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

In the matter of the application of

WELLS FARGO BANK, NATIONAL ASSOCIATION, et al.,

Petitioners,

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

Index No. 657387/2017

Friedman, J.

RESPONSE BRIEF OF THE INSTITUTIONAL INVESTORS AND AIG PARTIES CONCERNING THE PETITION

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Pursuant to the August 15, 2018 Stipulation Regarding Merits Briefing Schedule and Trustee Substitutions (Dkt. No. 486), the Institutional Investors and the AIG Parties submit this Response to the Opening Briefs submitted by other investors concerning the distribution of approximately $2.27 billion in settlement proceeds to 119 JPMorgan RMBS trusts identified in Exhibit 1 to the Opening Brief of the Institutional Investors and the AIG Parties.[1]

INTRODUCTION

Over $2 billion in settlement funds are still held in escrow. A variety of hedge funds have appeared and made arguments, contrary to the plain language of the Settlement Agreement and Governing Agreements, that would result in substantial portions of those settlement funds flowing to their certificates. The Court should reject these attempts to rewrite the Settlement Agreement and Governing Agreements. Despite the lengthy Opening Briefs, the key issues are simple and should be resolved on a global basis, across all affected trusts.

The two most consequential and disputed issues in the Petition are the order of operations for the Exhibit D trusts (i.e., Pay First vs. Write Up First), and whether, under the Pay First method, the Settlement Payment itself can *create* overcollateralization for Exhibit D trusts with an overcollateralization structure.

As to the order of operations for the Exhibit D trusts, the plain language of the Settlement Agreement requires Pay First, while the Governing Agreements are silent. Accordingly, the Settlement Agreement's Pay First methodology must control. That the vast majority of JPMorgan Governing Agreements are silent as to the order of operations is not all that surprising. In the

[1] Unless otherwise defined herein, all capitalized terms have the meaning given to them in the Petition. Further, all exhibit references are to Exhibits to the Sheeren Affidavit (Dkt. No. 577) filed with the Opening Brief of the Institutional Investors (Dkt. No. 576), or to the Supplemental Affidavit of David M. Sheeren, filed herewith, unless otherwise specified.

ordinary operation of the trusts, subsequent recoveries on individual loans are immaterial in relation to the trusts' overall cashflows. So, Pay First or Write Up First generally does not make a material difference to investors. An extraordinary, one-time infusion of cash, however, renders the order of operations crucial to investors. The Settlement Agreement fills that silence.

The JPMorgan Settlement Agreement's distribution sequence and structure is virtually identical to that of the four other global settlement agreements negotiated by the Institutional Investors and accepted by the Trustees, which collectively resolved repurchase and servicing claims for over 1,500 RMBS trusts in exchange for over $15 billion in cash infusions into the trusts. Each of those settlement agreements contains two consecutive distribution paragraphs: an initial paragraph that directs the trustees to ***distribute*** the settlement payment to investors as though it were a subsequent recovery, and a second paragraph that next directs the trustees to ***write up certificate balances*** by the amount of those subsequent recoveries.

Removing all doubt concerning this simple Pay First order of operations, the last sentence of the write-up paragraph in all five global settlement agreements (including the JPMorgan Settlement Agreement) states that the write-up "shall not affect the distribution" of the Settlement Payment "provided for" in the previous paragraph. That clarification prohibits the Write Up First method, because writing up certificate balances first would necessarily "affect the distribution" of the Settlement Payment "provided for" in the previous paragraph.

As to the second most consequential issue, the Settlement Payment cannot *create* temporary overcollateralization under the Pay First methodology. The reason is simple: the definition of overcollateralization in the Governing Agreements prevents that from happening. All investors except HBK's NIM trustee and Tilden Park continue to agree that it would be absurd for

the Settlement Payment to *create* overcollateralization.[2] Moreover, HBK's NIM trustee and Tilden Park's objection is limited to just 36 Exhibit D trusts, identified in Exhibit 15. In their Opening Briefs, however, neither HBK's NIM trustee nor Tilden Park even attempts to grapple with the definition of overcollateralization in the Governing Agreements, even though the Institutional Investors' January 29, 2018 Answer and supporting affidavit highlighted the definitions of overcollateralization in every single Exhibit D trust with an overcollateralization structure. Neither HBK's NIM trustee nor Tilden Park can credibly claim that the Settlement Payment itself can *create* overcollateralization. And, if the Settlement Payment cannot create overcollateralization, it follows that the Trustees' concern about so-called overcollateralization "targets" being met – which can *only* happen if there actually is overcollateralization – is unfounded.

As to the other, less consequential issues raised in the Petition for trusts included in Exhibits E, F, and G to the Petition, the length and complexity of the Opening Briefs again obscure that as to the vast majority of the 119 trusts held by the Institutional Investors and/or the AIG Parties, there are relatively few disputes.

