

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

----- X
 AMBAC ASSURANCE CORPORATION, :
 :
 Plaintiff, :
 :
 v. :
 :
 EMC MORTGAGE LLC (formerly known as :
 EMC MORTGAGE CORPORATION), J.P. :
 MORGAN SECURITIES LLC (formerly known :
 as BEAR, STEARNS & CO. INC.), and :
 JPMORGAN CHASE BANK, N.A., :
 :
 Defendants. :
 ----- X

Index No. 650421/2011
 Honorable Charles E. Ramos
 Commercial Division
 Part 53
 Motion Sequence No. 003

**DEFENDANTS' RESPONSE TO PLAINTIFF'S MOTION TO COMPEL
 PRODUCTION OF DOCUMENTS FROM NON-PARTY CLAYTON HOLDINGS, LLC**

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TABLE OF CONTENTS

	<u>Page</u>
I. AMBAC’S LAWYERS MANUFACTURED DEPOSITION TESTIMONY FROM FORMER CLAYTON UNDERWRITERS.....	2
II. AMBAC MISCHARACTERIZES THE DEPOSITION TESTIMONY FROM FORMER CLAYTON EMPLOYEES.....	6
III. AMBAC DISINGENUOUSLY CITES TO THE NYAG SUIT AGAINST BEAR STEARNS AS INDEPENDENT SUPPORT FOR ITS CLAIMS	9

Defendants EMC Mortgage LLC (“EMC”), J.P. Morgan Securities LLC (formerly known as Bear, Stearns & Co. Inc. (“Bear Stearns”)) and JPMorgan Chase Bank, N.A. (collectively, “defendants”) submit this response to Ambac Assurance Corporation’s (“Ambac”) motion to compel the production of documents and information from non-party Clayton Holdings, LLC (“Clayton”) for the limited purpose of clarifying and correcting the record in this action as it relates to Ambac’s motion.¹ Although this dispute is between Ambac and Clayton, and although the relevance and admissibility of any evidence obtained from Clayton or any other third parties is not before the Court on this discovery motion, Ambac’s mischaracterizations of deposition testimony provided by former Clayton employees and its continued efforts to try this case in the press rather than the courtroom compel an immediate response.

The story Ambac tells in its motion papers about the supposed Bear Stearns–Clayton relationship just happens to be the exact same story told on PBS’s *Frontline* on January 22, 2013 (before Ambac filed its motion papers), featuring Ambac’s counsel, the law firm of Patterson Belknap Webb & Tyler LLP (“PBWT”), for its work in representing Ambac and, in particular, for eliciting testimony from former Clayton employees about Clayton’s supposed role in the financial crisis—publicity that PBWT touts on its website. But, as this Court once rightly observed, “[w]e don’t try our cases in the newspapers” (Hr’g Tr., Feb. 21, 2012, at 25:17-18) and “[w]e don’t deal with stories, we deal with facts” (Hr’g Tr., June 4, 2012, at 7:5-6). Unlike stories on *Frontline*, in the courtroom, Ambac must prove its case with facts in accordance with the rules of evidence. Under those rules, none of this testimony, regardless of its substance, is admissible and, at the appropriate time, defendants intend to move to exclude all

¹ (See Memorandum of Law in Support of Ambac Assurance Corporation’s Motion to Compel Production of Documents from Non-Party Clayton Holdings, LLC, dated January 29, 2013 (Dkt. 71) (“Mem.”).)

of it. For now, however, in adjudicating Ambac’s motion to compel, the Court should not be misled about either the nature of this testimony or the tactics employed by Ambac’s lawyers in manufacturing it. Nor should the Court’s adjudication of Ambac’s motion be influenced by Ambac’s fanciful claim that its allegations are supported by the recent New York Attorney General (“NYAG”) lawsuit against Bear Stearns. (*See, e.g.*, Mem. at 2.) It is indeed the exact opposite—the NYAG’s suit largely copies Ambac’s allegations, which is perhaps not entirely surprising given that, in 2011, one of the PBWT partners leading Ambac’s case against Bear Stearns joined the NYAG to head the division overseeing the investigation against Bear Stearns.²

