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), Petitioners, for Judicial Instructions under CPLR Article 77.	Index No. 656028/2021 IAS Part 53 (Borrok, J.S.C.)

ELLINGTON MANAGEMENT GROUP L.L.C.'S ANSWER
TO FIRST AMENDED PETITION

I. PRELIMINARY STATEMENT

Respondent Ellington Management Group L.L.C. ("Ellington" or "Respondent"), by and through its undersigned counsel, respectfully submits this Answer and Statement of Positions (collectively, the "Answer") to the First Amended Petition (NYSCEF Doc. No. 33 (the "Petition") filed by U.S. Bank, National Association ("Petitioner" or "Trustee"), as Trustee, Securities Administrator, Paying Agent, and/or Calculation Agent under various Pooling and Servicing Agreements governing the Subject Trusts[1], for judicial instructions under Article 77 of the CPLR.[2]

[1] Unless otherwise noted, capitalized terms used herein shall have the same definitions as those contained in the Petition.

[2] Pursuant to this Court's Order to Show Cause filed January 10, 2022 (NYSCEF Doc. No. 55), Ellington understands that it will have the opportunity to submit further briefing to the Court and

Ellington holds an interest in thirty-eight (38) of the seventy-eight (78) Subject Trusts (hereinafter, the "Ellington Trusts").[3]

Broadly, the Trustee's Petition seeks instruction on three topics: *first*, whether amounts received on mortgage loans, where such amounts were previously deferred or forborne pursuant to loan modifications (referred to in the Petition as "Deferred Principal Collections"), should be applied to increase or "write up" the certificate principal balances of Primary Class certificates in the Subject Trusts; *second*, whether Primary Class certificates that have had their principal balances reduced to zero are eligible to have those balances increased or written up; and *third*, whether collections on the Subject Trusts' mortgage loans that occur after all of the Primary Classes have had their principal balances reduced to zero (referred to in the Petition as "Post-Zero Balance Collections") should be distributed under the principal or Excess Cashflow waterfalls.

For the reasons set forth more fully herein, Ellington requests that this Court enter an order instructing Petitioner to: (1) increase the principal balance of—i.e., "write up"—any Primary Classes that have outstanding Realized Losses, in the reverse order that such Realized Losses were

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enter further evidence into the record, including in support of the positions taken herein, prior to any Final Hearing, and thus has not endeavored to submit all Governing Agreements, Notices, Remittance Reports, or other documentary evidence supporting its positions, in connection with its Answer. In that regard, Ellington proposes that all interested parties coordinate on an efficient and orderly submission of deal documents to the Court with respect to the Subject Trusts, and requests that the Parties have the opportunity to conduct coordinated discovery into these issues in advance of the submission of their merits briefing and appearance at the Final Hearing.

[3] Ellington holds an interest in the following Subject Trusts: BSABS 2003-HE1; BSABS 2004-FR3; BSABS 2004-HE3; BSABS 2004-HE4; BSABS 2004-HE5; BSABS 2004-HE6; BSABS 2004-HE7; BSABS 2004-HE9; BSABS 2004-HE10; BSABS 2004-HE11; BSABS 2005-AQ1; BSABS 2005-AQ2; BSABS 2005-CL1; BSABS 2005-EC1; BSABS 2005-HE1; BSABS 2005-HE2; BSABS 2005-HE4; BSABS 2005-HE5; BSABS 2005-HE6; BSABS 2005-HE7; BSABS 2005-HE8; BSABS 2005-HE10; BSABS 2006-EC1; BSABS 2006-HE10; BSABS 2007-AQ1; BSABS 2007-AQ2; BSABS 2007-FS1; BSABS 2007-HE3; BSABS 2007-HE7; BSMF 2006-SL2; SACO 2005-9; SACO 2005-10 (Group II); SACO 2005-WM2; SACO 2006-10; SACO 2006-4; SACO 2006-5; SACO 2007-2.

applied, upon the receipt of Deferred Principal Collections; (2) apply principal balance increases, or write-ups, to the certificate principal balances of all Primary Classes with outstanding Realized Losses (as of the beginning of the applicable payment period), including any zero-balance Primary Classes, upon the receipt of Subsequent Recoveries or Deferred Principal Collections; and (3) distribute Post-Zero Balance Collections through the Excess Cashflow waterfall.

