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 IAS Part 36 Justice Doris Ling-Cohan Motion Sequence No. 4

Amended Objections to Plan of Rehabilitation

Pursuant to the Orders of this Court dated September 28, 2012 and December 19, 2012, Certain Jefferson County Warrantholders ("Jeffco Holders") hereby object as follows to the motion of Benjamin M. Lawsky, Superintendent of Financial Services of the State of New York as the court-appointed rehabilitator of FGIC, for entry of an order approving a proposed Plan of Rehabilitation for FGIC.

1. The Jeffco Holders object to Sections 3.5 and 7.8 of the Plan.

2. The Jeffco Holders object to Section 1.4(A) of the Plan.

The Grounds for the objections are set forth in the accompanying memorandum of law.

Dated: New York, New York
January 22, 2013

Kramer Levin Naftalis & Frankel LLP

By: ______________________
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Index No. 401265/2012

SUPREME COURT OF THE STATE OF NEW YORK
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In the Matter of the Rehabilitation of FINANCIAL GUARANTY INSURANCE COMPANY.

AMENDED OBJECTIONS TO PLAN OF REHABILITATION

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In the Matter of the Rehabilitation of FINANCIAL GUARANTY INSURANCE COMPANY.	Index No. 401265/2012 IAS Part 36 Justice Doris Ling-Cohan Motion Sequence No. 4

AMENDED OBJECTIONS OF CERTAIN JEFFERSON COUNTY <u>WARRANTHOLDERS TO PLAN OF REHABILITATION</u>

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Certain entities (the "JeffCo Holders")[1] holding more than $330 million in principal amount of sewer warrants[2] ("JeffCo Sewer Warrants") issued by Jefferson County, Alabama ("Jefferson County") supported by insurance policies (the "JeffCo Policies") issued by Financial Guaranty Insurance Company ("FGIC"), submit this objection (the "Objection") to the motion of Benjamin M. Lawsky, Superintendent of Financial Services of the State of New York (the "Superintendent"), as the court-appointed rehabilitator of FGIC (the "Rehabilitator"), for entry of an order, *inter alia*, approving a proposed plan of rehabilitation for FGIC (the "Plan"). In support of this Objection, the JeffCo Holders respectfully submit as follows:

PRELIMINARY STATEMENT

The JeffCo Sewer Warrants consist of approximately $1.6 billion of municipal bond obligations, in respect of which FGIC has insured all payments of principal and interest.[3] As tax-exempt, triple A-rated debt that was issued well before the 2008 financial crisis, the JeffCo Sewer Warrants were believed to be a conservative municipal bond investment appropriate for college or retirement savings accounts.

Jefferson County issued the JeffCo Sewer Warrants, which, in addition to being insured, are secured by all net revenues of the Jefferson County sewer system. Jefferson County filed for Chapter 9 bankruptcy protection in 2011. For the past several months, the JeffCo

[1] The JeffCo Holders are Brigade Capital Management, LLC, Claren Road Asset Management, LLC, Emerald Eagle Holdings, L.L.C., Emerald Eagle Holdings South, L.L.C., Fundamental Advisors, LP, Monarch Cayman Fund Limited, Monarch Alternative Solutions Master Fund Ltd, Monarch Capital Master Partners II LP, Monarch Capital Master Partners II-A LP, Monarch Capital Master Partners LP, Monarch Debt Recovery Master Fund Ltd., Monarch Debt Recovery Master Fund Ltd, Monarch Opportunities Master Fund Ltd, Monarch Research Alpha Master Fund Ltd, Oakford MF Ltd, P Monarch Recovery Ltd., Citigroup Global Markets, Inc., and Stone Lion Capital Partners L.P., each as either holders of JeffCo Sewer Warrants or as investment advisers to, or managers of, funds or accounts that hold JeffCo Sewer Warrants with power to direct the voting of warrants held by such funds.

[2] The JeffCo Sewer Warrants represent municipal indebtedness similar in many respects to that of municipal bond debt.

[3] Some of this amount may be reinsured.

Holders have negotiated with Jefferson County and its other creditors to maximize recoveries to holders of the JeffCo Sewer Warrants.

Now, the Rehabilitator has filed a Plan that not only proposes to pay the JeffCo Holders pennies on the dollar on their insurance claims, but also improperly attempts to usurp the JeffCo Holders' role in negotiating their rights against Jefferson County by unilaterally amending the JeffCo Policies – and also the indentures that govern the JeffCo Sewer Warrants, to which FGIC is not even a party. This, and other provisions of the Plan, render the Plan objectionable on multiple grounds.

First, contrary to the express terms of the JeffCo Indenture (defined below), Sections 3.5 and 7.8 of the Plan provide that FGIC's defaults, whether in the past or future, including its failure to pay policy claims, shall be deemed not to have occurred. On this basis, the Plan then purports to bar the JeffCo Holders from exercising their right to control the restructuring of the JeffCo Sewer Warrants (the "Control Rights"). In other words, at the same time FGIC proposes to pay only a small fraction of the JeffCo Holders' policy claims, the Rehabilitator wants this Court to grant it control over the holders' efforts to recover from Jefferson County the amounts that FGIC insured but will fail to pay under the JeffCo Policies. These provisions of the Plan exceed the Rehabilitator's powers under New York state insurance law, and are arbitrary and capricious. The Rehabilitator's legal defense of these provisions is premised on a misapplication of the *ipso facto* doctrine, and is therefore unsupportable. And enforcement of these provisions would constitute a taking of the JeffCo Holders' property rights against a third party (Jefferson County) in violation of the Fifth and Fourteenth Amendments to the United States Constitution and similar provisions of the New York Constitution.

