

Matter of Bank of N.Y. Mellon
2020 NY Slip Op 31584(U)
May 29, 2020
Supreme Court, New York County
Docket Number: 150738/2019
Judge: Joel M. Cohen
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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: COMMERCIAL DIVISION PART IAS MOTION 3EFM

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IN THE MATTER OF THE APPLICATION OF THE BANK OF NEW YORK MELLON, IN ITS CAPACITY AS TRUSTEE FOR 278 RESIDENTIAL MORTGAGE-BACKED SECURITIZATION TRUSTS,

INDEX NO. 150738/2019

MOTION DATE 01/24/2019

Petitioner,

MOTION SEQ. NO. 001

DECISION + ORDER ON MOTION

FOR JUDICIAL INSTRUCTIONS UNDER CPLR ARTICLE 77 CONCERNING THE PROPER PASS-THROUGH RATE CALCULATION FOR CWALT INTEREST ONLY SENIOR CERTIFICATES

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HON. JOEL M. COHEN:

The following e-filed documents, listed by NYSCEF document number (Motion 001) 4, 9, 10, 11, 14, 18, 23, 24, 27, 28, 31, 32, 33, 34, 35, 36, 37, 38, 48, 49, 52, 55, 56, 57, 58, 59, 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, 76, 78, 79, 80, 81, 82, 83, 84, 85, 96, 97, 98, 99, 100, 101, 109, 112, 113

were read on this Petition for JUDICIAL INSTRUCTIONS

This is a proceeding under CPLR Article 77. Petitioner Bank of New York Mellon ("BNYM"), as trustee for 278 residential mortgage-backed securitization ("RMBS") trusts (collectively, the "Trusts"), seeks judicial instructions as to the proper method for calculating the Pass-Through Rate under the Pooling and Servicing Agreements ("PSAs") (see NYSCEF 3 [PSA]) governing the Trusts.

In a nutshell, the question presented is whether payments to interest-only ("IO") senior certificate holders should be based on the original interest rates on the underlying mortgage

1 References to the "PSA" herein refer to the PSA governing the CWALT 2006-6CB Trust, which the parties agree is representative of the other PSAs relevant to this Petition (see NYSCEF 1 ¶ 2; NYSCEF 2 [listing all 278 covered Trusts]; NYSCEF 27 at 2 n.2 [Initial Statement of the Institutional Investors]; NYSCEF 31 at 4 n.1 [Silian Answer and Objection to Petition]; NYSCEF 72 [BNYM Br.]).

loans in each Trust (the “static” approach) or on the *actual* (lower) interest rates on those loans under modification agreements with borrowers (the “dynamic” approach). BNYM has used the dynamic approach throughout the life of the Trusts, without objection (until recently) from certificate holders who would have benefited from the static approach.

The Petition is prompted by objections raised by an IO senior certificate holder that acquired its certificates in 2017, more than a decade after the Trusts were established (NYSCEF ¶ 16 [BNYM Petition]; *see* Representative Trust dated March 1, 2006). The objector – Silian Ventures LLC (“Silian”), beneficial owner of the IO certificates – argues that BNYM was (and is) required under the PSAs to use the static approach in making payments. Silian’s view is that under the PSAs, the IO certificate holders were to be insulated from changes in interest rates unless such changes were envisioned in the original mortgage loans (*i.e.*, floating-rate loans). All other certificate holders who have appeared in this proceeding disagree with Silian. They contend that BNYM correctly uses actual interest payments in making its pass-through payments to all certificate holders. Doing otherwise, they argue, would violate the PSAs and improperly shift the risk of interest rate modifications entirely to other certificate holders, and would upset the settled and longstanding expectations and understanding of certificate holders and other market participants.²

The Court finds that the plain language of the PSAs supports BNYM’s use of the dynamic approach to allocate payments among certificate holders. In the alternative, even assuming there is some ambiguity on that issue in these agreements, the parties’ decade-long course of performance using the dynamic approach is “[t]he best evidence of the intent of parties

² Allied with BNYM, at least on the question whether to use the dynamic approach, is a group of investors who hold P&I certificates in 234 of the 278 covered Trusts (the “Investor Group”).

to a contract” (*Waverly Corp. v City of New York*, 48 AD3d 261, 265 [1st Dept 2008] [citations omitted]). “Generally speaking, the practical interpretation of a contract by the parties to it for any considerable period of time before it comes to be the subject of controversy is deemed of great, if not controlling, influence” (*Fed. Ins. Co. v Americas Ins. Co.*, 258 AD2d 39, 44 [1st Dept 1999] [quoting *Old Colony Trust Co. v City of Omaha*, 230 US 100, 118 [1913]).

