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

In the matter of the application of

THE BANK OF NEW YORK MELLON (as Trustee under various Pooling and Servicing Agreements and Indenture Trustee under various Indentures), *et al.*

Petitioners,

for an order, pursuant to C.P.L.R. § 7701, seeking judicial instructions and approval of a proposed settlement.

Index No. 651786/2011

Assigned to: Kapnick, J.

STEERING COMMITTEE'S RESPONSE TO PETITIONERS' REQUEST FOR JUDICIAL NOTICE REGARDING RESCAP BANKRUPTCY PROCEEDINGS

On July 22, 2013, Petitioners filed a request that the Court take judicial notice of certain pleadings in *In re Residential Capital, LLC*, Case No. 12-12020-mg (Bankr. S.D.N.Y.) ("*ResCap*") (Doc. No. 909). The Steering Committee does not oppose Petitioners' request. On the contrary, the Steering Committee agrees that these pleadings may assist this Court (but not in the way the Petitioners suggest). To that end, the Steering Committee highlights below portions of the pleadings Petitioners submitted in their request that contradict the positions taken in this proceeding. These contradictions cast further doubt on the fairness and adequacy of the settlement since they show that when it suits them, the Petitioners reject the very arguments they are making in this case to justify the pennies-on-the-dollar settlement.

A. The Institutional Investors tell Judge Glenn a different story than they have told this Court on several key issues.

1. The "material and adverse causation" story.

The PSAs state that a breach of representation or warranty under § 2.03 of the PSAs must "materially and adversely affect[] the interests of the certificateholders in any mortgage loan" in order for the Seller to repurchase the loan. Based on this "material and adverse" language, Bank

of America's position during settlement negotiations was that a breach of a representation or warranty must cause the loan to default as a condition of a valid repurchase claim. Despite abundant contrary authority,[1] the Institutional Investors and the Trustee seek to justify the settlement in part on the supposed uncertainty relating to the "material and adverse" causation argument. *See*, *e.g.*, Institutional Investors' Statement in Support of Settlement, Doc. No. 740 at 36-38. Indeed, two of the Trustee's experts opine that it was reasonable for the Trustee to accept the settlement in part because of legal uncertainty over this causation "defense." *See* Expert Report of Daniel R. Fischel, Doc. No. 553, ¶ 36; Expert Report of Barry Adler, § 3.

Yet in the *ResCap* proceedings, many of these same Institutional Investors, represented by Gibbs & Bruns, take the opposite position, arguing that there is no causation requirement. As the Institutional Investors explained to Judge Glenn:

> As in *Syncora* and *Flagstar Bank*, the PSAs contain no language that requires the RMBS Trusts to prove a "cause," "loss," or a "default" to obtain repurchase of a defective loan. Compare PSA §§ 2.03 & 2.04, with *Syncora*, 2012 WL 2326068, at *9-10 (SSA required proof only that the breach "materially and adversely affects the value of the interest . . . in any of the HELOCs"), and *Flagstar Bank*, 2012 WL 4373327, at *4 (SSA required repurchase "when a breach 'materially and adversely affects the interest of the Issuer, the Noteholders or the Note Issuer in the related Mortgage Loan'"). Accordingly, were the settlement to be disapproved, Debtors are unlikely to be able to assert any effective "causation defense" to reduce their repurchase liability. The settlement should be evaluated with that risk in mind.[2]

What the Institutional Investors told Judge Glenn is, in fact, true here as well. There is nothing in the PSAs that requires the Petitioners to prove a breach of representation or warranty caused a default and, indeed, default itself is not a condition to repurchase. PSA § 2.03(c).

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[1] *See MBIA Ins. Corp. v. Countrywide*, 2013 WL 1296525 (1st Dep't April 2, 2013); *Syncora Guar. Inc. v. EMC Mortg. Corp.*, 874 F. Supp. 2d 328, 333-39 (S.D.N.Y. 2012); *Assured Guar. Mun. Corp. v. Flagstar Bank*, 892 F. Supp. 596, 601-03 (S.D.N.Y. 2012).

[2] *See* Petitioners' Request for Judicial Notice Regarding ResCap Bankruptcy Pleadings, Doc. No. 909 at 4, n. 10 (citing Exhibit I, Doc. 1739 in ResCap, ¶ 24).

Instead, the loss causation argument is a several-times rejected defense that does not present any real risk to the Petitioners in this case – particularly in New York.