I. AMBAC’S LAWYERS MANUFACTURED DEPOSITION TESTIMONY FROM FORMER CLAYTON UNDERWRITERS.

In support of its motion to compel, Ambac contends that it needs further discovery from Clayton in light of deposition testimony provided by former Clayton employees, which supposedly reveals that Bear Stearns “controlled Clayton’s review to ensure that Clayton found a small defect rate in the loans that it reviewed, thereby permitting Bear Stearns to knowingly purchase and securitize defective loans.” (Mem. at 2.) This is absolutely false. Apart from distorting the substance of testimony provided by these former Clayton employees, which will be addressed in Part II of this response, the manner in which Ambac’s lawyers have elicited this testimony undermines, if not destroys, the credibility of these witnesses and the

² Defendants understand that, upon joining the NYAG, this former PBWT partner was initially screened from participating in the NYAG’s investigation relating to Bear Stearns, but that the screen was later lifted and she participated in the investigation. Following concerns raised by defendants, the NYAG apparently reimposed the screen. Defendants have asked the NYAG to confirm whether there is additional information about this lawyer’s involvement in the matters leading up to the NYAG’s suit against Bear Stearns that they should be aware of before deciding what further action is warranted.

admissibility of any of their testimony in future judicial proceedings. Each of the depositions of former Clayton employees noticed by Ambac in this action has followed the same pattern:

First, starting in 2011, Ambac’s lawyers began meeting with former Clayton due diligence underwriters. In exchange for their cooperation, Ambac paid substantial sums of money to the witnesses under the guise of “expenses” and “lost wages.” Each of the Clayton deponents has testified that he or she received at least one and usually two all-expense-paid trips to New York City to meet with Ambac’s counsel, including airfare, hotels, meals and other expenses. One witness even admitted that he decided to come to New York City rather than meet with Ambac’s counsel in the city where he resides because “it was a free trip to New York.” (Ex. A to the Affirmation of Darrell S. Cafasso, dated Feb. 19, 2013 (“Cafasso Aff.”), at 106:14-15.) Other deponents testified that Ambac paid for both the witness and his or her significant other to fly to New York City for two nights and even paid for the hotel and meals of the witness’s traveling companion. (Cafasso Aff. Ex. B, at 30, 74-75; Cafasso Aff. Ex. C, at 139-40.)

With regard to payments for “lost wages,” these payments are wholly disproportionate to any reasonable compensation for lost time from work. Most of the witnesses elected to take advantage of one or more all expense-paid trips to New York City for the weekend—and thus miss three days of work (all of the witnesses apparently work weekends)—rather than meet with Ambac’s lawyers in the city where they reside and avoid two days of travel. [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED] (Cafasso Aff. Ex. D, at 115-25.) [REDACTED]

[REDACTED]

[REDACTED] (*Id.* at 128-29.)

Second, during its initial meetings, Ambac’s lawyers drafted affidavits for each of the witnesses. (*See, e.g.*, Cafasso Aff. Ex. A, at 99-101, 106.) Each witness has testified that he or she signed the affidavit prepared by Ambac’s counsel without making any meaningful changes to it, or in some cases without making any changes at all. (*See, e.g., id.* at 100; Cafasso Aff. Ex. D, at 104-05.)

Third, prior to each deposition, Ambac produced the affidavit from the relevant witness to defendants, usually just days before the date of the deposition and only after waiting several days following defendants’ demand for its production. Ambac initially refused to produce any of these executed affidavits on the ground that they constituted attorney work product, but defendants applied to both this Court and Judge Crotty in the federal *Syncora* action to compel Ambac and Syncora to produce them. Judge Crotty heard the matter first and ordered the production of all executed affidavits for any third-party witnesses, regardless of whether they are ultimately deposed or not. Yet, while Ambac has agreed to produce some affidavits in this action in light of Judge Crotty’s ruling, it has limited its production of affidavits to those from witnesses it elects to subpoena for deposition. Ambac thus continues to withhold executed affidavits in its possession from former Clayton employees who have yet to be subpoenaed for deposition in the hopes that this Court will depart from Judge Crotty’s ruling on this issue.