As to the first question, Deferred Principal Collections are—as Petitioner points out in its Petition (*see* Petition ¶¶ 121-22)—generally not included within a strict reading of the definition of Subsequent Recoveries, as that term only includes amounts "specifically related to a Mortgage Loan that was the subject of a liquidation or final disposition of any REO property . . . that resulted in a Realized Loss." (*See, e.g.*, NYSCEF Doc. No. 35 (SACO 2005-10 Pooling and Servicing Agreement) § 1.01, definition of "Subsequent Recoveries.") However, as Petitioner admits and as the evidence in this proceeding will show, Petitioner and the servicers for the Subject Trusts have historically treated the amounts initially deferred as part of loan modifications (referred to in the Petition as "Deferred Principal Amounts") as "Realized Losses" to reduce the balance of, or "write down," certificates with the lowest payment priority. (Petition ¶¶ 13, 15.) This is despite the fact that "most of the Governing Agreements do not expressly call for treating Deferred Principal Amounts as losses," (*id.* ¶ 13) because those Governing Agreements permit Realized Losses to be recognized only in connection with a Final Recovery Determination[4] or where principal or interest is forgiven (i.e., written off completely and no longer owed, rather than still owing and simply delayed, as with principal or interest forbearance). Namely, Realized Losses are to be applied only when loan amounts are written off and not expected to be recovered, which typically occurs only

[4] A Final Recovery Determination is a determination by the servicer that all amounts expected to be recovered in connection with the mortgage loan have already been recovered.

in connection with a principal forgiveness modification or because the loan has been liquidated with a loss. By their nature, however, Deferred Principal Amounts were not forgiven or written off—they were amounts that were expressly still owed by the borrower and remained part of the loan's balance, but which were not due until some future date.

Having nevertheless elected to treat Deferred Principal Amounts as Realized Losses,[5] Petitioner should be instructed to treat the recovery of those amounts—the Deferred Principal Collections—in the same manner as Subsequent Recoveries, a designation typically reserved for the recovery of amounts previously forgiven or written off.[6] Namely, when Subsequent Recoveries are received on amounts that were previously written off as Realized Losses, the Governing Agreements instruct the Trustee to write up the Primary Classes' principal balances to reverse the write downs that had previously been applied as a result of those Realized Losses.

In other words, Realized Losses and Subsequent Recoveries are two sides of the same coin as it relates to written-off amounts, with the latter intended to reverse the effect of the former when written-off amounts are recovered. Because the servicers and Petitioner elected to treat Deferred Principal Amounts as amounts that were written off and not expected to be received in the future—namely, as Realized Losses—Deferred Principal Collections must be treated as Subsequent Recoveries when such amounts are received, consistent with the SR Approach outlined in the Petition. It would be inherently inequitable and asymmetric to permit Petitioner to ignore the plain

[5] This was purportedly done by the Trustee in response to Supplemental Directive 10-05 issued by the Treasury concerning the "Home Affordable Modification Program" ("HAMP"). (*See* Petition ¶¶ 72-76.)

[6] The Governing Agreements for the Subject Trusts typically define Subsequent Recoveries as amounts "specifically related to a Liquidated Mortgage Loan or the disposition of an REO property… after liquidation or disposition of such mortgage loan." (*See, e.g.*, NYSCEF Doc. No. 35 (SACO 2005-10 Pooling and Servicing Agreement) § 1.01, definition of "Subsequent Recoveries.")

language of the Governing Agreements when applying Realized Losses, only to compel strict adherence to that language when applying Subsequent Recoveries. Indeed, this would result in a windfall to the most junior residual certificates, in the form of additional distributions, instead of repaying the most senior certificates that suffered these Realized Losses in the first place.[7]

Logically then, and as the evidence in this proceeding will demonstrate, when Petitioner receives Deferred Principal Collections, which repay the amounts that were previously written off as losses (i.e., the Deferred Principal Amounts), Petitioner should be instructed to treat these amounts as a reduction in Realized Loss, and reverse prior write-downs associated with those amounts by increasing (i.e., writing up) the balances in the reverse order in which they were written down (i.e., by writing up the highest priority certificates to which losses had been previously applied). This would not only be the most equitable result, but would also best effectuate the structure and intent of the Governing Agreements, in which the more senior certificates are protected from losses by the more junior and subordinated certificates, and recovered amounts that were previously written off serve to reverse the effect of the write-offs.

With respect to the second question, the Petition provides that, "[f]or routine distributions for the Subject Trusts, Petitioner's general practice is to apply the Retired Class Provision to prevent both distributions *and* write-ups to zero-balance Primary Classes." (Petition ¶ 114 (emphasis in original).) However, with respect to "a small number of Subject Trusts, Petitioner

[7] The Governing Agreements provide no support for Petitioner's current unbalanced approach of permitting write downs associated with Realized Losses that can never be reversed. Thus, whether or not there is a specific mechanism or provision within the Governing Agreements for applying write-ups upon the receipt of Deferred Principal Collections is of no moment—if, as Petitioner has acknowledged, Petitioner has gone outside of the four corners of the Governing Agreements to treat Deferred Principal Amounts as Realized Losses despite not fitting within that defined term, the Court should apply its equitable powers to instruct Petitioner to follow the SR Approach to reverse the write-downs resulting from that approach when Deferred Principal Collections are received.

