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

In the Matter of The Rehabilitation of FINANCIAL GUARANTY INSURANCE COMPANY.	Index No. 401265/2012 Justice Doris Ling-Cohan Motion Sequence No. 4

AMENDED OBJECTION OF AURELIUS CAPITAL MANAGEMENT, LP TO THE PROPOSED PLAN OF REHABILITATION AND JOINDER TO THE AMENDED OBJECTIONS OF THE BANK OF NEW YORK MELLON AND THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., AS TRUSTEE TO THE PROPOSED PLAN OF REHABILITATION

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Aurelius Capital Management, LP (**"Aurelius"**), in its capacity as manager of entities that hold, in the aggregate, over $780 million original face amount of residential mortgage-backed securities insured by Financial Guaranty Insurance Company (**"FGIC"**), by and through its attorneys, hereby files its amended objection to the proposed *Plan of Rehabilitation for Financial Guaranty Insurance Company* and joinder to the *Amended Objections of The Bank of New York Mellon and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Proposed Plan of Rehabilitation* (**"BNY Mellon Objection"**) (the **"Amended Objection"**). Contemporaneously herewith, Aurelius is filing a memorandum of law in support of its Amended Objection.

Objection

Aurelius continues to object to the Plan's provisions that seek to eliminate policyholders' common law and statutory rights of setoff. The Plan unlawfully attempts to eliminate these rights, which are explicitly secured by Section 7427 of the Insurance Law, both prospectively and retroactively, while at the same time maintaining and even expanding FGIC's setoff rights. Moreover, the Plan is not fair and equitable because it seeks to redistribute funds from those policyholders that have lawfully exercised or will lawfully exercise their setoff rights to those who do not possess such rights or have not exercised them. The Plan fails to recognize that all policyholders are not similarly situated. Thus, the Plan, as currently drafted, cannot be approved because it violates the Insurance Law and because it is not fair and equitable.

Joinder in the BNY Mellon Objection

Aurelius hereby adopts and incorporates herein by reference the objections set forth in the BNY Mellon Objection to the extent such objections are applicable to Aurelius. Aurelius reserves the right to amend, supplement, alter or modify this Amended Objection.

WHEREFORE, for the reasons set forth herein, Aurelius respectfully requests that this Court reject or modify the Plan with such other and further relief as the Court deems appropriate.

Dated: New York, New York
January 22, 2013

Respectfully submitted,

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SUPREME COURT OF THE STATE OF NEW YORK
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In the Matter of The Rehabilitation of FINANCIAL GUARANTY INSURANCE COMPANY.	Index No. 401265/2012 Justice Doris Ling-Cohan Motion Sequence No. 4

MEMORANDUM OF LAW IN SUPPORT OF THE AMENDED OBJECTION OF AURELIUS CAPITAL MANAGEMENT, LP TO THE PROPOSED PLAN OF REHABILITATION AND JOINDER TO THE AMENDED OBJECTIONS OF THE BANK OF NEW YORK MELLON AND THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., AS TRUSTEE TO THE PROPOSED PLAN OF REHABILITATION

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Aurelius Capital Management, LP (**"Aurelius"**), in its capacity as manager of entities that hold, in the aggregate, over $780 million original face amount of residential mortgage-backed securities insured by Financial Guaranty Insurance Company (**"FGIC"**), by and through its attorneys, hereby files this memorandum of law in support of its *Amended Objection of Aurelius Capital Management, LP to the Proposed Plan of Rehabilitation and Joinder to the Amended Objections of The Bank of New York Mellon and The Bank of New York Mellon Trust Company, N.A., as Trustee, to the Proposed Plan of Rehabilitation* (the **"Amended Objection"**), filed concurrently herewith. In support of its Amended Objection, Aurelius respectfully states as follows:

BACKGROUND

On June 11, 2012, the Superintendent of Financial Services of the State of New York (**"Superintendent"**) petitioned this Court to place FGIC into rehabilitation and to obtain certain injunctive relief with respect to FGIC and its wholly-owned subsidiary, FGIC Credit Products, LLC (**"Proposed Rehabilitation Order"**). The Proposed Rehabilitation Order, as modified in response to objections raised by certain RMBS trustees, was entered by this Court on June 28, 2012 (**"Rehabilitation Order"**).

