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

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

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INTRODUCTION

This lawsuit concerns loan repayments made after the Certificate Principal Balances of all primary classes have been reduced to zero. Respondents disagree about how such repayments should be handled, and many resort to creative arguments about equity and the drafters' intent. But ultimately, instruction on these issues should be rooted in the plain language and fundamental purpose of the terms of the governing agreements. Under the agreements, payments made after a Certificate Principal Balance has been reduced to zero could be distributed only under the Excess Cashflow waterfall. The Excess Cashflow waterfall makes the most sense in the full context of the agreements—and no other distribution mechanism is available.

Certain respondents argue that the Excess Cashflow waterfall is unavailable as a mechanism to distribute post-zero balance collections because the Excess Cashflow waterfall acts to distribute excess funds generated by overcollateralization. That argument is misplaced. Overcollateralization was designed to protect the investments of the primary classes; once the primary classes' Certificate Principal Balances are zeroed, the concept of overcollateralization is no longer applicable. Instead, once the primary classes' Certificate Principal Balances are reduced to zero, *all* loan proceeds flow through the Excess Cashflow waterfall. Overcollateralization is no barrier to the appropriate disposition of these funds.

Similarly, certain respondents argue that the so-called 'Retired Class Provision' prohibits distributions of post-zero balance collections. This argument, too, is contrary to the plain language of the governing agreements and not supported by binding caselaw. Simply put, because the certificates at issue have not been retired, the Retired Class Provision does not apply.

Accordingly, the Court should instruct the Petitioner to distribute post-zero balance collections under the Excess Cashflow waterfall, as neither overcollateralization nor the Retired Class Provision prevent this distribution of post-zero balance collections. As to Petitioner's

subsidiary question, the Court should instruct Petitioner to write up the primary classes' Certificate Principal Balances based on deferred principal collections.

ARGUMENT

A. The Court need not look beyond the plain language of the agreements.

A straightforward reading of the governing agreements reveals that, of the three waterfalls available under the governing agreements, the Excess Cashflow waterfall is the only possible waterfall through which post-zero balance collections may be distributed.

The principal waterfall cannot apply because that mechanism only exists as long as the certificates have a principal balance. The governing agreements make it clear that once the primary classes' certificates are reduced to zero, the principal waterfall is no longer operable. (PSA[1] § 5.04(a)(2) (principal payments should be distributed "based on the respective Certificate Principal Balances . . . until the Certificate Principal Balance thereof is reduced to zero.").)[2] Likewise, the interest waterfall also cannot apply. The interest waterfall serves to distribute "Interest Funds," and Interest Funds definitionally do not accrue on principal balances of zero. (PSA §§ 1.01 (definition of Interest Funds), 5.04(a)(1).)

This clear and unambiguous contract language "must be enforced according to the plain meaning of its terms." (*Greenfield v. Philles Records*, 98 NY2d 562, 569 [2002]; *see also Matter of Part 60 Put-Back Litig.*, 36 NY3d 342, 351–60 [2020] (plain terms of sole remedy provision

[1] "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.

[2] Notably, under the governing agreements the amount of principal to be distributed is also tied to the Certificate Principal Balance. PSA § 5.04(a)(2). As a result, the principal waterfall could not operate to distribute post-zero balance collections because there would be no principal to distribute—the distribution amount would, like the Certificate Principal Balance, be zero—and any cashflow would go through the Excess Cashflow waterfall.

show it is not an exculpatory clause, therefore it cannot be avoided by a claim of gross negligence).) Where the contract language is unambiguous, the Court should not look beyond the four corners of the agreement. (*See* *Bank of New York Mellon Tr. Co., N.A. v. Solstice ABS CBO II, Ltd.*, 910 F. Supp. 2d 629, 641–42 [S.D.N.Y. 2012]; *accord.* *Natixis Real Est. Cap. Tr. 2007-HE2 v. Natixis Real Est. Holdings, LLC*, 149 AD3d 127, 133 [1st Dept 2017].) Respondents' arguments about equity or the parties' intent are unavailing.

Because the principal and interest waterfalls do not apply, by definition, the only possible mechanism through which post-zero balance collections can be distributed is the final waterfall: the Excess Cashflow waterfall. And, as discussed below, it also is the only sensible option, given 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. v. DLJ Mortg. Cap., Inc.*, 38 NY3d 169, 179 [2022]; *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").)

B. The overcollateralization mechanism is inapplicable to post-zero balance collections.

Certain respondents argue that the Excess Cashflow waterfall is unavailable as a mechanism to distribute post-zero balance collections because, essentially, the Excess Cashflow waterfall only operates when there is a surplus of funds to go around—in other words, when the trust has been overcollateralized. Such arguments about the "Overcollateralization Amount" are a red herring.

The Governing Agreements provide for an overcollateralization structure. They define the "Overcollateralization Amount" as the difference between the stated principal balances of the mortgage loans in the Subject Trusts and the Certificate Principal Balances of the primary classes. (*See* PSA § 1.01 (Definition of Overcollateralization Amount).) That is, the

"Overcollateralization Amount" is the value of the principal owed on the mortgage loans after the primary classes' certificates have been paid, or otherwise reduced to zero.

