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

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In the Matter of the Application of	:	Index No. _________/2016
THE BANK OF NEW YORK MELLON, in its Capacity as Trustee or Indenture Trustee of 530 Countrywide Residential Mortgage-Backed Securitization Trusts,	:	
	:	
Petitioner,	:	
	:	
For Judicial Instructions under CPLR Article 77 on the Distribution of a Settlement Payment.	:	

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MEMORANDUM OF LAW IN SUPPORT OF
VERIFIED PETITION SEEKING JUDICIAL INSTRUCTION

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Petitioner The Bank of New York Mellon, in its capacity as trustee or indenture trustee ("Trustee") of the 530 residential mortgage-backed securitization ("RMBS") trusts identified in Exhibit A to the Petition (the "Covered Trusts"), respectfully submits this memorandum of law in support of its concurrently-filed Verified Petition seeking judicial instruction.[1]

PRELIMINARY STATEMENT

The Trustee seeks judicial instruction concerning the distribution of an $8.5 billion Settlement Payment that the Trustee expects to receive on or about February 10, 2016 for the benefit of Certificateholders, because the relevant Governing Agreements that bear upon distribution are subject to competing interpretations. The Settlement Agreement directs the Trustee to distribute each Trust's Allocable Share of the Settlement Payment to Certificateholders in accordance with the relevant Governing Agreements, and more specifically to first remit each Allocable Share to Certificateholders and then to make a corresponding increase ("write up") to the principal balance of the Certificates. The Trustee has observed that due to the unusually large amount of the Allocable Share in each Covered Trust, which the Trustee is required to treat as a "Subsequent Recovery" for purposes of distribution, certain contractual issues have arisen that will affect the distribution of billions of dollars among Certificateholders. The Trustee has also received investor correspondence with competing interpretations of the Governing Agreements, and third-party distribution models incorporate different assumptions about the meaning of the Governing Agreements, appearing to confirm that there are meaningful questions about

[1] Unless otherwise noted herein, defined terms will take on the meaning ascribed to them in the Verified Petition.

how to interpret the contracts. The resolution of these contractual issues will dictate how – and to whom – the Allocable Shares of the Covered Trusts are distributed.

The Trustee has no economic interest in the outcome of this action. It merely requests judicial instruction in order to discharge its obligation to distribute the Settlement Payment fairly and equitably, in the face of competing interpretations and interests, and to allow Certificateholders the opportunity to be heard.

STATEMENT OF FACTS[2]

The Trustee is the trustee or indenture trustee of each Covered Trust. In that capacity, on or about June 28, 2011, the Trustee entered into a Settlement Agreement with Bank of America and Countrywide. *See* Verified Petition, Exhibit B. Following a special proceeding pursuant to CPLR Article 77 and an appeal to the Appellate Division, First Department, the Settlement was approved in all respects, and the Trustee was found to have acted in good faith and reasonably in connection with the negotiation, evaluation and entry into the Settlement Agreement. *In re Bank of New York Mellon (Bank of New York Mellon v. Ret. Bd. of the Policemen's Annuity & Benefit Fund*), 127 A.D.3d 120 (1st Dep't 2015). Judgment was entered on April 27, 2015.

Before the Settlement could go into effect, the Trustee was required to satisfy other conditions, including the receipt of certain approvals from the IRS and tax-related opinions of counsel. On October 13, 2015, having received the required court orders, IRS rulings and opinions of counsel, the Trustee notified Certificateholders of the occurrence of Final Court Approval of the Settlement. Pursuant to the Settlement Agreement, Final Court Approval triggered Bank of America and/or Countrywide's obligation to pay the

[2] The relevant facts are presented here in abbreviated form. A more comprehensive recitation of the facts is set forth in the Verified Petition.

Settlement Payment within 120 days, and the Trustee's obligation to engage a qualified financial advisor to calculate each Covered Trust's Allocable Share – that is, the portion of the Settlement Payment allocable to each Covered Trust.