has interpreted the Retired Class Provision to permit (i) write-ups to zero-balance primary classes, and (ii) distributions to such Primary Classes following the application of any write-ups." (*Id.* at n.10.) Petitioner notes that this latter method reserved for a small number of Subject Trusts—i.e., permitting write-ups zero balance primary classes—is consistent with the rulings in JPM II. Petitioner does not explain why it permits write-ups to zero-balance Primary Classes for this small number of Subject Trusts and not others, nor does it identify any distinguishing features between these two groups, which indicates that there is no valid basis for Petitioner to prevent write-ups to zero-balance Primary Classes in the bulk of the Subject Trusts. In any event, permitting write-ups to zero-balance Primary Classes is consistent both with the rulings in JPM II (as Petitioner acknowledges) and the letter and spirit of the Governing Agreements for *all* Subject Trusts. Accordingly, Petitioner should be instructed to follow this approach with respect to *all* Subject Trusts moving forward.

As a careful review of the Governing Agreements makes plain, zero-balance classes are entitled to have their balances increased, thereby reviving their right to distributions. The trial court in JPM II confirmed the same, and that decision was affirmed by the Appellate Division, First Department on appeal. *See* Decision and Order, *In re Wells Fargo Bank et al.*, Index No. 2020-02716 (1st Dep't, Aug. 19, 2021) (NYSCEF Doc. No. 111). The so-called Retired Class Provision in the Governing Agreements solely limits *distributions* to zero-balance classes while their balances are zero, but says nothing about write-ups. Conversely, the provisions governing write ups in the Governing Agreements typically state that they apply to "any Class of Certificates." (*See, e.g.*, NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 1.01, definition of "Realized Loss.") Further, the provisions of the Governing Agreements governing write-ups are set forth as matters "in addition to," and thus separate from, "distributions." (*See*

NYSCEF Doc. No. 43 (BSABS 2007-HE3 Pooling and Servicing Agreement) § 5.04(b).) In addition to the fact that the Governing Agreements typically permit, and contain no express prohibitions regarding, the application of write-ups to zero-balance classes, the foregoing makes plain that any provisions restricting distributions to zero-balance classes have no effect on these classes' eligibility to receive write-ups. Furthermore, as discussed in greater detail below, and as will be demonstrated in this proceeding, the relevant provisions of the Governing Agreements for the Subject Trusts contain specific instructions and instances in which certificates in the Subject Trusts will actually be "retired," which generally only takes place after a final distribution—i.e., when all possible principal and interest distributions have been made to a given Class of certificates. This is not possible if any such classes still have Realized Losses that have yet to be reimbursed. Thus, zero-balance classes are not the equivalent of retired classes, as the latter have both no certificate principal balance and no outstanding Realized Losses.

Finally, as to the third question, the only logical way for Petitioner to distribute and allocate Post-Zero Balance Collections is through the Excess Cashflow waterfall. In fact, the Excess Cashflow waterfall is specifically designed for this scenario and purpose. In this regard, because the distributions under the principal waterfall are based on the principal balance of certificates, any amounts received once the balances of Primary Classes have been reduced to zero have no way of flowing to the Primary Classes through the principal waterfall, despite the fact that these classes still suffer from unreimbursed losses. The Excess Cashflow waterfall, on the other hand, explicitly provides for a distribution of amounts for "any Unpaid Realized Loss Amount for Such Classes for such Distribution Date," including with respect to the Primary Classes. (*See, e.g.*, NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 5.04(a)(3).) As such, it is clear

that any Post-Zero Balance Collections should be distributed through the Excess Cashflow waterfall.

In sum, the only logical, equitable and consistent interpretation of the Governing Agreements for the Subject Trusts is to allow all classes of certificates—including, specifically, any zero-balance classes—to be written up to the extent of prior losses upon the receipt of Deferred Principal Collections and any other unscheduled recoveries, and to distribute and allocate Post-Zero Balance Collections through the Excess Cashflow waterfall. Any other outcome would conflict with the prior actions of the Petitioner, contravene the terms and structure of the Governing Agreements and the intent of the parties thereto, and lead to a commercially unreasonable result that would upset the long-settled expectations of RMBS market participants.