On September 27, 2012, the Superintendent, in his capacity as Rehabilitator (the **"Rehabilitator"**), filed the proposed Plan of Rehabilitation together with, among other things, a Disclosure Statement, Plan Supplement and a Proposed Plan Approval Order.

On November 19, 2012, Aurelius submitted its *Objection and Joinder to (I) the Objection of U.S. Bank National Association and U.S. Bank Trust National Association, Each in its Capacity as Trustee, to the Plan of Rehabilitation dated September 27, 2012, and (II) the Objections of the Bank of New York Mellon and the Bank of New York Mellon Trust Company, N.A., as Trustee to the Proposed Plan of Rehabilitation.*

On December 12, 2012, the Rehabilitator submitted the First Amended *Plan of Rehabilitation for Financial Guaranty Insurance Company* (the **"Plan"**)[1] as well as its *Omnibus Reply Memorandum of Law in Further Support of Approval of First Amended Plan of Rehabilitation for Financial Guaranty Insurance Company* (the **"Omnibus Reply"**). On December 19, 2012, the Court entered an Order providing that objectors shall submit amended objections, stating their unresolved objections, with a memorandum of law in support, by January 22, 2013.

PRELIMINARY STATEMENT

Among other objectionable provisions, the Plan, as currently drafted, seeks to abrogate policyholders' statutory and common law rights of setoff and recoupment, both prospectively and retroactively, while at the same time maintaining and even expanding those rights for FGIC. Contrary to the Insurance Law (**"Ins. Law"**), which explicitly prohibits the unilateral abolition of the policyholders' well-established rights of setoff, the Plan seeks to redistribute funds from those policyholders that have lawfully exercised or will lawfully exercise their setoff rights to those who do not possess such rights or have not exercised them.

STANDARD

A plan of rehabilitation must be consistent with the law, *see Matter of Frontier Ins. Co.*, 36 Misc. 3d 529, 542 (N.Y. Sup. Ct. 2012) ("a plan of rehabilitation cannot be approved where it is inconsistent with law"), and must be fair and equitable to policyholders and other creditors by providing them at least what they would have received in a liquidation of the insurer. *See Carpenter v. Pacific Mut. Life Ins. Co.*, 10 Cal. 2d 307, 335 (Cal. 1937), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938). Though the Rehabilitator has broad discretion to propose a plan, the plan must recognize the legal, contractual, and statutory rights of policyholders. *See New York*

[1] Capitalized terms used but not defined herein shall have the meaning ascribed to them in the Plan.

Title & Mortg. Co. v. Irving Trust Co., 241 A.D. 246 (1st Dep't 1934) (finding injunction which purported to deprive claimant of set-off rights to be "invalid since it would exceed the powers conferred upon the court by the statute"). Courts must prevent a rehabilitator from taking actions that "are arbitrary, capricious or an abuse of discretion." *Matter of Callon Petroleum Co. v. Superintendent of Ins. of N.Y.*, 53 A.D.3d 845 (N.Y. App. Div. 3d Dep't 2008).

ARGUMENT

I. Common Law and Article 74 of the New York Insurance Law Guarantee Policyholders' Setoff Rights

The right of setoff, long recognized in every state, is a recognition of "the absurdity of making A pay B when B owes A." *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528 (U.S. 1913). An "ancient" doctrine, "tracing its roots to early Roman law," setoff rights have been recognized and preserved under each of the nation's five bankruptcy acts. 5-553 Collier on Bankruptcy P 553.LH (16th ed.). Section 7427 of the Ins. Law explicitly requires the application of setoff rights, providing in relevant part, that:

> [i]n all cases of mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article, such credits and debts shall be set off and the balance only shall be allowed or paid...

Ins. Law § 7427(a).