On January 11, 2016, the Trustee received the financial advisor's calculation of each Covered Trust's Allocable Share. *See* Exhibit C to Verified Petition. Upon payment of the Settlement Payment, the Settlement Agreement requires (with certain exceptions not relevant here) the Trustee to distribute each Covered Trust's Allocable Share to Certificateholders in accordance with the provisions of the Governing Agreements as though the Allocable Share was a "Subsequent Recovery" – generally defined in the Governing Agreements to mean funds received by the trust unexpectedly in connection with a mortgage loan that previously had been written off. Historically, Subsequent Recoveries received by the Covered Trusts for distribution have been modest and often offset in the same month by new losses incurred by the trust. They are typically limited to funds such as property tax rebates received after foreclosure and adjustments to payments on private mortgage insurance claims.

The essential issue for which the Trustee is seeking Court instruction is how the Trustee should apply the "write up" provisions of the Governing Agreements in respect of the Allocable Shares. The "write up" provisions concern the manner by which the principal balance of previously written down certificates is increased, or "written up," in connection with Subsequent Recoveries. Every interest-bearing Certificate issued by the Covered Trusts has a Certificate Principal Balance that *decreases* over time as principal is repaid and losses on mortgage loans are realized. Conversely, in the vast majority of the

Covered Trusts, Certificate Principal Balance can also be *increased*, or "written up," when a trust is in receipt of a Subsequent Recovery that offsets a prior loss.

The Settlement Agreement specifies two operations for the Trustee to perform in connection with the distribution of Allocable Shares – (i) *payment* of the Allocable Share to Certificateholders, and (ii) *writing up* certificates in the amount of the Allocable Share. The write up will be in the amount of the Allocable Share, or if the aggregate amount of all prior write downs is less than the Allocable Share, in such aggregate amount. The Settlement Agreement also specifies the *order* of those two operations – the Trustee is directed to pay the Allocable Share *before* writing up the Certificate Principal Balance (in other words, to pay the Allocable Share based on the prior period Certificate Principal Balance). This order of operations is consistent with the Trustee's longstanding practice of distributing Subsequent Recoveries in the Covered Trusts, a practice that could be gleaned from monthly remittance reports delivered by the Trustee to Certificateholders.

Like the Settlement Agreement, the Governing Agreements for all but six Covered Trusts require the Trustee to both pay and write up when it receives Subsequent Recoveries. But unlike the Settlement Agreement, with only one exception, the Governing Agreements do not specify – one way or the other – the order in which those operations are to be executed. Given the relatively modest size of Subsequent Recoveries received by the Covered Trusts until now, the Governing Agreements' silence on the order of operations had no material impact. However, in preparing for the distribution of the Allocable Shares to Certificateholders, the Trustee has observed that due to the unusually large amounts of Subsequent Recoveries resulting from the Allocable Shares, the Trustee's practice of paying based on the prior period Certificate Principal Balance ("pay first and write up

second") – which is required by the Settlement Agreement and has been the Trustee's longstanding approach with regard to regular Subsequent Recoveries – results in certain contractual issues that affect the distribution of billions of dollars among Certificateholders.

This issue has the most pronounced effect among the Covered Trusts with an "overcollateralization" or "OC" structure (the "OC Trusts").[3] An OC Trust is designed to create credit enhancement, or protection, for more senior Certificateholders through a concept called overcollateralization. An OC Trust is overcollateralized when the principal balance of the underlying mortgage loans (the trust's assets) exceeds the Certificate Principal Balances of the Certificates issued by the OC Trust (the trust's liabilities). In a given month, principal distributions to securities below specified seniority levels (generally, "junior" or "subordinated" Certificates) are not permitted unless the trust as a whole has sufficient "overcollateralization" – that is, unless the balance of the underlying mortgage loans exceeds the Certificate Principal Balances by an amount specified in the Governing Agreements. If the overcollateralization falls short of the required "Overcollateralization Target Amount" – hereinafter referred to as the "OC Target" – then principal distributions cannot flow to less "junior" or "subordinated" Certificateholders. This senior-subordinate structure means that, as a general matter, subordinated Certificates are riskier than senior Certificates and, therefore, carry higher yields and are typically assigned lower ratings at closing.