Second, the Plan requires the JeffCo Holders to turn over to FGIC a portion of any amounts they recover from Jefferson County, up to the amount of the cash they receive from FGIC under the Plan. If such amounts are not turned over, FGIC will set off those amounts against any future cash payments that FGIC would otherwise owe to the JeffCo Holders under the Plan (the "Forced Payover/Setoff Provisions"). The Forced Payover/Setoff Provisions amount to an unlawful confiscation of the JeffCo Holders' recoveries from Jefferson County. They are inconsistent with the terms of the JeffCo Policies and the JeffCo Indenture, they violate the "made whole" doctrine under New York law, they constitute unlawful takings under the United States and New York Constitutions, and they conflict with Bankruptcy Code Section 509, which provides that FGIC cannot recover from Jefferson County until the FGIC-insured warrants are paid in full.

Municipal bonds have historically been the backbone of FGIC's insurance business. As of the commencement of this proceeding, FGIC had approximately $150 billion in municipal bond insurance policies outstanding. Other municipal bond policyholders are likely to find themselves in similar positions to that of the JeffCo Holders – with a municipal obligor that has defaulted on its bond debt and FGIC as their bond insurer, paying pennies on the dollar on its bond insurance policies but demanding full control over the insured bonds and appropriating bondholder recoveries in violation of bondholders' rights against their principal obligors. This is completely contrary to the intent of bond insurance, which is to provide *additional* protection to policy holders by *adding* to the deficient recoveries that they may obtain from the issuer of their bonds. While the JeffCo Holders understand that the Rehabilitator is attempting to maximize recoveries to all of FGIC's policy holders, the Rehabilitator cannot be permitted to leverage

FGIC's defaults to usurp the rights that the JeffCo Holders and other municipal bondholders have to recover against their primary obligors.

BACKGROUND

The JeffCo Sewer Warrants

Between 1997 and 2003, Jefferson County issued approximately $3.6 billion in municipal, tax-exempt debt instruments to fund certain capital improvements to the Jefferson County sewer system (the "Sewer System"). These debt instruments, called "warrants," are essentially tax-exempt revenue bond obligations secured by net revenues from the Sewer System and certain other assets, and were issued under a Trust Indenture, dated February 1, 1997 (as supplemented, the "JeffCo Indenture," a copy of which is annexed as Exhibit A to the affirmation of Amy Caton in support of this Objection (the "Caton Aff."), filed contemporaneously herewith), with AmSouth Bank of Alabama, as indenture trustee (together with The Bank of New York Mellon, as successor, the "JeffCo Indenture Trustee"). Initially, more than 90% of these warrants bore interest at a fixed rate. In 2002 and 2003, Jefferson County refinanced most of this debt with variable rate warrants, of which FGIC currently insures more than $1.6 billion in original principal amount under four separate bond insurance policies.[4]

In 2008, Jefferson County missed payment on the JeffCo Sewer Warrants. Thereafter, it entered into a series of forbearance and/or standstill agreements with certain

[4] The JeffCo Policies consist of multiple individual policies insuring, among other things, the payment of scheduled interest and principal under the JeffCo Sewer Warrants. The terms of the policies are substantially similar and do not differ in any way that is material to this Objection. An example of a JeffCo Policy is attached to the Caton Aff. as Exhibit B. FGIC has also issued two surety policies (with a combined remaining exposure of approximately $16.6 million) which serve as credit instruments in a reserve fund established under the JeffCo Indenture. Under the JeffCo Indenture and surety policies, the JeffCo Indenture Trustee may make draws to the extent there is a shortfall in the debt service fund to cover interest and principal as they come due. FGIC's claims for reimbursement for draws made under JeffCo surety policies are contractually subordinated under the JeffCo Indenture at least to the prior payment of debt service on the JeffCo Sewer Warrants. This Objection does not address the Plan's effect on these surety policies.

creditors that, among things, reduced the payments Jefferson County was required to make on a current basis, including payments to certain holders of the JeffCo Sewer Warrants.[5]

On November 9, 2011, Jefferson County filed a voluntary petition for relief under Chapter 9 of title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.* (the "Bankruptcy Code"). Approximately $3.136 billion of JeffCo Sewer Warrants remained outstanding as of Jefferson County's bankruptcy filing. It is uncertain whether Jefferson County will pay the JeffCo Sewer Warrants in full. Of the roughly $1.6 billion of those outstanding JeffCo Sewer Warrants insured by FGIC, approximately $330 million are held by the JeffCo Holders.

In February 2013, various principal and interest payments will come due on the JeffCo Sewer Warrants. It is expected that Jefferson County will not make such payments in full. Therefore, claims for payment under the JeffCo Policies will be asserted against FGIC in the near future.

The Rehabilitation Proceedings and Plan

On June 28, 2012, this Court appointed the Superintendent as Rehabilitator of FGIC. On September 27, 2012, the Rehabilitator filed the Plan and an accompanying disclosure statement (the "Disclosure Statement"). The Rehabilitator asserts that the Plan seeks to treat FGIC's policyholders in a fair and equitable manner while removing the causes and conditions that made this proceeding necessary. (Disclosure Statement at 1.) The Plan purports to achieve these goals by, among other things, the following:

First, the Plan does not propose to pay policy claims in full in cash, as required by the terms of FGIC's Policies. Instead, the Plan provides that FGIC will pay out on its policies as

[5] For purposes of this Objection, the JeffCo Holders take no position as to whether the obligations under the JeffCo Sewer Warrants have been accelerated. The JeffCo Holders note, however, that FGIC will imminently default on payments due on the JeffCo Sewer Warrants in February 2013, and that it may be argued that the obligations under the JeffCo Sewer Warrants have been accelerated or will be accelerated in February 2013.

its obligations to pay interest and principal come due over the life of the underlying insured obligation (in the cash of JeffCo Sewer Warrants, a period that could be up to 30 years), in the form of (i) cash in an amount equal to the cash payment percentage ("CPP") to be determined by the Rehabilitator, but presently expected to be approximately 15% of the amount of each Permitted Policy Claim, and (ii) the right to receive future payments (the "DPO" or deferred payment obligation) in an amount equal to the remaining portion of the Policy Claim. Payment on the DPO, moreover, is unlikely. Future payments will be made only if the Rehabilitator determines, in consultation with a third-party firm and with the approval of the New York State Department of Financial Services (the "NYSDFS"), that FGIC has sufficient assets to pay an increased percentage of cash. (Plan § 2.3; Plan Ex. B (Restructured Policy Terms) §§ 1.1, 1.2; Disclosure Statement at 21.) The Rehabilitator estimates that the average ultimate recovery to Policyholders will be 24% to 25%. (*Id.* at 2.)

