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.	**REPLY BRIEF OF THE INSTITUTIONAL INVESTORS AND AIG CONCERNING THE PETITION**

TABLE OF CONTENTS

SUMMARY OF ARGUMENT **1**

I. The Trustees Do Not Dispute the Controlling Legal Standard.. 3

II. Even If There Were *Bona Fide* Legal Disputes Concerning the Distribution Methodologies, Which There Are Not, the Trustees Failed to Determine Whether Those Disputes Actually Mattered to Investors' Recoveries. 6

III. The Trustees' Presentation of Justice Scarpulla's Countrywide Decision as to Fourteen Principal Cap Trusts is Misleading.. 7

CONCLUSION **9**

Pursuant to the September 5, 2018 Stipulation Regarding Merits Briefing Schedule and Trustee Substitutions (Dkt. No. 132), the Institutional Investors and AIG Parties submit this Reply Brief addressing the issues raised in the Petition concerning the distribution of approximately $60 million in settlement proceeds to 17 remaining disputed trusts.[1]

SUMMARY OF ARGUMENT

As noted in the Institutional Investors' and AIG Parties' Response Brief, the key substantive disputes with respect to the 17 remaining disputed trusts are with Nover, who argues for Write Up First and the non-enforcement of the Zero Distribution Provision.[2] Nover's Opening Brief simply referred back to the JPMorgan briefing.[3] For just two of those 17 trusts, Poetic Holdings VII also submitted an Opening Brief joining in certain arguments of the Olifant Funds for Write Up First.[4] Neither Nover nor Poetic Holdings VII, however, submitted Response Briefs. The Institutional Investors and AIG Parties therefore stand on the arguments made in their Opening and Response Briefs with respect to the merits of the various distribution methodologies.[5]

[1] Those 17 trusts are: LMT 2005-3; LMT 2006-1; LMT 2007-2; LMT 2007-4; LXS 2005-10; LXS 2005-4; LXS 2005-8; LXS 2006-10N; LXS 2006-16N; LXS 2006-7; LXS 2007-18N; SAIL 2005-1; SAIL 2005-11; SAIL 2005-7; SARM 2006-8; SASCO 2006-BC4; and SASCO 2006-BC6. The Institutional Investors and AIG Parties reserve the right to submit further merits briefing as to the 13 trusts identified in Footnote 2 to their Response Brief, for which undisputed distributions are anticipated. References to Exhibits are to the Exhibits to the Sheeren Affidavit, filed with the Opening Brief of the Institutional Investors and AIG Parties (Dkt. No. 152).

[2] The trusts for which the Olifant Funds and Ambac appeared are no longer in dispute. A proposed order for the Olifant Funds' trusts was submitted at Docket No. 186, and a proposed order for the Ambac trusts will be submitted in short order.

[3] *See* Dkt. No. 150.

[4] *See* Poetic Holdings VII Opening Brief (Dkt. No. 174) (submitted for LMT 2005-3 and LXS 2005-8).

[5] Tilden Park submitted a Response Brief as well (Dkt. No. 175), but—like the Institutional Investors and AIG Parties—Tilden Park argues for Pay First.

The only other substantive Response Brief was submitted by Petitioners (Dkt. No. 180), who go to great lengths to justify their filing of this unnecessary Article 77 proceeding and oppose its dismissal. The Trustees' arguments are meritless. For the reasons set forth in the Institutional Investors and AIG Parties' previous briefing, the arguments in support of Write Up First are baseless. Nor is there any conceivable defense to the Trustees' request that the Court instruct them to "apply" the Zero Distribution Provision—an unambiguous term of their contract.

Separately, as described below, it has become apparent that the Trustees filed this Article 77 without analyzing whether the different methodologies described in the Petition would ***even make a difference*** to investors' recoveries. Tellingly, not a single investor appeared in this Article 77 proceeding to argue for temporary overcollateralization. To the contrary, the vast majority of the settlement funds for the Trusts held by the Institutional Investors and/or AIG parties have now been distributed by agreement, or are on the verge of being distributed by agreement, on a Pay First basis, without overcollateralization.

Simply put, the Trustees should not have filed this Article 77. It has only served to delay the distribution of investors' funds for many months, depriving them of the time value of money. Making matters worse, the Trustees have deducted untold millions of dollars from the trusts to pay for the costs of this proceeding, including legal and expert fees. Investors pay for that, too. That delay, and those costs, have materially and unnecessarily harmed investors.

Further, as the transcript of the April 19, 2018 hearing on the Institutional Investors' motion to enjoin this Article 77 Proceeding demonstrates, the Trustees' decision to file this unnecessary case followed years of difficulties before the Bankruptcy Court. Judge Chapman made her views concerning the Trustees' conduct known on the record in that hearing.[6]

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[6] *See* Dkt. No. 158.

For these reasons, the Court should dismiss this Article 77 proceeding for the remaining 17 disputed trusts, and the Trustees should be directed to reimburse the trusts for the costs of this proceeding for those 17 trusts.