Substantial losses over the years have resulted in the failure of each of the OC Trusts to meet its OC Target. In fact, many of the OC Trusts have no overcollateralization

[3] In approximately 122 of the 173 OC Trusts, the impact is more than $1 million per trust; in some it exceeds $10 million.

whatsoever, meaning that the principal balance of the mortgage loans in such trusts *equals* the aggregate Certificate Principal Balances of all the Certificates in these trusts. Even when funds are received into the OC Trusts in a given month – which would otherwise build collateralization – they are typically offset by losses on mortgage loans realized in that month. That has maintained the OC Trusts in balance, without any material movement toward meeting their OC Target. In fact, it is likely that the OC Trusts will never meet their OC Target again.

However, due to the unique size of the Allocable Shares, if the Trustee pays the Allocable Share to Certificateholders *before* writing up Certificate Principal Balances (as is specified by the Settlement Agreement and consistent with the Trustee's historical practice), in most of the OC Trusts substantial amounts of each Allocable Share will flow to less senior, subordinated Certificateholders even though overcollateralization in the OC Trust is far short of the OC Target. That is because making the payment first will reduce the Certificate Principal Balance of the Certificates receiving the payment (in other words, those Certificates will be "paid down"), so the trust's liabilities will decline, but the trust's assets (the principal balance of the mortgage loans) remains the same. Therefore, the trust will have a temporary, and illusory, overcollateralization that exceeds the OC Target given the unprecedented amount of Subsequent Recoveries flowing into the OC Trusts. The Governing Agreements provide that, once that occurs, funds must flow to subordinated Certificateholders as reimbursement for their previously-allocated realized losses. Only *after* funds have "leaked" to subordinated Certificateholders is the Certificate Principal Balance increased or "written up" in the amount of the Allocable Share, returning the OC Trust to zero overcollateralization (assets equal to liabilities). In other words, the OC

Target is not satisfied before the distribution or after the distribution, but *during* the distribution process – in between step one (payment) and step two (write up) – the OC Target is temporarily, and artificially, met.

The Governing Agreements neither explicitly prohibit nor explicitly require any particular order of operations. Therefore, the Trustee could make an adjustment designed to avoid the "leakage" issue described above by calculating the overcollateralization in the OC Trusts in a manner that accounts for the expected write up of previously written down Certificates. That approach would avoid the temporary, and illusory, satisfaction of the OC Target.

Alternatively, the Trustee could avoid the leakage in the OC Trusts by changing its established order of operations for this settlement distribution (*i.e.*, not simply adjust the overcollateralization measurement) to apply *write ups* first, and then pay the Allocable Share. The "write up first and pay second" order of operations, however, is inconsistent with Subparagraph 3(d)(ii) of the Settlement Agreement, albeit with the caveat that the Settlement Agreement, by its terms (Subparagraph 3(d)(v)), cannot amend or be construed as amending the Governing Agreements. In other words, the Settlement Agreement permits "write up first and pay second" only if the Governing Agreements of the OC Trusts are interpreted as directing the Trustee to "write up first and pay second."

This alternative would affect the settlement distribution in the majority of the 530 Covered Trusts, including many of the non-OC Trusts. For example, changing the general order of operations has the potential to materially alter the relative portion of the Allocable Shares that senior Certificateholders would receive in any Covered Trust – whether or not an OC Trust – in which senior Certificates have incurred losses to date. That is because

distributions in many of the Covered Trusts are affected by the relative Certificate Principal Balances of all Certificates. Thus, a distribution based on a "write up first and pay second" order of operations in trusts where senior classes incurred losses to date would mean that less senior Certificates increase their Certificate Principal Balance in relation to more senior Certificates, potentially skewing the distribution in favor of less senior Certificates.

