Matter of U.S. Bank N.A.
2018 NY Slip Op 32875(U)
November 9, 2018
Supreme Court, New York County
Docket Number: 150183/2018
Judge: Eileen Bransten

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: IAS PART 3

----------X

In the matter of the application of
U.S. BANK NATIONAL ASSOCIATION IN ITS
CAPACITY AS PAYING AGENT OF MORGAN
STANLEY CAPITAL I TRUST 2007-IQ14,

Index No. 150183/2018
Mot. Seq. 001

Petitioner,

For Judicial Instructions under CPLR Article 77
Concerning the Proper Allocation of losses arising from
a permanent interest rate modification.

----------X

BRANSTEN, J.:

This is a special proceeding brought pursuant to CPLR Articles 4 and 77, in which petitioner U.S. Bank National Association, in its capacity as paying agent (the Bank), seeks instructions concerning the proper allocation of realized losses in two commercial mortgage loans held by the Morgan Stanley Capital One Trust 2007-IQ14 (the Trust).

BACKGROUND

The facts herein are taken from the Petition (Pet.) the underlying transactional documents and other submissions of the parties. The Trust is an express Trust consisting primarily of fixed-rate Mortgage loans secured by first mortgage liens on multifamily and commercial properties. Pet. ¶ 22. It is governed by a Second Amended and Restated Pooling Servicing Agreement (the PSA) *Id.* at ¶ 10, *Id.*, Ex. 1 (the PSA). For federal income tax purposes, the PSA creates three real estate mortgage investment conduits (REMICs), REMIC I, REMIC II, and REMIC III. *Id.* at ¶¶ 22-25. REMIC III issued various classes of certificates, which collectively represent the right to all of the cash

flow derived from the mortgage loans held by the Trust. *Id.* at ¶¶ 25-26. As relevant here, Class A-J, Class A-JFX and Class C were three of the classes encompassed by REMIC III. *Id.* at ¶ 25; PSA § 1.1.

Two commercial mortgage loans owned by the Trust, referred to as the "PDG loan" and the "Beacon Loan," and collectively known as the "Modified Loans," were subject to permanent interest rate reductions in 2010 and 2011. Pet. at ¶¶ 2, 28, 32. Following the modifications, US Bank followed instructions received from the Master Servicer and Special Servicer with respect to the treatment of funds on those loans subsequent to the modifications and the application of losses resulting from the modification. *Id.* at ¶¶ 2, 35. Generally speaking, the lost interest resulting from the reduction was applied to the Certificates in the Trust as a Realized Loss, which reduced the outstanding principal balance of the most junior Certificates in the Trust. *Id.* at ¶ 2.

As such, in the period after modification and prior to November 2015, the principal funds collected from the Modified Loans were reduced by the lost interest, thereby increasing the amount of cash collected that was treated as interest. *Id.* In July 2015, three Certificate Owners, (the Class A-J Owners) represented by their common investment manager, informed the Trustee and Paying Agent in writing that they believed the allocation of losses relating to the permanent reduction in interest rate for the

Modified Loans was not applied in accordance with the Trust's governing documents. *Id.* at ¶ 3.

After conferring with the Master Servicer, US Bank adopted the interpretation of the Class A-J Owners. In November of 2015, the Master Servicer for the PDG Loan changed its treatment and reporting of the forgiven interest, which was reflected in the monthly CSMA Loan Periodic update File for the mortgage loans. *Id.* at ¶ 4. Specifically, the Master Servicer allocated and reported the amount of forgiven interest in each month as an "Other Interest Adjustment," which reduced the amount of interest paid on Certificates but did not reduce the amount of collections treated as principal or reduce the outstanding balance of any Certificates. *Id.* For the Beacon Loan, US Bank treated and reported the forgiven interest as an "Interest Adjustment" or other reduction of the interest funds, and did not reduce the outstanding principal balance of any Certificates in the Trust. *Id.* In July 2017, US Bank issued a notice to the Certificateholders describing the 2015 change in procedure:

> Two loans ([the Beacon Loan and the PDG Loan]) were modified several years ago. Since that time and until the November 2015 period, the monthly distribution reports reflected interest forgiven resulting from the interest rate modifications as a Realized Principal Loss rather than solely as Realized Interest Loss. As a result of this treatment as a Realized Principal Loss, most classes of Certificates were overpaid interest over time, with Class C having received a larger overpayment of interest compared to other classes of certificates.
>
> (Ogden Decl., Ex. 4 at 1).