As the Court of Appeals has stated, in a dispute over the application of the "right of offset under [Section 7427]," "[t]he general rule, recognized by courts and commentators alike, holds that mutual debts and credits between parties may be set off even though they arise from different transactions. And this is so, even in cases involving insolvent insurance companies." *In re Midland Ins. Co.*, 79 N.Y.2d 253, 260 n.2 (N.Y. 1992).[2] "[T]he right of set-off expressly conferred

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[2] Recoupment rights are a subset of setoff rights that involve debts arising from the same transaction. As the Court of Appeals has stated, "the Legislature, in extending the remedy of offset to liquidation proceedings, did not intend it to be limited to mutual debts arising

by section 420 [now § 7427]" applies in both liquidations and rehabilitations. *Irving Trust*, 241 A.D. at 248.

Without question, the right of setoff secured by Section 7427 cannot be altered by the general injunctive authority granted elsewhere in Article 74. Thus, in *Irving Trust*, the First Department held that:

> The right to injunction in this proceeding is conferred by the provisions of section 410 [now § 7419] and such right is necessarily limited by the provisions of section 420 [now § 7427]. Accordingly, an injunction which assumed to deprive the claimant of the right of set-off granted under section 420 would be invalid since it would exceed the powers conferred upon the court by the statute.

Id. at 249. The holding of *Irving Trust*, moreover, is but an application of the well-settled precept that specific statutory provisions control over general statutory provisions. *See Williamson v. 16 West 57th St. Co.*, 256 A.D.2d 507, 513 (2d Dep't 1998) ("statutory construction requires that where a general statute is in apparent conflict with a specific statute dealing with the same subject matter, the specific statute creates an exception to the general") (*citing*, *inter alia*, McKinney's Cons. Laws of N.Y., Book 1, Statutes § 396).

II. <u>Provisions Of The Plan Would Strip Policyholders Of Their Setoff Rights And Expand FGIC's Setoff Rights</u>

The Plan, as proposed, would deprive policyholders of their setoff rights without impairing FGIC's ability to exercise its setoff rights. Sections 3.5 and 7.8(c) work together to deprive policyholders of their setoff rights. Section 3.5 reinstates any debts that policyholders would have owed to FGIC if not for FGIC's Rehabilitation or Rehabilitation Circumstances. Section 7.8(c) prohibits policyholders from setting off these reinstated debts against amounts that FGIC owes policyholders.

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from the same transaction." *In re Midland*, 79 N.Y.2d at 260 (*citing National Cash Register Co. v. Joseph*, 299 N.Y. 200, 203 (N.Y. 1949)).

Adding insult to injury, Section 4.9 not only preserves FGIC's setoff rights, but it expands them by permitting FGIC to offset against "any Permitted Claim *or any distribution* to be made under the Plan on account of such Permitted Claim." Plan § 4.9 (emphasis added). Distributions made by FGIC will only be a small percentage of the amounts FGIC owes to its policyholders, yet Section 4.9 allows FGIC to set off the full amount of debt owed to FGIC against the small percentage which FGIC is able to distribute.

A particularly egregious feature of the Plan is that Section 1.4(A) of the Restructured Policy Terms applies retroactively to require policyholders to pay to FGIC all amounts that would have been payable if the Plan had been in effect at all times dating back to the issuance of the 1310 Order in November 2009 – more than two and a half years prior to the commencement of FGIC's Rehabilitation Proceeding. The proposed Plan would condition distributions on account of claims against FGIC on compliance with these provisions.[3] *See* Restructured Policy Terms §§ 2.1, 2.2.

III. The Plan's Provisions Stripping Policyholders Of Their Statutory Setoff Rights Are Unlawful

A plan of rehabilitation must be consistent with the law, *see Frontier*, *supra*, 36 Misc. 3d at 542 ("a plan of rehabilitation cannot be approved where it is inconsistent with law"). Section 7427 of the Ins. Law specifically and unambiguously provides, in mandatory terms, that mutual debts "shall be set off and *the balance only* shall be allowed or paid." Ins. Law § 7427(a) (emphasis added). Thus, the proposed Plan cannot be approved because denying the policyholders their statutory setoff rights would violate the law.

