



## Global Finance ADVISORY ■

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### The TIA and REMIC Securitizations: One Year After *Policemen's Annuity*

#### Background

In April 2012, U.S. District Court Judge William Pauley concluded that mortgage-backed pass-through certificates issued pursuant to pooling and servicing agreements ("Certificates") are "debt securities, not equity," in a groundbreaking decision in ***Retirement Board of the Policemen's Annuity & Benefit Fund v. Bank of New York Mellon (Policemen's Annuity 1)***.<sup>1</sup> On the basis of that finding, Judge Pauley held that the plaintiffs were entitled to pursue claims against the trustee defendant under the Trust Indenture Act of 1939 (the "TIA").<sup>2</sup> Judge Pauley denied the trustee's motion to dismiss alleged claims for violation of the TIA based on failure to give notice of the master servicers' breaches of their duties and failure to act as a "prudent person" after these alleged defaults.<sup>3</sup>

#### Appeal to the Second Circuit

The Pauley decision took the structured finance industry by surprise, as for 25-plus years, industry convention treated Certificates as equity securities as opposed to debt securities. On April 17, 2012, The Bank of New York Mellon filed a motion for reconsideration or interlocutory (immediate) appeal pursuant to 28 U.S.C. § 1929(b), and the motion was supported by amicus submissions from The Clearing House Association L.L.C., the Securities Industry and Financial Markets Association, the American Bankers Association and the New York Bankers Association. On February 13, 2013, Judge Pauley certified his order for interlocutory appeal acknowledging that the question of whether the TIA applies to Certificates "raises 'novel and complex' issues that could impact a large number of cases."<sup>4</sup> The judge also recognized the practical concern that the unsettled question of the applicability of the TIA to Certificates contributes to industry uncertainty.<sup>5</sup>

<sup>1</sup> No. 11 Civ. 5459(WHP), 2012 WL 1108533, at \*6 (S.D.N.Y. Apr. 3, 2012).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* at \*8.

<sup>4</sup> *Retirement Bd. of the Policemen's Annuity & Benefit Fund v. Bank of N.Y. Mellon*, 11 Civ. 5459(WHP), 2013 WL 593766, at \*5-6 (S.D.N.Y. Feb. 14, 2013).

<sup>5</sup> *Id.* at \*5.

## The Next Cases to Watch

A little over a week after Judge Pauley's April 2012 decision, Scott & Scott (the same firm that represented the plaintiffs in *Policemen's Annuity 1*) brought a second case—this time against Bank of America and U.S. Bank as trustees for 41 trusts of residential Certificates.<sup>6</sup> Capitalizing on the favorable result it achieved in *Policemen's Annuity 1*, the plaintiff asserted that “the TIA applies to and is deemed to be incorporated into the Governing Agreements, and the related MBS.”<sup>7</sup> The plaintiff further alleged that the trustees violated Section 315 of the TIA by failing to provide notice of all known defaults within 90 days and failing to exercise their rights as a prudent person would upon the occurrence of an event of default.<sup>8</sup>

The defendant trustees moved to dismiss the plaintiff's TIA claims. In determining whether the TIA applied, the court considered whether the certificates bear characteristics of a debt instrument.<sup>9</sup> Relying on several Second Circuit opinions that drew superficial comparison between Certificates and traditional debt instruments and identifying a number of characteristics that are similar to those of debt instruments,<sup>10</sup> Judge Katherine Forrest followed Judge Pauley's lead, holding that the Certificates are debt, and therefore that the TIA applied.<sup>11</sup> In denying the defendants' motion, Judge Forrest concluded that the plaintiff could move forward on its claim that the defendant trustees had failed to provide notice as required by Section 315(b) of the TIA, but found that the Complaint did not adequately allege that the defendant trustees were subject to Section 315(c)'s “prudent person” standard. Judge Forrest dismissed the plaintiff's TIA claim under Section 315(c), but invited the plaintiff to replead the claim in an amended complaint, which the plaintiff has now done.

A similar motion to dismiss a class action complaint alleging violations of the TIA is currently before Judge John G. Koetl in the Southern District of New York.<sup>12</sup> As in the *Policemen's Annuity* cases, the issue of the applicability of the TIA to Certificates is central to the motion. Oral argument took place on February 1, 2013, but the court has yet to issue a decision.

## Moving Forward in Uncertain Times

As we await the Second Circuit's review, securitization parties are left to navigate the potential outcomes of the Pauley decision. We have seen recent mortgage-backed securitizations with offering documents that disclose the status of the Pauley litigation and its progeny, and contract documents that contemplate amendments depending on the ultimate litigation outcome. A decision by the Second Circuit upholding Judge Pauley's decision would present significant challenges for the structured finance industry.

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<sup>6</sup> Complaint, *Policemen's Annuity & Benefit Fund v. Bank of Am., NA*, No. 12 Civ 2865(KBF) (S.D.N.Y. Apr. 11, 2012).

<sup>7</sup> *Id.* ¶ 85.

<sup>8</sup> *Id.* ¶¶ 41, 42, and 86-87.

<sup>9</sup> *Policemen's Annuity & Benefit Fund v. Bank of Am., NA (Policemen's Annuity 2)*, No. 12 Civ. 2865(KBF), 2012 WL 6062544, at \*15 (S.D.N.Y. Dec. 7, 2012).

<sup>10</sup> *Id.* (noting that the certificates have a fixed maturity date and principal balance, certificate-holders receive regular principal and interest payments on fixed distribution dates, interest accrues on a periodic basis, the interest is paid off and the certificates are subject to yield maintenance agreements.)

<sup>11</sup> *Id.* at \*16.

<sup>12</sup> *Oklahoma Police Pension & Retirement Sys. v. U.S. Bank Nat'l Assoc.*, No. 11 Civ. 8066(JGK).

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