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

In the Matter of the Application of THE BANK OF NEW YORK MELLON, (as Trustee under various Pooling and Servicing Agreements and Indenture Trustee under various Indentures)

- v. -

for an Order, pursuant to CPLR 7701, seeking judicial instructions and approval of a proposed settlement

Index No. 651786/2011

THE PUBLIC PENSION FUND COMMITTEE'S MEMORANDUM OF LAW IN OPPOSITION TO THE PROPOSED SETTLEMENT

Assigned to: Hon. Kapnick, J.

INTRODUCTION

The Policemen's Annuity and Benefit Fund of Chicago, City of Grand Rapids General Retirement System, and City of Grand Rapids Police and Fire Retirement System (the "Public Pension Fund Committee") object to the $8.5 billion settlement proposed by the Bank of New York Mellon ("BNY Mellon"), and supported by a group of MBS holders with large holdings who were involved in the development of the Settlement (the "Institutional Investors"), for many of the same reasons that are set forth in detail in the Joint Memorandum of Law in Opposition to the Proposed Settlement (the "Jt. Mem.") filed this same date. However, in the Public Pension Funds' view, the Settlement is fatally flawed and should not be approved by this Court on two grounds alone:

- Neither BNY Mellon nor the Institutional Investors developed the facts, either through formal or informal discovery, that were needed to evaluate the merits and collectability of the claims and to negotiate a fair settlement.
- BNY Mellon has not faithfully performed as the MBS holders' fiduciary to vigorously and effectively protect their interests when seeking to extinguish claims for tens of billions of dollars. Instead, BNY Mellon exploited the use of

the "No Action" clauses in the Pooling and Servicing Agreements ("PSA's") and used the limitations on the ability of MBS holders to bring suit to protect their economic interests, in order to coerce an extra-judicial settlement and to protect itself from liability for its own breaches of the PSA's.

That the "Institutional Investors" stepped in to force BNY Mellon to act at all and advocated on behalf of MBS holders to arrive at the $8.5 billion agreement, is not enough to offset these debilitating problems. When it came time at the bargaining table to argue the case's strengths as well as its weaknesses, the Institutional Investors lacked the leverage and tools to extract a fair and adequate settlement. Instead, the Institutional Investors have been left to explain to this Court that they did the best they could under the circumstances where they and other MBS holders had no litigation alternative.

As the U.S. Supreme Court explained in *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997) when rejecting class certification for a sprawling "settlement-only" class of toxic tort plaintiffs, where the defendant was opposing a full litigation class certification under the standards of Fed. R. Civ. P. 23:

> [I]f a fairness inquiry under Rule 23(e) controlled certification, eclipsing Rule 23(a) and (b), and permitting class designation despite the impossibility of litigation, both class counsel and court would be disarmed. Class counsel confined to settlement negotiations could not use the threat of litigation to press for a better offer . . . and the court would face a bargain proffered for its approval without benefit of adversarial investigation.

Id. at 621.

Proceeding to settlement negotiations without the leverage of a pending lawsuit, or the formal discovery that it permits, is particularly troublesome here, because as Judge Bransten just held in *MBIA Insurance v. Countrywide Home Loans, Inc.*, Index No. 602825/2008, in denying summary judgment on a record that included more than 100 deposition transcripts and thousands of pages of Countrywide business records, the question of the extent of Countrywide's violations of its representations and warranties in its PSA's and associated agreements relating to the origination of its mortgage loans, and the issue of BofA's successor liability, turned on hotly disputed issues of fact.