Ambac also has refused to produce communications between its lawyers and third-party witnesses on the grounds that they are protected from disclosure on the basis of the trial preparation privilege and work product doctrine. Ambac’s refusal to produce affidavits and communications relating to third-party witnesses—and, in particular, its attempt to prevent

discovery into its interactions and dealings with these witnesses, which are not privileged and which directly go to the bias, motivation and credibility of these witnesses—will be the subject of a forthcoming motion to compel.

Fourth, with the affidavits in hand, Ambac’s lawyers met with each deponent prior to the depositions, in some cases for several hours, to prepare them for their depositions. (See, e.g., Cafasso Aff. Ex. B, at 62-65.) [REDACTED]

[REDACTED] (See, e.g., Cafasso Aff. Ex. D, at 126-28, 132-34.)

Fifth, at the depositions, Ambac’s lawyers used the affidavits and leading questions to elicit the prepared testimony from the witnesses. In each instance, they marked the affidavit as an exhibit and then asked each deponent on direct examination to confirm that the out-of-court statements drafted by Ambac’s counsel are true statements. (See, e.g., Cafasso Aff. Ex. A, at 14-15.) For instance, at one deposition, after asking the witness if the “statements in this affidavit [are] true and correct,” Ambac’s counsel stated: “We are going to be using this affidavit as a roadmap for today’s deposition. . . . [Y]ou can use it at any time during the deposition to refresh your recollection.” (*Id.* at 15:15-16:3.) In another recent deposition, Ambac’s counsel instructed the witness that if [REDACTED]

[REDACTED] (Cafasso Aff. Ex. D, at 10:3-6.) [REDACTED]

[REDACTED] (*Id.* at 11-12.) In other words, far from using these affidavits to “refresh recollection,” Ambac’s lawyers have used them to ensure that the witnesses provide the testimony Ambac’s lawyers want them to provide.

Sixth, although they purportedly were not representing these witnesses at their depositions, Ambac’s lawyers often provided them with legal advice during the deposition. At one deposition, for example, Ambac’s counsel advised the witness she was supposedly not representing, [REDACTED]

[REDACTED] (Cafasso Aff. Ex. C, at 168:4-7.)

Seventh, and finally, further undermining the credibility of these witnesses is the fact that some of them have been represented individually at these depositions by a former PBWT lawyer recommended to them by the lawyers from PBWT representing Ambac. (See Cafasso Aff. Ex. D, at 138-39.) [REDACTED]

[REDACTED]

[REDACTED] (*Id.* at 151:17-20, 164:4-6.)

[REDACTED]

[REDACTED]

[REDACTED] (*Id.* at 126-28, 132-34.) [REDACTED]

[REDACTED]

[REDACTED] (*Id.* at 134:3-6.)

II. AMBAC MISCHARACTERIZES THE DEPOSITION TESTIMONY FROM FORMER CLAYTON EMPLOYEES.

Ignoring the dubious circumstances under which it obtained the testimony of the former Clayton employees, Ambac argues that these witnesses have testified that Bear Stearns “directed” or “controlled” Clayton. (*E.g.*, Mem. at 2, 4-5.) This is not true. Clayton was an independent company that provided due diligence services to the entire mortgage industry, including Bear Stearns and EMC. In fact, Ambac itself utilized the services of Clayton (a fact it

likes to ignore in spinning its tales). In any event, Ambac has overstated and mischaracterized the testimony that has been elicited thus far from former Clayton employees.

As an initial matter, although these witnesses have testified to Clayton's general practices and procedures, none has been able to provide any testimony whatsoever relating to the transactions at issue in this action. As the Court knows, throughout this litigation, Ambac has taken the position that any documents or testimony unrelated to the transactions at issue are irrelevant and outside the scope of permissible discovery. (*See, e.g.*, Ambac Mem., Motion Seq. No. 002, Nov. 4, 2011 (Dkt. 46), at 1-2.) Indeed, Ambac even moved this Court for a protective order precluding defendants from obtaining discovery concerning transactions not at issue on the ground that "the materiality of Defendants' misrepresentations and the reasonableness of Ambac's reliance must be resolved with regard to what *these Defendants* told Ambac and what Ambac knew about *these four Transactions*." (*Id.*) Yet, Ambac's lawyers have spent countless hours deposing former Clayton employees on matters that have no connection to the transactions at issue.

