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

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| In the matter of the application of<br><br>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),<br><br>Petitioners,<br><br>For Judicial Instructions under CPLR Article 77 on the Administration and Distribution of a Settlement Payment. | Index No. 0657387/2017<br><br>**ANSWER OF AXONIC CAPITAL LLC TO THE PETITION** |

Pursuant to this Court's Orders dated December 19, 2017 and January 23, 2018 (the "Orders"), Axonic Capital LLC ("Axonic"), on behalf of its managed funds ("Axonic Funds") identified in the Affirmation of Brian S. Fraser filed herewith (the "Affirmation"), as a Certificateholder and Interested Person,[1] by and through its counsel, Akerman LLP, hereby submits its Answer to the Petition filed December 15, 2017. The Axonic Funds are holders of classes of certificates issued by the trusts listed in the Affirmation that is filed herewith.

## PRELIMINARY STATEMENT

On December 15, 2017, the Petitioners sought judicial instructions concerning the administration and distribution of the Settlement Payment with respect to the Settlement Trusts created pursuant to the Settlement Agreement described in the Petition. Petitioners have presented a number of issues raised by the Settlement Agreement that they ask this Court to

[1] Capitalized terms not defined herein are intended to have those meanings ascribed to them in the Order, the Petition, and the Settlement Agreement.

resolve. Axonic respectfully presents its position regarding four of those points below for the Court's consideration. For purposes of this Answer, we presume familiarity with the Petition's introduction and explanatory material. *See* Petition, ¶¶ 1-20.

## I. The Trustee Should Use The Write-Up First Method.

Petitioners assert that the interaction of two sections in Settlement Agreement, §§ 3.06(a) and 3.06(b), may create an ambiguity as to the order of the distribution of the Settlement proceeds and the write-up of Certificate Principal Balances. *See* Petition, ¶¶ 21-40. In paragraphs 21 to 40 of the Petition, Petitioners identify and discuss issues relating to the order of operations under Section 3.06 of the Settlement Agreement, i.e., whether to distribute the Settlement Payment to certificate holders on the basis of principal balances before writing up those balances to reflect the addition of, e.g., Subsequent Recoveries (the "Pay First Method") or to first apply the write-up to the principal balance and then the make the distribution (the "Write Up First Method"). Petitioners then describe the significant pitfalls of using the Pay First method.

Upon a careful review of the governing agreements, and taking into account relevant tenets of contract interpretation, it is clear the Write-Up First Method should be used in connection with the distribution of Settlement Payments as discussed below.

### A. *The Write-Up Method Correctly Results in "Distribution to Investors in Accordance with the Distribution Provisions of the Governing Agreements," as Required by Settlement Agreement § 3.06(a).*

In section 3.06(a), the Settlement Agreement prescribes the procedure of distribution of each Trust's Allocable Share: each Trust's Allocable share is deposited into the Trust's "distribution account" "for further distribution to Investors ***in accordance with the distribution provisions of the Governing Agreements . . . as though such allocable share was a 'subsequent recovery'*** relating to principal proceeds available for distribution on the immediately following

distribution date[.]" Settlement Agreement (Ex. A to the Petition) (emphasis added); *see also* Petition, ¶ 18-19. Section 3.06(b) prescribes the method for allocating the write-up of recovered losses and states that "after distribution of the Allocable Share to a Settlement Trust pursuant to subsection 3.06(a), the [Trustee] 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[.]"[2] Ex. A; *see also* Petition, ¶ 20-21.

Petitioners note that because there is no explicit instruction as to the order of operations between 3.06(a) and 3.06(b), the Petitioners could arguably "first distribute the Settlement Payment based on certificate principal balances that do not account for the Settlement Payment Write-Up and thereafter apply the Settlement Payment Write-Up to the pertinent certificate balances (the "Pay First Method"); or, in the alternative, first apply the Settlement Payment Write-Up to the pertinent certificate principal balances and thereafter distribute the Settlement Payment based on the newly written up certificate principal balances (the "Write-Up First Method")." Petition, ¶ 22. For the reasons below, this Court should instruct the Trustee to use the Write-Up First Method.