Here, because no lawsuit was filed against BofA and formal discovery was not available, BofA was left with the power to cherry-pick the facts and evidence to be disclosed at the settlement negotiations, so that a matter that turned on complex issues of fact was assessed only with knowledge of the case's weaknesses and not its strengths. The long list of depositions that have occurred since the settlement negotiations, and the expert reports recently obtained by BNY Mellon and the Institutional Investors, cannot make up for such a fundamental weakness that had occurred at the bargaining table a year earlier. Moreover, these expert opinions are only as good as the facts on which they were based. And, finally, as the Jt. Comm. points out, even many of the legal assumptions in those reports, such as that the Trusts had to prove that their credit losses were attributable to violations of the mortgage origination representations and warranties, or that mortgage loan "sampling" could not be used to extrapolate the identified representation and warranty violations to the remainder of the loans, have been recently and soundly rejected by both the New York state and federal courts. *See, e.g.*, *MBIA Ins. Corp. v. Countrywide Home Loans, Inc.*, --- N.Y.S.2d ---, 2013 WL 1296525, at *2 (1st Dep't Apr. 2, 2013); *Assured Guaranty Mun. Corp. v. Flagstar Bank FSB*, 892 F. Supp. 2d 596, 602 (S.D.N.Y. 2012); *Syncora Guarantee Inc. v. EMC Mortgage Corp.*, 874 F. Supp. 2d 328, 334-35 (S.D.N.Y. 2012).

Under these circumstances, the Public Pension Funds agree with the suggestion made by the Steering Committee that the settling parties should be referred back to the negotiating table for an arms-length negotiation overseen by an impartial and experienced mediator. Jt. Mem. at 7. To assure that MBS holders' bargaining power does not continue to be undermined by BNY

Mellon's misconduct and the limitations imposed by the PSA's 'no action" clause, BNY Mellon, however, should first be directed to file its lawsuit against Countrywide and BofA, so that MBS holders are not again coerced into accepting an inadequate result. And, to assure that MBS holders have the facts to negotiate a fair result, Countrywide and BofA should be directed to turn over all the evidence available in *MBIA*, including any re-underwriting reports covered by the MBIA protective order, and other documents filed under seal. Only then will all the parties to the negotiation and their experts have access to facts that demonstrate both the strengths and weaknesses of their claims.

ARGUMENT

I. The Trustee Failed in Its Fiduciary Duties and Misused the PSA's No Action Clause to Coerce an Extra-Judicial Settlement.

Attorney Robert Madden explained the "problem" the "Institutional Investors" faced at the onset of the process, that ultimately resulted in the $8.5 billion settlement, as follows[1]:

> [I]t started with a small group of investors that were facing a problem. That problem was that these repurchase claims were lying fallow. No one was doing anything. None of these people were doing anything. . . . Limitations was [sic] running on those claims, and nothing was happening . . . and they went to the trustee and said you've got to sue Bank of America. This was no effort to help Bank of America, your Honor. This was an effort to bring Bank of America to justice. They went to the trustee and said you have to sue the trustee [sic]. The trustee wouldn't act. What my clients did was they went through the hoops that have been talked about here. . . . We gathered together. We demonstrated to the trustee that we had 25 percent with respect to a subset of the trusts at issue here. We demanded that the trustee take action. . . . What we did is we went to Bank of New York and said we're going forward with this, either you're going to bring these claims or we're going to bring these claims derivatively.

The position that BNY Mellon had no fiduciary responsibilities to MBS holders to act under the terms of the PSA's has been asserted repeatedly, by BNY Mellon's counsel in arguments before this Court and to Judge Pauley, when the Article 77 case was pending before

[1] This explanation was given in response to Judge Pauley's questioning after the Article 77 proceeding had been removed to federal District Court. Ex. 1, 9/21/11 Tr. at 62-63.

him. *See, e.g.*, Ex. 1, 9/21/11 Tr. at 11-14. The deposition testimony of BNY Mellon managers taken in the federal case brought by members of the Public Pension Fund Committee against BNY Mellon under the federal Trust Indenture Act ("TIA") and raising common law claims for BNY Mellon's pre-settlement conduct, *Retirement Board of the Policemen's Annuity and Benefit Fund of the City of Chicago, et al. v. The Bank of New York Mellon*, Case No. 11-cv-5459, Southern District of New York (the "federal case") [redacted]

[redacted]

[2] [redacted]

Q. [redacted]

A. [redacted].

Ex. 9, Kravitt Tr. at 595:6-19.