US Bank, however, has now concluded that the Class A-J Owners were incorrect and that the pre-November 2015 application of the forgiven interest as a Realized Loss that reduced the outstanding principal balance of the most junior Certificates in the Trust was correct. *Id.* at ¶ 6. As a result, US Bank contends that Certificate holders of Class A-J certificates and Class A-JFX Certificates have received $18.9 million more in principal payments than they should have received. Conversely, Certificate holders of Class C Certificates were underpaid interest by a corresponding amount. *Id.* at ¶ 7.

In April of 2017, the Trust received a large payment settlement of litigation concerning different loan, known as the "City View Loan." For the April 2017 Distribution Date, US Bank applied those proceeds that were received in settlement based on Class C's entitlement to funds according to the pre-November 2015 allocations. In other words, US Bank excluded an overpayment of interest to Class C in the amount of $9,253,505.66, which otherwise reimbursed Class C for Realized Losses, and included a payment in the same amount as principal to Classes A-M and A-MFX to reduce their outstanding Certificate Balance. This change was disclosed in the monthly Certificate holders' statement for April 2017. *Id.* at ¶ 44.

The Trust has been in existence for more than ten years and currently all Certificates senior in priority to Class A through J and A-JFX have been paid in full all principal due on their certificates. The only Certificateholders that are entitled to receive

remaining cash flow received by the Trust are Certificateholders in Class A-J and Class A-JFX. *Id.* at ¶ 8.

On January 10, 2018, this Court signed US Bank's Order to Show Cause, and granted this request to segregate up to approximately $18.9 million of funds from cash collected by the Trust to pay for the proper Certificate holders. (Dkt. 11). The Court also authorized US Bank to disseminate notice to any Interested Person who may wish to be heard on the merits of the Petition. The Court received seven responses to the petition from:

(l) SBNC Holdings LLC and NAL USA, LLC ("Class C Holders") (holding 100% of the Class C Certificates),

(2) C-III Asset Management LLC, as the former Special Servicer for the Trust (also an affiliate of the managing member of SBNC),

(3) Elliot Management Corporation (as investment advisor for Elliott Associates, L.P., Elliott International, L.P., and The Liverpool Limited Partnership (Elliott), holding 50.57% of the Class A-J and A-JFX Certificates,

(4) DW Partners LP, (DW), holding an unspecified percentage of the Class A-J Certificates,

(5) Appaloosa Investment Limited Partnership I, Palomino Master Ltd., and Azteca Partners LLC (Appaloosa), holding a unspecified but substantial percentage of the Class A-J and Class A-JFX Certificates,

(6) M.H. Davidson & Co., Davidson Kempner Partners, Davidson Kempner Institutional Partners, L.P., Davidson Kempner International, Ltd., Davidson Kempner Distressed Opportunities Fund LP, Davidson Kempner Distressed Opportunities International Ltd., Davidson Kempner Long-Term Distressed Opportunities Fund II LP, and Davidson Kempner Long-Term Distressed Opportunities International Master Fund II LP (the DK funds), holding an unspecified percentage of the Class A-J and A-JFX Certificates, and

(7) OWS COF I Master, L.P., OWS Credit Opportunity I LLC, One William Street Capital Master Fund, Ltd, Baldr Fund Inc., OWS ABS Master Fund II, L.P., and OWS Credit Opportunity I LLC (the OWS Funds).

The Class C Holders and Class C-III support US Bank's interpretation. Elliot, Appaloosa and DW Partners (the Objectors) object to the Petition. Finally, the DK Funds and the OWS Funds (the Respondents) assert that they lack the information necessary to respond to the facts alleged in the Petition or form a final position regarding the relief sought.

DISCUSSION

US Bank seeks to obtain judicial instructions, pursuant to Article 77 of the CPLR, concerning the proper allocation of the realized losses with respect to modified loans. Pursuant to Section 15.4 of the PSA, the laws of the State of New York govern the rights and obligations of the Petitioner and Certificate holders in the Trust. New York Law permits bringing a special proceeding to determine a matter relating to any express trust. CPLR 7701; *see also In Re Ray Greene v Finley Kumble, Wagner, Heine & Underberg*, 88 AD2d 547, 548 (1st Dept 1982) (finding CPLR 7701 should be broadly construed to cover any matter of interest to trustees, beneficiaries, or adverse claimants concerning the trust).

The parties agree that the lost or forgiven interest resulting from the permanent rate reduction constitutes a "Modification Loss", which in turn constitutes a "Realized Loss" (see PSA § 1.1). They also agree that section 6.6(f) of the PSA addresses how Realized Losses are allocated to the certificates. The sole issue here is whether the "lost interest" on the Modified Loans should result in a reduction of the interest payable to Certificate holders, or whether that "lost interest" should instead result in reduction of the outstanding principal amount on the Certificates held by the Certificate holders.

