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

In the matter of the application of U.S. BANK NATIONAL ASSOCIATION (as Trustee, Securities Administrator, Paying Agent, and/or Calculation Agent under various Pooling and Servicing Agreements), Petitioner, for judicial instructions under CPLR Article 77.	Index No. 656028/2021 Hon. Andrew S. Borrok

OPENING MERITS BRIEF OF POETIC HOLDINGS 8 LP, POETIC HOLDINGS IX LP, AND POETIC HOLDINGS VII LLC

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INTRODUCTION

The Petitioner seeks instruction on the application of contract terms to a previously uncontemplated situation: loan repayments made after the Certificate Principal Balances of all primary classes has been reduced to zero. The contract terms of the governing agreements, however, are clear and unambiguous and must be enforced according to their plain language—nothing in them suggests that this situation should be treated any differently from any other distribution. A straightforward reading of the governing agreements reveals that (1) payments made after a Certificate Principal Balance has been reduced to zero must be distributed under the Excess Cashflow waterfall, and (2) the retired class provision does not prevent the distribution of these "post-zero balance collections."

The governing agreements provide three different mechanisms—called "waterfalls"—for distributing income to the trusts' investors. The Petitioner asks the Court for guidance as to which waterfall applies to the distribution of post-zero balance collections. The principal and interest waterfalls, by their own terms, do not apply. The only possible waterfall that could apply for the distribution of post-zero balance collections is the Excess Cash waterfall.

Relatedly, the Petitioner asks the Court to provide instruction on whether the retired class provision prevents the distribution of post-zero balance collections. This issue is settled law. Even if a Certificate Principal Balance has been reduced to zero, the certificate is not "retired" as long as it has accrued unreimbursed losses or shortfalls. The Appellate Division already held that "zero-balance certificates [that] have neither been fully repaid nor withdrawn from the market pursuant to the procedures set forth in the relevant governing documents" are not "retired." *In re Wells Fargo Bank et al.*, No. 2020-02716, Opinion at 8 (1st Dep't, Aug. 19, 2021) (Dkt. No. 111) ("*JPM II* Appellate Opinion"). Because these certificates have not been retired, the retired class provision does not prevent distribution of post-zero balance collections.

The Court should also instruct the Petitioner to write up the primary classes' Certificate Principal Balances when deferred principal is collected. The Certificate Principal Balances were reduced pursuant to accounting guidelines from the U.S. Department of Treasury—not as the result of an actual loss. It is only reasonable that such so-called "losses" be reversed when it becomes clear that those balances are paid.

BACKGROUND

A. Basics of the trusts.

Poetic Holdings 8 LP, Poetic Holdings IX LP, and Poetic Holdings VII LLC (together, "Poetic Holdings") own certificates in several of the residential mortgage-back securitization (RMBS) trusts as to which the Petitioner seeks instruction (together the "Subject Trusts").[1] (*See* Poetic Am. Answer to First Am. Pet. ¶¶ 1–3 (Dkt. No. 102).)

As investors in the Subject Trusts, Poetic Holdings owns certificates which are secured by the proceeds from the mortgage loans and other assets. (*See* First Am. Pet. ¶ 41 (Dkt. No. 33).) The certificates are divided broadly into groups: Class A, Class M, and Class B are the primary classes and Class C are the subordinate classes. (*Id.* ¶ 42.) Principal and interest payments are distributed to certificateholders every month. (*Id.* ¶ 44.) These distributions are

[1] Poetic Holdings 8 LP holds ownership interests in the following Subject Trusts: BSABS 2005-EC1, BSABS 2007-AQ1, BSABS 2007-HE3, and SACO I 2006-5. Poetic Holdings IX LP holds ownership interests in the following Subject Trusts: BSABS 2004-FR1, BSABS 2004-HE5, BSABS 2005-AQ2, BSABS 2005-EC1, BSABS 2005-HE8, BSABS 2005-HE10, BSABS 2006-HE1, BSABS 2006-HE10, BSABS 2007-AQ1, BSABS 2007-FS1, BSABS 2007-HE3, BSMFT 2006-SL2, SACO I 2006-4, and SACO I 2006-7. Poetic Holdings VII LLC holds ownership interests in the following Subject Trusts: BSABS 2005-HE10, BSABS 2005-HE3, BSABS 2005-HE7, BSABS 2005-HE8, BSABS 2006-HE1, SACO I 2005-9, and SACO I 2005-WM2.

allocated to each class of certificate according to an order of priorities among the classes set out as "waterfall" provisions in the PSAs.[2] (*Id.* ¶ 52; PSA § 5.04(a).)

