account cookie jar, however, Ambac ignores these provisions, which plainly require that all Subsequent Recoveries are transferred from the Custodial Account through to the Section 6.01 distribution waterfall.

Nor does Ambac cite the other provisions of Section 4.02, aptly entitled "Permitted Withdrawals and Transfers from the Custodial Account." (R.3691.) That Section states that the only parties with "special" access to the Custodial Account are the Trust's administrators—the Trustee, the Servicer, and the

Custodian—who have the right to withdraw funds directly from the Custodial Account, but only for specified categories of expenses that are recoverable from the Custodial Account pursuant to their express indemnification and reimbursement rights against the Trust's assets under the PSAs. (R.3691.) Ambac is not even mentioned in Section 4.02—the only section of the PSAs setting out "[p]ermitted withdrawals and [t]ransfers from the Custodial Account." Nor would it be; Ambac's entitlement to Subsequent Recoveries is already provided for in the Section 6.01 distribution waterfall.

And, while Ambac is correct that Section 6.02(b) of the PSAs confirms that Subsequent Recoveries must be deposited into the Custodial Account, Section 6.02(b) says nothing about withdrawals from the Custodial Account. Instead, as set out at length above, and as the IAS Court correctly held, Section 6.02 merely confirms Ambac's subrogation rights against the A-2 certificates and "does not modify or contradict section 6.01 to the extent that [Section 6.01] provides that A1 certificates are entitled to payment of Subsequent Recoveries through the principal distribution waterfall on a pro rata basis until the certificate principal balances are zero." (R.68.) Nor could a general section like Section 6.02, which addresses distributions and write-ups, control over Section 4.02 with respect to the subject matter of "[p]ermitted withdrawals and [t]ransfers from the Custodial Account"—

which are specifically addressed by Section 4.02. *See, e.g.*, *Muzak Corp. v. Hotel Taft Corp.*, 1 N.Y.2d 42, 46 (1956) (specific provisions control over general ones).

D. Ambac Has No Greater Rights in the 2006 Trusts Than It Does in the 2005 Trust, In Which Ambac Concedes It May Only Recover Subsequent Recoveries From the Section 6.01 Distribution Waterfall.

Ambac concedes that for a third trust it insured, GPMF 2005-AR5 (the "2005 Trust"), Ambac is only entitled through subrogation "to stand in the shoes of the holders of Insured Certificates and receive the settlement distributions otherwise due to those holders." (Ambac Opening Brief (Dkt. 60), at p 7.) Ambac argues that the absence of the Section 6.02 subrogation language in the 2005 Trust demonstrates Ambac bargained for greater rights in the 2006 Trusts. (*Id.* at 15.) This claim does not withstand even minimal scrutiny; rather, the structure and key terms of each of these three Ambac-insured trusts are substantively identical, and Ambac has no greater rights in the 2006 Trusts than it does in the 2005 Trust.

First, the subrogation terms in the 2005 Trust's insurance policy are substantively identical to those in the 2006 Trusts. (R.4642 [policy terms for 2005 Trust]); (*supra* n. 16 [policy terms for 2006 Trusts].) Second, the flow of all Subsequent Recoveries from the Custodial Account to the Distribution Account to the Section 6.01 distribution waterfall is equally clear in the 2005 Trust as it is in the 2006 Trusts. (R.4382-4385.) Third, the Section 6.01 distribution waterfall in the 2005 Trust limits Ambac's entitlement to Subsequent Recoveries to those that are "otherwise payable to the Class II-A-2 Certificates" which Ambac insured—just like the Section 6.01 waterfalls in the 2006 Trusts. (R.4404.) The Section 6.02 language in the 2006 Trusts did not add any new, substantive rights. Rather, that language merely confirms Ambac's subrogation rights to subsequent recoveries—which are also found in the insurance policies and in Section 6.01 in each of the three trusts.

In sum, Ambac has compounded its incredible claim that its insurance of the A-2 certificates provides it a right to all of the Trust's Subsequent Recoveries with an even more incredible claim: that Ambac has "special" access to the Custodial Account. (R.3691.) In so claiming, Ambac ignores: (i) that the PSAs expressly require all Subsequent Recoveries in the Custodial Account, without exception, to be transferred monthly to the Trustee's Distribution Account for distribution to investors pursuant to Section 6.01; (ii) that no provision of the PSAs allows withdrawals from the Custodial Account to Ambac; and (iii) that the Section 6.01 distribution waterfall expressly allocates Subsequent Recoveries "first" to the A-1 and A-2 certificates until they are paid down to zero, and then "second" to Ambac for any unpaid "Reimbursement Amounts," the definition of which makes clear that Section 6.01 is the only source of funds which are used to pay the Reimbursement Amounts owing to Ambac.

The Court should affirm the IAS Court's well-reasoned holding that Ambac's entitlement to Subsequent Recoveries is limited to its rights under the Section 6.01

distribution waterfalls, and that Ambac does not have a "special" right to reach into the Custodial Account to divert $31 million in Settlement Payments away from the Trusts and their senior-most, A-1 Certificates, which Ambac did not insure.

CONCLUSION

For these reasons, the Institutional Investors and AIG Investors respectfully submit that the Court should affirm each of the IAS Court's four well-reasoned holdings described in full above.[21]

Dated: New York, New York
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[21] The AIG Investors did not appear with respect to the two Ambac Trusts and thus do not join Section IV of this Responsive Brief.

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