Second, the Plan provides – contrary to undisputed fact – that certain of FGIC's payment defaults will be deemed not to have occurred or not to occur in the future, despite the Plan's provision for only partial payment of FGIC's obligations. On this basis, FGIC will appropriate certain contractual rights – which it labels "FGIC Rights" – that FGIC would not otherwise have had. (Disclosure Statement at 22.) The Plan further employs this fiction to enjoin all persons from exercising "FGIC Rights" under any Policy or related Transaction Document (including any approval, consent, direction, determination, appointment, request, voting, veto, waiver or other right that FGIC would otherwise have had had it not defaulted on any of its contractual obligations). (Plan § 7.8(e).) If any person seeks to exercise a "FGIC Right," moreover, the Plan allows FGIC to declare a Policy Crystallization Event and unilaterally determine its anticipated payment obligations under the relevant Policy for the remainder of its expected duration. (Plan Ex. B (Restructured Policy Terms) §§ 2.1, 2.2.)

OBJECTION[6]

I. The Plan Improperly Reverses Events of Default and Deprives JeffCo Holders of Expressly Bargained-For Contractual Rights

Sections 3.5 and 7.8(e) of the Plan provide, respectively, that FGIC shall be deemed not to have defaulted under any FGIC Contract or Transaction Document – even though the same Plan makes clear that FGIC will not meet its existing Policy obligations – and that all parties will be enjoined from exercising any contractual rights, including Control Rights, they may otherwise have had as a result of FGIC's failure to honor its pre-rehabilitation obligations (collectively, the "Control Rights Impairments").[7]

These provisions will profoundly restrict the JeffCo Holders' ability to protect their rights against Jefferson County in its Chapter 9 proceeding. Under the JeffCo Indenture, a

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[6] Capitalized terms not otherwise defined herein shall have the meaning ascribed in the Plan.

[7] Section 3.5 of the Plan provides, in relevant part:

> [U]pon the Effective Date, any default, event of default or other event or circumstance relating to the FGIC Parties then existing . . . under any FGIC Contract or Transaction Document, as a result of (whether directly or indirectly) the Rehabilitation or the Rehabilitation Circumstances shall be deemed not to have occurred (including, for the avoidance of doubt, any default, event of default or other event or circumstance that has arisen (or that may otherwise arise with the passing of time or the giving of notice or both) due to a lack of payment or performance of or by the FGIC Parties under any FGIC Contract or Transaction Document).

(Plan § 3.5.) Section 7.8(e) of the Plan further provides:

> From and after the Effective Date, all Persons shall be prohibited from:
>
> . . . [E]xercising or taking any action to exercise . . . any approval, consent, direction, determination, appointment, request, voting, veto, waiver or other right that the FGIC Parties have . . . (or that the FGIC Parties would have but for the Rehabilitation or the occurrence or existence of any of the Rehabilitation Circumstances) under or with respect to any FGIC Contract or any Transaction Document executed in connection with the issuance of or entry into such FGIC Contract or related to such FGIC Contract or any obligations insured or covered thereby . . . .

(*Id.* § 7.8(e).)

majority of the holders of the JeffCo Sewer Warrants are authorized to direct the JeffCo Indenture Trustee to take action against Jefferson County:

> The Holders of a majority in aggregate principal amount of the Parity Securities then outstanding shall have the right . . . to direct the time, method and place of conducting all remedial proceedings available to the Trustee under this Indenture or exercising any trust or power conferred on the Trustee by this Indenture.

(Caton Aff. Ex. A (JeffCo Indenture) § 13.5). If FGIC is paying its obligations under JeffCo Policies – and therefore bears all risk of loss under the JeffCo Sewer Warrants – the JeffCo Indenture permits it to exercise the warrantholders' Control Rights by "deeming" FGIC the sole warrantholder. (*Id.* § 17.3(c)). This deemed status grants FGIC enormous substantive rights, including the ability to waive certain defaults and agree to amendments of the JeffCo Indenture. (*Id.* §§ 13.10, 15.2.) However, the JeffCo Indenture specifically provides that FGIC maintains its "deemed" status and ability to exercise the Control Rights only for "*so long as it has not failed to comply with its payment obligations under the Bond Insurance Policy.*" (*Id.* § 17.3(c) (emphasis added).)

Because the Plan provides that FGIC will not comply with its payment obligations under the JeffCo Policies, the Control Rights will revert to the JeffCo Holders under the express terms of the JeffCo Indenture. The Plan, however, purports to forestall this reversion by deeming FGIC to have complied with the obligations that it has already breached (or will breach in the future) and enjoining third parties from taking steps to enforce their rights elsewhere.

These provisions cannot be approved for several reasons.