Generally speaking, distributions flow down the waterfall in order of seniority: primary classes are entitled to principal distributions before subordinate classes. Likewise, realized losses on mortgage loans are applied to the Certificate Principal Balances of junior classes first, before traveling 'up' the waterfall. (*See generally* PSA § 5.04(a).) There are three distinct waterfall provisions in the governing agreements: (i) the "interest" waterfall, (ii) the "principal" waterfall, and (iii) the "Excess Cashflow" waterfall. (First Am. Pet. ¶ 52; PSA § 5.04(a)(1).) Under the principal and interest waterfalls, funds are distributed to the primary classes in amounts calculated based on the Certificate Principal Balance of each primary class. (*See* First Am. Pet. ¶¶ 52–62; PSA § 5.04(a)(1).) Under the Excess Cashflow waterfall, funds are distributed in a priority position to the primary classes to reimburse them for realized losses and interest shortfalls, and any remaining funds are distributed to the subordinate classes. (*See* First Am. Pet. ¶¶ 52–62; PSA § 5.04(a)(1).)

B. Post-zero balance collections.

The governing agreements for the Subject Trusts provide that the primary classes' Certificate Principal Balances are reduced or "written down" in two ways. First, a Certificate Principal Balance is reduced when the primary class receives a distribution of principal. (PSA § 1.01 (definition of Certificate Principal Balance).) Second, a Certificate Principal Balance is reduced when the primary class is allocated realized losses. (*Id.*) Because of extensive losses on

[2] "PSA" refers to the Pooling and Servicing Agreement for the SACO I 2006-4 trust, which is attached to the First Amended Petition as Exhibit C (Dkt. No. 36). Poetic Holdings cites to this PSA because its language is illustrative of and not materially different than the language of the PSAs governing all the Subject Trusts in which Poetic Holdings owns certificates.

the mortgage loans, exacerbated in part by the 2008 financial crisis, the primary classes have incurred substantial realized losses which, in turn, have reduced those classes' Certificate Principal Balances—in some trusts to zero.

But the trust often continues to receive loan payments, even after the Certificate Principal Balance of all primary classes has been reduced to zero. These "post-zero balance collections" are not categorically addressed in the governing agreements. (First Am. Pet. ¶ 10.) The Petitioner seeks judicial instruction on how these collections should be distributed.

The governing agreements also contain a provision upon which the trustee seeks instruction: the "retired class provision." This provision states:

> In addition, notwithstanding the foregoing, on any Distribution Date after the Distribution Date on which the Certificate Principal Balance of a Class of Class A, Class M or Class B Certificates has been reduced to zero, that Class of Certificates will be retired and will no longer be entitled to distributions, including distributions in respect of Prepayment Interest Shortfalls or Basis Risk Shortfall Carry Forward Amounts.

(PSA § 5.04(a).) The Petitioner seeks judicial instruction as to how the retired class provision should be applied, if at all.

C. Deferred principal collections.

In the wake of the 2008 financial crisis, servicers for the mortgage loans in the Subject Trusts agreed to modifications that allowed borrowers to defer their scheduled principal payments. The U.S. Department of Treasury instituted the Home Affordable Modification Program ("HAMP") in order "to refinance mortgages . . . and thereby allow homeowners to avoid foreclosure"; it was designed for "homeowners who were in default or would likely soon be in default on their mortgage payments." *See* *Wigod v. Wells Fargo Bank, N.A.*, 673 F.3d 547, 556 (7th Cir. 2012). As an accounting matter and as a result of HAMP guidance—not because of anything contained in the governing agreements—servicers report these deferred principal

amounts as losses on the mortgage loans to account for the risk that borrowers may not pay back the deferred principal amounts. (*See* First Am. Pet. ¶¶ 13, 73.) The servicers' treatment of deferred principal as loan-level losses resulted in realized losses to the primary classes. (*Id.* ¶ 13.) When a realized loss is applied, the Petitioner reduces, or "writes down," the primary classes' Certificate Principal Balance.

Many borrowers, however, have made payments on deferred principal. (*Id.* ¶ 14.) Where deferred principal is collected and distributed, the Petitioner's general practice is not to reverse the loss on, or "write up," the primary classes' Certificate Principal Balance. (*Id.* ¶ 17.) But this means that a portion of loan balances reduce Certificate Principal Balances twice—once as a realized loss when the modification occurs and then a second time as a principal payment when that modified balance is paid. Therefore, the primary classes' Certificate Principal Balance have been reduced to zero more quickly, which in turn harms the primary classes' ability to receive future distributions under the principal waterfall. The Petitioner seeks judicial instruction to confirm this practice.