As to Exhibit E trusts, all investors except Nover and its CDO trustee continue to agree that senior certificates should be eligible for write-ups. Nover's objection is moreover limited to 26 trusts identified in Exhibit 19. The near unanimity on this issue from all interested investors except Nover is telling. The Court should reject Nover's objection because the clear intent of the

[2] In fact, a significant rationale for those investors that argue in favor of the Write-Up First methodology appears to be their belief that a Write-Up First approach is necessary to prevent the Settlement Payment from creating false overcollateralization. As discussed below and in the Opening Brief, the Pay First methodology is required by the Settlement Agreement, but in any event, there is near unanimity among investors in this proceeding that the Settlement Payment cannot *create* overcollateralization.

Settlement Agreement and the Governing Agreements is that senior certificates are eligible for write-ups.

As to Exhibit F trusts, the Opening Briefs reflect that most investors appear to agree that for the majority of the Exhibit F trusts, the write-up methodology in the Governing Agreements conflicts with that of the Settlement Agreement. The main dispute is whether, in light of those conflicts, the Settlement Agreement or the Governing Agreements should govern. For the reasons set out in the Opening Brief, and as set out in Exhibit 21, the Governing Agreements must control for 62 of the 72 disputed Exhibit F trusts held by the Institutional Investors and/or the AIG Parties, for which there is an actual conflict. As to ten trusts for which the Governing Agreements are silent as to the write-up methodology, however, the Settlement Agreement should control.

As to Exhibit G trusts, the issue presented in the Petition is again straightforward: the Trustees ask the Court whether they should "apply" a clear term of the Governing Agreements. Moreover, they do not allege an ambiguity or identify a conflicting term in the Settlement Agreement. The Court should direct the Trustees to enforce the Governing Agreements.

Finally, the Institutional Investors and the AIG Parties are compelled to respond to Ambac's Opening Brief, which focuses on an issue—not raised in the Petition—concerning prior insurance payments Ambac made to senior-support A2 certificates issued by two Bear Stearns trusts (GPMF 2006-AR2 and GPMF 2006-AR3). Because Ambac's arguments concerning its alleged reimbursement rights under the Governing Agreements are unconnected with any of the issues raised in the Trustees' Petition, the Trustees are not entitled to instructions on Ambac's arguments.

In the event, however, that the Court intends to instruct the Trustees concerning the issues raised in Ambac's Opening Brief, the Court should reject Ambac's arguments. In effect, Ambac

attempts to rewrite the Governing Agreements to permit Ambac to leapfrog the uninsured super-senior A1 certificates in the principal distribution waterfalls for those two trusts and reap a ***$30 million windfall***. Incredibly, Ambac's Opening Brief does not even cite the principal distribution waterfalls, which control the distribution of all principal payments, including subsequent recoveries, for those trusts. Those principal distribution waterfalls are straightforward and provide that the senior certificateholders are entitled to subsequent recoveries, until they have been paid down to zero, ***before*** Ambac has any claim to those funds by virtue of its reimbursement rights. The Court should reject Ambac's attempt to use this Article 77 proceeding to rewrite the principal distribution waterfalls to its own benefit.

I. The Trustees Must Employ the Pay First Method.

A. The Settlement Agreement Requires Pay First.

As explained in the Institutional Investors' and AIG's Opening Brief, there is no uncertainty concerning the order of operations with respect to the Exhibit D trusts: Paragraphs 3.06(a) and 3.06(b) of the Settlement Agreement require the Trustees to employ the Pay First method. Because the Governing Agreements are silent concerning the order of operations, the Settlement Agreement's Pay First methodology is therefore *res judicata* from the previous Article 77 proceeding, and the Trustees must employ the Pay First method in distributing the settlement.

(i) The Distribution of the Settlement Payment Mandated by Paragraph 3.06(a) is a Distribution *to Investors*.

Some investors argue that Paragraph 3.06(a) merely speaks to the deposit of the Settlement Payment into the trusts' collection or distribution accounts, and that it does not speak to the Trustees' distribution of the Settlement Payment ***to investors***. That is plainly wrong. The distribution mandated by Paragraph 3.06(b) is a distribution to the trusts' investors. Each of the three sentences in Paragraph 3.06(a) clearly and necessarily refers to the distribution of the

Settlement Payment to investors, and not merely to the deposit of the Settlement Payment into the trusts' collection or distribution accounts.

The ***first*** sentence of Paragraph 3.06(a) states that the Settlement Payment "shall be **deposited into the related Trust's collection or distribution account** pursuant to the terms of the Governing Agreements, **for further distribution to Investors in accordance with the distribution provisions of the Governing Agreements** . . . as though such Allocable Share was a 'subsequent recovery' relating to principal proceeds . . . ." That sentence requires the distribution of the Settlement Payment as a subsequent recovery "to Investors." In fact, the distribution to investors is the only "distribution" referenced in Paragraph 3.06(a); the initial conveyance of the Settlement Payments to the Trusts' collection or distribution accounts is described as a "*deposit*".