A. The Control Rights Impairments Are Capricious, Arbitrary and a Violation of the Rehabilitator's Discretion

Together, Sections 3.5 and 7.8 of the Plan operate to unilaterally and impermissibly amend the terms of the JeffCo Indenture (to which FGIC is not a party). By deeming FGIC not to have defaulted under the JeffCo Policies and enjoining the JeffCo Holders from asserting FGIC's default to enforce the reversion of their Control Rights, the Plan alters a basic element of the bargain embodied in the JeffCo Indenture. So long as FGIC bore all risk of loss under the JeffCo Sewer Warrants, the JeffCo Indenture permitted it to direct the Indenture Trustee.

Under the Plan, FGIC will bear only a sliver of the risk of loss under the JeffCo Sewer Warrants – the Disclosure Statement estimates its payments will total, at best, 25% on a net present value basis. (Disclosure Statement at 2.) To enjoin the JeffCo Holders, who now bear the great majority of the risk under the JeffCo Sewer Warrants, from receiving the reversion of the Control Rights rewrites their contract and upends the traditional purpose of insurance by placing the insurer's interests ahead of the insured's. As such, the Plan unilaterally amends the terms of the JeffCo Indenture, in clear violation of the terms of the Indenture, which require the JeffCo Indenture Trustee and Jefferson County to agree to any such amendments. (Caton Aff. Ex. A (JeffCo Indenture) §§ 15.1, 15.2).

While the Rehabilitator is granted wide latitude to manage FGIC's affairs and administer its assets, it is bound by applicable law and the contracts and facts that exist. *In re Frontier Ins. Co.*, 36 Misc. 3d 529, 541-42 (Albany Cnty. 2012) ("While the Court recognizes that deferential standard of review applicable to the Rehabilitator's actions, a plan of rehabilitation cannot be approved where it is inconsistent with law."). The Rehabilitator's authority is "circumscribed by [the court's] mandate to act as a check on potential discretionary abuse and to insure equitable apportionment of loss." *Grode v. Mut. Fire, Marine, & Inland Ins. Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990); *Mills v. Fla. Asset Fin. Corp.*, 31 A.D.3d 849, 850 (3d Dep't 2006) (rehabilitator may not act arbitrarily, capriciously or in manner that constitutes abuse of discretion). Sections 3.5 and 7.8 of the Plan exceed even these generous boundaries on the Rehabilitator's authority.

The discretion afforded a rehabilitator does not include the power to unilaterally amend contracts to expand an insurer's rights. Rather, it steps into the shoes of the insolvent insurer and obtains no greater rights than those that the insurer had prior to its insolvency. As the New York Court of Appeals has recognized, insolvency does not expand an insurer's rights and the fiduciary "should not and may not be placed in a better position than the company he takes over . . . ." *Bohlinger v. Zanger*, 306 N.Y. 228, 234 (1954) (addressing liquidation).[8]

The same applies to an insolvent insurer's contractual rights. *See, e.g.*, *Kaiser v. Monitrend Invest. Mgmt, Inc.*, 672 A.2d 359, 364 n.5 (Pa. Commw. Ct. 1996) (holding, in an action to enforce a contract, that "the Statutory Liquidator has no greater rights under the contract than the insurer and would be subject to any defense that may be asserted against the insurer by the other party to the contract"). Before the appointment of the Rehabilitator, FGIC's ability to exercise the Control Rights would be eliminated upon a payment default. The Rehabilitator cannot expand FGIC's rights under the JeffCo Indenture through artful formulation of Plan terms and a judicial fiction.

No authority cited by the Rehabilitator, moreover, suggests that this Court has jurisdiction to enforce an amendment of this sort. This Court exercises only *in rem* jurisdiction over the assets of FGIC and its affiliates. *Ballesteros v. N.J. Prop. Liab. Ins. Guar. Ass'n*, 530 F. Supp. 1367, 1371-72 (D.N.J. 1982). But FGIC is not a party to the JeffCo Indenture, which is an

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[8] *See also Mich. Nat'l Bank-Oakland v. Am. Centennial Ins. Co. (In re Union Indem. Ins. Co. of N.Y.)*, 89 N.Y.2d 94, 108 (1996) (holding that liquidator was subject to same defenses that insurer was subject to); *Craig v. Bank of N.Y.*, 169 F. Supp. 2d 202, 210 (S.D.N.Y. 2001) ("Under New York law the general rule is that the liquidator of an insurance company stands in the shoes of the insolvent, gaining no greater rights than the insolvent had.") (quotations omitted); *Stevens v. Am. Home Assurance Co.*, 811 F. Supp. 937, 947-48 (S.D.N.Y. 1993) (holding that liquidator had no greater rights than those of insurer prior to liquidation and noting that "New York courts have been strongly supportive of preserving rights which existed prior to liquidation proceedings.")

agreement between Jefferson County and the JeffCo Indenture Trustee. The JeffCo Indenture therefore is not FGIC's property and this Court lacks jurisdiction to issue orders concerning the rights of Jefferson County, the Indenture Trustee or any other third-party possessing rights thereunder.

Even assuming this Court had jurisdiction over the JeffCo Indenture – and it does not – the Rehabilitator identifies no proper authority that would permit it to modify that contract. While the Rehabilitator cites cases purportedly authorizing it to modify FGIC's *insurance policies*, none suggests – let alone holds – that a court supervising a rehabilitation may modify a contract that is *not* an insurance policy or to which the insurer is not a party.[9] In fact, based on the "public interest" in the "business of insurance," those cases conclude that "the contract of the policyholder is subject to the reasonable exercise of the state's police power." *Carpenter*, 74 P.2d at 774-75; *accord Minor*, 898 S.W.2d at 80. On this basis, they hold that "neither the company nor the policyholder has the inviolate rights that characterize private contracts." *Id.* A municipal bond indenture, however, is not the "contract of a policyholder" or "the business of insurance." As a result, the Rehabilitator offers no basis to adjust the "inviolate rights" of the parties to the JeffCo Indenture. Nor does the Rehabilitator explain how New York State's police power might extend to adjust the terms of an Alabama law contract that governs public debt issued by a subdivision of the State of Alabama.[10]

Similarly, the cases cited by the Rehabilitator in support of Section 7.8's injunction (Rehabilitator's Memorandum of Law at 25-26) do no more than enjoin creditors from

[9] *Carpenter v. Pac. Mut. Life Ins. Co*, 74 P.2d 761, 776 (Cal. 1938) (modifying insurance policy terms); *Minor v. Stephens*, 898 S.W.2d 71 (Ky. 1995) (same); *In re Mut. Benefit Life Ins. Co.*, 1993 N.J. Super LEXIS 940, at *133-34 (Ch. Div. Aug. 12, 1993) (same).