First, the Write-Up First Method best comports with the plain language of the terms of the Settlement Agreement and the governing agreements. A review of one such governing agreement, BSARM 2007-1 ("BSARM 2007") makes this clear. BSARM 2007 contemplates one principal payment per period, in which the Subsequent Recovery (i.e., the amount written-up in connection with the recovery of previously realized losses), as calculated for that payment period, is one of the elements of the amount to be distributed that pay period. Specifically, the

[2] The Allocable Share includes Subsequent Recoveries.

definitional scheme that controls the BSARM agreements makes clear that Subsequent Recoveries are included in Principal Funds, which Principal Funds are then included in Available Funds. Moreover, the Basic Principal Distribution Amount includes Available Funds, and the Principal Distribution Amount includes the Basic Principal Distribution Amount or Principal Funds.[3]

The BSARM 2007 agreement also provides:

> *Principal Distributions.* **On each distribution date, the securities administrator will**, based on the related monthly statement provided to it by the master servicer, **distribute the Principal Distribution Amount** . . .

Ex. 1, at 44 (emphasis added). Thus, BSARM 2007 contemplates one payment each period that includes the principal payment relevant to a given pay period and the Subsequent Recovery for that same pay period, based on a write-up for that same period, as evidence by the fact that both the principal payments and the Subsequent Recovery payments are included in the definition of Principal Distribution Amount. The Write-Up Method is the method that best comports with this scheme. Put differently, if the governing agreements intended a Pay-First Method, that would require either two payments each period, or a rollover of the Subsequent Recovery amount into the next principal distribution amount, upon the calculation of the Subsequent Recovery amount after the payment of the principal amount pursuant to the Pay-First Method. This is not what BSARM 2007 provides for in connection with the payment of Subsequent Recoveries, and the Settlement Agreement provides that Allocable Shares shall be distributed as though they were "subsequent recoveries," and as such, the Pay-First Method must be rejected.

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[3] *See* BSARM FWP, at 30-40 ("Principal Funds" definition), at 33 ("Available Funds" definition and "Basic Principal Distribution Amount" definition), at 39 ("Principal Distribution Amount" definition) and at 43 ("Subsequent Recoveries" definition) (the BSARM FWP is attached hereto as Exhibit 1 , and the BSARM PSA is attached hereto as Exhibit 2).

**B.** *The Pay-First Method Is Antithetical to the Intent of the Settlement Agreement and the Purpose of the Overcollateralization Provisions.*

The PSAs should be interpreted consistent with the intent of the parties. *See, e.g.*, *Novak & Co., Inc. v. New York Convention Center Development Corp.*, 202 A.D.2d 205, 608 N.Y.S.2d 219 (1st Dep't 1994) ("in a matter where parties seek enforcement of a contract, the court has the responsibility of effectuating the true intent of the parties") (quoting *Furgang v. Epstein*, 106 A.D.2d 609, 483 N.Y.S.2d 103 (2d Dep't 1984)). For those Trusts where Subsequent Recoveries are treated as principal funds that are distributed as principal amounts of given certificates, the Write-Up First Method is in accordance with the parties' intent (as described above). However, as noted in the Petition, many Trusts have an "overcollateralization structure" (the "OC Trusts"), under which a portion of principal funds can be distributed as excess cash flow. *See* Petition, ¶ 24. For these Trusts, too, the Write-Up First Method should be used to distribute Settlement proceeds.

The purpose of overcollateralization is to protect and insulate the senior certificates from the risk of loss. *See* Petition, ¶ 25. In plain terms, overcollateralization is an asset cushion meant to provide stable and predictable protection to the senior certificates against the risk of loss. The subordinate certificates, in contrast, bear the risk of loss and are compensated for that greater risk with a higher coupon rate than the rate paid to the less risky senior certificates. Where the prescribed overcollateralization cushion is absent, trust distributions are made in order of seniority, with senior certificates being paid principal first. Typically, subordinate certificateholders receive principal payments only when senior certificateholders are fully protected (because they are fully over-collateralized) or when the senior certificates have been paid in full. This is the structure provided for by the PSAs and is one to which all certificateholders bound themselves when they purchased their certificates.