II. BACKGROUND

Petitioner asserts that it has filed the Petition to seek instruction on a number of different issues pertaining to the proper treatment and distribution of Deferred Principal Collections under the various Governing Agreements for the Subject Trusts, and to provide "all interested parties with the opportunity to appear and be heard," in an effort to obtain "a resolution of all relevant issues such that Petitioner may distribute the funds at issue with finality." (*See* Petition ¶ 21.) Specifically, Petitioner seeks instructions on:

> 1. the manner in which distributions are calculated and applied under the waterfalls after the aggregate outstanding principal balances of the Class A, Class M, and/or Class B classes of certificates (the "Primary Classes") are reduced to zero; and
>
> 2. the treatment of borrower payments of deferred or forborne principal, interest, and/or other amounts on mortgages that have been subject to servicer modifications in connection with a default or a reasonably foreseeable default (as determined by servicers), which is a subsidiary issue that has the potential to impact issue (i). (Petition at 2.)

Ellington's interests in the Ellington Trusts will be affected by any instruction from the Court regarding (1) whether write-ups resulting from the receipt of Deferred Principal Collections should be applied to write up the principal balances of *any* Primary Classes, including zero-balance classes, and (2) whether Post-Zero Balance Collections are allocated and distributed through the Excess Cashflow waterfall. This is because Ellington owns various certificates in the Ellington Trusts, including Primary Class certificates whose principal balance is currently zero or may hereinafter be reduced to zero, and certificates to which Realized Losses have been applied as a result of Deferred Principal Amounts and/or that stand to be written up if Deferred Principal Collections are treated as Subsequent Recoveries.

III. STATEMENT OF POSITIONS AND ANSWER TO PETITION

A. DEFERRED PRINCIPAL COLLECTIONS SHOULD BE APPLIED TO WRITE UP ALL CERTIFICATES

1. The Language, Structure and Spirit of the Governing Agreements Support the Reversal of Previously Applied Realized Losses through Write Ups to the Primary Classes.

A plain reading of the Governing Agreements for the Ellington Trusts reveals numerous terms evidencing an intent to write up those certificates to which Realized Losses have previously been applied, which contradicts Petitioner's historical practice of not applying Deferred Principal Collections to reverse Realized Losses stemming from Deferred Principal Amounts. Indeed, Petitioner's historical practice is antithetical to the plain meaning and intent of the Governing Agreements for the Subject Trusts, which are structured to maintain protection by the junior Classes against losses by the senior Classes and to maintain accounting symmetry by permitting the reversal of Realized Losses when written-off amounts are recovered.

As an initial matter, the definition of Certificate Principal Balance in the Governing Agreements conflicts with any claimed prohibition on write-ups stemming from Deferred Principal

Collections, because it provides that any reduction in Realized Losses—which occurs whenever unscheduled recoveries are received—will be applied to increase the Certificate Principal Balance of "any Class of Certificates." (*See, e.g.*, NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 1.01, definition of "Realized Loss.") Tellingly, the Prospectus Supplements for the Subject Trusts often contain broad statements confirming that all classes of certificates that had suffered Realized Losses would be eligible to receive write-ups when such amounts were recovered. For example, the Prospectus Supplement for the SACO 2006-4 Subject Trust provides that, "the Certificate Principal Balance of *each Class of* Class A, Class M, and Class B Certificates [i.e., each Primary Class] that has been reduced by the allocation of a Realized Loss to such class will be increased, in order of seniority, by the amount of such Subsequent Recoveries." (*See, e.g.*, NYSCEF Doc. No. 38 (SACO 2006-4 Prospectus Supplement) at S-70 (emphasis added).)

As set forth above, the provisions of the Governing Agreements for the Subject Trusts, and in particular the definitions of Realized Loss and Subsequent Recovery recounted in Section I, *supra*, demonstrate that if deferrals of principal payments were to be treated as Realized Losses at all, it was only to the extent that such amounts were not expected to be recovered following liquidation, and only for so long as such amounts were not thereafter recovered. In short, Deferred Principal Amounts were never intended to be treated as permanent and unreversible Realized Losses, particularly where such Deferred Principal Amounts largely consisted of principal forbearance, and as such, remained due and owing. Because Petitioner has invariably treated Deferred Principal Amounts as Realized Losses and applied such Losses to *all* classes of certificates, it would be wholly inconsistent with those past actions and the spirit and intent of the

Governing Agreements to prohibit, upon the receipt of Deferred Principal Collections, the reversal of Realized Losses that were applied to the Primary Classes.

Furthermore, barring Primary Class losses from being reversed would conflict with the overall structure of the Subject Trusts, which contain numerous provisions confirming that junior certificates are the first to absorb losses to protect senior certificates, while senior certificates are the first to receive principal and principal recoveries before those amounts flowed to the junior certificates. To wit, Realized Losses in the Trusts are first allocated to the most junior certificates—including first to the Class C Interest and Class C Certificates (*see e.g.*, NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 5.05(a))—and then later to more senior certificates, but only after the certificate balances of all more junior certificates have been reduced to zero by the application of Realized Losses. This structure is at the heart of the bedrock principle of "subordination" on which the Subject Trusts were built—that subordinate certificates will absorb losses before senior certificates, thereby protecting the senior certificates from loss. (*See, e.g.*, NYSCEF Doc. No. 38 (SACO 2006-4 Prospectus Supplement) at S-9 ("Subordination provides the holders of certificates having a higher payment priority with protection against losses realized when the remaining unpaid principal balance on a mortgage loan exceeds the amount of proceeds recovered upon the liquidation of that mortgage loan. In general, we accomplish this loss protection by allocating any realized losses on the mortgage loans, first to reduce the amount of excess spread, second to reduce the overcollateralization amount, and third among the certificates, beginning with the Class of subordinated certificates with the lowest payment priority until the principal amount of that subordinated class has been reduced to zero.").)