The ***second*** sentence of Paragraph 3.06(a) makes clear that if the Allocable Share would "become payable to a class of REMIC residual interests," the "payment shall be maintained in the collection or distribution account for distribution [to investors] on the next distribution date *according to the provisions of this Subsection 3.06(a).*" Here, too, the text makes clear that the contemplated distribution to be made under Subsection 3.06(a) is to investors.

Finally, the ***third*** sentence of Paragraph 3.06(a) confirms again that the purpose of Paragraph 3.06(a) is to govern the actual distribution to investors, stating that "**[t]he related Accepting Trustee will distribute each Settlement Trust's Allocable Share** or, if any other transaction party is acting as paying agent under the related Governing Agreement, use reasonable commercial best efforts to cause such paying agent to do so **pursuant to this Subsection 3.06(a)**." This third and final sentence concludes the distribution process described in the prior sentences by directing the Trustees to distribute the Settlement Payment to investors "pursuant to this Subsection 3.06(a)."

The clear point of Paragraph 3.06(a) is to mandate a process by which the Settlement Payment is distributed to investors, and not merely deposited into the trusts' collection or distribution accounts. The mandated distribution is not complete until the Settlement Payment reaches investors. And as explained in the section below, it is only *after* this distribution to investors is complete that any of the certificates are written up pursuant to the Settlement Agreement.

(ii) Paragraph 3.06(b) Prohibits the Write-Up From "Affecting" the Distribution of the Settlement Payment to Investors.

Paragraph 3.06(b) begins by stating that "**[a]fter the distribution of the Allocable Share to a Settlement Trust pursuant to Subsection 3.06(a),**" the Trustees must write up the certificate balances by the amount of the Settlement Payments, in reverse order of realized losses. This write-up is clearly intended to occur "after" the distributions to investors mandated in Paragraph 3.06(a) have been completed.

First, as an initial matter, Paragraph 3.06(a) follows Paragraph 3.06(b), which at least suggests that the operations described in each paragraph should be performed consecutively, with the events described in Paragraph 3.06(a) preceding those in Paragraph 3.06(b).

Second, the first word "after" in the first sentence of Paragraph 3.06(b) confirms that the operations described therein are intended to be performed after the operations described in Paragraph 3.06(a) are complete, which occurs when the Settlement Payments have been distributed to investors.

Third, Paragraph 3.06(b) concludes by stating that "For the avoidance of doubt, this Subsection 3.06(b) is intended ***only*** to increase the balances of the related classes of securities, as provided for herein, and **shall not affect the distribution of the Settlement Payment provided for in Subsection 3.06(a).**" No matter how certain investors in this proceeding try to contort these

words, the meaning is clear—the write-up described in Paragraph 3.06(b) must not affect the distribution of the Settlement Payment pursuant to Paragraph 3.06(a). If the certificates at issue are written up prior to distributing the Settlement Payment to investors (i.e., the Write-Up First Method), that would necessarily "affect the distribution of the Settlement Payment provided for in Subsection 3.06(a)," which is impermissible. The only way of the squaring the last sentence in Paragraph 3.06(b) with Paragraph 3.06(a) is to apply the Pay First Method—by first distributing the Settlement Payment to investors pursuant to Paragraph 3.06(a), ***and then*** by writing up certificates pursuant to Paragraph 3.06(b).

As set out in the Opening Brief of the Institutional Investors and the AIG Parties, in the Lehman case, Judge Chapman honed in on that final clarifying sentence, commenting as follows with respect to a virtually identical final clarifying sentence in the Lehman settlement agreement:

> [Judge Chapman:] So, Mr. Siegel, I'll go back to you. I clearly can order and direct that the settlement agreement's terms be enforced, including without limitation that payments shall be made in accordance with **Section 3.06(a) (b) and (c), which in sum and substance say pay first, write up second?** . . . You can go – right? I mean, I can say that. **That's obvious.** […]
>
> [S]ir, you're ignoring the language about that it cannot affect the distribution of plan payments. **And if you did write up first, that would affect the distribution of the plan payments.**[3]

Like the virtually identical paragraphs of the Lehman Settlement Agreement, the "sum and substance" of the JPMorgan Settlement Agreement says pay first, write up second. The JPMorgan Settlement Agreement's Pay First methodology should therefore be enforced as written—and as previously directed by this Court in the prior Article 77 proceeding in which the JPMorgan Settlement Agreement was approved.

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

(iii) The Pay First Sequence and Structure of the JPMorgan Settlement is Consistent with the Four Other Global RMBS Settlements Negotiated By the Institutional Investors.

As shown in the Opening Brief of the Institutional Investors and the AIG Parties, the Pay First sequence and structure of the JPMorgan Settlement Agreement is consistent with that of the four other global RMBS settlement agreements negotiated by the Institutional Investors and accepted by the trustees. Those global settlements resolved contractual repurchase and servicing claims for over 1,500 RMBS trusts issued by the five most significant RMBS issuers, in exchange for cash settlement payments in excess of $15 billion.

