APL-2014-00156
New York County Clerk's Index No. 650980/12

COURT OF APPEALS
of the
STATE OF NEW YORK

ACE SECURITIES CORP., Home Equity Loan Trust, Series 2006-SL2, by HSBC Bank USA, National Association, solely in its capacity as Trustee pursuant to a Pooling and Servicing Agreement, dated as of March 1, 2006,

Plaintiff-Respondent,

– against –

DB STRUCTURED PRODUCTS, INC.,

Defendants-Petitioners.

BRIEF FOR AMICI CURIAE FEDERAL HOME LOAN BANK OF BOSTON, FEDERAL HOME LOAN BANK OF INDIANAPOLIS, AND FEDERAL HOME LOAN BANK OF TOPEKA

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Date Completed: April 1, 2015

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INTRODUCTION

New York courts interpret contracts "to ascertain the intention of the parties at the time of the contract." *Evans v. Famous Music Corp.*, 1 N.Y.3d 452, 458 (2004). Courts thereby effect the reasonable expectations of the parties going into the contract—and, just as importantly, avoid the lure of post-hoc, made-for-litigation theories. *See Sutton v. E. River Sav. Bank*, 55 N.Y.2d 550, 555 (1982) (New York courts aim at "a practical interpretation of the expressions of the parties to the end that there be a realization of [their] reasonable expectations").

As Amici will explain, Respondent DB Structured Products ("DBSP") advances precisely that kind of made-for-litigation theory here. DBSP advances a theory that nullifies investors' reasonable expectation that the cure-or-repurchase covenant would continue throughout the life of a residential mortgage-backed security ("RMBS"). DBSP's proffered theory should be rejected.

INTEREST OF AMICI CURIAE

The Federal Home Loan Banks of Boston, Indianapolis, and Topeka (the "Banks") are three of the twelve regional Federal Home

Loan Banks, which are congressionally chartered pursuant to the Federal Home Loan Bank Act of 1932. The Banks are government-sponsored enterprises, but are privately capitalized and independently managed. Operating as wholesale banks in cooperative form, they provide a reliable source of low-cost liquidity to support the housing finance (including affordable housing) and community investment activities of the banks, thrifts, credit unions, and insurance companies that are their member/owners.

The Boston Bank holds RMBS with a combined par value of almost $2 billion. The Indianapolis Bank holds RMBS worth approximately $400 million. And the Topeka Bank's RMBS are worth over $4 billion. In light of their public policy mission and statutory and regulatory limitations, the Banks have a very conservative investment philosophy. Hence, the Banks bought RMBS because they reasonably believed that they were safe, prudent, and highly rated investments. The characteristics of the mortgages underlying those investments, however, were not as they had been represented to the Banks. As a result, the securities held by several of the Federal Home Loan Banks have significantly declined in value.

As conservative institutional investors with major RMBS holdings, the Banks can give the Court a perspective on this case that is unavailable elsewhere. In particular, they can communicate the reasonable expectations of investors who bought RMBS not to speculate, but to provide a safe and dependable source of income that would last for up to thirty years. As investors with those goals, the Banks may not have purchased RMBS if their governing Pooling and Servicing and Mortgage Loan Purchase Agreements ("Agreements") had shifted the risk of nonconforming loans to security-holders only six years into a thirty-year investment. As explained below, however, that is precisely the argument that DBSP makes here.

ARGUMENT

I. Because private-label RMBS were mostly purchased for long-term, conservative investment, investors reasonably expected that the cure-or-repurchase covenant would continue through the life of the investment.

In the years leading up to the 2008 financial crisis, the overwhelming majority of typical RMBS deals, by value, were rated triple-A. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 72 (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

Unsurprisingly, then, the overwhelming majority of a typical RMBS deal, by value, was purchased by conservative institutional investors such as pension funds, hospitals, banks, and the Federal Home Loan Banks. *Id.* at 117. These investors were looking to invest, not speculate. In part, what drew them to RMBS was how safe they were represented to be. Indeed, some of these investors, like the Banks, were permitted by regulation or internal policy to purchase only triple-A-rated investments. But they were also drawn to RMBS by the long-term nature of the investment, with cashflows extending up to thirty years—something that appealed to investors whose mission required prudence over the long haul.

Thus, it is simply false to imply, as does DBSP, that the only investors interested in the outcome of this case are Johnny-come-lately vulture funds betting on litigation. Br. of Def.-Resp. at 64. The investors with the greatest interest in the outcome of this case, in fact, are those, like the Banks, who bought RMBS to hold them for long-term-investment purposes.

Precisely because the majority of RMBS were designed for long-term investment, it was crucial to investors that the cure-and-repurchase obligation would continue throughout the life of the investment. For while RMBS investors certainly bore the disclosed and agreed-upon *credit* risk of the underlying mortgages—the risk that conforming mortgages might default in the future—they never expected to bear the risk that the underlying mortgages would be defective from the outset. That risk would be shifted onto RMBS investors if DBSP were allowed to wriggle out of its affirmative covenant to cure or repurchase nonconforming mortgages.