2. The "post-settlement circumstances" story.

In their pleadings, and several times during lengthy speaking objections, counsel for the Institutional Investors and the Trustee have urged the Court not to consider decisions issued *after* the settlement was reached, but before approval of the settlement. *See*, *e.g.*, The Institutional Investors' Statement in Support of the Settlement, Doc. No. 740 at 12-13; *see also* July 9, 2013 Tr. at 1549:18-1550:23 (Kathy Patrick: "Impeaching the trustee's action or attempting to argue that the trustee should have done X, Y or Z, based on information that comes to light two years later would mean that no settlement agreement could ever be final and no Article instruction could every [sic] issue, and that is not relevant . . . It's not a perpetually renewing issue."). Yet, in *ResCap*, the Institutional Investors say just the opposite. As they explain:

> *Syncora* and *Flagstar* also vindicate Debtors' decision to eliminate the risk that their repurchase liabilities might be magnified by adverse judicial interpretations of the PSAs. Debtors are sophisticated in the area of repurchase litigation; they surely understand their repurchase liability could suffer an enormous upward swing if they were to lose their causation defense. Debtors' expert applied a substantial discount to Debtors' GSE data in his estimate of the RMBS Trusts' repurchase claims . . . but Debtors were right to be concerned that any such discount would not hold if the law on causation developed adversely to them. Now that this adverse law *has* developed, Debtors face a *magnified* risk if the settlement is disapproved.[3]

In support of their position that Judge Glenn should take into account post-settlement circumstances, the Institutional Investors cite *Newman v. Stein*, which stands for the sensible principle that "it would be inappropriate for a reviewing court to freeze matters as of the moment at which the parties entered into an agreement and ignore subsequent developments which either

[3] *Id.* at ¶ 25 (emphasis in original).

reinforce or undermine the original decision to settle." 464 F.2d 689, 696 (2d Cir. 1972).[4] Of course, this inappropriate freeze is precisely what the Institutional Investors and the Trustee have urged throughout the Article 77 proceedings. The Trustee went so far as to contractually agree to this inappropriate freeze through the Further Assurances clause, under which it is prevented from bringing to this Court's attention any information that undercuts the proposed settlement. *See, e.g.*, Testimony of Jason Kravitt, July 16, 2013 Tr. 2176:10-19; 2177:10-2181:22.

3. The "liquidated loan repurchase" story.

Counsel for the Institutional Investors has argued that another purported basis for approving the settlement is a recent decision from the District of Minnesota in which the court held that there was no repurchase remedy for loans that had been liquidated through foreclosure, *MASTR Asset Backed Sec. Trust 2006 HE3 v. WMC Mortg. Corp.*, 2012 WL 4511065 (D. Minn. 2012). Absent a settlement, Bank of America purportedly would rely on this decision to significantly reduce its liability to the Covered Trusts – rendering any effort to re-open settlement discussions now "dangerous." *See, e.g.,* Institutional Investors' Response to Settlement Objections, Doc. No. 763 at 18 n.14 (discussing litigation risk pertaining to the *WMC* decision).

Yet again, however, the Institutional Investors told a very different story to Judge Glenn. In their Consolidated Reply to the Objections to the RMBS Trust Settlement Agreement, the Institutional Investors argued that the decision was "wrongly decided. It is premised on an overly technical reading of the contracts that failed to consider either the function of representations and warranties (and the repurchase obligation tied to them), or the custom and

[4] *Id.* at ¶ 20.

practice in the mortgage industry in which foreclosed loans are routinely repurchased."[5] They also explained that:

> Even if the *WMC* decision is correct (and it is not), it does not apply here. It was the Debtors, as Master Servicer, who caused the delay on which this defense is premised. If the Debtors had pursued repurchase claims when they became known to them, the foreclosures about which the Committee complains would never have occurred. Moreover, it was Debtors, as Master Servicers, who directed and carried out the foreclosures at issue. Thus, Debtors must point to their own lack of notice and their own foreclosure on mortgages and their own failure to assert repurchase claims before they foreclosed, to defend the Trusts' repurchase claims against themselves. As with the statute of limitations, any attempt by the Debtors to rely on this defense would run counter to the "deeply rooted" principle that "a wrongdoer should not be able to take refuge behind the shield of his own wrongdoing."[6]

Significantly, the Institutional Investors characterized the ResCap Creditor's Committee response to these facts as "frivolous."[7] And, yet, the circumstances are precisely the same here. It was Bank of America and Countrywide as Master Servicers that directed and carried out the foreclosures without first demanding repurchase from *themselves*.

Moreover, directly contrary to the Institutional Investors' take on the *WMC* decision in the Article 77 proceedings, in *ResCap*, they argued that even if followed, the *WMC* decision would not decrease the Trusts' recoverable losses:

> Proving that foreclosure on defective mortgages eliminated the Trusts' right to pursue repurchase claims would simply establish the measure of Debtors' liability for failing to discharge their obligation to pursue the Trusts' valid repurchase claims prior to foreclosure. This substitution of claims would not reduce, in any way, the amount Debtors would otherwise owe to the Trusts on the repurchase claims.[8]

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[5] *See* "The Steering Committee Investors' Consolidated Reply to the Objections to the RMBS Trust Settlement Agreement" in the ResCap Bankruptcy Proceedings, (Doc. No. 2808 at 20) (attached hereto as Exhibit A). The Steering Committee respectfully requests that the Court take judicial notice of this brief.