The Trustee has received conflicting investor correspondence on this point, advancing different interpretations and urging the Trustee to follow different orders of operation in light of, or notwithstanding, the overcollateralization issue. Intex, a leading provider of cash flow models that are used and relied upon by investors throughout the structured fixed income industry, has modeled different OC Trusts based on different assumptions about the order of write ups and payments. Certain of the models appear to apply a "pay first and write up second" order of operations but appear to include a script to prevent leakage. Other models appear to use a "write up first and pay second" order of operations and thus show no leakage. These varied approaches in models available to Certificateholders and other market actors confirm that there is disagreement concerning the proper interpretation of the contracts.

The Trustee is also aware that in non-Countrywide deals that are unrelated to the Settlement, the agreements address the order of operations in three separate ways – by requiring "pay first; write up second"; by requiring "write up first; pay second"; and by staying silent (like the Governing Agreements here) on the order of operations issue. In other words, the governing agreements for non-Countrywide deals provide no guidance on

industry practice, because there is no consistency in how they treat the order of operations question.

Given this background and the potential impact of these questions on the distribution of billions of dollars, the Trustee brings this action to obtain judicial direction on the proper method of distributing the Settlement Payment.

ARGUMENT

I. The Court Is Authorized to Issue Judicial Instructions.

The Court has authority to provide judicial instructions to the Trustee regarding the distribution of the Settlement Payment to the Covered Trusts. Section 7701 of the CPLR provides, with certain exceptions not relevant here, that "[a] special proceeding may be brought to determine a matter relating to any express trust." This section is "broadly construed to cover any matter of interest to trustees, beneficiaries or adverse claimants." *In re Greene v. Finley, Kumble, Wagner, Heine & Underberg*, 88 A.D.2d 547, 548 (1st Dep't 1982). New York courts have recently applied Article 77 to RMBS trusts in several cases, including in *In re The Bank of New York Mellon*, Index No. 651786/2011, the case that approved the Trustee's negotiation, evaluation and entry into the Settlement Agreement.

The substantive relief that the Trustee seeks – construction of trust-related agreements – is a longstanding equitable remedy. *See In re Trusteeship Created by American Home Mortg. Inv. Trust 2005-2*, No. 14 Civ. 2494 (AKH), 2014 WL 3858506, at ¶¶ 91, 179 (S.D.N.Y. July 24, 2014) (allowing reformation of Indenture due to scrivener's error to "reflect[] the intent of the contracting parties"); *Petition of Percy*, 191 Misc. 1052, 1054 (Sup. Ct. N.Y. Cty. 1948) (interpreting the indenture provision governing the disbursement of the trust fund); *In re The Bank of New York Mellon*, No. 651786/11, 2014

WL 1057189 (N.Y. Sup. Ct. Jan. 31, 2014) (approving settlement in Article 77 proceeding brought by The Bank of New York Mellon); *In re Scarborough Props. Corp.*, 25 N.Y.2d 553, 555 (1969) (granting Article 77 petition by "trustees of various trusts" concerning decision to sell trust assts); *see also* Restatement (Second) of Conflict of Laws § 267 cmt. a (1971) ("A proceeding may be brought by the trustee or by the beneficiaries for instructions as to his powers and duties. Application may be made to the court to direct or permit the trustee to deviate from the terms of the trust where unanticipated exigencies have arisen.").