However, as noted in the Petition, ¶ 28, the Pay-First Method may result in "illusory" or "temporary" overcollateralization during the distribution process. This 'illusory' overcollateralization may then have precisely the opposite effect intended *ab initio* by the overcollateralization provisions in the PSAs, i.e., the 'illusory' overcollateralization may lead to overcollateralization release payments in the OC Trusts. For instance, this could happen in cases where the settlement payment is larger than the amount necessary to reach the overcollateralization target prescribed by the relevant overcollateralization provisions. In such cases, the senior certificates are in practice "under-collateralized," because the illusory overcollateralization results in an Overcollateralization Release Amount that will be distributed as excess cash flow and not principal amount. *See* Petition ¶ 29-33 (describing effects of the distribution proceeding according to the excess cash flow mechanisms as opposed to the principal amount mechanisms).

Such an outcome is entirely at loggerheads with the intent of such provisions and the structure of the governing agreements as a whole. First, the settlement payment is intended as remuneration for realized losses incurred by the certificateholders – not as distribution of excess cash flow as a result of the overcollateralization mechanisms, which are themselves in all relevant Trusts intended to provide credit enhancement to the senior certificates. The Settlement Agreement makes reference primarily to the distribution provisions of the governing agreements, and to subsequent recoveries (which are what the proceeds are intended to be distributes *as*) and realized losses – it does not purport to administer the overcollateralization provisions or distribute payments as excess cash flow. Put simply, using the Write-Up First Method serves to include as much realized loss as possible in the Certificate Principal Balances, and prevents the settlement payment from redounding to the benefit of subordinate certificateholder classes or as

overcollateralization release payments prior to the senior classes receiving the benefits intended by the governing agreements. The Write-Up First Method is thus the method which comports best with both the intention of the Settlement Agreement and the underlying terms of the governing agreements themselves.[4]

## II. The Trustee Should Apply the Same Write-Up Instructions to All Certificate Classes Without Regard to Any Allegedly Inconsistent Write-Up Provisions in the Trusts' Governing Agreements.

The Settlement Agreement prescribes that the Petitioners must "apply . . . the amount of the Allocable Share for that Settlement Trust . . . " as per the Settlement Agreement Write-Up Instruction contained in § 3.06(b). Ex. A. § 3.06(b), *see also* Petition ¶ 41. This provision of the Settlement Agreement explicitly applies to "each class of securities." However, Petitioners assert that 'write-up instructions' in certain PSAs that apply only to Class B certificates, *see, e.g.,* Petition, ¶45 (discussing BSARM 2005-11 PSA), may be in tension with the Settlement Agreement Write-Up Instruction in light of section 7.05 of the Settlement Agreement that provides that the Settlement Agreement "shall not be argued or deemed to constitute, an amendment of any term of any Governing Agreement."

First, the Court should apply the Settlement Agreement Write-up Instruction because it is black letter law that where a specific contract provision conflicts with a more general provision, the specific provision controls. *Croce v. Kurnit*, 737 F.2d 229, 237–38 (2d Cir. 1984) (noting this principal). Second, careful consideration of the governing agreements supports the argument

[4] In support of using the Write-Up First method, *see* the Order issued on September 11, 2017 by Judge Elizabeth Cutter (the "Cutter Order") with respect to the petition from US Bank NA, as trustee for BSMF 2007-SL1 and BSABS 2007-AQ2. *In re Loan Group I of the Bear Stearns Mortgage Funding Trust 2007-SL1,* 2017 WL 4358286 (Minn.Dist.Ct.) (2017). Judge Cutter, reviewing virtually identical arguments from Certificateholders in those two trusts (both of which also reached a settlement agreement with JPMorgan Chase & Co.), ruled that the Write-Up First method must be applied. A copy of the Cutter Order is attached hereto as Ex. 3.

that the write-up instructions were intended to apply to any class of certificates. Take, for instance, the trust documents for BSARM 2007-1. There, "Certificate Principal Balance" is defined as:

> with respect to any class of senior certificates and subordinate certificates and any distribution date, is the original certificate principal balance of such class as set forth in the term sheet, plus, in the case of the Accrual Certificates, an amount equal to the Accrued Certificate Interest added to the Certificate Principal Balance of such Accrual Certificates on each distribution date on or prior to the related Accretion Termination Date, less the sum of (i) all amounts in respect of principal distributed to such class on previous distribution dates and (ii) any Realized Losses or Applied Realized Loss Amounts allocated to such class on previous distribution dates; ***provided that, the Certificate Principal Balance of any class of senior certificates, if Realized Losses are applied to the senior certificates as described in the related term sheet, or subordinate certificates with the highest payment priority to which Realized Losses have been allocated shall be increased by the amount of any Subsequent Recoveries*** on the related mortgage loans received by the master servicer, but not by more than the amount of Realized Losses previously allocated to reduce the Certificate Principal Balance of that certificate.

Ex. 1, at 34 (emphasis added). The bolded section explicitly states that both senior and subordinate certificates should be written up by Subsequent Recoveries. However, when further describing how Subsequent Recoveries should be treated under the section *Allocation of Losses – Shifting Interest Transactions*, the FWP states:

> In the event that the related servicer or the master servicer receives any Subsequent Recoveries in respect of the mortgage loans**, such Subsequent Recoveries will be included as a part of the Interest Funds or Principal Funds for the related loan group or subgroup**, as the case may be, for the related distribution date and distributed in accordance with the priorities described under "Description of the Certificates" in this term sheet supplement ***and the Certificate Principal Balance of each class of subordinate certificates that has been reduced by the allocation of a Realized Loss to such certificate will be increased, in order of seniority, by the amount of such Subsequent Recoveries.*** Holders of such certificates will not be entitled to any payment in respect of current interest on the amount of such increases for any Interest Accrual Period preceding the distribution date on which such increase occurs.

*Id.* at 51.

First and foremost, the two provisions are simply not in conflict. The latter ***bolded*** portion contains no explicit reference to the senior class of certificates and thus it cannot (and should not) be read to preclude the writing-up of Certificate Principal Balances for senior class certificates. This conclusion is bolstered when considering the contract as a whole, e.g., the **bolded** portion clearly states that "Subsequent Recoveries" will be included in those funds distributed for any "related loan group or subgroup," i.e., any loan group, whether senior or subordinate. So, while the latter ***bolded*** portion of this excerpt may lack a reference to the senior class of certificates, given the clear and explicit statement in the definition of Certificate Principal Balance that Subsequent Recoveries ***shall*** increase the Certificate Principal Balance, there is no reason to reach any conclusion other than that the second passage's failure to touch on the senior certificate class is irrelevant or inadvertent.[5]

## III. The Trustee Should Apply the Settlement Write-Up Instruction Uniformly To Trusts[6] That Have Realized Loss Allocation Methods That Differ From Subsequent Recovery Write-Up Methods.

While the governing agreements for some Trusts have realized loss allocation methods that differ from Subsequent Recovery Write-Up methods (*see, e.g.,* Petition, ¶¶ 49-52), the

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[5] This conclusion is further supported by the definition in the BSARM FWP of "Applied Realized Loss Amount," which states that the Applied Realized Loss Amount,

> **with respect to any class of senior certificates** (if Realized Losses are allocated to the senior certificates as described in the accompanying term sheet supplement) and any subordinate certificates in an OC Transaction **and as to any distribution date, means the Realized Losses with respect to the mortgage loans in such loan group which have been applied in reduction of the Certificate Principal Balance of such class, *minus any Subsequent Recoveries applied to such Applied Realized Loss Amount.***

Ex. 1, at 33 (emphasis added).

[6] Those listed in Exhibit F to the Petition, and as relevant to Axonic BSABS 2005-AC8, JPALT 2006-A6, JPMMT 2006-A4, PRIME 2006-2, BSARM 2007-1, BSARM 2007-4. The last two trusts just listed are not listed in Exhibit F, but are relevant to this issue because pursuant to those Trust agreements the senior certificates will be written up by Subsequent Recoveries.