[10] Nothing in the New York Insurance Law ("NYIL"), including Sections 7403 or 7419, grants the Rehabilitator the unilateral right to amend a contract between third parties, or to declare that an acknowledged and indisputable fact has not occurred.

asserting claims against the property of the insurer outside the rehabilitation court.[11] None purports to restrict third parties from asserting their rights under contracts to which the insurer is not a party and that are not subject to the jurisdiction of the rehabilitation court. The JeffCo Holders, moreover, are participants in the Jefferson County Chapter 9 proceeding currently pending in the United States Bankruptcy Court in Alabama. As a state tribunal, this Court cannot properly enjoin the JeffCo Holders, or any other party, from litigating to vindicate their rights in a federal court, let alone negotiating with respect to those rights. *See Gen. Atomic Co. v. Felter*, 434 U.S. 12, 18-19 (1977); *Donovan v. City of Dallas*, 377 U.S. 408, 413 (1964).

B. The Rehabilitator's Justifications for Misappropriating the Control Rights Lack Merit

In its Memorandum of Law, the Rehabilitator cites two principal justifications for the Control Rights Impairments. *First*, it argues that clauses providing for the transfer of control rights and/or the termination of FGIC's consent rights constitute *ipso facto* clauses that are unenforceable under Section 365(e)(1) of the Bankruptcy Code which bars the termination of a debtor's contractual rights as a result of, among other things, "the insolvency or financial condition of the debtor at any time before the closing of the case" or "the commencement of a [bankruptcy] case"). (Memorandum of Law at 27-29.) *Second*, it contends that, absent the Control Rights Impairments, certain policyholders and other counterparties may exercise their Control Rights to the detriment of policyholders generally. Neither argument is tenable, and the extraordinary relief the Plan seeks fails to withstand arbitrary and capricious review.

As an initial matter, Section 365(e) of the Bankruptcy Code does not apply here and the Rehabilitator cites no analogous New York authority. More importantly, the Rehabilitator misunderstands what an *ipso facto* clause is. "An ipso facto clause is an option to

[11] *See, e.g.*, Ambac, Plan of Rehabilitation Case No. 10-CV-1576, § 8.01 (Wis. Cir. Ct. App. Jan. 24, 2011); *Muir v. Transp. Mut. Ins. Co.*, 523 A.D.2d 1190, 1193-94 (Pa. Commw. Ct. 1987).

terminate a contract conditioned solely on the bankruptcy, insolvency or financial condition of the debtor." *Nemko, Inc. v. Motorola, Inc. (In re Nemko, Inc.)*, 163 B.R. 927, 938 n.5 (Bankr. E.D.N.Y. 1994)). A contractual provision that triggers a remedy upon a *payment default* is not an *ipso facto* clause. *See, e.g.*, *I.T.T. Small Bus. Fin. Corp. v. Frederique*, 82 B.R. 4, 5-6 (E.D.N.Y. 1987) (payment default provision not *ipso facto* clause); *In re Del. River Stevedores, Inc.*, 129 B.R. 38, 41 (Bankr. E.D. Pa. 1991) (*ipso facto* doctrine not applicable where "it was not the Debtor's bankruptcy filing, but rather its failure to make the requisite payments" under a payment agreement that had resulted in debtor's contractual liability).

In *In re C.A.F. Bindery*, the debtor sought to exercise certain rights that a lease provided were forfeited upon a payment default. 199 B.R. 828, 833 (Bankr. S.D.N.Y. 1996). Like the Rehabilitator, the debtor argued that the payment default provision was an unenforceable *ipso facto* provision. *Id.* at 832. The court rejected this, explaining that "[i]f the debtor's default arises for some reason other than those set forth in section 365(e)(1), the prohibition against *ipso facto* clauses does not apply." *Id.* at 833. This is true, moreover, even where "the debtor's [payment] default could be regarded as having been the product of its distressed financial condition and also as having paved the way for its petition for relief" under the Bankruptcy Code. *In re Gaslight Vill., Inc.*, 6 B.R. 871, 875 (Bankr. D. Conn. 1980).

The Rehabilitator's contention that Sections 3.5 and 7.8(e) of the Plan are necessary to prevent "holders of bonds insured by FGIC who purchased such bonds at a discount" from directing the JeffCo Trustee to liquidate collateral underlying instruments insured by FGIC to obtain a "quick and certain recovery," (Rehabilitator's Memorandum of Law at 29), is unsupported and irrational and, in any event, cannot justify the relief the Rehabilitator seeks.

There is no rational basis to believe that the JeffCo Indenture Trustee, properly directed by the JeffCo Holders and other warrantholders, will not obtain the maximum recovery possible on the JeffCo Sewer Warrants. The JeffCo Holders are far better positioned than the Rehabilitator to obtain favorable treatment of the JeffCo Sewer Warrants in the Jefferson County bankruptcy case. The JeffCo Holders have a much greater economic stake in the JeffCo Sewer Warrants than will the Rehabilitator. Further, the JeffCo Holders have already been participating in the Chapter 9 case and their advisors have been engaged in negotiations with the County concerning the treatment of the warrants for months.