Further, these witnesses have all testified that (i) they never communicated with Bear Stearns or EMC or, if they did, could not recall the substance or details of any communications; (ii) they could not recall working on any specific Bear Stearns transactions; and (iii) they could not say, one way or the other, whether Bear Stearns or EMC had knowledge of the practices allegedly occurring at Clayton, let alone that Bear Stearns "directed" or "controlled" those practices. (*See, e.g.*, Cafasso Aff. Ex. A, at 124-26, 129, 142-43; Cafasso Aff. Ex. B, at 86-88, 113-15; Cafasso Aff. Ex. C, at 137-39, 161-66; Cafasso Aff. Ex. D, at 82-87; Cafasso Aff. Ex. E, at 125-26, 156-63.) Put simply, none of the testimony supports Ambac's mantra that Bear Stearns "controlled" or "directed" Clayton.

Turning to Ambac’s summary of the testimony provided by these witnesses (*see* Mem. at 5), Ambac fails to mention the contradictory testimony elicited during cross-examination of these same witnesses—the only testimony that was not rote repetition of the self-serving affidavits that Ambac’s lawyers drafted for the witnesses—including that:

- ***Clayton Did Not Sacrifice Quality for Quantity at the Direction of Bear Stearns.*** The witnesses have testified that their compensation was not tied to the number of loans reviewed, nor were they ever docked pay for not reviewing loans quickly enough. (*See, e.g.,* Cafasso Aff. Ex. C, at 218; Cafasso Aff. Ex. A, at 143-44, 146.) Although one deponent testified that the Clayton underwriters were expected to review about one loan per hour, he also testified that he thought that was a reasonable amount of time and that he could review a loan file “[t]horoughly [in] on average 45 minutes to an hour.” (Cafasso Aff. Ex. E, at 153:14-154:17.)
- ***Clayton Did Not Overlook Defects at the Direction of Bear Stearns.*** The witnesses testified that they gave loans the grades they thought the loans deserved and that neither they, nor any of their colleagues at Clayton, did anything fraudulent or improper while working for Clayton. (*See, e.g.,* Cafasso Aff. Ex. C, at 151-52, 186; Cafasso Aff. Ex. E, at 132-33, 169.) For instance, one deponent testified that “if [a loan] deserved a 2 or 3 or 1, that’s what I graded it as.” (Cafasso Aff. Ex. E, at 169:22-24.)
- ***Clayton Did Not Overlook Fraudulent Loans at the Direction of Bear Stearns.*** [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
(Cafasso Aff. Ex. C, at 182:11-183:7.) [REDACTED]
[REDACTED] (*Id.*)
- ***Clayton Did Not Rubber-Stamp Unreasonable Stated Incomes at the Direction of Bear Stearns.*** The Clayton witnesses testified that the reasonableness of stated income is a subjective judgment on which reasonable underwriters can and do disagree. (*See, e.g.,* Cafasso Aff. Ex. C, at 170; Cafasso Aff. Ex. A, at 157.)
- ***Clayton Did Not Perform 1003/1008 Underwriting at the Direction of Bear Stearns.*** One former Clayton underwriter who admitted that he had engaged in “1008 underwriting”—meaning that he sometimes completed loan reviews without reviewing the supporting documents in the loan files—testified that he knew this practice was against company policy, that his supervisors did not know he was engaging in the practice and that he could not say whether Bear Stearns or EMC had any knowledge of the practice. (*See* Cafasso Aff. Ex. A, at 121-24.) Other witnesses testified that they did not engage in 1008 underwriting and that no one at Clayton ever directed them to engage in 1008 underwriting. (*See, e.g.,* Cafasso Aff. Ex. B, at 121; Cafasso Aff. Ex. C, at 186-87.)

