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

In the matter of the application of	
U.S. BANK NATIONAL ASSOCIATION, et al.,	Index No. 651625/2018
	Friedman, J.
Petitioners,	
For Judicial Instructions under CPLR Article 77 on the Administration and Distribution of a Settlement Payment.	**OPENING BRIEF OF THE INSTITUTIONAL INVESTORS AND AIG CONCERNING THE PETITION**

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Other Authorities

Pursuant to the September 5, 2018 Stipulation Regarding Merits Briefing Schedule and Trustee Substitutions (Dkt. No. 132), the Institutional Investors and the AIG Parties submit this Opening Brief addressing the issues raised in the Petition concerning the distribution of over $230 million in settlement proceeds to 30 Lehman RMBS trusts identified in Exhibit 1 to the Affidavit of David M. Sheeren, filed herewith.[1] The aggregate current unpaid balance of the certificates held by the Institutional Investors and the AIG Parties in those trusts exceeds $1.3 billion. The Institutional Investors and the AIG Parties submit this Opening Brief only with respect to the trusts identified in Exhibit 1.

STANDARD OF REVIEW

Article 77 Proceedings are summary in nature. In an Article 77 proceeding, the Court must examine the Trustee's Petition (as well as any evidence filed), after which it "shall make a summary determination upon the pleadings, papers and admissions to the extent that no triable issues of fact are raised."[2] No triable issues of fact are raised here.

On a motion to dismiss an Article 77 petition, the Court must afford the Petition a liberal construction and take the factual allegations therein as true.[3] If, upon doing so, the Court determines that the Petition fails to raise a *bona fide* question about the scope of the trustee's powers or duties, the petition should be dismissed.[4]

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[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 filed herewith, unless otherwise specified. At least 24 additional trusts held by the Institutional Investors and/or the AIG Parties have become undisputed following the Court's standing decision, and the Institutional Investors and/or the AIG Parties will soon submit a proposed consensual judgment as to those undisputed trusts, which will reflect the distribution methodology set forth in this Opening Brief.

[2] N.Y.C.P.L.R. 409.

[3] *EBC I, Inc. v Goldman, Sachs & Co.*, 5 N.Y.3d 11, 19 (2005)

[4] *See* Section I, *infra*.

INTRODUCTION

The Trustees' Petition does not properly invoke Article 77 because it fails to raise *bona fide* questions about the meaning of the trust instruments and settlement agreement. Consequently, the Petition should be dismissed under C.P.L.R. 3211(a)(2) and 3211(a)(7), the Trustees should be required to reimburse the trusts for the Trustees' costs in bringing the proceeding, and the settlement agreement and governing agreements should be enforced as written.

In the event the Court declines to dismiss the Petition and elects to provide guidance to the Trustees, the Court should direct the Trustees to distribute the settlement on a Pay First basis, *without* temporary overcollateralization.

As to the order of operations, the Settlement Agreement requires the Pay First method, unless the Court determines that the Governing Agreements require otherwise. The Trustees concede in the Petition, however, that the Governing Agreements "do not clearly specify" the order of operations.[5] Indeed, the Trustees do not cite a single provision of the Governing Agreements that allegedly speaks to the order of operations. That is because the Governing Agreements are silent as to the order of operations.

As to temporary overcollateralization, the plain definition of "Overcollateralization Amount" in the Governing Agreements requires that overcollateralization be measured after "*giving effect to*" distributions—including distributions of subsequent recoveries like the Settlement Payment. As in the JPMorgan and Countrywide distribution Article 77s, "*giving effect to*" the distribution of the Settlement Payment requires the Trustees to take into account *both* the certificate write-down and write-up associated with subsequent recoveries. Doing so eliminates any possibility of temporary overcollateralization during a distribution.

[5] Petition ¶ 36.

As to the only other issue in the Petition—whether the Trustees should enforce a term of the Governing Agreements that already prohibits distributions to Zero Balance Classes—the Trustees should simply enforce the plain term of the contracts they have identified. They do not need judicial assistance in determining whether or not to apply a term of the trust instrument.