For the reasons that follow, the Petition (with the instructions proposed by BNYM) is granted.³

BACKGROUND

The Trusts

To simplify a notoriously complex arrangement, the Trusts generate payment streams to investors from a mass of underlying mortgage loans. Each Trust pools the interest and principal payments received from loan servicers, who in turn collect the principal and interest payments from hundreds or thousands of mortgage borrowers, on the mortgage loans that constitute the assets of that Trust. The Trustee (here, BNYM) allocates this income among different classes of certificates that are held by investors in the Trust (Pet. ¶ 3). Each certificate entitles its holder to a specific stream of payments from the pool: the principal (the principal-only, or “PO” certificates), interest (the interest-only, or “IO” certificates), or both (the “P&I Certificates”). Each Trust’s respective PSA assigns each class of certificates a place in the distribution line, and describes the order of payments to each class, in provisions commonly known as a “waterfall” (*id.* ¶ 4).

³ During the course of this proceeding, a related issue arose with respect to whether BNYM should make certain Pass-Through Rate calculations on a “Loan-Level” or “Pool-Level” basis. As set forth *infra*, the Court finds that BNYM’s longstanding use of Loan-Level calculations is the correct approach under the PSAs.

These Trusts employ what is called a “ratio-strip” structure in allocating the principal and interest payments among the certificate holders. While holders of the P&I certificates receive both principal and interest payments on the underlying mortgage loans, IO certificate holders receive only the *excess interest*, if any, that is left over on high-interest mortgages (known as “Non-Discount Mortgage Loans”) above a certain interest rate (the “Required Coupon”). The structure gets its name from the way it “strips” the portion of the interest rate above the Required Coupon and packages that segregated portion of the interest rate as the contractual rate payable to the IO senior certificates.⁴ As the interest rate on Non-Discount Mortgage Loans climbs higher above the Required Coupon, the IO certificates rise in value, and vice versa.

There is a finite amount of money to be distributed. An increase in payments made to one class of certificate holders necessarily comes at the expense of another class. It is a zero-sum game.

Impacts of Loan Modifications

As has been recounted many times, the performance of mortgage loans contained in many RMBS trusts performed substantially worse than expected by investors. Many loans were modified with lower interest rates, and in some cases lower principal amounts, in an attempt to stave off harmful and costly defaults. As a result, the cash flows to RMBS trusts (including the Trusts at issue here) took a significant hit.

⁴ For lower-interest mortgage loans – *i.e.*, those mortgage loans whose interest rate falls below the Required Coupon – an analogous process unfolds with respect to the PO certificate holders. The PSAs strip a portion of the principal payment (to raise the effective interest rate on the remaining principal payment to the Required Coupon) and define that segregated portion of principal as the principal amount payable to the PO certificates. These lower-interest mortgage loans are designated as “Discount Mortgage Loans.”

That raised the question of how these interest-rate modifications, and their impact on funds throwing into the Trusts, should ripple through to the certificate holders in the Trusts. Should interest-based payments to IO senior certificate holders under the PSAs be based on the mortgage loans' *initial* interest rates (the static approach), or on their *current* rates over time (the dynamic approach)? For years, BNYM has been using the latter approach, without complaint from certificate holders.

Under the payment calculations performed over the past decade by BNYM, holders of all interest-bearing certificates – including the P&I and IO certificates – have received interest payments based on the mortgage loans' current (*i.e.*, as modified) interest rates. But Silian, which purchased the IO certificates for 156 of the 278 Trusts in December 2017, insists that BNYM's approach runs afoul of the PSAs. According to Silian, the PSAs *mandate* that BNYM ignore the impact of rate modifications in making payments to IO certificate holders.