[redacted]

This put the Institutional Investors, who had assumed the responsibility to advocate for the economic interests of all MBS holders, in a difficult position. BNY Mellon, by wielding the PSA's "no action" clause to disable the Institutional Investors from bringing suit and from obtaining discovery to learn and leverage the strengths of their case, left the Institutional Investors with only limited rights to sue derivatively; they lacked any ability to sue to extract ***any*** recovery for MBS holders on Trusts where they did not own a 25% voting interest. Thus, despite the undisputed pervasive breaches of the documentation and mortgage origination representations and warranties by Countrywide that were resulting in stunning amounts of losses in the Covered Trusts, their repurchase rights remained in jeopardy of lapsing because BNY Mellon stubbornly refused to act.

Under the terms of the PSA, §3.01, the Master Servicer was supposed to be prudently servicing the Trusts and thus enforcing the repurchase rights in the first instance, but failed to do so because the Master Servicer and Seller were closely affiliated, so that the Master Servicer would experience the economic loss from its put-backs. [redacted]

As the Institutional Investors explained in their October 31, 2011 Statement in favor of Settlement, one of the key reasons for supporting the settlement was that, given the "No Action" clause, even their group who owned $40 billion of certificates, was unable to effectively sue to protect the interests of MBS holders -- with the implication that BNY Mellon, while willing to represent them in an extra-judicial resolution, would still not institute suit on their behalf:

> In fact, of the over $40 billion in securities held by the Institutional Investors or by funds and clients they advise, almost $14 billion are in Trusts where the Institutional Investors lack the required 25% threshold. ***If the settlement is disapproved, these Trusts will receive no remedy at all.***

No. 1:11-cv-05988-WHP (S.D.N.Y.), ECF No. 124 at 6 (emphasis added). The Trustee, in its October 31, 2011 papers re-enforced this coercive message:

> In 2010, a group of some of the largest investors in the world, including funds run by the Federal Reserve Bank of New York, major life insurance companies and asset managers, and several major financial institutions (the "Institutional Investors") -- investors who held tens of billions of dollars' worth of interests in the Trusts -- approached BNYM and alleged that the Seller and Master Servicer had breached Pooling and Servicing Agreements and Sale and Servicing Agreements ("PSAs"). ***Despite their enormous holdings, the Institutional Investors understood that they could not pursue legal claims directly against the Seller or Master Servicer.*** Under Section 10.08 [the no action clause] they were required first to seek action by the Trustee.

No. 1:11-cv-05988-WHP (S.D.N.Y.), ECF No. 126 at 3 (emphasis added). Then, the Trustee, in responding to the substantive objections of the intervenors, further drove the point home that the objectors should understand that without the settlement, they would receive nothing:

> ***None*** of the objectors suggest any possible route by which investors in the Trusts could obtain any benefit or remedy through a vehicle other than the Settlement -- be it litigation or otherwise. They identify no viable alternative route of recovering money from Countrywide -- much less an amount that exceeds $8.5 billion.

Id. at 7.

This coercion on the part of BNY Mellon is a clear violation of the Trustee's fiduciary duties of loyalty and due care, as well as a blatant violation of the PSA itself. And, contrary to the assertions of BNY Mellon and the Institutional Investors, the MBS holders and this Court are not impotent to correct this abuse. MBS holders might be limited in their ability to sue BofA directly, but they can sue BNY Mellon for wrongfully causing the loss of their repurchase rights -- as the District Court in the federal case has already ruled. *Retirement Board*, 2012 WL 1108533 (S.D.N.Y. Apr. 3, 2012) (Memorandum and Order).

II. BNY Mellon is a Conflicted Trustee Who Has Violated Its Duties to MBS Holders.

As described above, by entering into the settlement process, BNY Mellon has assumed the full "prudent person" fiduciary duties of a regular Trustee and can be sued for its failure to prudently and loyally represent MBS holders by instituting suit against BofA should this settlement fail. While Courts have generally enforced an indenture trust's "no action" clause for investor suits against a master servicer or seller, the Courts have not recognized these clauses as a bar to an investor's suit ***against a Trustee*** who acts in derogation of its duties by permitting valuable trust claims to lapse. Particularly, MBS investors are not barred under an indenture's "no action" clause from suing their trustee for its own breach of the Indenture agreement or for claims under the federal Trust Indenture Act -- as the members of the Public Pension Fund