ARGUMENT

In their Response Brief, the Trustees strain to find "facially reasonable" arguments in favor of Write Up First, temporary overcollateralization and the non-enforcement of the Zero Distribution Provision. For the reasons set out in the Institutional Investors and AIG Parties' Opening and Response Briefs, however, the arguments for Write Up First, temporary overcollateralization, and the non-enforcement of the Zero Distribution provision are not facially reasonable – they are meritless. Those issues have already been exhaustively briefed. The Institutional Investors and AIG Parties are compelled, however, to make three points concerning the Trustees' Response Brief.

I. The Trustees Do Not Dispute the Controlling Legal Standard.

First, the Trustees do not dispute the Institutional Investors' and AIG Parties' presentation of the legal standard the Trustees must meet to properly seek judicial instructions in an Article 77.

As set out in Section I of the Opening Brief of the Institutional Investors' and AIG Parties, courts "will not advise [a] trustee as to [its] powers where they are clearly fixed by the trust instrument," and equitable trust instructional 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."[7] The policy behind this rule is simple: "***[C]ourts do***

[7] Bogert, THE LAW OF TRUSTS AND TRUSTEES, § 559 (emphasis added) (Ex. 8); *see also* RESTATEMENT (THIRD OF TRUSTS) § 71, cmt. e (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

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."[8]

Instead of rebutting that controlling law, the Trustees retreat to a comment in the Restatement that contemplates trustees might have "reasonable doubt" justifying judicial instructions if there is legitimate concern that a trust beneficiary's "insistence upon an ***unreasonable position*** might, without instruction on the matter, ***lead to significantly costlier and disruptive litigation***."[9]

The Trustees' retreat to this defense of this Article 77 proceeding is telling, though still insufficient. It is telling because it implicitly recognizes that the Trustees have sought instructions on issues for which there are not reasonable disputes. It is still insufficient because, unlike in previous Article 77 petitions, the Trustees have failed to allege here:

(i) that any investor ever contacted the Trustees, before the Trustees filed this proceeding, presenting conflicting views with respect to the distribution methodology or threatening the Trustees with any liability in that regard;[10]

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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").

[8] 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").

[9] Trustee Response Brief at 6 (citing RESTATEMENT (THIRD OF TRUSTS) § 71, cmt. d).

[10] *Compare* JPMorgan Article 77 Petition ¶ 67 (noting that "***Petitioners have heard from many Certificateholders*** that have already provided competing and conflicting views") (Dkt. No. 1, Index No. 657387/2017) (emphasis added) & Countrywide Article 77 Petition ¶ 41 ("The Trustee

(ii) that the Trustees analyzed the distribution waterfalls and concluded that the different distribution methodologies described in the Petition ***make any difference*** to investors' recoveries (*see* Section II, below);

(iii) that the costs to the Trusts of defending a suit brought by an investor asserting unreasonable positions would be "***significantly costlier and more disruptive***" to the Trusts than this Proceeding has been, considering that this Article 77 has:

a. unnecessarily held up over $800 million in settlement proceeds for many months, depriving investors of the time value of money (the rate of return on the RMBS trusts' certificates substantially exceeding the government money market funds in which the settlement funds are invested in escrow);

b. unnecessarily caused the Trusts, and therefore investors, to expend untold millions of dollars on legal fees associated with this case, without any disclosure of the amount of those fees; and

c. unnecessarily caused the Trusts, and therefore investors, to pay the Dean of the Columbia Business School and former Chairman of the President's Council of Economic Advisers ***$1,500 an hour*** to submit an expert report ***concluding that government money market funds are safe investments***;[11]

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has received conflicting investor correspondence on this point, urging the Trustee to follow different orders of operation in light of, or notwithstanding, the overcollateralization issue.") (Dkt. No. 1, Index No. 150973/2016) (emphasis added) *with* Lehman Article 77 Petition ¶ 61 ("Certificateholders and other interested parties -- the direct economic beneficiaries of the Settlement Payments -- ***may have competing views*** concerning how the issues should be resolved . . .") (emphasis added).

[11] *See* Dkt. No. 12 at 2.

In short, Article 77 has its limits. Because the Trustees have failed to meet the standards for an Article 77, they should reimburse the Trusts for the costs of the proceeding, and the case should be dismissed for the remaining 17 disputed trusts.

II. Even If There Were *Bona Fide* Legal Disputes Concerning the Distribution Methodologies, Which There Are Not, the Trustees Failed to Determine Whether Those Disputes Actually Mattered to Investors' Recoveries.

It has become apparent that ***regardless*** of the merits of the arguments concerning the order of operations, temporary overcollateralization, and the Zero Distribution Provision, the Trustees failed to analyze whether the resolution of those issues one way or another ***would even make a difference*** to investors' recoveries.