Senior certificates are further protected by overcollateralization—the excess of the value of a given Trust's collateral over the principal balance of the Trust's Primary Class certificates—

which is represented by the Class C principal balance. As Petitioner acknowledges, a Trust's Class C Certificates, "function[] as a first-loss position that absorbs realized losses before they reach the Primary Classes. This is another way in which overcollateralization provides credit enhancement for the Primary Classes." (Petition ¶ 64 (internal citations omitted).)

This concept of subordination and credit enhancement is further supported by the manner in which principal distributions are administered—namely, Subsequent Recoveries and ordinary principal amounts are paid through the principal waterfall to the most senior certificates first, so as to increase "the likelihood that the senior certificateholders will receive regular payments of interest and principal . . . ." (*See, e.g.,* NYSCEF Doc. No. 38 (SACO 2006-4 Prospectus Supplement) at S-8.) Principal distributions, which include ordinary principal payments and the amount of any Subsequent Recoveries not previously allocated, are allocated from the most senior to the most junior Primary Classes based on the certificate principal balance of each such Primary Class. (*See, e.g.,* NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) §§ 1.01(a)(2), 5.04(a)(2).) Namely, principal distributions are made first to the most senior Class A certificates, then successively to each more junior Class of the Class A certificates, then to the most senior Class M certificates, then successively to each more junior Class of the Class M certificates, then to the most senior Class B certificates, and then successively to each more junior Class of the Class B certificates, in each case until the principal balance of that Class of certificates is reduced to zero. (*Id.* § 5.04(a)(2).) The Class C Certificates are not included in the principal waterfall. (*Id.*)

Taken together, the language of the Governing Agreements[8] concerning the application and reversal of Realized Losses suggests an intent by the drafters that *all* certificates in the Trusts—and particularly the most senior certificates—would be eligible to be written up in the order of seniority upon the receipt of Deferred Principal Collections. Such language stands in direct conflict with any claim that the Primary Classes should not be written up upon the receipt of Deferred Principal Collections.

Any reading of the Governing Agreements that ignores such language would be absurd and commercially unreasonable and, "a contract should not be interpreted to produce a result that is absurd, commercially unreasonable, or contrary to the reasonable expectations of the parties." *New York Univ. v. Pfizer Inc.*, 151 A.D.3d 42, 52 (1st Dep't 2017) (cleaned up) (quoting *Matter of Lipper Holdings v. Trident Holdings*, 1 A.D.3d 170, 171 (1st Dep't 2003)). Among other things, preventing Primary Class write-ups would (1) eliminate a key protection for the most senior classes in the senior-subordinate structure—their primary right to reversal of Realized Losses; (2) create illusory overcollateralization that could result in "leakage" and potentially increase distributions to the most junior Class C Classes, resulting in windfall gains given that the Trusts were not actually overcollateralized; and (3) destroy the symmetry of the Trusts' mechanism for accounting for Realized Losses and Subsequent Recoveries by rendering permanent and irreversible any

[8] The Governing Agreements include both the pooling and servicing agreements and prospectus supplements, all of which are to be read together as unified agreements. *See Nau v. Vulcan Rail & Construction Co.*, 286 N.Y. 188, 197 (1941) (holding that instruments executed at substantially the same time and related to the same subject matter are contemporaneous writings that must be read together as one); *Fundamental Long Term Care Holdings, LLC v. Cammeby's Funding LLC,* 20 N.Y.3d 438, 445 (2013) (same); *Wells Fargo Bank, N.A. v. Fin. Sec. Assur. Inc.*, 504 Fed. Appx. 38, 40 (2d Cir. 2012) (prospectus supplement properly considered with mortgage pooling and servicing agreement as "all writings forming part of a single transaction"); *Bank of New York Mellon v. WMC Mortg., LLC*, 12-CV-7096, 2015 WL 4597540, at *8 (S.D.N.Y. July 30, 2015) (interpretation should give force and effect to all provisions contained in transaction documents, including Prospectus).

losses suffered by the Subject Trusts' Primary Classes as a result of Deferred Principal Amounts, no matter how much the Trusts ultimately receive in Deferred Principal Collections.