[6] *Id.* at 16-17.

[7] *Id.* at 18.

[8] *Id.* at 22.

This Court was told that the *WMC* decision threatens to eliminate billions of dollars of potential liability in this case, and, yet, Judge Glenn was told that the same decision would not reduce "in any way" the value of the repurchase claims in *ResCap*.[9]

4. The loan file review story.

As this Court well knows, the Institutional Investors and the Trustee did not even ask for loan files in this case, and have taken the position that loan file review would not be helpful (even though, as their witnesses have admitted, they are not aware of a single put-back case that has been resolved without review of a statistically significant sample of loan files). *See, e.g.*, Testimony of Phillip R. Burnaman, July 23, 2013 Tr. 2977:8-12 (Q: "[A]re you aware of any put-back case that has been resolved without any loan file review? And specifically I'm referring to … the mortgage-backed securities arena. A: Any individual loan file review? I'm not sure that I can. I'm not sure I know of one."). Yet, in *ResCap*, following objection to the RMBS settlement, the Trustees, including BNYM, agreed to perform a statistically valid re-underwriting of 6,500 loans in order to identify the breach rate for the loans in the trusts, and estimate losses caused by the breach.[10]

Petitioners, including the Trustee, now contend that the loan file review in *ResCap* supports its decision in this case not to review loans because the results produced widely

[9] The position taken by the Institutional Investors in *ResCap* regarding *WMC* has been endorsed by New York courts. *See Deutsche Alt-A Securities Mortg. Loan Trust, Series 2006-OA1 v. DB Structured Prods., Inc.*, 2013 WL 3863861, at *12 (S.D.N.Y., July 24, 2013) ("Defendant is likewise incorrect that liquidated and extinguished loans are not subject to repurchase."); *see also ACE Securities Corp. Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc.*, 965 N.Y.S.2d 844, 850 (Sup. Ct. N.Y. Cty. May 13, 2013) (same). In *ACE Securities*—a case notably brought by a trustee to enforce the terms of one trust—Justice Kornreich specifically denied a motion to dismiss where "most, if not all of the loans, [had] defaulted." *Id.* at 850. Like *WMC*, defendants argued that liquidated loans are not subject to the repurchase provision. The Court rejected that argument as "perversely incentiviz[ing] DBSP to fill the Trust with junk mortgages that would expeditiously default so that they could be Released, Charged Off, or Liquidated before a repurchase claim is made." *Id.*

[10] *See* ResCap Doc. No. 3940, ¶ 26; Doc. No. 3940-1, ¶¶ 26-37; 33-36. The Court has previously taken judicial notice of these pleadings.

divergent views on the size of the trusts' claims in *ResCap*. *See* Doc. No. 909 at 3. Yet, the purportedly "widely divergent" damage estimates were based on analyses *prior* to the loan file review.[11] Notably here, where no loan file review has occurred, the parties' estimates of the lifetime losses to the Covered Trusts are "widely divergent," with a $40 billion swing between the low-end estimate of the Trustee's advisor, Brian Lin, and the Institutional Investors' high-end estimate. *See* Testimony of Burnaman, July 22, 2013 Tr. 2825:18-26.

At any rate, the Petitioners miss the point. The loan file review in *ResCap* allowed the parties to determine the breach rate, and estimate losses *based on the actual loans in the affected trusts.* This has not happened here. And, even if the parties would not necessarily give equal weight to the results of a loan file review of Countrywide loans, it cannot be disputed that a plaintiff armed with the results of the review is in a stronger bargaining position than a plaintiff who has only the information self-servingly volunteered by Bank of America. This point is best made—and, in fact, made obvious by—the results of loan file reviews that have been done of Countrywide loans. Whereas the Trustee's expert Brian Lin estimated a breach rate between 36% and 40% (without looking at a single loan file), actual loan file reviews of Countrywide trusts paint a starkly different picture:

- In *MBIA Insurance Corp. v. Countywide Home Loans, Inc*., *et al.*, Index No. 602825/2008 (N.Y. Sup. Ct.), a re-underwriting of 4,104 Countrywide loans across 15 trusts revealed that ***91%*** of defaulted or delinquent loans show material discrepancies from underwriting guidelines. *See* Amended Complaint, Doc. No. 9, ¶¶ 80-81.[12]

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[11] *See* Exhibits G, J, and I of Petitioners' Request for Judicial Notice Regarding ResCap Bankruptcy Pleadings, Doc. No. 909.