US Bank asserts that the language of Section 6.6(f) is dispositive. That section provides, in pertinent part:

> REMIC III. On each Distribution Date, all Realized Losses . . . shall be allocated to the REMIC Regular Certificates and the Floating Rate Regular Interests in Reverse Sequential Order, with such reductions being allocated among the Class A-l, Class A-1A, Class A-2, Class A-3, Class A-AB and Class A-4 Certificates and the Class A-2FL and Class A-5FL Regular Interests and, in the case of interest, the Class X Certificates, pro rata (treating principal and interest losses separately), in each case reducing (A) the Certificate Balance of such Class (excluding the Class X Certificates) until such Certificate Balance is reduced to zero; (B) Unpaid Interest owing to such Class to the extent thereof; and (C) Distributable Certificate Interest owing to such Class, provided that Realized Losses and Expense Losses shall not reduce the Aggregate Certificate Balance of the REMIC Regular Certificates and the Floating Rate Regular Interests below the sum of the Aggregate Certificate Balances of the REMIC II Regular Interests.

US Bank argues that this language requires that "all Realized Losses" are first allocated to reduce the Certificate Balance of Certificates issued by the Trust under subsection (A) of 6.6(f). The Objectors contend the correct interpretation is to treat the

permanent reduction of interest payments on the two loans as a reduction in interest distributions to the junior Certificates, not as reductions in principal. In favor of this construction, they argue that (1) the allocation of Realized Interest Losses to Distributable Certificate Interest in section 6.6(a) is a procedure that should "flow through" and control the allocation as to the certificates in REMIC III; (2) the purported requirement in section 6.6(f) that Realized Losses of any kind be allocated to both interest and principal is inconsistent with the common sense approach of applying interest losses to interest only, as well as with the parenthetical reference to treating principal and interest losses "separately" in 6.6(f), and with the repeated application of Realized Interest Losses in the later sentences of 6.6(f); (3) the language of 6.6(f) does not unambiguously prioritize the application of Realized Losses to the Certificate Balances designated in 6.6(f)(A); and (4) US Bank should be charged with its prior admissions regarding the propriety its employment of the Objectors' approach. Additionally, the Objectors assert that section 6.5 of the PSA actually governs the distribution of loan principal and interest among the classes, mandating that the principal certificate balances of the most senior classes be paid down by reference to the Principal Distribution Amount, without reduction for Realized Losses of any kind. The Objectors further contend that US Bank did not even correctly apply its now-preferred interpretation of 6.6, in that it applied Realized Losses class-by-class only to the principal Certificate Balance under 6.6(f)(A) until reduced to

zero, but not also the Unpaid Interest and Distributable Certificate Interest items designated in 6.6(f)(B) and (C).

US Bank rejects all of the Objectors' arguments as contrary to the plain language of the PSA, asserting that drafters were careful to distinguish between Realized Losses, Realized Principal Losses, and Realized Interest Losses where appropriate. Specifically, it argues that if the drafters had intended to allocate Realized Interest Losses solely to the items designated in 6(f) (B) and (C), the PSA could have so specified, and then provided that Realized Principal Losses were to be allocated to the Certificate Balances under section 6(f)(A). It also notes that section 6.6(a) applies only to REMIC I and REMIC II Regular Interests, none of which are held by the Objectors or Respondents. As to the later references to Realized Interest Losses in 6.6(f), US Bank contends that the language only applies to the remaining subclasses of Certificates in 6.6(f). Similarly, it argues that the parenthetical requirement to treat principal and interest separately applies only to the pro rata reductions allocated among the nine classes of Certificates listed immediately before the parenthesis. US Bank also contends that the need for the PSA to specify that the losses are applied "first" to the Certificate Balances is obviated by the requirement that the losses be applied "until" the balances are reduced to zero, signifying that they cannot be applied to the items in section 6.6(f)(B) and (C) until that process is first completed.

With respect to section 6.5, US Bank argues that it only governs the distribution of cash "down" the waterfall in sequential order, not the allocation of Realized losses "up" in the opposite direction. Petitioner thus urges that the more specific provisions regarding Realized Losses in 6.6(f) must control. It also contends that is own prior erroneous interpretation of the PSA is irrelevant, and that the only question is what the agreement legally requires. Finally, US Bank asserts that the Prospectus Supplement (ProSupp), issued in connection with the marketing of the Certificates, supports its interpretation because it specifically represents that Realized Losses "will reduce (i) first, the Certificate Balance of such Class until such Certificate Balance is reduced to zero . . .; (ii) second, Unpaid Interest owing to such Class and (ii) third Distributable Certificate Interests Amounts owning to such Class."