Nothing in the Governing Agreements demonstrates that the Primary Classes were intended to be saddled with such a punitive and illogical restriction. If such a result were intended, it would have been clearly disclosed in the offering documents, especially because it would have been so dramatically contrary to typical RMBS structures and market participants' expectations. Instead, the Governing Agreements disclosed the opposite by discussing the concept of Subsequent Recoveries as a mechanism specifically intended to reverse (or "write up") previously applied Realized Losses upon the receipt of additional amounts that neither the servicer nor the trustee necessarily expected to receive. (*See, e.g.,* NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 1.01, definition of "Subsequent Recoveries.") By including the concept of Subsequent Recoveries in both the PSAs and offering documents, the drafters made clear, and explicitly included a mechanism to carry out, their intent that any previously applied Realized Losses would be reversible and impermanent. The investors relied upon these disclosures and provisions when purchasing Primary Class certificates in the Subject Trusts.

Given the senior-subordinate structure discussed above, it would be absurd to allow additional or increased amounts to flow to the Class C Classes while the Primary Classes still have outstanding Realized Losses, based on the illusion of overcollateralization created by the accounting asymmetry of failing to treat Deferred Principal Collections as Subsequent Recoveries. Such a result would allow the Class C Classes to receive windfall benefits at the expense of the Primary Classes, while permanently impairing the Primary Classes with losses that could never be reversed and likely should not have been treated as Realized Losses in the first place. The Court

should avoid that result and hold that all Primary Classes are entitled to write-ups upon the receipt of Deferred Principal Collections.

2. Petitioner Should Apply the SR Approach to Implement Write Ups from Deferred Principal Collections.

To accomplish the write-ups discussed in the prior section, the Court should direct Petitioner to follow the SR Approach and apply such collections as Subsequent Recoveries, which necessarily will cause the balances of the Primary Classes to be written up.

Generally speaking, the definition of Subsequent Recoveries is limited "to a Mortgage Loan that was the subject of a liquidation or final disposition of an REO Property prior to the related Prepayment Period that resulted in a Realized Loss." (*See, e.g.,* NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 1.01, definition of "Subsequent Recoveries.") However, at its heart, a Subsequent Recovery is the recovery of funds that were previously written off as Realized Losses, which is precisely the relationship between Deferred Principal Amounts and Deferred Principal Collections.

Therefore, given that the Petitioner elected to treat Deferred Principal Amounts as Realized Losses, the SR Approach is the most logical and equitable approach to the application of Deferred Principal Collections. This approach would require, by the plain language of the Governing Agreements, that Petitioner write up the balances of the Primary Classes, in the reverse order of previously applied Realized Losses, upon the receipt of Deferred Principal Collections.

B. THE RETIRED CLASS PROVISION DOES NOT PROHIBIT WRITE-UPS TO ZERO BALANCE CLASSES UPON THE RECEIPT OF DEFERRED PRINCIPAL COLLECTIONS.

A careful review of the Governing Agreements for the Ellington Trusts makes plain that zero-balance classes of the Ellington Trusts are entitled to have their balances increased through the application of write-ups, thereby reviving their right to distributions. By way of example,

Section 5.04(a) of the Pooling and Servicing Agreement for the BSABS 2007-HE3 Subject Trust (the "BSABS 2007-HE3 PSA"), provides that:

> 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 Certificates or Class M Certificates has been reduced to zero, that Class of Certificates will be retired and will no longer be entitled to distributions . . . . (NYSCEF Doc. No. 43 (BSABS 2007-HE3 PSA) § 5.04(a).)

Notably, as Petitioner has observed,[9] provisions such as the one quoted above say nothing about write-ups, and specify only that a "retired" Certificate "will no longer be entitled to ***distributions***," meaning the specific process by which money is paid out to Certificateholders. (*Id*. (emphasis added).) In fact, the provision for writing up certificates in the BSABS 2007-HE3 PSA is found in a separate subsection than the distribution subsection, and notes that such write-up occurs "***in addition to***," and thus separate from, "distributions." (NYSCEF Doc. No. 43 (BSABS 2007-HE3 PSA) § 5.04(b) (emphasis added).) The BSABS 2007-HE3 PSA thus maintains the distinction between "writing up" certificates and "distributing" to Certificateholders, with the former separate from and unaffected by the latter, thereby confirming that a restriction on distributions to zero balance classes with the PSA's distribution provisions does not carry with it any restriction on write-ups.