FACTUAL BACKGROUND

On March 17, 2017, the Institutional Investors presented the Lehman Trustees with a global RMBS settlement agreement, which they accepted, as modified, on June 1, 2017.

On July 6, 2017, the Lehman Bankruptcy Court entered an Order Approving RMBS Settlement Agreement and Including Certain Proposed Findings of Fact and Conclusions of Law (the "9019 Order").[6] The 9019 Order provided that the "[Bankruptcy] Court retains ***exclusive*** jurisdiction to hear and determine any dispute regarding the interpretation or enforcement of the RMBS Settlement Agreement until the closing of the LBHI Debtors' bankruptcy cases" and that the "Court otherwise retains jurisdiction with respect to all matters arising from or related to the implementation of this Order." (emphasis added)

On March 8, 2018, following a 22-day estimation proceeding, the Bankruptcy Court issued a decision from the bench, setting an allowed claim in favor of the underlying Lehman-sponsored RMBS trusts in an aggregate amount of approximately $2.38 billion.[7]

On March 15, 2018, the Court issued an Order Estimating Allowed Claim Pursuant to RMBS Settlement Agreement (the "Estimation Order").[8] The Estimation Order states, among other things, that "the allocation and distribution of the Allowed Claim shall be conducted in accordance with the terms of the RMBS Settlement Agreement" and that the Bankruptcy Court

[6] *See* Bankr. Dkt. No. 55706 (Ex. 2).
[7] *See* Bankr. Dkt. No. 57791 (Ex. 3).
[8] *Id.*

"shall retain jurisdiction with respect to all matters arising from or related to the implementation of this Order." *Id.* (emphasis added).

On April 4, 2018, the Lehman Trustees filed this Article 77 proceeding without advance notice to the Institutional Investors or the Bankruptcy Court.

On April 6, 2018, the Institutional Investors moved in the Bankruptcy Court to enjoin this Article 77 Proceeding, in light of the Bankruptcy Court's retention of exclusive jurisdiction in the 9019 Order and Estimation Order.[9] A transcript of the oral argument on that motion is attached as Exhibit 6.

The Bankruptcy Court declined to enjoin the Article 77 proceeding, but issued an order (the "Injunction Order") stating that "the terms of the RMBS Settlement Agreement shall be strictly enforced, including without limitation Sections 3.06(a)-(c) of the RMBS Settlement Agreement [i.e., the distribution provisions]."[10] Judge Chapman's Injunction Order further stated that in light of the Bankruptcy's Court retention of exclusive jurisdiction in the Settlement Agreement, "the Court respectfully requests of the Supreme Court, New York County (*per* Friedman, J.) that if issues arise during the Article 77 Proceeding regarding the interpretation of the RMBS Settlement Agreement, such issues be referred to this Court for determination."[11]

[9] *See* Ex. 4 (injunction motion) & Ex. 5 (supplemental memorandum of law in support of injunction motion).
[10] *See* Ex. 7 at p. 3 (emphasis added).
[11] *Id.* at p. 2.

I. The Petition Should Be Dismissed and the Trustees Should Reimburse the Trusts for the Costs of the Proceeding.

In the context of equitable trust instructional proceedings, such as those under Article 77,[12] it is well established that courts "will not advise the trustee as to [its] powers where they are clearly fixed by the trust instrument" and that such proceedings are only properly brought "in cases of *real difficulty where there is an honest doubt* after a careful reading of the instrument and the procurement of legal advice from counsel."[13]

The policy behind this rule is simple: "[C]ourts do not hold themselves out to act as lawyers for timid trustees who seek court protection for every move they make or who wish to save the trust the expense of procuring the assistance of a lawyer."[14] Similarly, trustees' expenses in seeking such judicial instructions are not reimbursable from trust assets where there is not "reasonable uncertainty about the powers or duties of the trustee or about the relevant law or proper interpretation of the trust."[15]

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[12] Bogert, THE LAW OF TRUSTS AND TRUSTEES, § 559 (Ex. 8); *Matter of Lipin*, 9 Misc.2d 708, 710 (Sup. Ct. N.Y. Cnty. 1957), *aff'd* 6 A.D.2d 1011 (1st Dep't 1958) (Ex. 9) (CPLR Article 79, the predecessor to CPLR Article 77, is equitable in nature).