ARGUMENT

I. The governing agreements must be interpreted according to their plain meaning.

As this Court has observed, "It is a well-settled principle of contract interpretation that an agreement has to be interpreted according to its plain meaning." *Telefonica S.A. v. Millicom Int'l Cellular S.A.*, 70 Misc. 3d 1205(A), 135 N.Y.S.3d 810, at *2 (Sup. Ct., N.Y. Cnty. Jan. 5, 2021). Nowhere does this "well-settled principle" apply with more force than in the RMBS setting, where the Court of Appeals has repeatedly held that an RMBS governing agreement "means what it says." *U.S. Bank N.A. v. DLJ Mtge. Cap. Inc.*, 38 N.Y.3d 169, 181 (2022) (quotation omitted) (holding that the plain terms of agreement required loan-specific pre-suit notice to

invoke repurchase obligation and limited "accrued" interest on liquidated loans to interest that accrued up to the time of liquidation).

II. Post-zero balance collections should be distributed under the Excess Cashflow waterfall.

The Court should conclude that the governing agreements require the Petitioner to distribute post-zero balance collections under the Excess Cashflow waterfall. The reason is simple: the Excess Cashflow waterfall is the only possible waterfall that could apply.

The principal waterfall does not apply. The principal waterfall expressly distributes principal payments "based on the respective Certificate Principal Balances . . . until the Certificate Principal Balance thereof is reduced to zero." (PSA § 5.04(a)(2) (emphasis added).) Once Certificate Principal Balances are zero, the principal waterfall no longer applies. It is therefore by definition inapplicable to post-zero balance collections. In order for the principal waterfall to apply here, the Court would need to ignore the limiting clause "*until the Certificate Principal Balance thereof is reduced to zero*." But courts may not, "through their interpretation of a contract, add or excise terms or distort the meaning of any particular words or phrases, thereby creating a new contract under the guise of interpreting the parties' own agreements." *Nomura Home Equity Loan, Inc., Series 2006-FM2, by HSBC Bank USA, Nat'l Ass'n v. Nomura Credit & Cap., Inc.*, 30 N.Y.3d 572, 585 (2017) (sole remedy provision "by its very terms" excludes separate remedy based on violation of "no untrue statement" representation).

The interest waterfall also does not apply. The interest waterfall serves to distribute "Interest Funds." Interest Funds definitionally do not accrue on principal balances of zero. (PSA §§ 1.01 (definition of Interest Funds), 5.04(a)(1).) Therefore, under the plain language of the PSAs, the interest waterfall is also inapplicable to post-zero balance collections. Where the parties set out their agreement in clear, complete terms, their writing should be enforced

according to its plain language. *See* *Matter of Part 60 Put-Back Litig.*, 36 N.Y.3d 342, 351–60 (2020) (plain terms of sole remedy provision show it is not an exculpatory clause, therefore it cannot be avoided by a claim of gross negligence); *ACE Sec. Corp., Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc.*, 25 N.Y.3d 581, 593–97 (2015) (cause of action for breach of representations and warranties accrued on closing date; language did not create ongoing or future obligation).

This leaves a final waterfall: the Excess Cashflow waterfall. The Excess Cashflow waterfall is intended to operate when primary class balances have been reduced to zero and reimburses interest shortfalls or realized losses incurred by the primary classes—which, sensibly, are the amounts owed to but not paid to the primary classes in the other two waterfalls—before distributing remaining residuals to Class C classes. Given that post-zero balance collections must be distributed under one of the three waterfalls expressly provided in the governing agreements, the Excess Cashflow waterfall must apply. It is the only operable waterfall and the only one that makes sense in the full context of the governing agreements. Where, as here, there is only one "sensible reading" of the contract, that reading must apply. *See* *U.S. Bank N.A.*, 38 N.Y.3d at 179; *see also id.* at 177–78 (contracts that are products of "an arm's length transaction between sophisticated parties" are "enforced according to [their] terms"). Accordingly, post-zero balance collections must be distributed under the Excess Cashflow waterfall.

III. Post-zero balance collections are not subject to the retired class provision.

The retired class provision does not apply to post-zero balance collections. This provision has already been interpreted by both the Supreme Court and the Appellate Division in the "*JPM II*" case. (*See* First Am. Pet. ¶¶ 24–25.) In *JPM II*, the trial court held that the retired class provision allows for the primary classes' Certificate Principal Balances to be written up after they are reduced to zero and allows "post-write-up distributions." *See* *In re Wells Fargo Bank et*

al., No. 657387/2017, Decision and Order at 37–39 (Sup. Ct. N.Y. Cnty. Feb. 13, 2020) (Dkt. No. 843) ("*JPM II* Trial Court Order"). This ruling paved the way for settlement funds to be distributed to the primary classes following the application of write-ups.