Committee have asserted in bringing their suit against BNY Mellon. *Id.*; *and see Cruden v. Bank of New York*, 957 F.2d 961, 968 (2d Cir. 1992) ("The district court held that the 'no action' clause applied only to debenture holder suits against Levin-Townsend, not the Indenture Trustees. . . . This construction of §9.04 [the no action clause] obviously is correct, as it would be absurd to require the debenture holders to ask the Trustee to sue itself."); *RJ Capital, S.A. v. Lexington Capital Funding III, Ltd.*, No. 10 Civ. 25(PGG), 2011 WL 3251554 (S.D.N.Y. July 28, 2011) (citing *Cruden*).

BNY Mellon, however, also had full "prudent person" obligations to protect MBS holders' repurchase rights under the terms of the PSA and federal TIA long before it was contacted by the Institutional Investors. Thus, BNY Mellon had good reason to seek a quiet extra-judicial settlement, in lieu of a high profile lawsuit with full discovery that would shed unwelcome light on BNY Mellon's own misconduct, as well as BofA's.

Under the PSA's in this case, the "event of default" for a Master Servicer's failure to enforce repurchase rights -- and which gives rise to BNY Mellon's fuller prudent person obligations under §8.01 -- may be triggered ***either*** by notice given by the Trustee ***or*** a 25% holder:

> <u>§7.01 Events of Default</u>
>
> "Event of Default," wherever used in this Agreement, means any one of the following events:
>
> * * *
>
> (ii) ***any failure by the Master Servicer to observe or perform in any material respect any other of the covenants or agreements on the part of the Master Servicer contained in this Agreement*** (except with respect to a failure related to a Limited Exchange Act Reporting Obligation), ***which failure materially affects the rights of Certificateholders, that failure continues unremedied for a period of 60 days after the date on which written notice of such failure shall have been given to the Master Servicer by the***

> ***Trustee***, the NIM Insurer or the Depositor, ***Or*** to the Master Servicer and the Trustee ***by the Holders of Certificates evidencing not less than 25% of the Voting Rights*** evidenced by the Certificates in the applicable Certificate Group; provided, however, that the sixty day cure period shall not apply to the initial delivery of the Mortgage File for Delay Delivery Mortgage Loans nor the failure to substitute or repurchase in lieu of delivery;

Under the PSA, §2.06, BNY Mellon had the obligation to perform its specified duties, "to the end that the interests of the Holders of the Certificate may be adequately and effectively protected."

Contrary to BNY Mellon's stubborn position that it had no "prudent person" obligations under §8.01 because a triggering notice under §7.01 for an "event of default" had not been sent by a qualified group of MBS holders (or that group had agreed to "forbear" on the notice), where, as here, BNY Mellon fully knew, since 2008, that the Master Servicer was wholly ignoring its critical obligations to put back billions of dollars of defective loans to its affiliate, BNY Mellon did not have the discretion to insulate itself from its fuller prudent person duties, by deciding not to send out the §7.01 triggering notice. Neither the PSA by its terms nor well-established principles of common law, permit BNY Mellon to raise as a defense to its full prudent person obligations, its own negligent failure to provide the §7.01 notice. As §8.01 provides: "No provision of this Agreement shall be construed to relieve the Trustee from liability for its own negligent action." And, as the Second Circuit Court of Appeals explained in *In re Bankers Trust Co.*, 450 F.3d 121 (2d Cir. 2006), when assessing the duties of an Indenture Trustee whose negligence had resulted in a failure to satisfy a pre-condition to its responsibilities under the Indenture, "One who unjustly prevents the performance or the happening of a condition of his own promissory duty thereby eliminates it as such a condition." *Id.* at 126 (internal citations and quotation marks omitted).