Trustee should uniformly follow the Settlement Agreement Write-Up Instruction of § 3.06(b), and, as such, Subsequent Recoveries should be applied to write up Certificate Principal Balances in reverse order of Realized Loss Allocations. This approach comports best with the intent of the agreements governing the Certificates, as subordinate certificateholders are meant to bear the risk of loss and are compensated for that greater risk with a higher coupon rate than the rate paid to the less risky senior certificates. Thus, when Subsequent Recoveries are paid into the pool of distribution funds, the class which is meant to absorb losses first (i.e., any subordinate class) should be written-up after the class that is meant to be buffered from losses (i.e., any senior class). Any other method would be at loggerheads with the intention of the senior/subordinate regime.

Consider the example of writing-up Subsequent Recoveries *pro rata* to Realized Losses in the following hypothetical: (1) there exists certificate class A1 and class A2; (2) A2 absorbs losses before A1; and (3) A2 has absorbed enough losses to be completely written down, and (4) then A1 has absorbed losses as well. If the Trustee were to write up these two classes *pro rata* to losses incurred, Class A1 will not necessarily recover all of its losses before Class A2 recovers losses. This result runs counter to the intent of the agreements, which is that Class A1 should be made whole before class A2 begins to recover losses.

Similarly, writing-up losses based on payment priority does not serve the purposes of the credit enhancement function that subordinate classes are intended to provide to senior classes. This is because the issue of payment priority is irrelevant to and entirely separate from the issue of credit enhancement. Which is to say, because Subsequent Recoveries are by definition recoveries that reverse Realized Losses, those recoveries should be applied to write-up

certificates in the same manner in which Realized Losses are allocated – in reverse priority, not payment priority.

At bottom, the Court is presented with two options[7]: **(1)** direct the Trustee to uniformly follow the specific and agreed upon Settlement Agreement instruction, or **(2)** apply the Settlement Agreement's general boilerplate prohibition of amendment of the governing agreements to frustrate that specific provision.[8] Should the Court choose option 2, the Trustee would not be permitted to apply the agreed-upon Settlement Agreement Write-Up Instruction in any instance where it would lead to a different result than that provided for in a given trust agreement.

First, this court should reject option (2) because, again, it is black letter law that where a specific contract provision conflicts with a more general provision, the specific provision controls. *Croce,* 737 F.2d at 237–38 (2d Cir. 1984). Second, the latter option would in certain instances render the agreed-upon Settlement Agreement Write-Up Instruction a nullity, and it is black letter law that courts should not interpret agreements so as to render any term a nullity. Third, the uniform application of the Settlement Agreement Write-Up Instruction best serves the intent of the parties in agreeing to the Settlement and the underlying goal of the Settlement: a swift and fair and, insofar as is possible, uniform distribution of the Settlement Proceeds.[9]

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[7] The Petitioner has also suggested that the Court may craft a "different method." *See* Petition, Requests for Relief, ¶ 5(b). While that may be within the Court's power, the two options discussed above are those that are contemplated by the texts of the governing agreements themselves.

[8] Section 7.05 of the Settlement Agreement states that the Settlement Agreement "shall not be argued or deemed to constitute, an amendment of any term of any Governing Agreement."

[9] *N.B.* that the Petitioners, upon receiving the Court's Order, will have only a short time to complete the distribution of settlement proceeds.

## IV. It Would Lead to An Absurd Result If Classes of Certificates or Loan Groups with Current Aggregate Certificate Principal Balances of Zero As A Result of Realized Loss, and Not As A Result of Payment of All Principal, Were Excluded from Distributions from the Settlement.

Certain of the trusts have so-called Retired Class Provisions, which preclude any further distributions to any certificate if the aggregate principal balance of such class has been reduced to zero ("Zero Balance Classes") (*see, e.g.,* Petition, ¶¶ 54-56). Petitioners raise this as a possible impediment to those certificates participating in the distribution of settlement proceeds.