For example, the issue of temporary overcollateralization only matters to the extent that the expected settlement proceeds exceed the overcollateralization target amount for a given trust. If the settlement proceeds are less than the overcollateralization target amount, then temporary overcollateralization, even if wrongly recognized, would not impact investors' recoveries. It has become apparent that the Trustees did not do this basic comparison to determine whether temporary overcollateralization would make a single dollar of difference to investors. Tellingly, not a single investor even appeared to argue in favor of temporary overcollateralization. Perhaps investors recognized that the arguments for temporary overcollateralization are not "facially reasonable" – and perhaps they ***also*** recognized that they would not receive a single dollar more in recoveries even if temporary overcollateralization ***were*** recognized.

Similarly, in the vast majority of Trusts, it has become apparent that investors' recoveries would not materially differ between Write Up First and Pay First. It has thus become apparent that the Trustees did not do the basic waterfall analysis to determine whether the order of operations makes a single dollar of difference to investors' recoveries in the Trusts.

Instead of doing the basic work to figure out whether the alleged issues in the Petition ***made a difference*** to investors' recoveries, the Trustees effectively threw up their hands and included nearly every single Trust with significant settlement proceeds in this Article 77. Contrary to the Trustees' suggestion that they were judicious in including only some trusts in this proceeding, it appears that Trusts representing almost 90% of the total settlement funds were intercepted by the Trustees and included in this Article 77.

In any event, substantially all of the settlement proceeds that were placed in escrow for the Trusts held by the Institutional Investors and/or AIG Parties have now been distributed on an undisputed, Pay First basis, without temporary overcollateralization. That fact speaks volumes to whether there were *bona fide* disputes among investors concerning distribution methodologies, and whether this Article 77 was necessary in the first place.

III. The Trustees' Presentation of Justice Scarpulla's Countrywide Decision as to Fourteen Principal Cap Trusts is Misleading.

Third, the Trustees give the misleading impression that Justice Scarpulla's decision concerning Fourteen Principal Cap Trusts in the Countrywide proceeding supports their decision to raise the question of temporary overcollateralization in ***this*** Article 77.

Justice Scarpulla's decision as to those fourteen Principal Cap trusts, however, had nothing to do with the issue of temporary overcollateralization as described in their Lehman Petition**.** The issue for those fourteen Principal Cap Trusts in Countrywide was that the term "Principal Distribution Amount" was mechanically defined as "A" (certificate balances), *minus* "B" (mortgage loan balances) *plus* "C" (overcollateralization target amount).[12] Tilden Park urged the Court to apply this provision literally—which would effectively "cap" the settlement funds

[12] *See* Dkt. No. 193 (Index No. 150973/2016) at p. 11 of 19.

distributed to super-senior certificates in an amount equal to "C" (the overcollateralization target amount), with the excess settlement funds distributed to the junior certificates purchased by Tilden Park.

AIG and two of the Institutional Investors argued that (i) the literal application of the Principal Distribution Amount formula for a large, one-time settlement would be inconsistent with other provisions of the PSAs and their overall purpose, and (2) the Court should make a one-time adjustment to permit the entirety of the settlement to be included in the Principal Distribution Amount.[13] Based on the unique language of those fourteen trusts—language that does not appear in the Lehman trusts—Justice Scarpulla agreed with Tilden's interpretation.[14]

Here, in contrast, the issue of temporary overcollateralization is resolved by the definition of Overcollateralization Amount in the Governing Agreements, the plain meaning of which requires the Trustees to "take into account" both the certificate write-down and write-up associated with the payment of subsequent recoveries. Remarkably, in the Countrywide case, Tilden Park *joined* the Institutional Investors and AIG in entering into an undisputed judgment for 512 trusts that did not have the "cap" in the Principal Distribution Amount. Instead, like the Lehman trusts, those Countrywide trusts defined "Overcollateralization Amount" to account for *both* the write-down and the write-up.[15] Tilden Park ***agreed*** with the Institutional Investors and signed onto a

[13] *See* Tilden Park Answer (Dkt. No. 32) at 15 (noting "cap" in Principal Distribution Amount) & merits brief (Dkt. No. 122) at 11 (same); *see also* the Institutional Investors' and AIG's Answer (Dkt. No. 34) & merits brief (Dkt. No. 96), in Index No. 150973/2016.

[14] It is notable that Justice Scarpulla's interpretation was challenged on appeal, but the parties settled the matter prior to the First Department ruling on the merits of her decision.

[15] *See* Supporting Affidavit to the Institutional Investors' Answer (Dkt. No. 36) in Index No. 150973/2016.

judgment directing the trustee "not [to] measure [the] Overcollateralization Amount during the distribution between the pay down and write up steps described in . . . the Verified Petition."[16]

In short, the dispute over the fourteen Principal Cap trusts in Countrywide is completely irrelevant to the issues raised in the Lehman Petition concerning temporary overcollateralization, and the Trustees' attempt to conflate those issues is misleading.

CONCLUSION

For these reasons, the Court should dismiss this Article 77 proceeding for the remaining 17 disputed trusts, and the Trustees should be ordered to reimburse the trusts for the costs of this proceeding for those 17 trusts.

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[16] Dkt. No. 77 at p. 8 of 14, Index No. 150973/2016.

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