The JeffCo Sewer Warrants are currently trading at 77 cents on the dollar. If the Plan is approved, the Rehabilitator *projects* that it might pay, on a present value basis, only 24 to 25 cents on the dollar for those warrants. (Disclosure Statement at 48.) Based on current prices, the market believes that JeffCo Holders will therefore receive a far greater recovery on their warrants than they will in this rehabilitation proceeding, and are therefore highly motivated to extract the greatest possible value in that proceeding.

It is also simply irrational to suggest that investors who bought at a discount are less inclined to maximize recoveries on their investments. The purchase price of an investment has no bearing on the investor's objective to maximize recovery. Regardless, it is disingenuous for the Rehabilitator to make such an argument as the Rehabilitator is proposing to pay only 15 cents on the dollar in cash on policy claims up front – an amount far less than the 77 cents on the dollar that is being paid on the JeffCo Sewer Warrants in the market today.

The JeffCo Holders have invested, and continue to invest, substantial resources toward the maximization and realization of value from Jefferson County on account of the JeffCo Sewer Warrants. It would be perverse to allow the Rehabilitator – which holds a pronounced minority of the economic risk underlying the JeffCo Sewer Warrants – to usurp control over the exercise of remedies from the true economic parties in interest – the JeffCo Holders. In these circumstances, it is irrational to suggest that the JeffCo Holders would be any less vigorous than the Rehabilitator in pursuing and maximizing claims against Jefferson County.

For the Rehabilitator to predicate a determination that thousands of parties with contractual rights governed by the laws of other states should be prohibited from exercising those rights on the basis of such flimsy and speculative arguments is patently arbitrary and capricious. *See, e.g.*, *Metro. Taxicab Bd. of Trade v. N.Y. City Taxi & Limousine Comm'n.*, 18 N.Y.3d 329, 334 (2011); *Daubman v. Nassau County Civil Serv. Comm'n*, 195 A.D.2d 602, 603 (2d Dep't 1993) (2d Dep't 1993) (finding civil service commission disqualification of police officer candidate on basis that candidate may have heightened risk of disability because of existing medical condition to be "arbitrary and capricious because it is premised upon speculation rather than fact"); *Realmuto v. N.Y. State Liquor Auth.*, 181 A.D.2d 772, 774 (2d Dep't 1992) (affirming trial court's annulment of liquor authority's refusal to grant license as arbitrary and capricious where "the ground for disapproval is without any reasonable basis in fact, and is supported only by speculation and conjecture" as to potentially undisclosed aspects of applicant's business).

C. The Control Rights Impairments Constitute Unconstitutional Takings of the JeffCo Holders' Property

The Control Rights Impairments dictated by the Plan not only exceed this Court's jurisdiction and the Rehabilitator's statutory authority, but they also constitute an unlawful taking under the Fifth and Fourteenth Amendments to the United States Constitution and Article 1, §§ 6 and 7 of the New York Constitution.

The Fifth Amendment to the United States Constitution provides that private property shall not be taken for public use without just compensation. This prohibition binds the states through the Fourteenth Amendment's mandate that no state shall deprive any person of property without due process of law. *See Chicago, Burlington & Quincy R.R. Co. v. City of Chicago*, 166 U.S. 226, 235-41 (1897). Similarly, Article 1, §§ 6 and 7 of the New York Constitution forbid the taking of private property for public use without just compensation. *Gangemi v. City of New York*, 13 Misc. 3d 1112, 1130 n.3 (Kings Cnty. 2006) (noting New York courts rely on federal cases in determination of "takings" claims under state constitution). As set forth below, the Plan neither accomplishes a valid public use nor compensates the JeffCo Holders for the Rehabilitator's appropriation of their contractual rights and other property.

The court in *Hager v. Anderson-Hutchinson Ins. Agency*, No. 86-841-E, 1989 U.S. Dist. LEXIS 13614, at *45-59 (S.D. Iowa July 19, 1989), considered an insurance liquidator's claim against an insurance agent for uncollected and unearned premiums, where no insurance was provided in exchange for the premiums. Before an insurer's insolvency, Iowa law did not require insurance agents to pay such premiums to the insurer, because the insurer would not be providing coverage to the insured. *Id.* at *56. Upon insolvency, however, the Iowa statute made the insurance agent fully liable to the liquidator for uncollected premiums, regardless of whether insurance was actually provided. The liquidator argued that the insolvency statute should be upheld because it served a public purpose and benefited other claimants against the insolvent insurer. The court, however, struck down the statute as violative of the Fifth and Fourteenth Amendments. In effect, the Court held, the Iowa statute authorized the liquidator to claim property from the agent upon liquidation in which the insurer had no legal interest before insolvency, and for which it had provided no consideration. *Id.* at *55. The court accordingly found that it constituted "an unlawful taking of private property . . . for public use without just compensation." *Id.* at *59.

The case is even more extreme here, where the Rehabilitator seeks (i) to retain the JeffCo Holders' property – the Control Rights – in which FGIC would have had no property interest upon a payment default before insolvency, (ii) for the benefit of certain classes of policyholders, mostly those holding insured RMBS instruments and CDS counterparties, (iii) without compensation to the JeffCo Holders.

Furthermore, the United States Supreme Court has made clear that even a *compensated* taking is impermissible where it would confer a private benefit on private parties. *See, e.g.*, *Thompson v. Consol. Gas Utils. Corp.*, 300 U.S. 55, 80 (1937) ("[O]ne person's property may not be taken for the benefit of another private person without a justifying public purpose, even though compensation be paid."); *see also Kelo v. City of New London*, 545 U.S. 469, 477-78 (2005) ("[I]t has long been accepted that the sovereign may not take the property of *A* for the sole purpose of transferring it to another private party *B*, even though *A* is paid just compensation. . . . Nor would the [sovereign] be allowed to take property under the mere pretext of a public purpose, when its actual purpose was to bestow a private benefit.").