Moreover, as "the court first assuming jurisdiction over property," this Court "may maintain and exercise that jurisdiction to the exclusion of [other courts]." *United States v. Bank of New York & Trust Co.*, 296 U.S. 463, 477 (1936) (noting that principle applies "where suits are brought to … administer trusts."). There is no question that New York courts have jurisdiction over the trusts (governed by New York law), the Trustee (a New York corporation administering trusts governed by New York law), and the trust beneficiaries (investors in trusts governed by New York law). *See* Restatement (Second) of Trusts § 220 cmt. c (1959) ("Where a trust is administered under the supervision of the courts of a State, those courts have jurisdiction to determine the interests of all claimants, resident or non-resident, with respect to the administration of the trust.").

II. Competing Interpretations of Distribution Provisions in the Governing Agreements Require Judicial Instruction.

The Trustee is required to distribute the Settlement Payment to Certificateholders, but how the distribution provisions of the Governing Agreements interact with the distribution provisions of the Settlement Agreement are subject to multiple, competing interpretations by Certificateholders and industry participants.

Where, as here, conflicting interpretations of trust documents affect the administration of a trust, judicial instruction is warranted to protect the beneficiaries and confirm the trustee's obligations. *See In re Bankers Trustee Co.*, Index No. 604336/1996 (N.Y. Sup. Ct. N.Y. Cty. July 24, 1997); *In the Matter of the Trusteeships Created by Tropic CDO I Ltd*., 92 F. Supp. 3d 163 (S.D.N.Y. 2015) (seeking judicial confirmation that trustee correctly interpreted trust indentures and properly distributed proceeds where investors advanced contrary interpretation). In *In re Bankers Trustee*, the court granted a trustee's request for judicial instructions regarding the enforcement of a promissory note, which the trustee believed had the potential to cause a conflict among trust beneficiaries. In ruling that it had authority to issue judicial instructions, the Court pointed out one of the essential purposes of an Article 77 proceeding: "the judicial instructions will permit conflicts relating to priorities among [trust beneficiaries] to be resolved in one proceeding instead of in piecemeal in a number of proceedings." *Id.* at 6; *see also In re Bankers Trustee Co.,* Index No. 114077/1998, at 2-3 (N.Y. Sup. Ct. N.Y. Cty. Mar. 8, 1999) (granting trustee's request, pursuant to Article 77, for judicial instructions regarding the disposition of certain trust funds that were the subject of conflicting letters of direction from trust beneficiaries).

Judicial instructions are particularly necessary where, as here, there is reasonable doubt about the powers or duties of the trusteeship or about the proper interpretation of trust provisions. *See Petition of Percy*, 191 Misc. at 1054 (interpreting the indenture provision governing the disbursement of the trust fund); *see also In re Estate of Fales*, 106 Misc. 2d 419, 422 (Sur. Ct. N.Y. Cty. 1980) (providing instructions regarding trustee conduct that was the subject of conflicting requests from trust beneficiaries); Restatement

(First) of Trusts § 170 (1935), cmt. q (proper for court to provide instructions where trust beneficiaries express conflicting interests).

Here, as discussed, the Trustee has received conflicting investor correspondence regarding the distribution of the Settlement Payment; Intex has modeled the distributions in different OC Trusts based on different assumptions about the order of write ups and payments; and agreements in non-Countrywide deals provide no guidance on industry practice. This presents the classic case for judicial instruction.

III. Escrow of Settlement Funds Is Required to Preserve the Status Quo.

The Court has discretion to order the escrow of the Settlement Payment "to maintain the status quo pending a hearing on the merits." *See 630 West 11th LLC v. ACG Credit Co. II, LLC,* 46 A.D.3d 367, 367 (1st Dep't 2007); *Ficus Invs. Inc. v. Private Capital Mgmt., LLC*, 61 A.D.3d 1, 11-12 (1st Dep't 2009) ("The escrow order properly preserved the status quo… [t]he equitable relief was appropriate because the assets constituted a specific res that is 'the subject of the action'") (internal citations omitted).