[13] Bogert, THE LAW OF TRUSTS AND TRUSTEES, § 559 (emphasis added) (Ex. 8); *see also* RESTATEMENT (THIRD OF TRUSTS) § 71, cmt. d (Ex. 10) ("Because of concern regarding burdens on the judicial system and unwarranted costs and delays in trust administration, a trustee . . . normally is not entitled to instructions with respect to the administration of a trust unless there is some reasonable doubt about the extent of the trustee's powers or duties or about proper interpretation of the trust provisions."); *see also Marvin F. Hall Tr. v. Hall*, 810 S.W.2d 710, 715 (Mo. Ct. App. 1991) (Ex. 11) ("there are limits on a court's authority to advise and instruct trustees, the prime limitation being that such instructions should be given only when the trustees have reasonable doubt about their duties").

[14] Bogert, THE LAW OF TRUSTS AND TRUSTEES, § 559 (Ex. 8); *see also City Bank Farmer's Trust Co. v Smith*, 263 N.Y. 292, 295-296 (1934) (Ex. 12) (explaining that judicial instructions "are not to provide a substitute for the usual legal advisers, but to protect trustees in the class of cases where the advice of competent lawyers is not sufficient protection, because of the doubtful meaning of the trust instrument, or because of uncertainty as to the proper application of the law to the facts of the case").

[15] RESTATEMENT (THIRD OF TRUSTS) § 71, cmt. e (Ex. 10) ("Expenses incurred by a trustee in applying to the court for instructions are payable from the trust estate unless the application for instructions was plainly unwarranted, there being no reasonable uncertainty about the powers or duties of the trustee or about the relevant law or proper interpretation of the trust. In such a case it is normally improper for a trustee to incur the expenses of making the application.") (citing *Ferguson v. Rippel*, 23 N.J. Sup. 132, 92 A.2d 647 (1952)

Here, the Trustees' duties are clearly fixed by the trust instruments and settlement agreement, so judicial instructions are unnecessary and inappropriate. There is not "real difficulty" or "honest doubt" concerning the issues raised in the Petition. As set out more fully below, the Settlement Agreement requires Pay First, and the trust instruments do not require otherwise. The trust instruments also provide that the Overcollateralization Amount must be measured in a way that "*gives effect to*" the write-down and write-up associated with the distribution of subsequent recoveries—which precludes the creation of temporary overcollateralization. Further, the Trustees do not need judicial assistance in deciding whether to enforce the Zero Distribution Provision, which the Trustees concede "appears to preclude" distributions to Zero Balance Classes.[16]

Although several investors have appeared and made opportunistic arguments that would benefit the certificates they hold, the arguments they advance are without merit and do not raise reasonable questions about how the Trustees must proceed here. Accordingly, the Court should dismiss the Petition and reject the Trustees' attempt to use the Court as a safety net.

II. If the Court Declines to Dismiss the Petition, the Settlement Should Be Distributed on a Pay First Basis, Without Temporary Overcollateralization.

A. The Settlement Agreement Requires Pay First.

The Petition alleges the Trustees are uncertain whether the settlement funds should be distributed before the certificate balances are written up (the Pay First method), or whether the settlement funds should be distributed after the certificate balances are written up (the Write-Up First method).[17] There is no uncertainty: Like each of the five global RMBS settlements negotiated

(Ex. 13) (trustee not entitled to costs where meaning of trust provision was clear, despite having brought the instruction proceeding in good faith); *see also Baxter's Ex'rs v. Baxter*, 43 N.J.Eq. 82, 10 A. 815 (Ex. 14); Bogert, THE LAW OF TRUSTS AND TRUSTEES, § 559 (Ex. 8) (award of costs rests in discretion of the court, which will consider whether the application was "reasonable and of benefit to the trust estate").

[16] *See* Petition ¶ 57.

[17] *See* Petition at ¶¶ 34 - 36.

by the Institutional Investors and accepted by the Trustees, Paragraphs 3.06(a) and 3.06(b) of the Settlement Agreement requires the Pay First method.