Instead, the write-up provisions in the BSABS 2007-HE3 PSA demonstrate that zero balance classes are eligible to be written up. Section 5.04(b) provides that Subsequent Recoveries, "shall be applied to increase the Certificate Principal Balance of the Class of Certificates to which the highest payment of priority to which Realized Losses have been allocated." (*Id*.) Similarly, the definition of "Realized Loss" provides that, "to the extent the Master Servicer receives Subsequent

[9] The Petition acknowledges that it is unclear whether the Retired Class Provision should be applied to prevent the write-up of zero balance classes. (*See* Petition ¶ 107.)

Recoveries with respect to any Mortgage Loan, the amount of the Realized Loss with respect to that Mortgage Loan will be reduced to the extent such recoveries are distributed ***to any Class of Certificates*** or applied to increase Excess Spread on any Distribution Date pursuant to Section 5.04(b)." (*Id.* § 1.01, definition of "Realized Loss" (emphasis added).) By expressly providing for write-ups to "any Class of Certificates" and by neglecting to include any zero-balance Class restriction, the express language of the BSABS 2007-HE3 PSA, and all other Ellington Trust PSAs, makes clear that Certificates with zero balances are to be written up upon the receipt of applicable Subsequent Recoveries.

Though certain certificateholders may suggest that the term "retired" necessarily implies that future write-ups are restricted, a review of the BSABS PSA provisions associated with retirement reveals that only those zero-balance classes that have been paid in full become retired, as opposed to those whose balances were reduced to zero as a result of the application of Realized Losses. First, the process for retirement of a Class of Certificate is set forth in a section entitled "Final Distribution on the Certificates," which provides that retirement can occur if, "the Trustee determines that a Class of Certificates shall be retired ***after a final distribution on such Class***. . . ." (*Id.* § 10.02(ii) (emphasis added).) This provision further requires the Trustee to "notify the Certificateholders within five (5) Business Days after such Determination Date that ***the final distribution in retirement of such Class of Certificates*** is scheduled to be made on the immediately following Distribution Date." (*Id.* (emphasis added).)[10] Further, Section 10.02 requires that retired Certificates be "cancell[ed]" upon final distribution—a process that involves

[10] Such a provision plainly requires that, for a Class of Certificates to be retired, the Trustee must provide notice to the affected Certificateholders in advance of the final distribution to such Class. No such notice has been provided to Ellington for any of the Ellington Trusts, indicating that Petitioner did not believe that such Certificates should be retired.

the "presentation and surrender" of Certificates at the Trustee's corporate trust office prior to the final distribution. (*Id.*) Similarly, if a Certificateholder opts to transfer or exchange its Certificates, or if Certificates are lost or mutilated, those Certificates must be "surrendered" and "shall be cancelled." (*Id.* §§ 6.02(a), 6.03, 6.09.)

These provisions surrounding retirement make clear that this drastic measure only occurs if certificates are lost, destroyed, or fully paid off and not, as here, when their balance has been temporarily reduced to zero as a result of the application of Realized Losses—losses that may be reversed under the write-up provisions of the Governing Agreements. Indeed, the terms of the Governing Agreements for the Ellington Trusts that address distributions to zero-balance classes say nothing about cancelling or surrendering those certificates. This, logically, explains why Petitioner has not indicated that it has taken any steps to cancel or make final distributions for any zero-balance classes in the Ellington Trusts, or provided any notice of same. Indeed, Ellington's Certificates in the Ellington Trusts were never presented or surrendered to the Trustee for cancellation, and no final distributions were made. (Petition ¶ 4.)

Instead, by definition, the zero balance certificates that Ellington holds in the Ellington Trusts are "outstanding." In this regard, the BSABS 2007-HE3 PSA provides that "all Certificates" are deemed "Outstanding" "except [for] (a) Certificates theretofore canceled by the Trustee or delivered to the Trustee for cancellation; and (b) Certificates in exchange for which or in lieu or which other Certificates have been executed and delivered by the Trustee pursuant to this Agreement." (NYSCEF Doc. No. 43 (BSABS 2007-HE3 PSA) § 1.01, definition of "Outstanding.") Similarly, Section 5.04(c) of the BSABS PSA provides that, "[s]ubject to Section 10.02 hereof respecting the final distribution, distributions with respect to Certificates registered

in the name of a Depository shall be made to such Depository in immediately available funds." (*Id.* § 5.04(c).)