In an attempt to justify the retroactive elimination of policyholders' setoff rights, the Rehabilitator correctly points out that Section 7427(b)(1), "excludes from the right of setoff otherwise granted by Section 7427, setoff where 'the obligation of the insurer to such person

[3] As noted below, the Rehabilitator cannot do indirectly what he is prohibited from doing directly. The Rehabilitator does exactly that by conditioning distributions on compliance with unlawful provisions of the Plan.

would not at the date of entry of any liquidation order... entitle him to share as a claimant in the assets of such insurer.'" Omnibus Reply at 25 (*quoting* Ins. Law § 7427(b)(1)). The Rehabilitator then baldly asserts that the 1310 Order "[e]ffectively... marks the commencement of FGIC's insolvency proceeding." Omnibus Reply at 27. But that is plainly wrong. As is clear from Section 7403, a rehabilitation proceeding is commenced by an "[o]rder of rehabilitation." An order to rehabilitate:

> shall direct the superintendent... forthwith to take possession of the property of such insurer and to conduct the business thereof, and to take such steps toward the removal of the causes and conditions which have made such proceeding necessary as the court shall direct.

Ins. Law § 7403. The 1310 Order, issued not by a court but by the Superintendent, directs *no* such actions. For this reason alone, the Rehabilitator can eke no support for his position from the 1310 Order.[4]

Furthermore, the Rehabilitator's reliance on the limitation set forth in paragraph (1) of subsection (b) of Section 7427 to the broad setoff rights vouchsafed by subsection (a) is woefully misplaced. In fact, in language inexplicably omitted by the Rehabilitator, Section 7427(b)(1) explicitly limits its application to liquidation proceedings under Article 74. The full text of Section 7427(b)(1) reads as follows:

> (b) No offset shall be allowed in favor of any such person, however, where:
>
> (1) the obligation of the insurer to such person would not at the date of the entry of any *liquidation order*, or otherwise, *as provided in section seven thousand four hundred five of this article*,[5] entitle him to share as a claimant in the assets of such insurer

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[4] Moreover, subsequent to the entry of the 1310 Order, FGIC embarked on a series of exchange offers with the intention of avoiding a rehabilitation proceeding. Therefore, the notion that the 1310 Order "effectively... mark[ed] the Commencement of FGIC's insolvency proceeding" is untenable.

[5] Section 7405 is titled, "Order of liquidation; rights and liabilities." Subsection (a) provides:

Ins. Law § 7427(b)(1) (emphasis added). Thus, by its express terms, the limitation set forth in Section 7427(b)(1) applies only when a liquidation order has been entered.

In support of his contention that Section 7427(b)(1) applies in rehabilitation proceedings, the Rehabilitator cites *In re Midland, supra*. In that case, however, the Court of Appeals never discussed or so much as mentioned the Section 7427(b)(1) limitation. Rather, the Court confirmed that the setoff rights secured by subsection (a) of Section 7427 allow setoff of debts arising from separate transactions in both liquidation and rehabilitation proceedings. *In re Midland*, accordingly, does not provide a shred of support for the Rehabilitator's position.

The only other case cited by the Rehabilitator in support of his contention that Section 7427(b)(1) applies in rehabilitation proceedings is *New York Title & Mortg. Co. v. Friedman*, 153 Misc. 697 (N.Y. Mun. Ct. 1934). Although the Rehabilitator acknowledges that the statute at issue in *Friedman* was "the statutory predecessor of Section 7427(b)(1), Section 420(a)(2)," Omnibus Reply at 25, the Rehabilitator fails to bring to the Court's attention the text of Section 420(a)(2). By its express terms, Section 420 was *not* limited to liquidation proceedings. The text of the statute, as quoted in *Friedman*, 153 Misc at 699-700, is as follows:

> 1. In all cases of mutual debts or mutual credits between the insurer and another person, such credits and debts shall be set off and the balance only shall be allowed or paid.
>
> 2. No set-off shall be allowed in favor of any such person, however, where (a) the obligation of the insurer to such person would not then entitle him to share as a claimant in the assets of such insurer.