Key Definitions in the PSAs

Both sides urge that the plain language of the PSA supports their respective positions. Under the PSAs, distributions to the IO certificates are calculated by applying a “Pass-Through Rate” to the total outstanding principal balance of the Non-Discount Mortgage Loans.⁵

As relevant here, three definitions determine the Pass-Through Rate for the IO certificates:

⁵ More precisely, the interest rate payable on the IO certificates is calculated based on a Pass-Through Rate equal to the amount by which (x) the weighted average of the interest rates of all Mortgage Loans whose interest rates (net of certain fees and expenses) exceed a threshold interest rate (the “Required Coupon”) exceed (y) the Required Coupon (Pet. ¶ 27). The stated principal balance of the Non-Discount Mortgage Loans is called the “Notional Amount” (*id.* ¶ 28). This calculation of payment to IO certificates ignores Discount Mortgage Loans, because by definition there is no excess interest to compute for those loans (*id.* ¶ 27).

1. “**Adjusted Net Mortgage Rate**” defined, in relevant part, “[a]s to each Mortgage Loan, *and at any time*, the per annum rate equal to the Mortgage Rate [less certain fixed percentage fees not relevant here]” (PSA, art. I, I-1 [emphasis added]);
2. “**Mortgage Rate**” defined as “[t]he annual rate of interest borne by a Mortgage Note *from time to time*, net of any interest premium charged by the mortgagee to obtain or maintain any Primary Insurance Policy” (PSA, art. I, I-17 [emphasis added]);
3. “**Mortgage Note**” defined as “[t]he original executed note *or other evidence of indebtedness* evidencing the indebtedness of a Mortgagor under a Mortgage Loan” (*id.* [emphasis added]).

The Instant Action

BNYM filed this petition for judicial instruction under Article 77 of the CPLR on January 24, 2019. An Article 77 proceeding “may be brought to determine a matter relating to any express trust . . .” (CPLR § 7701). “Permissible uses of Article 77 are broadly construed to cover any matter of interest to trustees, beneficiaries or adverse claimants concerning the trust,” and “[s]uch proceedings are used by trustees to obtain instruction as to whether a future course of conduct is proper, and by trustees (and beneficiaries) to obtain interpretations of the meaning of trust documents” (*BlackRock Fin. Mgt. Inc. v Segregated Account of Ambac Assur. Corp.*, 673 F3d 169, 174 [2d Cir 2012] [collecting New York cases]).

Here, BNYM asks the Court to address two questions concerning BNYM’s calculation of interest payments under the PSAs. *First*, BNYM asks whether it should use the initial rate or the current rate to calculate the Pass-Through Rate for payment to IO senior certificate holders (*see* Pet. ¶¶ 18–20). *Second*, if the current rate applies, BNYM asks whether it should use a “Pool-

Level” or “Loan-Level” calculation in determining the Pass-Through Rate.⁶ On both questions, the Court finds in favor of the approaches BNYM has used since the inception of the Trusts.

DISCUSSION

I. BNYM’s Use of the Dynamic Approach to Calculate the Pass-Through Rate is Appropriate

A. The Language of the PSAs Supports BNYM’s Position

The Court finds that the language of the PSAs supports BNYM’s use of the dynamic approach to determining the Pass-Through Rate for payments to IO senior certificate holders. The definitions of the three key components of the Pass-Through Rate expressly envision that the applicable interest rate may change over time. “Adjusted Net Mortgage Rate” and “Mortgage Rate” both use temporal language to describe the applicable interest rate – *i.e.*, “at any time” and “from time to time.” That language would be rendered largely superfluous by the static method, which freezes the interest rate at a single point in time. Although Silian argues that the temporal language reflects only periodic rate adjustments pursuant to the original terms of adjustable-rate mortgages, the PSAs do not expressly provide for such a limitation. Moreover, 155 of the 156 relevant Trusts in which Silian purchased certificates contain exclusively *fixed-rate* mortgage loans, further undermining Silian’s strained reading of the language (NYSCEF 79 ¶¶ 3-4 [Aff. of David M. Sheeren]).