An order to place the Settlement Payment in escrow is urgent and essential to maintain the status quo in the instant case. The purpose of this proceeding – to obtain the Court's direction on the method of distributing the Settlement Payment (*i.e.*, "the subject of the action") – would be frustrated if the Trustee immediately routed the incoming cash to Certificateholders, as the relevant agreements would otherwise require. Immediate distribution of the Settlement Payment using any of the possible distribution methods discussed above would irreversibly alter the status quo, as it would be impracticable for the Trustee to claw back and redistribute the $8.5 billion Settlement Payment in the face of a contrary judicial instruction.

The Trustee therefore proposes the execution of an Escrow Agreement and the initial appointment of The Bank of New York Mellon (in its non-trustee capacity) as escrow agent (the "Escrow Agent"). *See* Affidavit of Michael O. Ware ("Ware Aff."), Exhibit 1.[4] The Escrow Agent receives no benefit from this arrangement; indeed, it will accept *no fees, interest or other compensation* as escrow agent. The proposed Escrow Agreement provides as follows:

> **Compensation**. The Escrow Agent shall not be entitled to any fees or other compensation for the Escrow Agent's services hereunder; provided, however, that the Escrow Agent shall be entitled to reimburse itself out of Escrow Earnings in the Escrow Account for such reasonable out of pocket expenses, disbursements, charges, advances and other amounts incurred by it in connection with its services hereunder, if any, that the A77 Court may approve from time to time.

Ware Aff., Exhibit 1 at ¶ 9.[5]

IV. The Trustee's Notice Program Satisfies Due Process.

The Trustee has proposed a notice program to inform all Certificateholders and other Interested Parties that this Article 77 proceeding has been filed. It includes, within seven (7) business days of the entry of the Proposed Order, (a) mailing the Notice and the

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[4] It does so for two reasons. First, because the filing of this proceeding may have constituted material non-public information with the potential to affect the value of the Certificates, the Trustee was unable to disclose its contemplated action before filing this proceeding. The Trustee could not, therefore, have "shopped" for an outside escrow agent to handle the funds during the pendency of this action. Second, given the size and time value of the Settlement Payment, the Trustee is seeking to avoid delay in the investment of the Settlement Payment. The Trustee was able to customize an escrow agreement with the Escrow Agent, tied to the outcome of this action, and develop an investment strategy for the funds that it could implement immediately.

[5] Nor does the Trustee benefit from this arrangement. None of the Trustee's fees in connection with this proceeding will be paid from the Settlement Payment or any escrow earnings.

initial papers filed herein (other than the compact disc containing electronic copies of the Governing Agreements) to Certificateholders listed on the Certificate Registry for each of the Covered Trusts and to the general counsel of each monoline insurance company that insures any part of any of the Covered Trusts; (b) transmission of the Notice electronically to The Depository Trust Company ("DTC"), which will post the Notice to Certificateholders in accordance with DTC's established procedures; and (c) posting the Notice on the Trustee's investor reporting website.

This notice program is based on a program recently approved by Justice Ramos in another Article 77 proceeding concerning the distribution to investors of the proceeds of an RMBS settlement. *See In re Bank of New York Mellon (GE-WMC 2006-1)*, Index. No. 653558/2015 (Sup. Ct. N.Y. Cty. Oct. 27, 2015). It is also substantially more robust than even the Governing Agreements require: notice through DTC alone is the only form of notice provided for in the Governing Agreements for all Trustee-to-investor communications, in part because the Trustee has no way of knowing the identities of the beneficial owners of book-entry (*i.e.*, DTC-registered) certificates.

It is well established that due process does not require that every interested party actually receive direct notice from the Trustee. *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950). Due process requires only "notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *Mullane*, 339 U.S. at 314. The notice program here easily comports with due process.

CONCLUSION

For all the foregoing reasons, The Bank of New York Mellon, as Trustee, respectfully requests that the Court grant the relief requested in the Verified Petition.

Dated: February 5, 2016
New York, New York

Respectfully submitted,

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