153 Misc. 697, 699-700 (N.Y. Mun. Ct. 1934).

> An order to liquidate the business of a domestic insurer shall direct the superintendent and his successors in office, as liquidator, forthwith to take possession of the property of such insurer and to liquidate the business of the same and deal with such property and business of such insurer in their own names as superintendents or in the insurer's name as the court may direct, and to give notice to all creditors to present their claims.

Thus, paragraph (a) of subsection 2 of Section 420, which the Rehabilitator apparently regards as analogous to the limitation found in Section 7427(b)(1), contained no language limiting its application to certain insolvency proceedings brought by the Superintendent. It is hardly surprising, accordingly, that the court found it applicable in an action brought by the rehabilitator of the insolvent insurer. Thereafter, when the Insurance Law was recodified by chapter 882 of the Laws of 1939, Section 420 was repealed and replaced by Section 538 of the Insurance Law. *See* 1939 N.Y. Laws, chapter 882, at 2893.

In relevant part, the applicable language of Section 538 is identical to the language of Section 7427(b)(1). That is, the Legislature limited the exception to the statutory setoff right to certain insolvency proceedings.[6]

Established canons of construction compel the conclusion that the Legislature's decision to add the qualifying language, "any liquidation order," to the exception must be regarded as intentional. *See, e.g., People v. Tran*, 80 N.Y.2d 170, 176 (1992) ("Under long-standing statutory interpretation rubrics, we may not ignore the Legislature's switch in the nucleic words of this statute."); McKinney's Cons. Laws of N.Y., Book 1, Statutes §193 at 357 ("in enacting an amendment of a statute the legislature, by changing the language, is deemed to have intended to materially change the law.").[7] Yet another canon of construction negates the Rehabilitator's

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6 The relevant language of Section 538 reads as follows:

> No offset shall be allowed in favor of any such person, however, where (a) the obligation of the insurer to such person would not at the date of the entry of any liquidation order, or otherwise, as provided in section five hundred fourteen, entitle him to share as a claimant in the assets of such insurer..." Section 538(2).

7 *See also People v. Dethloff*, 283 N.Y. 309, 315 (1891) (court interpreted statute, "as we must, upon the assumption that the Legislature did not deliberately place in the statute a phrase which was intended to serve no purpose"); McKinney's Cons. Laws of N.Y., Book 1, Statutes § 231 at 389-390 ("it is broadly held that every word, phrase, clause and paragraph must be presumed to have meaning and to have been inserted in a statute for a purpose."); *People v. Grasso*, 42 A.D.3d 126, 138 (2007) ("a due respect for the

position. "[A] court cannot amend a statute by inserting words that are not there, nor will a court read into a statute a provision which the Legislature did not see fit to enact." *Matter of Chemical Specialties Manuf. Ass'n v. Jorling*, 85 N.Y.2d 382, 394 (1995). The Rehabilitator, however, impermissibly interlineates words into the phrase, "any liquidation order," effectively reading it as if the Legislature had stated "any liquidation or rehabilitation order." Accordingly, the only conclusion that can be drawn from the Legislature's inclusion of that qualifying language in 1938 (which it retained when, pursuant to chapter 367 of the Laws of 1984, Section 7427 was enacted) is that the exception in paragraph (1) of subsection (b) of Section 7427 is not applicable in rehabilitation proceedings.[8]

For another and independent reason, the Rehabilitator's reliance on Section 7427(b)(1) is misplaced. That is, the limitation would not apply here even if it did apply in rehabilitation proceedings. The limitation disallows an offset where "the obligation of the insurer to such person would not at the date of the entry of any liquidation order... entitle him to share as a claimant in the assets of such insurer." Ins. Law § 7427(b)(1). Thus, the plain meaning of this language bars only persons who are not creditors of the insurer at the time of the order from exercising the offset rights secured by Section 7427(a).[9] FGIC's obligation to policyholders arose, of course, prior to the entry of the Rehabilitation Order. For this additional reason, it would not matter even if the Court could accept the Rehabilitator's invitation to read the statute as if it said "any liquidation or rehabilitation order."

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competence of the Legislature requires us to conclude that the... remedial choices it made were considered choices."), *aff'd*, 11 N.Y.3d 64 (2008).