The Subject Trusts were structured to ensure that the balance of the Trusts' loans—their collateral—was higher than the balance due to the primary classes. This resulted in overcollateralization: a cushion of funds, above and beyond the amount needed to satisfy interest and principal amounts owed to the primary classes. (*See* Am. Pet. ¶ 6 (Dkt. No. 33).) No party disputes that the Trusts were designed to pay the primary classes' outstanding balances first, until a certain threshold was reached, before distributing the "excess" funds to subordinate certificateholders. (*See* Am. Pet. ¶ 6.) In situations where loans are being repaid and the primary classes' certificates have balances, the Excess Cashflow waterfall serves to distribute only those 'excess' funds—the collections above and beyond the amount needed to pay the primary classes' principal and interest payments.

This changes once the primary classes' balances reach zero. Because the Overcollateralization Amount is the excess of the mortgage loan principal balances over the aggregate principal balance of the primary classes, once the primary classes have a zero principal balance, the Overcollateralization Amount equals the remaining principal balance of the mortgage loans. (Am. Pet. ¶ 98.) That is, after the primary classes' certificates are written down to zero, the governing agreements effectively treat *all* proceeds as excess. That shift is appropriate. Overcollateralization was designed to protect the investments of the primary classes; once the primary classes' certificate balances are zeroed, the concept of 'overcollateralization' is no longer applicable. Instead, under the loan agreements, once the primary classes' certificate principal balances are reduced to zero, *all* loan proceeds flow through the Excess Cashflow waterfall. (*See* PSA § 1.01 (definition of "Class C Distribution Amount").)

The Excess Cashflow waterfall is effectively the waterfall of last resort. It is intended to operate as a catch-all when primary class balances have been reduced to zero—as they have here. Under the plain language of the agreements, any collections after "the Certificate Principal Balances of the Class A, Class M and Class C Certificates have been reduced to zero" should flow through the Excess Cashflow waterfall and be distributed to the subordinate class. (*See id.*)

Regardless of whether the drafters of the governing agreements contemplated post-zero balance collections when they crafted the Excess Cashflow waterfall, the Excess Cashflow waterfall is nevertheless the appropriate mechanism for distributing any post-zero balance collections.

C. The Retired Class Provision is inapplicable to certificates that have not been retired.

Some respondents argue the Retired Class Provision prohibits distributions to primary class certificateholders whose balances have been reduced to zero. This argument ignores the plain language of the governing agreements, which sets out the process by which certificates are "retired." To formally retire a certificate, the Trustee must notify certificateholders that the "final distribution in retirement" is scheduled, and the certificateholders must "[present] and surrender" the certificates at the Corporate Trust Office of the Trustee. (PSA § 10.02.) Until those affirmative steps are taken, the certificates cannot be considered retired, and therefore are not subject to the Retired Class Provision. Those steps have not happened here. Respondents cannot invoke the Retired Class Provision while ignoring the related contractual provisions that describe the retirement process. "It is a cardinal rule of contract construction that a court should 'avoid an interpretation that would leave contractual clauses meaningless.'" (*Natixis*, 149 AD3d at 133.)

Furthermore, this issue was already resolved in the *JPM II* case. (*See* *Matter of Wells Fargo Bank, N.A.*, 198 AD3d 156, 163–64 [1st Dept 2021] ("*JPM II* Appellate Opinion").) The

Appellate Division held that zero-balance certificates that have not been "fully repaid nor withdrawn from the market pursuant to the procedures set forth in the relevant governing agreements"—as is the case here—should not be considered as "retired." (*Id.* at 164.) Instead, "certificates are only considered 'retired' when the trustee has undertaken certain affirmative steps to accomplish that end." (*Id.*) "The mere reduction of the certificate balances to zero is insufficient." (*Id.*)

That is plainly the situation here. Although primary classes may have Certificate Principal Balances of zero, under the *JPM II* Appellate Opinion they are not "retired" as long as they have "outstanding losses." Because the primary classes' certificates have not been "retired" under the process set out in the governing agreements, the Retired Class Provision does not apply.

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

The Amended Petition seeks guidance on a subsidiary issue to general post-zero balance collections: the treatment of borrower payments of deferred principal as the result of servicer modifications. (Am. Pet. ¶ 2.) As to these collections, because of their unique circumstances, the distribution mechanism is different. The parties agree that losses due to deferred principal were reported pursuant to HAMP guidance in expectation of *potential* future losses. They did not reflect *actual* losses, as contemplated by the governing agreements. Indeed, the Petitioner itself acknowledges that its decision to write down certificates to account for deferred principal is based on "common industry practice"—*not* on the language of the contracts. (Am. Pet. ¶ 13. ("It is a common industry practice for servicers to treat such amounts as losses even though most of the Governing Agreements do not expressly call for treating Deferred Principal Amounts as losses.").) It is only reasonable that any such losses be reversed when it becomes clear that those balances are paid. 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.[3] *See JPM II* Appellate Opinion, 198 A.D.3d at 162.

CONCLUSION

Poetic Holdings respectfully requests the Court to enter judgment with respect to the Subject Trusts and instruct the Petitioner to distribute post-zero balance collections under the Excess Cashflow waterfall and write up the primary classes' Certificate Principal Balances based on deferred principal collections.

[3] The *JPM II* Appellate Opinion considered a settlement agreement in which the parties explicitly agreed to treat settlement distributions as "subsequent recoveries." (198 AD3d at 161.) Here, the Petitioner interprets the governing agreements to say that deferred principal collections do not constitute Subsequent Recoveries. (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 for the purposes of this analysis.

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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.