In *Thompson*, the Railroad Commission of Texas limited the production of a certain grade of natural gas by pipeline owners from their own land to compel them to purchase gas from, and share their pipelines with, suppliers who did not have their own pipelines, thereby balancing access to the pipelines. *Thompson*, 300 U.S. at 57-58. The commissioner apparently sought to reduce the inequality between those whose investments had proven successful (*i.e.*, those who had built pipelines) and those who had not made similar investments and therefore lacked a market. *Id.* at 59-61.

The Supreme Court found no valid public purpose underlying its orders and therefore held that the limitations were takings in violations of the Fifth and Fourteenth Amendments. Endorsing the lower court's ruling, it held "[t]he necessary operation and effect of such orders is to take from complainant and others similarly situated substantial and valuable interests in their private marketing contracts and . . . the use of their pipe lines and other facilities for transmitting their gas to their markets, without compensation, and to confer same upon the owners of the approximately 180 sweet gas wells in the field not connected to pipe lines." *Id.* at 78. Rejecting the Texas commissioner's argument that "the situation in the Panhandle field presented a conflict of private interests so serious as to become a matter of public concern," *id.* at 80, the Court held that "[t]here is here no taking for the public benefit; nor is the payment of compensation provided." *Id.* at 78.

The same is true here. The Plan contemplates a deprivation of the JeffCo Holders' contractual rights for the imagined benefit of other private parties – namely those who invested in RMBS and CDS, and whose liabilities FGIC is unable to cover – without compensation. As in *Thompson*, the Rehabilitator claims a valid public interest in enforcement of the Plan (Memorandum of Law at 17), the effect of which would be to spread losses incurred by one class of investors across multiple classes of investors, whose "conflicting private interests" the Rehabilitator apparently believes rise to the level of a valid public purpose. The Rehabilitator cannot support such a plain transfer of private rights under the guise of the state's police power, particularly where those being deprived of property are not being compensated. The Control Rights Impairments must therefore be rejected as violating both the United States Constitution and its New York State analogue.

II. The Plan Improperly Adjusts Policyholders' Rights to Payment Based on Recoveries from Third-Parties

As explained above, the Plan contemplates that Policyholder Claims will not be paid in full in cash, as the terms of their policies provide. Instead, under the Plan, parties holding Policy Claims will receive (i) an initial cash payment of 15% of the permitted amount of their claims and (ii) a right to future payments under the DPOs (*i.e.*, deferred payment obligations), provided that the Rehabilitator, in its discretion, determines sufficient assets are available. But holders of Policy Claims are not assured of receiving even these fractional and contingent amounts. Rather, the Plan creates new payment obligations for many creditors that at least partially offset their already diminished insurance recoveries.

The Plan first creates two concepts it styles "FGIC Payments" and "FGIC Payment Payors." "FGIC Payments" include "the then-current CPP multiplied by the amount of all recoveries, reimbursements, settlements and other amounts . . . which would be payable to [FGIC], or which [FGIC] would otherwise have a right to receive or recover . . . under the terms of or in connection with such Policy or any related Transaction Document, as if . . . FGIC had at all times paid Policy Claims in full in Cash." (Plan Ex. A (Definitions) at A-6.) A "FGIC Payment Payor" is defined in terms that would include the JeffCo Indenture Trustee and Jefferson County. (*Id.*).

The Plan then provides that:

> Each FGIC Payment Payor shall pay in Cash to the FGIC Parties all FGIC Payments payable by such FGIC Payment Payor, or that would have been payable had the Plan . . . been in effect at all times from and after the issuance of the 1310 Order, when due under the applicable Policy or any related Transaction Document, or if such FGIC Payment would have been due prior to the Effective Date . . . .
>
> If FGIC determines in good faith that, notwithstanding the requirements of the foregoing paragraph, all or a portion of any FGIC Payment has not been paid to the FGIC Parties in accordance with the such paragraph, then,

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> in addition to any other rights or remedies that FGIC may have, *Cash payments that would otherwise be payable by FGIC in respect of the applicable Policy shall be reduced by the amount of such unpaid FGIC Payment.*

(Plan Ex. B (Restructured Policy Terms) § 1.4(A).)

These provisions impose material new payment obligations on the JeffCo Indenture Trustee that are unlawful and prevent approval of the Plan.

A. The Forced Payover/Setoff Provisions Contravene the Express Terms of the JeffCo Policies and the JeffCo Indenture

Under the express terms of the JeffCo Policies and the JeffCo Indenture, FGIC has no right to payment from the JeffCo Indenture Trustee or Jefferson County unless and until FGIC pays all amounts due under its policies *in full and in cash.* The JeffCo Policies provide, in relevant part, as follows:

> [FGIC] . . . agrees to pay . . . [the Fiscal Agent] for the benefit of [JeffCo Holders], that portion of the principal and interest on [the JeffCo Sewer Warrants] which shall become Due for Payment but shall be unpaid by reason of Nonpayment by [Jefferson County].
>
> . . . The Fiscal Agent will disburse to the [JeffCo Holders] the *face amount of principal and interest which is then Due* for Payment but is unpaid by reason of Nonpayment by the Issuer . . . . *Upon such disbursement*, [FGIC] shall become the owner of the [JeffCo Sewer Warrants], appurtenant coupon or right to payment of principal or interest in such [JeffCo Sewer Warrants] and shall be fully subrogated to all of the [JeffCo Holders'] rights thereunder, including the . . . right to payment thereof.

(*See* Caton Aff. Ex. B (example of JeffCo Policy) (emphasis added).)