8 Substantive reasons for limiting the exception to liquidation proceedings, moreover, are easy to conceive. In a liquidation proceeding, of course, policyholders are not required to continue to perform under the insurance contracts, including by paying premiums.

9 The court in *Friedman* read the Section 420 limitation to operate only in this manner. *Friedman*, 153 Misc. at 701.

Breezily ignoring his own failure to cite a case supporting his position, the Rehabilitator protests that he "know[s] of no case, and none is cited by the objectors, in which a court held that policyholders could continue setting off against pre-restructured obligations even after such obligations were reduced pursuant to a court approved plan." Omnibus Reply at 27. Because the statute unequivocally supports the objectors' position, however, they need not cite such a case. Moreover, it may well be that in a rehabilitation proceeding, no rehabilitator has sought approval of a plan that, over the objection of policyholders, would prevent them from exercising their setoff rights even though they are receiving only a small percentage of the value of their claims.

In sum, for all the foregoing reasons, the Plan violates Section 7427's explicit requirement that mutual debts "shall be set off and the balance only shall be allowed or paid." Ins. Law § 7427(a). For this reason alone, the Plan cannot be approved. *See Frontier, supra*, 36 Misc. 3d at 542 ("a plan of rehabilitation cannot be approved where it is inconsistent with law"); *cf. Irving Trust*, 241 A.D. at 249 ("injunction which assumed to deprive the claimant of the right of set-off granted under section 420 would be invalid since it would exceed the powers conferred upon the court by the statute").

IV. The Plan's Provisions Abridging Policyholders' Statutory Setoff Rights Are Unfair And Inequitable

The Rehabilitator's other arguments ostensibly justify the Plan's abridgment of policyholders' statutory setoff rights (and expanding those of FGIC) on the basis of his view of what is fair and equitable. Although the Court need not consider these arguments, they are all meritless in any event. Indeed, there is nothing fair and equitable about the Plan's provisions relating to and affecting those rights. To the contrary, the Rehabilitator has it exactly backwards.

It is the Plan's setoff-related provisions that are unfair and inequitable.[10] They also constitute an unconstitutional intrusion by the Rehabilitator into the Legislature's policy-making authority.

In re Midland conclusively refutes the Rehabilitator's claim that allowing policyholders to exercise their statutorily protected setoff rights "would undermine the fundamental principle that, '[u]pon insolvency, assets must be equally distributed among creditors without preference or priority.'" Omnibus Reply at 24 (*quoting Southern Indus., Inc. v. Jeremias*, 66 A.D.2d 178, 184, (2d Dept 1978)). *In re Midland* and other binding precedent establish that giving effect to the setoff rights secured by Section 7427(a) does not entail the granting of an inequitable preference. As the Court of Appeals has stated: "Indeed, if an offset is otherwise valid, there would seem to be no reason why its allowance should be considered a preference: it is 'only the balance, if any, after the set-off is deducted which can justly be held to form part of the assets of the insolvent.'" *In re Midland*, 79 N.Y.2d at 262 (*quoting Scott v. Armstrong*, 146 U.S. 499, 510 (1892)).[11] Thus, the policyholders' setoff rights are simply not assets of FGIC.

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10 As explained by the U.S. Supreme Court in the context of a plan of reorganization for a corporation under Section 77B of the Bankruptcy Act: "The words 'fair and equitable' as used in § 77B(f) are words of art which prior to the advent of § 77B had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations." *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 115 (1939). Cases applying the standard in insurance rehabilitations have highlighted aspects of the concept important here: (1) the plan may not discriminate unfairly between claimants *with the same legal rights* (*Matter of People by Van Schaick (Nat. Surety Co.)*, 239 A.D. 490, 496 (1st Dep't 1933), *aff'd*, 269 N.Y. 473 (1934) (emphasis added); *Carpenter*, 10 Cal.2d at 331, 337); (2) the parties receive at least as much as they would recover in a liquidation (*Carpenter*, 10 Cal.2d at 335); and (3) the terms of the plan must be authorized by law (*Frontier*, *supra*, 36 Misc. 3d at 542).