[12] Remarkably, the Institutional Investors used these figures in ResCap to demonstrate the potential exposure faced by ResCap and argue that the Trusts' potential claims were between $38.7 to $44.3 billion. *See* Petitioners' Request for Judicial Notice Regarding ResCap Bankruptcy Pleadings, Doc. No. 909 at 4, n. 10 (citing Exhibit I, Doc. 1739 in ResCap, ¶ 16).

- In *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, *et al.*, Index No. 651612/2010 (N.Y. Sup. Ct.), a re-underwriting of 8,804 Countrywide loans similarly revealed a ***91%*** breach rate, including a remarkable 100% breach rate in four of the 17 trusts. *See* First Amended Complaint, Doc. No. 37, ¶¶ 12, 157.

- In *Financial Guaranty Ins. Co. v. Countywide Home Loans, Inc., et al.*, Index No. 650736/2009 (N.Y. Sup. Ct.), a re-underwriting of 962 Countrywide loans across two trusts revealed an approximate ***75%*** breach rate. *See* First Amended Complaint, (Doc. No. 31), ¶¶ 221-237.

- In *Syncora Guarantee, Inc. v. Countywide Home Loans, Inc., et al.*, Index No. 650042/2009 (N.Y. Sup. Ct.), a re-underwriting of 3,700 loans across two trusts revealed an approximate ***75%*** breach rate, and an additional re-underwriting review of 298 additional loans across two separate trusts revealed an ***85%*** breach rate. *See* Amended Complaint, Doc. No. 51, ¶¶ 82.

- In *US Bank N.A. v. Countrywide Home Loans, Inc., et al.*, Index No. 652388/2011 (N.Y. Sup. Ct.), a re-underwriting of 786 Countrywide loans in one trust *performed by a trustee* revealed an approximate ***66%*** breach rate. *See* Complaint, Doc. No. 2, ¶¶ 52, 131; *see also* Ex. D.

- In *United Guaranty Mortgage Indemnity Co. v. Countrywide Home Loans, Inc., et al.*, Case No. 09-1888 (C.D. Cal.), a re-underwriting of Countrywide loans across 11 trusts revealed an approximate ***55%*** breach rate. *See* Amended Complaint, Doc. No. 8, ¶ 68; *see also* Appendices A and B.

If a settlement range in this case had been based on even the lowest breach rate determined above, the difference would have been dramatic. For instance, even assuming that all other discounts employed by Mr. Lin are correct, and the Steering Committee does not believe they are, a 55% breach rate would result in a settlement range of $12.4 - $16.9 billion, instead of the $8.8 - $11 billion figure arrived at by Mr. Lin. A 91% breach rate would result in a settlement range of $22.3 – $28.5 billion. Given these ranges, it is no wonder that Bank of America insisted on a Further Assurances clause that required the Trustee to continue pushing for approval of a settlement even if the Trustee became aware of information that was contrary to or inconsistent with the information volunteered by Bank of America during the settlement negotiations.

II. CONCLUSION

The picture these inconsistent positions paint is a disturbing one. In *ResCap*, the Institutional Investors argued that "any attempt to impose a loss causation requirement on the Trusts' repurchase claims *is a losing proposition*."[13] Yet, in the proceeding before this Court, the Institutional Investors and the Trustee stand behind this same "losing proposition" to justify accepting pennies on the dollar. Likewise, in *ResCap*, the Institutional Investors argued that post-settlement decisions should be taken into account when evaluating the risk faced by the putative defendant, but here they argue that anything and everything that happened after the settlement is irrelevant. Furthermore, in *ResCap*, the Institutional Investors argued that *WMC*—the one case holding that there is no repurchase remedy for foreclosed loans—is wrong, and contrary to New York law, and arguments based on the decision are "frivolous"; yet, counsel for the Institutional Investors has latched on to this very same case to suggest that the path ahead is perilous if the settlement is not approved. And in *ResCap* the Trustee commissioned a loan file review that enabled the Trustees to determine the breach rate and estimate losses for the loans in the affected trusts. Here, in contrast, the Petitioners argue that loan file review would serve no use, and instead rely on damages estimates that, in truth, are no more than a guess based on loans not even in the Covered Trusts.

Respectfully, the Court should take these inconsistent positions into account when evaluating whether, in fact, the settlement is fair and adequate. The question for the Court is if the Petitioners told this Court the same story they have told Judge Glenn, would the decision to settle for pennies on the dollar still pass muster. The Steering Committee submits that it would not.

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[13] *See* "The Steering Committee Investors' Consolidated Reply to the Objections to the RMBS Trust Settlement Agreement" in the ResCap Bankruptcy Proceedings, (Doc. No. 2808 at 8-9) (attached hereto as Exhibit A) (emphasis added).

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RESPECTFULLY SUBMITTED,

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