Paragraph 3.06(a) of the Settlement Agreement requires the Trustees to distribute the Settlement Payment "as though" it was a "subsequent recovery available for distribution." The next paragraph, Paragraph 3.06(b), provides for the certificate write-up, and requires the Trustees to write-up certificates in the reverse order of previously allocated realized losses. There is no doubt the Settlement Agreement requires Pay First because the last sentence of Paragraph 3.06(b) (i.e., the "write-up" paragraph) states plainly 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 Plan Payments on the Net Allowed Claim provided for in Subsection 3.06(a)***.

This final sentence confirms that the Settlement Agreement prohibits the certificate write-up contemplated in Paragraph 3.06(b) from "affect[ing]" the distribution of the Settlement Payment provided for in Paragraph 3.06(a). Inexplicably, the Trustees *completely ignore* this final sentence of Paragraph 3.06(b) in their Petition, notwithstanding that it clearly speaks to the very issue that is purportedly the basis for this unnecessary proceeding.

The Write-Up First Method would, by definition, "affect the distribution" of the Settlement Payment provided in Paragraph 3.06(a) because it would increase certificate principal balances ***before*** the settlement distribution is made. If the certificate balances were altered ***before*** the Settlement Payment were distributed, that would necessarily shift which certificates receive the Settlement Payment—*i.e.*, the write-up would impermissibly "affect the distribution" of the Settlement Payment provided for in Paragraph 3.06(a). The Settlement Agreement, therefore, requires Pay First.

Importantly, Judge Chapman of the United States Bankruptcy Court, who has retained jurisdiction over the interpretation and enforcement of the Settlement Agreement, highlighted this final sentence of Paragraph 3.06(b) at the oral argument on the Institutional Investors' motion to enjoin this Article 77 proceeding:

> So, Mr. Siegel [counsel for Trustees], 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?** . . . . **That's obvious.**[18]

As noted above, Judge Chapman also stated in the Injunction Order that "the Court respectfully requests of the Supreme Court, New York County (*per* Friedman, J.) that if issues arise during the Article 77 Proceeding regarding the interpretation of the RMBS Settlement Agreement, such issues be referred to this Court for determination."[19] Accordingly, the Institutional Investors and the AIG Parties respectfully request that, if this Court concludes that there is a question as to whether the Settlement Agreement requires Pay First, the Court refer that question to the Bankruptcy Court.

B. The Governing Agreements are Silent as to the Order of Operations.

Paragraph 3.06(c) of the Settlement Agreement provides a mechanism for the distribution methodology in the Governing Agreements to control over that in the Settlement Agreement to the extent that they conflict.[20] In the Petition, however, the Trustees do not cite a single provision of

[18] Ex. 6 at 45:24 - 46:19.

[19] Ex. 7 at p. 2.

[20] Paragraph 3.06(c) states: "Should the party responsible for calculating distributions and/or making distributions to Investors under the terms of the Governing Agreements of a given Trust or a court determine that the payment procedure described in Sections 3.06(a) and 3.06(b) may not conform to the terms of the Governing Agreement for a particular Accepting Trust, the distribution described above shall be modified to distribute that Trust's Plan Payments as a payment of principal under the Governing Agreement for that Trust, or in such other manner as the party responsible for calculating distributions under the terms of the Governing Agreements of a given Trust or a court should determine is in conformance with the terms of the Governing Agreement for a particular Trust."

any Governing Agreement bearing on whether Pay First or Write Up First should be employed. To the contrary, the Trustees concede that the Governing Agreements "do not clearly specify" the order of operations.[21] They are correct. The Governing Agreements are silent as to the order of operations. Because the Governing Agreements are silent as to the order of operations, there is no conflict between the Settlement Agreement's Pay First method and the terms of the Governing Agreements. Therefore, the Settlement Agreement's Pay First method must control.

C. The Settlement Payment Cannot Create Overcollateralization.

Another alleged issue raised in the Petition is whether, under the Pay First method, the Settlement Payment itself can create temporary overcollateralization. It cannot.