The foregoing interpretation of the Governing Agreements for the Subject Trusts is consistent with the holding in JPM II, which was affirmed by the Appellate Division, First Department, and should be adopted by this Court. While not binding, the reasoning of these orders is compelling and persuasive on this point. As noted by the trial court in JPM II, Subsequent Recoveries are meant to compensate investors for previously applied losses in connection with mortgage loans, and the "write-up provisions of the Trusts . . . permit write-ups of the zero balance certificates to the extent of previously allocated realized losses." Decision and Order, *In re Wells Fargo Bank, N.A. et al.*, Index No. 657387/2017, (N.Y. Sup. Ct., N.Y. Cnty., Aug 31, 2021) (NYSCEF Doc. No. 843) at 39. In addition, as pointed out by Petitioner, the First Department went even further, holding that the retired class provisions only apply when a certificate has been fully repaid and formally retired, and that 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." Decision and Order, *In re Wells Fargo Bank, N.A., et al.*, Index No. 2020-02716 (1st Dep't, Aug 19, 2021), (NYSCEF Doc. No. 111) at 8. This same logic should be adopted here—Ellington's Certificates in the Ellington Trusts have not been cancelled and are still "outstanding" under the plain terms of the Governing Agreements, such that they are entitled to the same write-ups as any other outstanding certificate.

C. POST-ZERO BALANCE COLLECTIONS SHOULD BE DISTRIBUTED PURSUANT TO THE EXCESS CASHFLOW WATERFALL.

"Excess cashflow" is defined as, "[w]ith respect to any Distribution Date, an amount, if any, equal to the sum of (a) the Remaining Excess Spread for such Distribution Date and (b) the

Overcollateralization Release Amount for such Distribution Date." (NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 1.01, definition of "Excess Cashflow.") As discussed in Section III.A.1, *supra*, and acknowledged by Petitioner (Petition ¶ 64), overcollateralization is a mechanism set forth in the Governing Agreements as a credit enhancement to protect Primary Classes from losses. Pursuant to the Governing Agreements, if the Overcollateralization Amount or Overcollateralization Release Amount on any Distribution Date exceeds the Overcollateralization Target Amount, that necessarily means that Primary Classes still have unreimbursed Realized Losses, and thus any excess funds received on that date would then be distributed through the Excess Cashflow waterfall. (*See, e.g.*, NYSCEF Doc. No. 36 (SACO 2006-4 Pooling and Servicing Agreement) § 5.04(a)(3).)

The order of priority in the Excess Cashflow waterfall provides for distributions to the Primary Classes first, including with respect to "any Unpaid Realized Loss Amount for such Classes for such Distribution Date, *pro rata*, in accordance with the Applied Realized Loss Amount allocated to each such class; based on the respective Certificate Principal Balance thereof . . . ." (*Id.*) As such, the Governing Agreements specifically set forth the process for distributing Post-Zero Balance Collections, providing for a *pro rata* distribution of any such amounts when the balances of all Primary Classes are zero. The Excess Cashflow waterfall is the only waterfall in the Governing Agreements that could be operable under this scenario and, therefore, the Court should direct Petitioner to distribute Post-Zero Balance Collections through the Excess Cashflow waterfall.

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D. FINAL JUDGMENTS AND SEVERANCE ORDERS IN JPM II PERMITTED SENIOR CERTIFICATES TO BE WRITTEN UP WITH RESPECT TO SUBSEQUENT RECOVERIES.

To the extent the JPM Order carries any weight with respect to this proceeding or the Trusts at issue here, the severance orders entered in JPM II must also carry weight, as they memorialized all interested parties' agreement as to how the receipt of unscheduled recoveries should be handled. Namely, severance orders were only permitted in JPM II if all interested parties agreed on the proper result. Thus, any severance orders entered in JPM II that permitted the write up of all Primary Classes (including zero-balance classes) in connection with the receipt of the Settlement Payment (*see, e.g.*, Partial Severance Order and Partial Final Judgment (7 Trusts), *In re Wells Fargo Bank, N.A. et al.*, Index No. 657387/2017 (N.Y. Sup. Ct., N.Y. Cnty., Jul. 8, 2020) (NYSCEF Doc. No. 875)) constitute compelling evidence of the parties' consistent and unanimous understanding of the at-issue Governing Agreements.

PRAYER FOR RELIEF

Ellington respectfully requests that the Court enter judgment as follows:

a) Instructing Petitioner, upon the receipt of any Deferred Principal Collections or other unscheduled recoveries with respect to the Ellington Trusts, to apply such Deferred Principal Collections or other unscheduled recoveries as Subsequent Recoveries to increase the certificate principal balance of the Primary Classes of the Ellington Trusts, in the reverse order of previously applied Realized Losses;

b) Instructing Petitioner to include zero balance certificates when increasing the certificate balance of Primary Classes upon the receipt of any Deferred Principal Collections or other unscheduled recoveries with respect to the Ellington Trusts, in the reverse order of previously applied Realized Losses;

c) Instructing Petitioner, after all of the Primary Classes of any particular Ellington Trust have had their principal balances reduced to zero, to distribute any additional amounts received by the Ellington Trusts under the Excess Cashflow waterfall; and

d) Granting such other, further, and different relief as may be just and proper.

Dated: January 24, 2022
New York, New York

Respectfully Submitted,

BAILEY DUQUETTE P.C.

By: _____

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