Each of those settlement agreements contains a Pay First methodology. The governing agreements for many of the 1,500 RMBS trusts were silent as to the order of operations. That silence should not be surprising. In the ordinary course of the trusts, subsequent recoveries received on individual liquidated loans are immaterial in the context of the trusts' overall cash flows. Pay First versus Write Up first therefore hardly ever makes a material difference to investors. Here, in contrast, large one-time cash infusions into the trusts render the order of operations crucial to investors.

Each of the global settlement agreements fills the silence in many Governing Agreements, providing the trustees necessary direction in distributing the Settlement Payments to investors. Each requires the trustees to distribute the settlement payments "***as though***" they were subsequent recoveries relating to principal proceeds, and then to write up certificate balances by the same amount. The characterization of the settlement payments as subsequent recoveries was extensively litigated in the previous Article 77, and objections to that methodology were "overruled" and "deemed waived."[4] Therefore, the Settlement Agreement's Pay First methodology is *res judicata*

[4] *See* Ex. 2 (Final Order and Judgment) at ¶ 3 (overruling W&L's objection) & Ex. 3 (Decision) at p. 32 ("The court does not find that it was an abuse of discretion for the Trustees to accept a Distribution

and the Trustees should be directed to distribute the Settlement on a Pay First basis for the Exhibit D trusts.

B. The Governing Agreements for Exhibit D Trusts are Silent as to the Order of Operations.

Some investors argue that while the Governing Agreements for certain Exhibit D trusts do not expressly instruct the Trustees to distribute subsequent recoveries "first," or to write up certificate balances "first," the Governing Agreements *implicitly embed* a particular order of operations in the definition of Certificate Principal Balance. As an initial matter, the position of these investors is contrary to the Petition itself, which concedes the Governing Agreements "do not clearly specify" an order of operations. Second, these investors' arguments are simply wrong, as no order of operations is specified in the Governing Agreements for the Exhibit D trusts, which is why the Court should follow the Settlement Agreement, as that was intended to fill any silence in the Governing Agreements concerning the distribution of the Settlement Payment.

(i) The Trustees Concede the Governing Agreements For Exhibit D Trusts Do Not Clearly Specify an Order of Operations.

As set out in the Opening Brief of the Institutional Investors and the AIG Parties, the Trustees' Petition does not cite a single provision of any Governing Agreement for the Exhibit D trusts bearing on the order of operations. To the contrary, the Trustees concede that the Governing Agreements for the Exhibit D trusts "do not clearly specify" the order of operations.[5] They are correct.

Methodology that provides for the settlement payment to be treated as a Subsequent Recovery and distributed to certificateholders in accordance with the priorities set in the PSA section 6.01 waterfall provision.").

[5] *See* Petition ¶ 23 & Opening Brief of Institutional Investors and the AIG Parties § II.B (Dkt. No. 576).

Tellingly, the Trustees excluded several Pay First "JPALT" and "JPMMT" trusts from Exhibit D (the "JPALT trusts," for brevity).[6] Those excluded JPALT trusts are instructive. The Governing Agreements for those JPALT trusts specify Pay First by requiring the certificate balances for a particular distribution date to be measured "**as of the close of business of the immediately preceding Distribution Date**, after giving effect to all distributions made on such date."[7] The directive to measure certificate balances as of the immediately *preceding* distribution date prevents subsequent recoveries from the *current* distribution date from being included in certificate balances—which rules out Write Up First.

The Governing Agreements for Exhibit D trusts contain no such provision directing the trustees when to measure certificate balances or whether to include the current period's subsequent recoveries in certificate balances before making a distribution. In contrast to these JPALT trusts, the Governing Agreements for the Exhibit D trusts are simply silent as to the order of operations.

(ii) The Definitions of Certificate Principal Balance in the Governing Agreements for Exhibit D Trusts Do Not Specify the Order of Operations.

Investors such as Olifant grossly misread the relevant sections of the Governing Agreements for Exhibit D trusts in arguing that they require Write Up First. Specifically, these investors point to the definition of Certificate Principal Balance, which is calculated by (a) subtracting from the Initial Certificate Principal Balance ***prior*** principal distributions and ***prior*** realized losses, and (b) adding "any Subsequent Recoveries." Because the Governing Agreements do not specifically refer to the subsequent recoveries as being those received in prior periods,

[6] The six such trusts included in Exhibit 1 (i.e. the trusts held by the Institutional Investors and/or the AIG Parties) are: JPALT 2006-A1, JPALT 2007-A1, JPMMT 2005-A5, JPMMT 2005-A6, JPMMT 2005-A7, and JPMMT 2006-A3.

[7] *See* Ex. 22 to Supplemental Affidavit of David M. Sheeren, filed herewith (Key Definitions in Pay First Trusts Excluded From Exhibit D).

Olifant and others illogically infer that the Governing Agreements *implicitly embed* an order of operations by requiring Certificate Principal Balances to be increased by subsequent recoveries from the *current* distribution period, rather than from *prior* distribution periods.