Worse, that risk would be shifted to RMBS investors only six years into a thirty-year investment. A conservative investor looking to purchase a safe, thirty-year income stream would have no rational incentive to invest if the risk profile of the investment could be other than represented at any point in the life of the investment. Otherwise, the very purpose of a long-term investment is frustrated.

DBSP now seeks to rewrite its covenant. According to DBSP, when it entered into an agreement containing an affirmative covenant that it would either cure defects or repurchase defective mortgages, what it really meant was that it was only promising to do that for the first six years of a thirty-year investment. But if that had been the deal, one would expect the contract to say so, and also to contain a mechanism for performing a systematic accounting prior to the six-year expiration date. Yet neither sunset language nor any type of accounting mechanism exists in the Agreements.

II. A decision that the cure-or-repurchase obligation lapses after only six years would cause wide-ranging harm to the recovering economy.

Amici in the court below asserted a parade of horribles that might occur if the appellate division were to rule against DBSP. According to the Mortgage Bankers Association ("MBA"), there might be fewer securitization transactions, and consumers could be harmed because banks would lend less to the public and charge higher interest rates. Amicus Curiae Br. of MBA at 18-19. According to the Securities Industry and Financial Markets Association ("SIFMA"), an adverse decision could undermine New York's role as the "preeminent commercial center" by introducing unpredictability into New York contract law. Amicus Curiae Br. of SIFMA at 28.

In addition to being unsupported speculation, these arguments ignore the harm that would be caused to the housing market and to New York contract law by allowing sponsors, like DBSP, to re-write their contractual obligations after transactions have been entered into. If the contractual protections for conservative institutional investors are stripped away, these investors—who provide the funding without which the mortgage finance market would not exist—could lose confidence in the reliability of RMBS and seek alternative investments, with obvious negative repercussions to the fledgling mortgage-market recovery.

The Federal Home Loan Bank system alone, of which the Banks are a part, constitutes a massive source of capital for mortgage finance. The Federal Home Loan Banks have half a trillion dollars' worth of advances to their member banks outstanding; these advances are secured primarily by mortgage-backed securities and whole mortgage loans. FED. HOME LOAN BANKS, OFF. OF FIN., COMBINED FINANCIAL REPORT FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2014, at F-21 (Nov. 13, 2014), *available at* http://www.fhlb-of.com/ofweb_userWeb/resources/14Q3end.pdf; FED. HOUS. FIN. AGENCY, 2013 REPORT TO CONGRESS 22 (2014), *available at* http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FHFA_2013_Report_to_Congress.pdf. In addition, the Federal Home Loan Banks hold over $130 billion in RMBS for investment purposes. *See* FED. HOME LOAN BANKS, OFF. OF FIN., *supra*, at 9.

Rewriting the contracts underlying the RMBS held by long-term investors such as the Federal Home Loan Banks would hurt the economy and the mortgage finance market by causing such investors to reconsider the prudence of investing in RMBS in the future. A long-term investor is not likely to commit its capital to an investment in which the risk of underlying defects (which it has no ability to identify through its own due diligence due to lack of access to loan files) shifts to it relatively early in the life of the investment. Moreover, it will lose confidence investing in a type of instrument whose terms have been effectively rewritten once; if DBSP is successful here, what assurance does an investor have that DBSP or another similar sponsor will not seek to shift its other risks back to the investors?

If this Court decides that RMBS sponsors' cure-or-repurchase covenants lapse after only six years into a thirty-year investment, not only will the future mortgage finance market be harmed, but the investors in existing RMBS—the Federal Home Loan Banks and other conservative investors—will be harmed, as the income they receive from, and the value of, their existing RMBS holdings could be impacted. This is, in fact, a likely result, since over time it has become apparent that significant percentages of the loans backing RMBS issued in the years leading up to the financial crisis are subject to repurchase. This will be a windfall to DBSP and other issuers who bear significant responsibility for the financial crisis, and an undeserved burden on the Banks and other conservative institutional investors who reasonably expected that the contractual cure-or-repurchase covenant would function as a dependable safeguard of their investments. The Court should resist DBSP's invitation to up-end the nature of the parties' bargain and introduce further uncertainty into the economy. *See* Br. for Pl.-Appellant at 45-46.

CONCLUSION

The majority of RMBS might never have been sold if investors had thought that the sponsors' contractual covenant to cure or repurchase would lapse after a mere six years into a thirty-year investment. From the nature of the investment, the many conservative investors who purchased RMBS reasonably believed that the cure-or-repurchase covenant would be a continuing one. This Court should vindicate the reasonable expectations of investors by reversing the Appellate Division's decision.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on April 1, 2015, I certify under penalty of perjury of the laws of the State of Washington that I caused a true and correct copies of the foregoing BRIEF FOR AMICI CURIAE FEDERAL HOME LOAN BANK OF BOSTON, FEDERAL HOME LOAN BANK OF INDIANAPOLIS, AND FEDERAL HOME LOAN BANK OF TOPEKA to be delivered via overnight mail on this same day.

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