11 *See also id.* ("the Legislature has resolved the competing concerns and recognized offsets as a species of lawful preference"). As is evident from the Court of Appeals' quotation from *Scott v. Armstrong*, it broke no new ground in this regard. The First Department, moreover, also has held that granting the setoff rights of the Insurance Law does not entail the granting of a preference. *See Irving Trust*, 241 A.D. at 248 ("No preference would be granted by allowing the set-off pleaded. It has long been the law that 'the equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity.'") (*quoting Scott v. Armstrong*, 146 U.S. at 511).

The Rehabilitator recognizes that in carrying out his mandate under Section 7403 to remove the causes and conditions which made the rehabilitation necessary, he "must endeavor to do so in a manner that treats similarly situated claimants, and in particular policyholders, fairly and equitably." Omnibus Reply at 17. But rather than provide equal treatment for similarly situated creditors, the Plan would artificially place all policyholders in a similar situation by abridging or eliminating entirely the setoff rights of those policyholders that possess them (or have previously exercised them). By depriving some policyholders of their statutorily-secured setoff rights, the Plan would transfer the economic benefit of those setoff rights to other creditors who do not possess those rights. Accordingly, the Rehabilitator would violate the very cardinal principle that he concedes he must abide by: treating similarly situated policyholders in a fair and equitable manner.

Moreover, FGIC's policyholders have invested in various trusts, with a wide range of qualities and characteristics. Obviously, for example, some trusts are performing better than others. Because of these differences, there is considerable variation in the ability of trusts to make payments to their investors, and there is also considerable variation in the ability of trusts to exercise setoff rights with respect to amounts owed by FGIC. The Rehabilitator acknowledges that "[m]any of FGIC's policyholders paid their premiums in full, up front, while others pay their premiums in installments over time." Affidavit of John S. Dubel ¶21; *see also* Omnibus Reply at 21. Of course, however, policyholders who paid their premiums in full, up front, did so knowingly, and undoubtedly received a discount commensurate with the risk they thus assumed. By curtailing and eliminating policyholders' setoff rights, the Rehabilitator relieves policyholders who pre-paid all premiums of the risks they knowingly assumed, effectively requiring these policyholders to be subsidized by policyholders who were unwilling to assume the risks inherent in pre-paying all premiums.

The Rehabilitator erroneously maintains that the Plan's provisions curtailing or eliminating setoff rights are necessary both to remedy "arbitrary factors," including "the amount and timing of recoveries obtained by the issuer of FGIC-insured securities," Omnibus Reply at 18, and to prevent "disproportionately higher recoveries" for policyholders that "*happen* to have amounts to withhold and setoff," *id.* at 24 (emphasis added). As the common law has long recognized, setoff rights cannot be dismissed as "arbitrary" or "fortuitous." Obviously, when a business entity becomes insolvent, it can be true that as a result of circumstances that are more or less fortuitous some creditors will have setoff rights and others will not. This real-world reality is what the Rehabilitator is actually objecting to in advancing this argument. The argument also simply ignores the unfairness that would result from depriving creditors with setoff rights of the value of those rights. Because he cannot, the Rehabilitator offers no *a priori* reason for visiting on creditors with setoff rights, rather than those without these rights, the economic consequences of such fortuitous circumstances. The Rehabilitator also ignores another real-world reality: setoff rights often depend on *substantive* considerations, as is illustrated by the discussion above of policyholders who chose to pay all premiums up front. Finally, this argument is irrelevant because the Legislature has "resolved the competing concerns and recognized offsets as a species of lawful preference." *In re Midland*, 79 N.Y.2d at 262.