The Governing Agreements say nothing of the sort. They are silent as to (i) *which* subsequent recoveries are used to increase the Certificate Principal Balance and (ii) whether the Certificate Principal Balance should be increased by subsequent recoveries *before* or *after* the subsequent recoveries are distributed. On the other hand, the *Settlement Agreement* is crystal clear as to the order of operations—the Settlement Payment is distributed to investors, *after which* the Certificate Principal Balance is written up. This Court should instruct the Trustees to follow the Settlement Agreement, given that the Governing Agreements are silent on this question.

Tellingly, the same textual features in the Exhibit D Governing Agreements that Olifant and others argue require Write Up First appear in the definitions of Certificate Principal Amount in each of the ***Pay First*** JPALT trusts excluded from Exhibit D. Those definitions likewise refer to principal receipts on "previous" distribution dates, and to realized losses "allocated" in prior periods, but contain no such temporal limitation with respect to subsequent recoveries.[8]

These textual features simply do not speak to the order of operations. What speaks to the order of operations in the Governing Agreements for the JPALT trusts excluded from Exhibit D is the separate provision that expressly directs the JPALT trustees to calculate certificate balances "as of the close of business of the immediately preceding Distribution Date, after giving effect to all distributions made on such date."[9] The *absence* of that key provision in the Exhibit D

[8] *See* Ex. 22 to Supplemental Affidavit of David M. Sheeren, filed herewith (Key Definitions in Pay First Trusts Excluded From Exhibit D).

[9] *Id.*

Governing Agreements does not silently convert the order of operations from Pay First to Write-Up First.

(iii) Provisions in the Governing Agreements for Exhibit D Trusts Concerning The Timing of Realized Losses Do Not Specify the Order of Operations.

Similarly, Olifant and others argue that provisions in some Exhibit D trusts' Governing Agreements specifying that realized losses are to be allocated "*after*" distributions somehow compels a conclusion that subsequent recoveries must be added *before* distributions.[10] This is plainly wrong. There is absolutely no relationship between realized losses and subsequent recoveries that happen to be allocated in the same distribution month. Subsequent recoveries allocated in a particular distribution month are associated with entirely different loans than the realized losses allocated in that period. The only inference one can draw from the realized loss provisions cited by Olifant and others is that the Governing Agreements do provide an order of operations for realized losses, but do not provide an order of operation for subsequent recoveries. The Settlement Agreement fills that silence for subsequent recoveries.

(iv) Interest Accrual Provisions in the Governing Agreements for Exhibit D Trusts Do Not Specify the Order of Operations.

Some investors arguing for Write Up First point to a common provision in the Governing Agreements for Exhibit D trusts that prevents certificates from receiving interest accruals on the amount of subsequent recovery write-ups.[11] This provision does not speak to the order of operations. Rather, it clarifies that certificates are not entitled to interest for the period of time

[10] *See, e.g.*, Opening Briefs of Tilden Park (Dkt No. 515) at pp. 14 – 15 & Olifant Funds (Dkt No. 545) at p. 15.

[11] *See, e.g.*, Opening Briefs of Olifant Funds (Dkt No. 545) at pp. 8-9 ("This limitation on the accrual of interest on the written-up balances would be entirely unnecessary if Subsequent Recoveries were applied after distributions") & Nover (Dkt No. 600) at pp. 17-18 ("[The interest accrual] clause regarding current interest confirms that the only appropriate interpretation is the Write-Up First Method.").

between (i) the distribution date on which such certificate suffered a realized loss on a particular loan and (ii) the distribution date on which such certificate received the subsequent recovery write-up with respect to such loan, which reverses the prior realized loss. That period of time could be months, or even years. This interest accrual provision therefore has consequences regardless of whether the Write Up First or Pay First methods is employed. Tellingly, each of the ***Pay First*** JPALT trusts excluded from Exhibit D contains an identical interest accrual provision, again showing that this textual feature is not limited to a Write Up First methodology.[12]

(v) Non-Litigated Settlement Distribution Judgments in Minnesota Courts For Different Settlement Agreements and Different Trusts Are Evidence of Nothing.

The Olifant Funds emphasize that several Minnesota courts have entered judgments instructing trustees to employ a Write Up First method with respect to several of the "opt out" Bear Stearns trusts, which were later settled.[13] The Olifant Funds admit that the settlement agreements in those cases materially differed from the JPMorgan Settlement Agreement by expressly requiring Write Up First.[14] The Olifant Funds fail to note, however, that the order of operations in the Settlement Agreement was apparently not litigated in the Minnesota courts.[15] Nor have the Olifant Funds alleged that the order of operations made any practical difference to investors. In any event, the entry of non-litigated judgments approving the Write Up First methodology in Minnesota proceedings is completely irrelevant to this Court's consideration of the disputed order of operations in ***this*** Article 77 proceeding, which concerns a different settlement agreement,

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[12] *See* Ex. 22 to Supplemental Sheeren Affidavit.

[13] Opening Brief of Olifant Funds (Dkt No. 545) at pp.7-9.

[14] *Id.*

[15] *See id.* & Exhibits 5-14 to the Tomlinson Affidavit, filed therewith (Dkt No. 551-560).

different waterfalls, different outstanding certificate balances, different realized losses, and actual disagreements among interested investors.