Many of the trusts included in the Petition have an overcollateralization structure, meaning that when the trusts were originally issued, the trusts' assets (*i.e.*, the mortgage loans) exceeded the trusts' liabilities (*i.e.*, the trusts' certificates). Like subordination, which protects senior certificates at the expense of more junior ones, overcollateralization is a form of "credit enhancement" meant to absorb the first losses experienced by the trusts and to protect the certificates from the risk of loss. Because of the significant collateral losses the trusts have suffered since their original issuance, however, the original overcollateralization in the trusts has been substantially or completely exhausted, leaving the trusts generally *not* overcollateralized.

The Petition suggests that the Pay First Method may cause the trusts to "appear to be temporarily overcollateralized" because the trusts' liabilities (*i.e.*, the certificate balances) would be reduced by the amount of the Settlement Payment, but the trusts' assets (*i.e.*, the mortgages) would remain unchanged.[22] In other words, the Petition suggests that the Settlement Payment

[21] Petition ¶ 36.

[22] *See* Petition ¶¶ 37 - 48.

itself can create overcollateralization. If, as the Trustees suggest, the temporary overcollateralization allegedly created by the Settlement Payment exceeds a threshold typically defined as an overcollateralization "target," then such excess would be distributed under the trusts' "excess cashflow" waterfall, which may result in much of the Settlement Payment flowing to entirely different certificates than if the Settlement Payment was not deemed to have created such transitory overcollateralization.[23]

The Trustees' alleged concern is unfounded. As the Trustees note, the trusts are not overcollateralized before the Settlement Payment is made, and they will not be overcollateralized after the Settlement Payment is made. Rather, the trustees suggest that the trusts may "temporarily appear" overcollateralized at some point during the distribution itself, even though the balances of the underlying mortgages never exceed the balances of the outstanding certificates.

The definition of overcollateralization in the Governing Agreements, however, does not allow the calculation of overcollateralization *during* a distribution. Rather, as detailed below, it requires the Trustees to *look through* the distribution and "*give effect to*" not only the reduction of certificate balances associated with the receipt of subsequent recoveries, but also an equal and offsetting increase in certificate balances required upon the receipt of subsequent recoveries. The level of overcollateralization in the trusts would remain unchanged by the Settlement Payment, because overcollateralization cannot be assessed at some fleeting moment during the distribution itself. Put simply, the Settlement Payment cannot create overcollateralization.

[23] *Id*.

(i) Overcollateralization is Calculated After Giving Effect to Both the Write-Down and the Equivalent Write-Up of the Certificate Balances.

Each of the Governing Agreements requires the Trustees to calculate overcollateralization after "*giving effect to*" the ***full*** distribution of principal proceeds to be distributed in a given distribution—which involves both the paydown of certificate balances by the amount of the subsequent recoveries, and an equal, completely offsetting increase of certificate balances associated with the receipt of subsequent recoveries. Thus, "temporary" overcollateralization cannot be created by the Settlement Payment.

The Institutional Investors and the AIG Parties have attached a compendium of trust language with respect to the trusts with an overcollateralization structure. Trust-by-trust excerpts from each such trust are attached as Exhibit 15. As shown in Exhibit 15, "Overcollateralization Amount" is generally defined in the Governing Agreements as a trust's aggregate collateral balance, minus the trust's aggregate certificate balances after "*giving effect to*" the distribution. A representative definition, from LXS 2005-10, is as follows:

> **Pool 1 Overcollateralization Amount**: With respect to any Distribution Date, the amount, if any, by which (x) the Pool Balance of Pool 1 for such Distribution Date determined as of the last day of the related Collection Period exceeds (y) the aggregate Class Principal Amount of the Group 1 Certificates, **in each case after giving effect to distributions on such Distribution Date**.

As this definition makes clear, the Overcollateralization Amount is defined as the excess of the trust's assets (*i.e.*, the balance of the outstanding mortgage loans) over the trust's liabilities (*i.e.*, the certificate balances). Importantly, however, the definition requires that this excess be calculated "after giving effect to distributions on such Distribution Date." Thus, in calculating the Overcollateralization Amount, the trustees must "giv[e] effect to" both steps associated with the distribution of subsequent recoveries like the Settlement Payment.

The ***first*** step the Trustees must "giv[e] effect to" is the distribution of settlement funds that, like the payment of any other principal proceeds, results in a reduction of certificate balances.