On appeal, the Appellate Division affirmed and further substantiated the trial court's interpretation of the retired class provision:

> The retired class provisions merely provide that once a certificate has been paid in full and formally retired, it is no longer entitled to receive distributions that it might have otherwise received under the waterfall. The zero-balance certificates here have neither been fully repaid nor withdrawn from the market pursuant to the procedures set forth in the relevant governing agreements; rather, they have outstanding losses and are still actively traded. The provisions make clear that certificates are only considered "retired" when the trustee has undertaken certain affirmative steps to accomplish that end—e.g., paying off the certificates and withdrawing them from circulation; the mere reduction of the certificate balances to zero is insufficient.

JPM II Appellate Opinion at 8 (emphasis added).

The Appellate Division's reasoning applies equally to the monthly payments that are the subject of this Petition. The primary classes may have Certificate Principal Balances of zero, but under the *JPM II* Appellate Opinion they are not "retired" as long as they have accrued unreimbursed losses or shortfalls. As the Appellate Division made clear, "zero-balance certificates [that] have neither been fully repaid nor withdrawn from the market pursuant to the procedures set forth in the relevant governing documents" are not "retired." *Id.*

The Petitioner does not allege or otherwise show that the primary classes' certificates in the Subject Trusts have been "retired" under the procedures in the governing agreements. Nor does the Petitioner distinguish the payments discussed in the First Amended Petition from those discussed in JPM II insofar as allegedly "retired" certificates are concerned. In short, *JPM II* controls, and the Court should conclude that the retired class provision does not prevent distributions of post-zero balance collections to primary classes.

IV. Primary classes should be written up when deferred principal is collected.

Under the PSAs, the Petitioner must write up a primary class's Certificate Principal Balance when there is a Subsequent Recovery against a previously applied realized loss arising from liquidation or final disposition. (PSA § 5.04(b); *see also id.* § 1.01 (Definitions of Certificate Principal Balance, Subsequent Recoveries).) The Petitioner interprets the governing agreements to say that deferred principal collections do not constitute Subsequent Recoveries. (First Am. Pet. ¶ 81.) The Petitioner believes that, because Subsequent Recoveries do not include deferred principal collections, the Petitioner is not required to write up the Certificate Principal Balance when deferred principal collections are distributed. But whether a deferred principal collection amounts to a Subsequent Recovery or not is immaterial.

The Court should instruct the Petitioner that the primary classes' Certificate Principal Balances should be written up upon receipt of deferred principal—regardless of whether or not deferred principal collections are Subsequent Recoveries under the terms of the governing agreements. The losses due to deferred principal were reported in expectation of *potential* future losses, pursuant to HAMP guidance. They are not the *actual* losses contemplated by the governing agreements. As a result, it is only reasonable that they be reversed when it becomes clear that those balances are paid rather than lost. This would be consistent with the Appellate Division's reasoning in *JPM II*, which affirmed that Certificate Principal Balances that have been reduced to zero may be written up. *See* *JPM II* Appellate Opinion at 8.

CONCLUSION

For those reasons, the Court should enter judgment with respect to Poetic Holdings' interests in the Subject Trusts and instruct the Petitioner as follows: (1) distribute post-zero balance collections under the Excess Cashflow waterfall, (2) the retired class provision does not

prevent the distribution of post-zero balance collections, and (3) write up the primary classes' Certificate Principal Balances based on deferred principal collections.

Dated: April 3, 2023

GREENE ESPEL PLLP

s/ Aaron P, Knoll

Aaron P. Knoll, admitted *Pro Hac Vice*
Erin R. Emory, admitted *Pro Hac Vice*
222 S. Ninth Street, Suite 2200
Minneapolis, MN 55402
(612) 373-0830
aknoll@greeneespel.com
eemory@greeneespel.com

and

Gary Greenberg
99 Hudson Street, 5th Floor
New York, NY 10013
(212) 765-5770
gg@ggreenberglaw.com

Attorneys for Poetic Holdings 8 LP, Poetic Holdings IX LP, and Poetic Holdings VII LLC

CERTIFICATION

This memorandum of law contains 2,857 words, including footnotes but not including its cover, table of contents, table of authorities, and signature block, as counted by the Microsoft Word word-processing system on which it was prepared, and therefore complies with the word-count limit set forth in Rule 202.8-b of the Uniform Civil Rules of the Supreme Court and of the County Court, and in Commercial Division Rule 17.