II. The Settlement Payment Cannot Create Temporary Overcollateralization.

The second most consequential issue in the Petition is whether, under the Pay First method, the Settlement Payment itself can create overcollateralization. It cannot.

On January 29, 2018, the Institutional Investors filed an Answer and supporting Affidavit showing that the definitions of overcollateralization in the Governing Agreements do not permit the measurement of overcollateralization at some point *during* a distribution—or by only giving effect to the write-down of certificates and not the write-up of certificates.[16] The Institutional Investors' January 29, 2018 Answer and supporting affidavit showed, instead, that overcollateralization must be measured after "taking into account" or "giving effect to" the entire distribution of a subsequent recovery, necessarily including equal and offsetting certificate write-downs and certificate write-ups. Properly calculated, overcollateralization cannot be temporarily ***created*** by the Settlement Payment. Exhibits 14 and 15 to the Institutional Investors' and the AIG Parties' Opening Brief again demonstrate that the definitions of overcollateralization do not permit subsequent recoveries to temporarily ***create*** overcollateralization.

Only HBK's NIM trustee and Tilden Park argue in favor of temporary overcollateralization—and only as to 36 of the 93 disputed Exhibit D trusts in which the Institutional Investors and/or the AIG Parties hold certificates.[17] Despite being confronted with this basic argument more than seven months ago, neither Tilden Park nor HBK's NIM trustee even attempt to argue in their Opening Briefs that the definitions of overcollateralization permit the

[16] *See* Dkt. No. 136 (Answer) & 139 (table summarizing definitions of overcollateralization in the 155 Exhibit D trusts with an overcollateralization structure included in the Petition).

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

measurement of overcollateralization at some point during a distribution. Their choice to ignore the definition of overcollateralization in their Opening Briefs shows their resistance to the actual text of the Governing Agreements, which do not permit subsequent recoveries to *create* temporary overcollateralization.

Also revealing is that the Olifant Funds,[18] Nover and its CDO trustee,[19] and GMO[20] continue to agree with the Institutional Investors that permitting the Settlement Payments to "temporarily" create overcollateralization would be an absurd, commercially unreasonable result. The Court should direct the Trustees to distribute the Settlement Payment on a Pay First basis, *without* temporary overcollateralization.

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

With respect to the trusts in Exhibit E to the Petition, only Nover and its CDO trustee argue that subordinate certificates, but not senior certificates, should be eligible for a write-up. Further, they make this argument for only 26 trusts identified in Exhibit 19. As to all other Exhibit E trusts, no investor disputes that senior certificates are eligible for a write-up. The near unanimity of interested investors on this issue is telling.

Nover's Opening Brief focuses exclusively on an isolated reference to "subordinate" certificates in a write-up section of the Governing Agreements. Nover completely ignores, however, other provisions of the Governing Agreements which do not impose any prohibition on writing up senior certificates.[21] Nover also ignores the absurd consequences that would occur if

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[18] Opening Brief of Olifant Funds (Dkt. No. 545) at 11.

[19] Opening Brief of Nover and its CDO trustee (Dkt. No. 600) at 20.

[20] Opening Brief of GMO (Dkt. No. 599) at 4.

[21] *See* Opening Brief of Institutional Investors and the AIG Parties at § IV and Exhibits 18 and 19.

only subordinate certificates were eligible for subsequent recovery write-ups.[22] For the reasons set forth in the Opening Brief of the Institutional Investors and the AIG Parties, Nover's lone objection to senior certificate write-ups should be rejected as to the 26 disputed trusts.

IV. As to Exhibit F Trusts, the Governing Agreement Methodology Should Control Where It Conflicts with the Settlement Agreement Methodology.

As set out in the Opening Brief, the Governing Agreements for most Exhibit F trusts require the write-up to be performed in order of the certificates' "***payment priority***"—not in the order of their previously allocated realized losses, as set forth in the Settlement Agreement.[23] As to those Exhibit F trusts, most investors concede that the Governing Agreement methodology conflicts with the Settlement Agreement methodology.[24] The more substantial dispute is whether, in light of those conflicts, the Settlement Agreement or the Governing Agreements should control.

Unlike the Exhibit E trusts, for which the Governing Agreements can be harmonized with the Settlement Agreement, the Governing Agreements for most Exhibit F trusts set out a clear scheme for subsequent recovery write-ups that conflicts with the Settlement Agreement's provisions. The Settlement Agreement provides that it "is not intended to, and shall not be argued or deemed to constitute, an amendment of any term of any Governing Agreement."[25] Therefore, the Trustees should simply follow the Governing Agreements in light of a clear conflict. For those

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[22] *Id.*

[23] *See* Petition ¶ 49 – 52. Exhibits 20 and 21 show that for 62 of the 72 disputed Exhibit F trusts held by the Institutional Investors and/or the AIG Parties, the Settlement Agreement methodology conflicts with the Governing Agreements. For ten of the 72 trusts, Exhibits 20 and 21 show the Governing Agreements are silent.