Relatedly, the Rehabilitator justifies the Plan on the ground that it seeks to prevent "individual creditors [from] . . . increas[ing] their own recoveries -- at the expense of other creditors." Omnibus Reply at 2. This invocation of the specter of greed is repeated so frequently, *see id.* at 18, 29, as to be an incantation. It is devoid of merit. Of course, because the assets are limited, if some creditors have rights that others do not have, the recognition of those rights necessarily means that creditors without those rights will recover less value. But the notion that the greater recovery of those with those rights comes at the "expense" of other creditors is indefensible. After all, it implicitly and wrongly assumes that creditors without setoff rights are no different from those with setoff rights. In repeatedly decrying the efforts of some creditors to increase their recovery at the "expense" of others, the Rehabilitator dresses a wolf in sheep's clothing. What the Rehabilitator is really arguing is that at the expense of creditors with setoff rights, creditors without those rights nonetheless must share in the economic benefit of those rights. And that is nothing more than an effort to do indirectly what the Rehabilitator cannot do directly: eliminate the setoff rights secured by Section 7427. *See, e.g.*, *People v. Grasso*, 42 A.D.3d at 140 n. 9 (N.Y. App. Div. 1st Dep't 2007) (invoking the "venerable prohibition on public officials doing indirectly what they are forbidden from doing directly").

The Plan is also not fair and equitable because it provides some policyholders with less than they would receive if FGIC were liquidated. *See, e.g.*, *Carpenter*, 10 Cal. 2d at 335 (Cal. 1937) (finding that a creditor is "entitled to… the equivalent of what he would receive on liquidation"); *In re Midland*, 79 N.Y.2d at 264-265 ("liquidation cannot place the liquidator in a better position than the insolvent company he takes over, authorizing him to demand that which the company would not have been entitled to prior to liquidation"). Policyholders would be able to exercise their setoff rights in a liquidation proceeding, *see id.* ("section 7427 of the Insurance Law applies to liquidation proceedings"), and thus stripping them of their setoff rights in this rehabilitation proceeding would leave those policyholders with such rights worse off than if FGIC liquidated.

The Rehabilitator is plainly wrong in asserting that allowing "the type of setoffs urged by the objectors would diminish FGIC's claim-paying resources, resulting in… lower ultimate recoveries to policyholders as a whole." Omnibus Reply at 24. Depriving policyholders of their setoff rights would not increase the amount available for policyholders – it would simply redistribute funds from those policyholders that have lawfully exercised or will lawfully exercise their setoff rights to those who do not possess such rights or have not exercised them.

At bottom, the Rehabilitator's fairness and equity arguments in support of the Plan's provisions curtailing or eliminating policyholders' statutory setoff rights represent nothing more than his disagreement with the public policy judgment the Legislature made when it "resolved the competing concerns and recognized offsets as a species of lawful preference." *In re Midland*, 79 N.Y.3d at 262. As an executive branch official, the Rehabilitator cannot, consistent with fundamental principles of separation of power, substitute his policy judgment for the one made by the Legislature. In *People v Grasso*, another public official, the Attorney General, alleged causes of action inconsistent with policy choices made by the Legislature. 42 A.D.3d at 141. Precisely because the Attorney General sought "to displace the policy choices made by the Legislature," *id.* at 143, the First Department rejected these causes of action as "inconsisten[t] with the principle of separation of powers." *Id.* at 140. And in unanimously affirming the First Department, the Court of Appeals reached the same conclusion. 11 N.Y.3d at 72 (to permit the Attorney General to assert those causes of action "would tread on the Legislature's policy-making authority"). The Rehabilitator's effort to vitiate policyholders' statutory setoff rights is fatally flawed for this additional reason.

CONCLUSION

The Plan, as currently drafted, contains provisions that would deprive policyholders of their statutory and common law rights of setoff, both prospectively and retroactively, while at the same time maintaining and even expanding those rights for FGIC. These provisions violate Section 7427 and cannot be approved. Moreover, the Rehabilitator's attempt to deprive policyholders of their setoff rights as a supposed means of ensuring equal treatment of creditors is at best misguided. The Rehabilitator inexplicably fails to recognize the obvious: policyholders are not all similarly situated. To the contrary, they have invested in trusts that are different from one another in important respects, and the availability of setoff rights necessarily differs among trusts based on, among other things, the performance of the underlying mortgages held by the trusts and whether policyholders agreed to pay premiums in full, up front.

WHEREFORE, for the reasons set forth herein, Aurelius respectfully requests that this Court reject or modify the Plan with such other and further relief as the Court deems appropriate.

Dated: New York, New York
January 22, 2013

Respectfully submitted,

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