- ***Clayton Did Not Contrive Compensating Factors at the Direction of Bear Stearns.*** The Clayton witnesses testified that they gave loans the grades they thought were deserved and that whether there were adequate compensating factors is a matter of judgment on which reasonable underwriters can and do disagree. (*See, e.g.*, Cafasso Aff. Ex. C, at 151-52, 157; Cafasso Aff. Ex. A, at 138.) In response to the question whether the sufficiency of compensating factors is largely a subjective judgment, one witness responded, “Definitely.” (Cafasso Aff. Ex. A, at 138:7.) [REDACTED] (See Cafasso Aff. Ex. C, at 151-52.)
- ***Clayton Did Not Change Grades on Defective Loans at the Direction of Bear Stearns.*** The witnesses testified that there are many legitimate reasons why the initial grade assigned to a loan might be changed. (*See, e.g.*, Cafasso Aff. Ex. A, at 137-38, 142; Cafasso Aff. Ex. C, at 157, 176.) [REDACTED] (Cafasso Aff. Ex. C, at 176:21-22.) Moreover, these witnesses were contract underwriters who assigned preliminary grades to loans and understood that the grades they assigned to loans were not the final grades assigned by Clayton. (*See, e.g.*, Cafasso Aff. Ex. A, at 135-36; Cafasso Aff. Ex. C, at 177.)

In short, in addition to testifying that they never communicated directly with Bear Stearns or EMC, the testimony these witnesses gave on cross-examination when they were not being asked merely to regurgitate the story Ambac tells in the affidavits its lawyers scripted for the witnesses is entirely contrary to the version of events Ambac touts in its publicly filed motion papers.

III. AMBAC DISINGENUOUSLY CITES TO THE NYAG SUIT AGAINST BEAR STEARNS AS INDEPENDENT SUPPORT FOR ITS CLAIMS.

Ambac attempts to bolster its allegations about Bear Stearns’ supposed “control” over Clayton with the imprimatur of the NYAG by stating that the NYAG, too, is “scrutiniz[ing] the Bear Stearns-Clayton relationship.” (Mem. at 2, 6-7.)³ This borders on the ridiculous. First of all, Ambac fails to mention that one of the senior lawyers who represented Ambac in this case

³ The NYAG’s lawsuit has been assigned to this Court, and defendants moved to dismiss the NYAG’s complaint on January 4, 2013. *See* Notice of Motion to Dismiss, *New York v. J.P. Morgan Sec. LLC*, No. 451556/2012 (Sup. Ct. N.Y. Cnty. Jan. 4, 2013) (Dkt. 8).

and signed its earlier complaint against Bear Stearns and EMC is now the Executive Deputy Attorney General of the Economic Justice Division that is overseeing the NYAG lawsuit against Bear Stearns. Apart from this, the NYAG subpoenaed Ambac for the documents and testimony in this litigation. (See Cafasso Aff. Ex. F.) Indeed, even PBS's *Frontline*—which Ambac's counsel boasts about on its website⁴—revealed that the NYAG began the investigation that led to its lawsuit by coordinating with Ambac's counsel, reviewing Ambac's complaint and interviewing witnesses that Ambac had prepared for this case. *Frontline* reported that the NYAG's complaint “was based largely on work done by private law firms” and that the NYAG was “drawn to the work of . . . [Ambac's counsel].”⁵ This is obvious from the complaint filed by the NYAG, which piggybacks on the allegations made by Ambac in its pleadings. Consequently, Ambac's reliance on the NYAG's complaint as independent support for its allegations is at best backwards and at worst extremely disingenuous.

* * *

At a prior conference in this action, the Court admonished Ambac and its lawyers that “[m]y courtroom is not a newsroom.” (Hr'g Tr., June 4, 2012, at 7:5.) Yet, Ambac persists in attacking EMC and Bear Stearns in its public filings and constant whisperings to the press, even to the point of misleading the Court on both the substance of deposition testimony from former Clayton employees and the manner in which its lawyers obtained that testimony. Although the Court will have the opportunity to assess for itself the relevance and admissibility

⁴ See Patterson Belknap Webb & Tyler LLP, *PBS's "Frontline" Notes Firm's Leading Role in Financial Litigation* (Jan. 2013), <http://www.pbwt.com/pbs-frontline-notes-firm-leading-role-financial-litigation>.

⁵ Martin Smith, *Transcript: The Untouchables*, *Frontline*, <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/transcript-37> (last visited Feb. 19, 2013).

of this testimony at a later date, defendants urge the Court to view Ambac's motion in light of the record evidence as it really exists, not as Ambac embellishes it. The Court may ultimately decide to grant Ambac's motion, but it should do so with a fair representation of the record evidence as it pertains to that motion.

Dated: New York, New York
February 19, 2013

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