⁶ This issue was not raised by BNYM in its Petition, but rather by certain respondent investors (NYSCEF 44 [BNYM Ltr. to the Court dated May 14, 2019]). Consequently, the issue was placed in the Supplemental Notice (*see* NYSCEF 45 [Proposed Supplemental Notice]). The Pool-Level calculation determines the Pass-Through Rate by calculating the weighted average of the Adjusted Net Mortgage Rate of all Non-Discount Mortgage Loans before subtracting 5.50%. The Loan-Level calculation determines the excess of the Adjusted Net Mortgage Rate of each Non-Discount Mortgage Loan over 5.50%, then takes the weighted average of this loan-by-loan excess.

Similarly, “Mortgage Note” is defined as “[t]he original executed note *or other evidence of indebtedness*” (PSA, art. I, I-17 [emphasis added]). The second part of that disjunctive definition would be rendered meaningless by rigid adherence to the static method, which fixates solely on the original mortgage loan and ignores subsequent “evidence of indebtedness” such as the interest-rate modifications at issue (*see Matter of Viking Pump, Inc.*, 52 NE3d 1144, 1154 [NY 2016] [constructions that cause surplusage “cannot be countenanced under our principles of contract interpretation”]; *FCI Grp., Inc. v City of NY*, 54 AD3d 171, 177 [1st Dept 2008] [“[A] court should not adopt an interpretation which will operate to leave a provision of a contract without force and effect.”] [internal quotation marks and citation omitted]).

Other features of the Trusts confirm the changing nature of the Mortgage Rate, providing further support for the dynamic approach. For example, in the context of a particular type of mortgage-loan modification, known as a modification in lieu of refinancing, the PSAs use the term Mortgage Rate to describe a changing rate of interest. To meet the conditions for a modification in lieu of refinancing, “the Mortgage Rate on the Modified Mortgage Loan” must be “approximately a *prevailing market rate*” (PSA § 3.11 [b] [emphasis added]). Since such modifications would be expected to occur only when the “prevailing market rate” moves below the initial rate, this wording indicates that the Mortgage Rate is not necessarily fixed at origination. It is worth noting, too, that the PSA does not use a new defined term to describe the changing interest rate on a Modified Mortgage Loan; the term Mortgage Rate is still used, meaning that its definition is flexible enough to reflect a changing interest rate. And by its terms, calculating the Mortgage Rate requires factoring in certain mortgage guaranty insurance costs, which can also change over time (*see* PSA, art. I, I-17; PSA, art. I, I-24). The mechanics of these Trusts therefore reinforce the validity of the dynamic approach used by BNYM.

The arguments advanced by Silian, on the other hand, fall short. For example, Silian fails to explain how its interpretation squares with the second half of the definition of Mortgage Note, which includes “other evidence of indebtedness” (PSA, art. I, I-17). As the Investor Group points out, once a modification takes place, it is only the modification documents that reflect the “annual rate of interest borne by [the] Mortgage Note” (*id.* [definition of Mortgage Rate]). Accordingly, the modification documents, not the original loan documents, serve as the “evidence of indebtedness” from that time forward (until another modification occurs).

Silian argues that adopting a modified interest rate creates inconsistencies in the Trusts, but these purported inconsistencies do not support Silian’s reading of the PSAs. To take two of Silian’s examples: (1) Silian contends that the dynamic approach is at odds with the one-time classification of mortgage loans into the Discount or Non-Discount buckets. This one-time “bucketing,” however, is consistent with the argument that the use of temporal language in the key definitions above signals the use of the dynamic approach; the bucketing provisions do not include such language, and therefore do not call for such an approach (*see* PSA, art. I, I-17). (2) Silian also argues that the dynamic approach yields commercially unreasonable results because, among other things, it “turn[s] IO senior certificates into first-loss certificates on losses caused by interest-rate modifications” (NYSCEF 65 at 15 [Silian Objection to Pet.]). But this is not an inconsistency. Silian’s “senior” IO certificates are first in line to receive a specific stream of payments – excess interest cash flows generated by the underlying loans (*see* PSA § 4.02; *see also* NYSCEF 80 [Prospectus Supplement for the 2006-6CB Trust, at S-135]). To the extent interest-rate modifications choke off the excess interest cash flows, and disproportionately harm certificate holders entitled to those cash flows, that result follows from the design of the Trusts. Indeed, it is *Silian’s* view of the seniority structure that poses the real inconsistency: Silian’s