Thus, to respond to the Institutional Investors' question in their October 2011 brief that they put to objectors -- "What are the Alternatives to Settlement?" -- (No. 1:11-cv-05988-WHP (S.D.N.Y.), ECF No. 126 at 33), the answer is that MBS investors can sue BNY Mellon for its refusal to perform as their fiduciary, without regard to a 25% ownership interest in the Trusts, including for their losses caused by BNY Mellon's failure to institute suit to enforce the repurchase rights, and vigorously advocate for MBS holders' interests. Thus, neither MBS holders deciding whether to object to the $8.5 billion Settlement, nor this Court, should be cowed into approving a flawed settlement -- particularly where, as here, the justification for approval is that BNY Mellon has coerced MBS holders by refusing to enforce repurchase rights where it is the only person with the power to bring suit.

III. Neither the Proponents of the Settlement Nor Their Experts Had the Facts to Effectively Negotiate a Fair Settlement

As the Jt. Comm. brief shows, the findings that the Trustee asks this Court to make in a proposed final order approving this settlement, particularly that

- The Settlement Agreement is the result of factual and legal investigation by the Trustee . . . (h);
- The Trustee appropriately evaluated the terms, benefits, and consequences of the Settlement and the strengths and weaknesses of the claims being settled . . . (i);
- The arms'-length negotiations that led to the Settlement Agreement and the Trustee's deliberations appropriately focused on the strengths and weaknesses of the Trust Released Claims . . . (j); and
- The Trustee acted in good faith, within its discretion, and within the bounds of reasonableness . . . (k)

could not be further from the truth.

[redacted].[3] Instead of re-underwriting a sample of the mortgage loans and extrapolating the results of the review to determine the extent of the representation and warranty violations in the Trusts, as insurers bringing suit against Countrywide had done, BNY Mellon, to evaluate the merits and damages attributable to tens of billions of dollars of credit losses in the 530 Trusts, hired RRMS and relied upon its seven-page report for its position that the $8.5 billion settlement number was reasonable. Ex. 11.

[redacted]

3 [redacted]

4 [redacted]

[redacted]

While the Institutional Investors purported to have a more reliable study from which they had derived a higher settlement position, because the Institutional Investors did not produce it for RRMS's review, RRMS rejected it in favor of BofA's analysis:

> The [Investor Group's] "Breach Rate" and "Success Rate" were obtained by a third party who completed a forensic underwriting project of a non-agency whole loan portfolio. This review consisted of approximately 250,000 loans of similar product types, and of the same origination period as the Settlement Portfolio. It was observed that there was an instance of a breach in approximately 60% of the loans examined and the actual repurchase rate of these loans by the originator ranged between 50% and 75%. I was not able to verify these figures since I was not given access to any documents or specifics pertaining to the underwriting review. However, based on the limited amount of publicly available information and my industry knowledge, it is my opinion that these percentages are too high.

Ex. 11 at 3.

This is the extent of BNY Mellon's "investigation" into the merits of the 530 Trusts' repurchase claims which it asks this Court to approve in its Final Order.

To see what the Trustee should have done, as a prudent person, this Court need only glance across the hall to see the effort that was expended to learn the facts in the repurchase case brought by MBIA -- where the counsel litigating the case took 90 depositions on the repurchase rights issue. In *MBIA*, unlike here, the attorneys were employed by a plaintiff economically interested in establishing its rights, and a defendant who understood that it was preparing a case to be tested in an adversarial proceeding. Indeed, here, for the $8.5 billion settlement, the factual

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[redacted]

investigation was so superficial that it reinforces the conclusion that the Settlement is the product of coercion.

In *Fiala v. Metropolitan Life Insurance Co., Inc.*, 899 N.Y.S.2d 531, 27 Misc. 3d 599 (N.Y. Sup. Ct. 2010), Judge Kornreich ticked off the facts that she found convincing to demonstrate that a proposed class action settlement was free of collusion and coercion:

- the settlement occurred after comprehensive and meaningful discovery;
- on the brink of trial;
- with the help of an accomplished and scrupulous mediator; and
- with almost universal approval.

These factors, by their absence in this case, speak volumes. By any measure, this Settlement cannot be approved as fair, adequate or reasonable.

DATED: New York, New York
May 3, 2013

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