The ***second*** step the Trustees must "giv[e] effect to" is the equal and offsetting write-up of certificate balances associated with the receipt of subsequent recoveries. As explained in Section II(A)-(B), above, Paragraph 3.06(b) of the Settlement Agreement provides for such a write-up. The Governing Agreements provide for them, too.[24]

Accordingly, in employing the Pay First method for trusts with an overcollateralization structure, the Trustees should be instructed to assess overcollateralization only after "giving effect to" both the write-down and write-up of certificate balances by the amount of the Settlement Payment—and not by taking into account ***only*** the write-down. If overcollateralization is correctly calculated in this way, the Settlement Payment will not, and cannot, create overcollateralization.

(ii) Temporary Overcollateralization is an Absurd, Commercially Unreasonable Result.

"[A] contract should not be interpreted to produce a result that is absurd, commercially unreasonable or contrary to the reasonable expectations of the parties" *Luver Plumbing and Heating, Inc. v Mo's Plumbing and Heating*, 144 A.D.3d 587, 588 (1st Dep't 2016). "The ultimate aim" of these interpretive rules, of course, "is to realize the parties' reasonable expectations

[24] *See, e.g.*, Definition of Class Principal Amount in LXS 2005-10 ("**[O]n each Distribution Date on which a Subsequent Recovery is distributed, the Certificate Principal Amount of any Group 1 Certificates whose Certificate Principal Amount has previously been reduced** by application of Pool 1 Applied Loss Amounts or the Certificate Principal Amount of any Group 2 Certificates whose Certificate Principal Amount has previously been reduced by application of Pool 2 Applied Loss Amounts, as applicable, **will be increased, in order of seniority, by an amount** (to be applied pro rata to all Certificates of such Class) **equal to the lesser of** (1) any Deferred Amount for each such Class immediately prior to such date and (2) in the case of holders of the Group 1 Certificates and the Group 2 Certificates, **the total amount of any Subsequent Recovery from the related Mortgage Pool distributed on such Distribution Date after application** (for this purpose) to any more senior Classes of such Certificates; provided, further, that to the extent that any Applied Loss Amount was reimbursed under the Certificate Insurance Policy, any Subsequent Recovery otherwise payable on the Insured Certificates shall instead be payable to the Certificate Insurer.") (emphasis added).

through a practical interpretation of the contract language." *Gessin Elec. Contractors, Inc. v. 95 Wall Assocs., LLC*, 74 A.D.3d 516, 518 (1st Dep't 2010).

The trusts have experienced massive losses since the financial crisis, and their initial overcollateralization, meant to absorb the first losses suffered by the trusts, was generally long ago depleted. The trusts have since suffered billions of dollars of realized losses, and the basic allocation methodology in the settlement distributes the Settlement Payment across trusts according to their past and future losses. The Settlement Payments, while substantial, will not come close to reimbursing the trusts for the full amount of their prior and future losses. In that context, with respect to trusts that are—by the Trustees' own admission—*not* overcollateralized, the Trustees' allegation that the Settlement Payment could lead to the creation of "temporary" overcollateralization is an absurd result that is neither a "reasonable" nor a "practical" interpretation of the Governing Agreements. *Gessin*, 74 A.D.3d at 518.

III. The Trustees Should Enforce the Zero Distribution Provision.

The Trustees ask the Court whether to "apply" the Zero Distribution Provision. They should. The Trustees do not allege that this provision is ambiguous or conflicts in any way with the Settlement Agreement. Moreover, the Settlement Agreement is silent as to the treatment of Zero Balance Classes. The Trustees should therefore "apply" this unambiguous provision of the Governing Agreements they have identified, and not permit the write-up of Zero Balance Classes where that is prohibited by the Governing Agreements.

CONCLUSION

In sum, the Court should dismiss the Petition, and order the Trustees to reimburse the trusts for the costs of the proceeding. In the alternative, the Court should direct the Trustees to distribute

the settlement on a Pay First basis, without temporary overcollateralization. The Trustees should also be directed to enforce the Zero Distribution Provisions of the Governing Agreements.

Dated: New York, New York
October 19, 2018

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