approach creates a guaranteed payment stream to senior IO certificate holders, which could only be funded by diverting cash flows from other “senior” certificate holders.

B. The Parties’ Course of Performance Affirms BNYM’s Use of the Dynamic Approach

To the extent the PSAs are susceptible to multiple interpretations about how to calculate the Pass-Through Rate, the parties’ course of performance is powerful evidence that BNYM’s reading accurately reflects the intent of the parties to the PSAs. As noted above, “[g]enerally speaking, the practical interpretation of a contract by the parties to it for any considerable period of time before it comes to be the subject of controversy is deemed of great, if not controlling, influence” (*Fed. Ins. Co. v Americas Ins. Co.*, 258 AD2d 39, 44 [1st Dept 1999] [quoting *Old Colony Trust Co. v City of Omaha*, 230 US 100, 118 [1913]]). The parties’ decade-long performance here – BNYM’s use of the dynamic approach, without objection from certificate holders – offers “[t]he best evidence of [their] intent” (*Waverly Corp. v City of New York*, 48 AD3d 261, 265 [1st Dept 2008] [citations omitted]). On the record presented to the Court, Silian is the only objector to BNYM’s use of the dynamic approach. The fact that other IO certificate holders have not objected, despite a financial incentive to do so if they believed BNYM’s approach violated the PSAs, is persuasive evidence that BNYM’s approach reflects the intent of the parties.

BNYM’s use of the dynamic approach was no secret. Nor was the fact that many loans included in these Trusts were modified with lower interest rates. Each month, BNYM publishes a statement, or remittance report, containing the underlying numbers that it uses to calculate the Pass-Through Rate (*see* NYSCEF 74 [CWALT Alternative Loan Trust 2006-6CB November 2018 Remittance Report]). This statement, which is publicly accessible for registered offerings through the BNYM website, explains how much a Trust paid out in a particular month and why.

The trust-level reports provide information specific to each class of certificates for that trust (*id.* at 1) and refer investors to the loan-level report for all “current and existing loan level modification details” (*id.* at 39). The loan-level report shows information on each mortgage loan, including the loan’s current interest rate net of servicing fees (*see* NYSCEF 115 [BNYM Supplemental Filing]; NYSCEF 116 [CWALT Alternative Loan Trust 2006-6CB November 2018 Loan-Level Report]). As Silian’s counsel acknowledged during oral argument, “among sophisticated investors this practice” – *i.e.*, BNYM’s historical practice of using the dynamic approach to reflect rate modifications – “is something that would be known” (NYSCEF 121 at 8 [Oral Argument Tr.]).⁷

Silian discounts this course of performance as mere “unilateral conduct,” and urges instead that more probative extrinsic evidence can be found in the way other trusts, under different PSA agreements, performed. While the “custom and use prevailing in a particular trade” is useful in certain situations (*Zurakov v Register.Com, Inc.*, 304 AD2d 176, 179 [1st Dept 2003] [opting for trade usage over dictionary definition of undefined term in contract]), “[t]here is no surer way to find out what parties meant, than to see what they have done” (*Brooklyn Life Ins. Co. of N.Y. v Dutcher*, 95 US 269, 273 [1877]; *D.S. 53- 16-F Assocs. v Groff Studios Corp.*,

⁷ Counsel’s comment was made in response to the Court’s inquiry whether a dispute as to BNYM’s dynamic approach to interest rates had been “percolating for years so that buying and selling would incorporate this issue, or is this a fairly new debate” (Oral Argument Tr. at 8.) In a post-argument submission, Silian argues that while the monthly reports and loan-level data may show interest-rate modifications to underlying mortgage loans, the Trustee reports do not explicitly state that the modified rates were being used to calculate the Pass-Through Rate for the IO senior certificates (NYSCEF 122). It does not, though, seriously contest that the sophisticated certificate holders and investors in the RMBS market were aware of BNYM’s practice. And there is no dispute that Silian was the first to challenge it. Silian’s objection to BNYM’s course of performance has been that it was mistaken or unilateral (*see* NYSCEF 86 at 15-17 [Silian’s Resp. Br.]), not that it was concealed from investors.