[24] *See, e.g.*, Opening Brief of Tilden Park (Dkt No. 515) at 19.n 13 ("[T]he specific write-up order required by Section 3.06(b) – that classes be written up 'in the reverse order of previously allocated losses' – should be followed regardless of any contrary provisions in the Governing Agreements, such as provisions calling for write-ups to occur in the order of payment priority or, alternatively, on a pro rata basis.") & Opening Brief of Nover (Dkt No. 600) at p. 22 (noting conflicts with respect to Exhibit F trusts).

[25] Settlement Agreement at ¶ 7.05.

Exhibit F trusts for which the Governing Agreements are silent, however, the Trustees should follow the Settlement Agreement.[26]

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

As to the trusts included in Exhibit G to the Petition, the Trustees ask the Court whether to "apply" the Retired Class Provisions and Class A Redirection provisions.[27] They should. The Trustees do not allege that these provisions are ambiguous or conflict in any way with the Settlement Agreement. Moreover, the Settlement Agreement is silent as to the treatment of retired classes or class redirection. The Trustees should therefore "apply" the unambiguous provisions of the Governing Agreements they have identified.[28]

VI. For the Ambac Trusts, the Court Should Decline to Instruct the Trustees Concerning Certificate Insurer Reimbursement Issues Not Raised in the Petition, And In Any Event Should Reject Ambac's Arguments.

The Trustees' Petition seeks judicial instruction in this Article 77 proceeding on a limited number of issues concerning the distribution of the Settlement Payment. This Article 77 proceeding is not a forum to resolve any and all issues concerning the trusts' waterfalls or general questions concerning the priority of payment between investors and certificate insurers. Moreover, nowhere in the Trustees' Petition do the Trustees allege any ambiguity concerning Ambac's reimbursement rights with respect to prior certificate insurance payments. Because the issues

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

[27] Petition ¶ 53 - 62.

[28] 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 continue to support this structural adjustment.

raised by Ambac are not properly before this Court, the Trustees should not receive any instruction concerning Ambac's purported reimbursement rights.

If the Court intends to consider Ambac's position on the merits, the Court should reject Ambac's arguments and simply direct the Trustees to enforce the principal distribution waterfalls as written. Ambac's Opening Brief focuses on its argument that it is entitled to the ***entirety*** of the Settlement Payments—***in excess of $30 million***—for the relevant loan groups in GPMF 2006-AR2 and GPMF 2006-AR3 by virtue of its reimbursement rights with respect to prior insurance payments. Remarkably, Ambac does not even cite the principal distribution waterfalls in its Opening Brief. The principal distribution waterfalls in these trusts require that Subsequent Recoveries must first be paid to the senior certificates on a ***pro rata*** basis according to their certificate balances, until they are paid down to zero. Only after the senior certificates are paid down to zero do the waterfalls entitle Ambac to a reimbursement right for prior certificate insurance payments made to the A2 senior-support certificates. A representative principal distribution waterfall in Ambac's trusts states in relevant part, as follows:

> 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 withdrawn by the Trustee from the Distribution Account to the extent of funds on deposit therein and distributed for such Distribution Date, in the following order of priority: [. . .] to pay as principal on the Class A and Class B Certificates, in the following order of priority: (A) For each Distribution Date (i) prior to the Stepdown Date or (ii) on which a Trigger Event[29] is in effect, from the Principal Funds and the Extra Principal Distribution Amount for such Distribution Date: 1. (b) An amount equal to the Group II Principal Distribution Amount will be distributed ***first to each class of Class II-A Certificates[30] on a pro rata basis*** until the Current Principal Amount of each such Class is reduced to zero and ***second, to***

[29] Trigger Events refer to cumulative loss and/or delinquency thresholds. Given the massive losses experienced by these trusts, it cannot be disputed that the Trigger Events were met long ago. *See* Ex. 23 and Ex. 24 to Supplemental Affidavit of David M. Sheeren, attaching excerpts from the September 2018 remittance reports for GPMF 2006-AR2 and GPMF 2006-AR3.

[30] Class II-A Certificates include both the uninsured, super-senior II-A-1 certificate and the insured, senior-support II-A-2 certificate wrapped by Ambac. *See* Exhibit 2a to Affidavit of Robert Tyrell (Dkt. No. 534).

> ***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 Realized Losses were paid by the Certificate Insurer would otherwise be payable to the Class II-A-2 Certificates;[31]

This principal distribution waterfall governs the distribution of Principal Funds, which expressly include Liquidation Proceeds,[32] which in turn expressly include Subsequent Recoveries.[33] From those Principal Funds (which expressly include Subsequent Recoveries), the Group II Principal Distribution Amount[34] is distributed "***first to each class of Class II-A Certificates on a pro rata basis*** until the Current Principal Amount of each such Class is reduced to zero . . . ." The waterfall requires that Subsequent Recoveries, which are included in Principal Funds, are paid "pro rata" to the Class II-A Certificates until their balances are zero. Only once the certificate balances of the Class II-A Certificates are paid down to zero does the *second* step in the distribution waterfall relating to Ambac's reimbursement rights apply.