Under New York law, "written agreements are construed in accordance with the parties' intent and the best evidence of what parties to a written agreement intend is what they say in their writing." *Schron v Troutman Sanders LLP,* 20 NY3d 430, 436 (2013). Thus, "a written agreement that is complete, clear and unambiguous on its face must be enforced according to the plain meaning of its terms." *Greenfield v Philles Records, Inc.,* 98 NY2d 562, 569 (2002). Extrinsic evidence may be used to interpret a contract only where it is ambiguous, and the determination as to ambiguity is a question of law to be answered by the court. (Id., at 570.) A contract is ambiguous if "on its face [it] is

reasonably susceptible of more than one interpretation" *Chimart Assoc. v Paul*, 66 NY2d 570, 573 (1986). There must be "no reasonable basis for a difference of opinion," *Greenfield v Philles Records, Inc.*, 98 NY2d 562, 569, but ambiguity does not exist "simply because one of the parties attaches a different, subjective meaning to one of its terms." *Sasson v TLG Acquisition LLC*, 127 AD3d 480, 481 (1st Dept 2015). Furthermore, "[t]he existence of ambiguity is determined by examining the entire contract and consider[ing] the relation of the parties and the circumstances under which it was executed, with the wording viewed in the light of the obligation as a whole and the intention of the parties as manifested thereby." *Banco Espirito Santo, S.A. v Concessionaria Do Rodoanel Oeste S.A.*, 100 AD3d 100, 106 (1st Dept 2012) (internal quotations and citations omitted).

The petition is denied and the parties are directed proceed with discovery. As a preliminary matter, it is of some significance that the alleged error in allocation was not discovered by the Objectors for three years, and that US Bank then found the new interpretation to be sufficiently reasonable that it employed it for two years. Indeed, the bank was so persuaded that the new procedure was correct that it did not seek judicial instructions at that time. And even after reversing its conclusion, US Bank has asserted only that the original allocation procedure was the "best reading." Pet. ¶ 45. Assuming that that is so, it still does not mean that it is the *only* reasonable reading. The case thus

presents something more than merely one of the parties attaching a subjective meaning to the language of a contract; rather, it is a case of a third party, disinterested sophisticated financial institution attaching conflicting meanings to the same language on three different occasions. The court finds this confusion to be understandable and holds that the PSA is ambiguous regarding the proper allocation of the lost interest.

Read in context with sections 6.5, 6.6(a) and the later passages of 6.6(f), the PSA can reasonably be construed as either permitting, or prohibiting, application of the interest losses to the Certificate Balances. The parties have attempted to support their positions by applying competing axioms of contractual construction to selected passages of the PSA. However, those tools are too blunt to be applied to such a complex financial transaction and do not meaningfully resolve the conflict. And even if the language were sufficiently clear to permit the court to commit to one interpretation or the other, the parties' submissions have failed to provide an easily comprehensible explanation (if one is possible) of how the payments are calculated and distributed to the various classes of Certificates. The mechanism is apparently something to be pieced together from the 300-page PSA's Preliminary Statement, the Definition section and the schedules contained therein, and the various paragraphs of section 6.

In this connection, the court notes that the status of the Class A-JFX Certificates is unclear, counsel having stipulated at oral argument as to the seniority of the Class A-J

Certificates but indicated that Class A-JFK was a "different story" (Dkt. 61, Tr. 33). Those Certificates are mentioned in footnote (c) of the schedule of REMIC III Class designations, which indicates that they represent the "Class JFX Percentage Interests of the Class JFL Regular Interests." Later in that footnote, it is stated that "[f]ollowing the Second Restatement Date the Aggregate Certificate Balances of the [Class JFX Certificates and three other classes] will be subject to further re-designations as between such Classes pursuant to Section 3.10." Expert affidavits or testimony may thus be required to clarify this and other issues, especially because apart from appeals to "common sense" and contractual construction, some of parties' arguments center around the financial purposes, tax policies and other considerations underlying the complicated structure of the Trust. Their resolution may implicate business judgments rather than legal considerations.

Finally, the court concurs that the ProSupp may have some evidentiary value, in that it provides a clear sequence to the allocation of Realized Losses among the items in 6.6(f)(A), (B) and (C). But that also raises the question of why the clarifying language was not incorporated into the PSA itself. Resort to the intent of the drafters, and witnesses with expertise in REMIC structured trusts, will be needed. Similarly, their assistance would be helpful in explaining the relevance and import of the guidance

provided the Commercial Real Estate Finance Council with respect to the reporting of a modification resulting in a permanent rate reduction.

Accordingly, it is hereby

ORDERED, that the Petition is denied, and it is further

ORDERED, that all parties are to appear for a Preliminary Conference on January 15, 2019 at 11:00 am.

Dated: 11-9-18

ENTER:

HON. EILEEN BRANSTEN
J.S.C.