168 AD3d 611, 611 [1st Dept 2019]). Certainly, the course of performance by *these* parties under *these* PSAs sheds more light on the parties' intentions than what "peer trustees" (allegedly) do under different governing agreements.

Finally, the Court is wary of being employed to retroactively create winners and losers in an untold number of previous transactions that were priced based, at least in part, on the course of performance described above. The most obvious example of that is Silian itself, which acquired its IO certificates in 2017 from a prior holder that had been receiving IO payments based on the dynamic approach to interest rate modifications. The record does not reflect the terms upon which Silian acquired its certificates, but it is safe to assume that a sudden and retroactive change from a dynamic approach to a static approach would lead to a substantial windfall for Silian and a corresponding loss to holders of other classes of certificates who acquired their interests prior to such a change. While that would not be enough to approve an approach that squarely conflicted with the terms of the PSAs, it is a concrete example of why adopting an interpretation that would override a longstanding course of performance and settled expectations is disfavored.

The Court has considered Silian's remaining arguments on this issue and finds them to be without merit.

II. Loan-Level Calculation of the Pass-Through Rate is Appropriate

Independent of the dispute over the applicable interest rates, the investor parties argue that BNYM should begin using a Pool-Level approach to calculate the excess interest owed to the IO certificate holders, rather than the Loan-Level approach it has used for years. They do not, however, point to any language in the PSAs that would warrant such a change in BNYM's approach.

The relevant provision states that the Pass-Through Rate on IO certificates is “the excess of (a) the weighted average of the Adjusted Net Mortgage Rates on the Non-Discount Mortgage Loans in Loan Group 1, weighted on the basis of the Stated Principal Balance thereof as of the Due Date in the preceding calendar month . . . , over (b) 5.50% [i.e., the Required Coupon]” (PSA, Preliminary Statement at 4 n.19). BNYM’s longstanding use of the Loan-Level approach to calculating the weighted average is consistent with that language.

Moreover, the Court (again) concludes that BNYM’s longstanding course of performance reflects the parties’ intentions when the PSAs were written (*see, e.g., Fed. Ins. Co.*, 258 AD2d at 44). It is undisputed that BNYM has been using the Loan-Level approach for years, calculating the weighted average of the excess (if any) of each individual Non-Discount Mortgage Loan’s current interest rate over the Required Coupon. If that approach was at odds with the intent of the parties, it is reasonable to assume that objections would have been raised promptly by certificate holders. In the absence of any text mandating a contrary approach, the Court finds that BNYM’s continued use of a Loan-Level approach best reflects the intent of the parties to the PSAs.

The Court has considered the Investor Group’s and Silian’s remaining arguments on this issue and finds them to be without merit.

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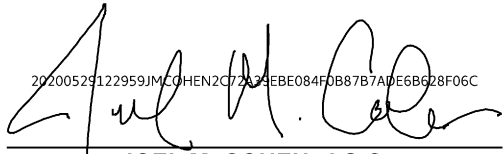
Accordingly, for the reasons stated above, it is

ORDERED that BNYM’s petition under CPLR Article 77 for judicial instructions is **Granted**.

The Court finds and instructs that BNYM (as trustee) has correctly used and should continue to use the “dynamic” approach and the “Loan-Level” approach, as described above, in

calculating the Pass-Through Rate for payments to IO senior certificate holders under the terms of the PSAs governing the Trusts.

This constitutes the Decision and Order of the Court.


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JOEL M. COHEN, J.S.C.

5/29/2020
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