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[31] *Id.*

[32] Principal Funds is defined as follows, in relevant part: "With respect to each Loan Group and each Distribution Date, (i) the greater of zero and 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 . . . ." *Id.*

[33] Liquidation Proceeds 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**." *Id.*

[34] The Group II Principal Distribution Amount is essentially Group II's share of the Principal Funds excluding overcollateralization release, which is not relevant here. The full definitions are pasted below.

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."

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."

That second step in the principal distribution waterfall states that once the Class II-A Certificates are paid down to zero, remaining amounts are paid "***second, to the Certificate Insurer***, any accrued and unpaid Reimbursement Amounts payable to the Certificate Insurer for that Distribution Date . . ." This ***second*** step in the principal distribution waterfall reflects Ambac's only entitlement to reimbursements for previous insurance payments. Ambac is entitled to "Reimbursement Amounts" only ***after*** the Class II-A Certificates are paid down to zero. Such "Reimbursement Amounts" are generally defined by the related insurance policy as the sum of insurance payments made by Ambac to the A2 certificates for which Ambac has not been previously reimbursed.[35]

Incredibly, in arguing that it should receive the ***entirety*** of the Settlement Payment for the relevant loan groups in the GPMF 2006-AR2 and GPMF 2006-AR3 trusts (exceeding $30 million[36]), Ambac's Opening Brief does not call the Court's attention to the actual principal distribution waterfalls, which unambiguously state that Ambac has an entitlement to Reimbursement Amounts from Principal Funds ***only after*** the Class I-A or Class II-A certificates, as applicable, have been paid down to zero. As shown above, those principal distribution waterfalls do not permit Ambac to leapfrog the super-senior A1 certificates by receiving the entirety of the Settlement Payments ***before*** the Class I-A or Class II-A certificates, as applicable, have been paid down to zero.

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[35] *See* Ex. 4 to the Affidavit of Robert Tyrrell (Dkt. No. 539), in support of Ambac's Opening Brief (defining Reimbursement Amount as follows: "the sum of (i) all Insured Payments paid by the Certificate Insurer, but for which the Certificate Insurer has not been reimbursed prior to such Distribution Date pursuant to Section 6.01 of the Agreement, plus (ii) interest accrued thereon . . . .").

[36] Ambac alleges that it insured the I-A-2 and II-A-2 certificates in GPMF 2006-AR2, and the Class II-A-2 certificate in GPMF 2006-AR3. The Allocable Shares for these loan groups are as follows: GPMF 2006-AR2 (Group I) ($7.1 million), GPMF 2006-AR2 (Group II) ($2.8 million), and GPMF 2006-AR3 (Group II) ($21.4 million). *See* Ambac Opening Brief (Dkt. No. 528) at p. 6.

Instead of citing the principal distribution waterfalls to the Court, Ambac instead focuses selectively on Section 6.02(c) of the Governing Agreements for GPMF 2006-AR2 and GPMF 2006-AR3. That provision, however, merely clarifies that Ambac is entitled to be reimbursed for its prior insurance payments to the senior-support A2 certificates before the *A2 certificates* can receive Subsequent Recovery payments associated with prior realized losses for which Ambac already made the A2 certificates whole. Section 6.02(c) states as follows:

> 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.

All this provision does is make clear that A2 certificateholders cannot get paid ***twice*** with respect to loans that default and lead to realized losses – *first* through receipt of the initial Ambac insurance payment, and *second* through receiving the Subsequent Recovery associated with the prior realized loss. That provision makes perfect sense: If Ambac makes an insurance payment to the A2 certificates associated with realized losses on a liquidated loan, and then at some point in the future, the trust receives a Subsequent Recovery, that Subsequent Recovery should be paid to Ambac, not the A2 certificates. After all, the A2 certificates will have already been made whole through Ambac's previous insurance payment.

In essence, Section 6.02(c) clarifies that Ambac must receive subsequent recoveries before the senior-support A2 certificateholders can receive them. It does not, however, permit Ambac to leapfrog the super-senior *A1* certificates' right to receive those Subsequent Recoveries, which the principal distribution waterfalls plainly require to be distributed to the Class I-A or Class II-A certificates *pro rata*, according to principal balances, until they are paid down to zero, before Ambac has any reimbursement rights with respect to such funds.

CONCLUSION

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

As to the Ambac-insured trusts, the Court should decline to issue instructions relating to stand-alone certificate insurance questions, as these issues are simply not before the Court. Should the Court determine the Trustees are entitled to instructions on the issue Ambac has raised, the Court should direct the Trustees to enforce the principal distribution waterfalls for GPMF 2006-AR2 and GPMF 2006-AR3 as written, and include the Settlement Payment in Principal Funds, for distribution to the senior certificates on a *pro rata* basis, according to their certificate balance, until they are paid down to zero.

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