The Petitioners concern arises from § 5.04 in certain PSAs:

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

(Emphasis added). There are two situations in which a Certificate Principal Balance could be reduced to zero: **(1)** where Realized Losses have reduced the balance to zero and thus completely eliminated the value of the certificate; or **(2)** the Certificate Principal Balance has been reduced to zero because it has been fully paid down as a result of distributions of Principal and Interest, and the Certificateholder has thus received the greatest possible value available pursuant to the certificate.

The context of § 5.04 makes clear that "retirement" is intended only in the second instance. The Retired Class Provision is contained in a section of the relevant PSAs that pertains only to the various forms of distributions of principal and interest. This § 5.04 has nothing to do with the application of Realized Losses, which are addressed in an entirely different section of the PSA. Taking the contrary view – that certificates are retired as soon as realized losses reduce their balance to zero – also ignores the fact that § 5.04 says nothing about Subsequent

Recoveries, which are nowhere restricted by language referencing retirement.[10] That is, because § 5.04 is silent as to whether a certificate that has a zero balance at any point in time can thereafter be written up from Subsequent Recoveries, § 5.04 cannot be construed as implicitly precluding it.

Furthermore, the view that certificates are "retired" automatically when realized losses reduce their balance to zero leads to an absurd result: if the Retired Class Provision at the end of § 5.04 was intended to retire certificates that hit a zero balance ***due to realized losses*** attributable to poor performance of underlying loans, then the effect of now "retiring" these groups of certificates from the settlement trusts would be to compound the damages the settlement is meant to remedy. That result should be rejected out of hand.[11] Nothing in the Settlement Agreement – in Section 2.08 Other Excluded Trusts or elsewhere – indicates that those Trusts that contain the Retired Class Provision are not eligible to receive an Allocable Share of the settlement proceeds.[12] In light of the purposes of this Settlement – to remunerate all trusts that were

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[10] The PSA's other reference to retirement indicates that it refers to the situation where the certificate has been paid in full:

> [i]f on any Determination Date[1] . . . the Trustee determines that a Class of Certificates shall be retired ***after a final distribution*** on such Class, the Trustee shall notify the Certificateholders within five (5) Business Days after such Determination Date that the final distribution in retirement of such Class of Certificates is scheduled to be made on the immediately following Distribution Date. Any final distribution made pursuant to the immediately preceding sentence shall be made only upon presentation and surrender of the Certificates at the Corporate Office of the Trustee.

Ex. 2, at 44 (section 10.02(i)) (emphasis added).

[11] Indeed, Trustee for trust BSABS 2007-AQ2 (U.S. Bank), in executing the Cutter Order (Ex. 3), wrote up the balance of Class A-1 certificates before paying Class A-1 the settlement payment amount due, despite the PSA containing the same Retired Class Provision.

[12] In any case, the PSAs make clear that the Retired Class Provision is not self-executing. PSA § 10.02(ii). Plainly, the certificate classes that may have been affected by the Retired Class Provision during the pre-suit life of the Certificates were *not* retired, as they remain in the settlement trusts, and no trustee has claimed that they made an attempt to retire any certificates

governed by the agreements at issue in these proceedings – this Court should, in consideration of the foregoing textual analysis and the prudential concerns discussed, give no effect to the Retired Class Provision.[13]

**REQUEST FOR RELIEF**

For the reasons set forth above, Axonic respectfully requests that the Court direct the Petitioners to:

(1) use the Write-Up First Method in connection with distribution of Settlement proceeds;

(2) apply the Write-Up First Method to all classes of certificates, even in those cases where a trust has certain Write-Up Instructions that reference only subordinate classes;

(3) apply the Settlement Agreement Write-Up Instruction method uniformly across all Trusts, even in those Trusts that have Realized Loss Allocation methods that differ from Subsequent Recovery write-up methods; and

(4) give no force or effect to certain Trusts' Retired Class Provisions.

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that had allegedly lost all value and been reduced to a zero Certificate Principal Balance as a result.

[13] Or the Class A Redirection Provision. As described in the Petition, both BSMF Trust PSAs contain identical language for both provisions.