In other words, under the terms of the JeffCo Policies, FGIC may take ownership of the appropriate portion of the JeffCo Sewer Warrants upon FGIC's disbursement to the JeffCo Holders of "the face amount of principal and interest which is then due" but otherwise unpaid under the JeffCo Sewer Warrants. The JeffCo Indenture is clear that such principal and interest must be paid *in cash* – not a percentage of cash plus a deferred payment obligation of uncertain value. (*See* Caton Aff. Ex. A (JeffCo Indenture) § 7.6 (requiring payment "in lawful money of the United States of America.").)

By its terms, the Plan purports to require the JeffCo Indenture Trustee to pay FGIC a portion of its recovery from Jefferson County, even though the holders will not be paid in full and in cash on their warrants. Accordingly, the Plan's Forced Payover/Setoff Provisions contravene the express terms of the JeffCo Policies.

B. The Forced Payover/Setoff Provisions Violate New York's "Made Whole" Doctrine

The Plan's Forced Payover/Setoff Provisions also violate the well-settled New York law principle – known as the "made whole" doctrine – that an insurer claiming subrogation rights may not recover until the insured is fully compensated for its insured loss. In New York, "[u]nder the common law of subrogation, an insurer has the right to 'stand in the shoes' of the insured and seek recompense from the third-party tortfeasor for the amount paid to the insured, *provided that the insured has been made whole*." *USF&G v. Maggiore*, 299 A.D.2d 341, 344 (2d Dep't 2001) (citation omitted; emphasis in original). This rule is premised on bedrock insurance principles. Where an insurer has provided coverage, "the burden of loss should rest on the party paid to assume the risk, and not on an inadequately compensated insured, who is the least able to shoulder the loss." *Id.* To hold any other way would be "contrary to the principal purpose of an insurance contract: to protect an insured from loss, thereby placing the risk of loss on the insurer, and the insurer has accepted payments from the insured to assume this risk of loss." *Id.* (quoting 16 Couch, Insurance 3d § 223:136).[12]

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[12] This is black-letter law both in New York and elsewhere. *See, e.g.*, *Fasso v. Doerr*, 12 N.Y.3d 80, 87 (2009) ("If the sources of recovery ultimately available are inadequate to fully compensate the insured for its losses, then the insurer—who has been paid by the insured to assume the risk of loss—has no right to share in the proceeds of the insured's recovery from the tortfeasor") (citation omitted); *Niemann v. Luca*, 168 Misc. 2d 1023, 1026 (Suffolk Cnty. 1996) ("[The made-whole rule] is based upon the nature of the relationship between the insurer and the insured: if the loss of one of the two must go unsatisfied, it should be the insurer who bears such loss since it is has

Far from honoring the "made whole" doctrine, the Forced Payover/Setoff Provisions would grant FGIC a right of subrogation enforceable even though its insured will not be paid in full on its insured loss. They would require the JeffCo Indenture Trustee to turn over a portion of each distribution it receives from Jefferson County to FGIC when it receives that distribution – regardless of whether the JeffCo Holders have been made whole on their insured loss. Allowing FGIC to recover any amounts from Jefferson County or the JeffCo Indenture Trustee before the JeffCo Holders are paid in full would turn the subrogation and "made whole" doctrines on their heads.

Nor can the Rehabilitator contend that FGIC's provision of a small cash payment and a deferred payment obligation satisfies the "made whole" doctrine. In fact, the Second Circuit recently rejected the same argument in *Northwestern Mutual Life Insurance Co. v. Delta Air Lines, Inc. (In re Delta Air Lines, Inc.)*, 608 F.3d 139 (2d Cir. 2010). There, certain parties to a leveraged leasing arrangement asserted claims against Delta under a tax indemnity agreement to recover the value of certain disallowed tax benefits. The tax indemnity agreement relieved Delta of the obligation to make these payments if it had paid a "stipulated loss value" to certain bondholders in the transaction. Delta argued that it had paid the "stipulated loss value" by awarding the bondholders a claim in the bankruptcy in that amount and therefore had no obligation under the tax indemnity agreement.

The Second Circuit rejected this argument. In so ruling, it held that such an interpretation of the meaning of "pay" would require a "strained and improbable reading, which

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been paid to assume the risk of such loss."); *AMERCO v. Comm'r*, 96 T.C. 18, 38-39 (T.C. 1991) ("Basic to any insurance transaction must be risk. An insured faces some hazard; an insurer accepts a premium and agrees to perform some act if or when the loss event occurs. If no risk exists, then insurance cannot be present."); *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 246 S.W.3d 653, 673 (Tex. 2008) ("Insurance is an agreement by which one party assumes a risk faced by another in return for a premium payment. This risk-shifting is the purpose of insurance.") (citation omitted); *McShane v. N.J. Mfrs. Ins. Co.*, 867 A.2d 1207, 1213 (N.J. App. Div. 2005) (citing *Wine v. Globe Am. Cas. Co.*, 917 S.W.2d 558, 562 (Ky. 1996), for proposition that placing burden of loss on the claimant instead of the insurer that was paid to bear risk would defeat the "age old" principles of subrogation).

inevitably defeated the intentions of the contracting parties." *Delta*, 608 F.3d at 147. The court emphasized further that, "[n]otwithstanding that dictionary definitions of 'pay' include this strained alternative, the bankruptcy court was not at liberty to adopt it as the meaning of the contractual term, when that was plainly not the understanding of the contracting parties." *Id.*

Similarly, requiring Jefferson County or the JeffCo Indenture Trustee to pay over amounts to FGIC based on FGIC's payment of "rehabilitation dollars" – a combination of cash and hope certificates – would impose a "strained and improbable" reading of "made whole" entirely unsupported by the law and plainly contradictory to the contracting parties' intent. To permit FGIC to replace its cash payment obligations in the manner the Rehabilitator proposes would be to give FGIC the benefit of yet another legal fiction.

C. The Forced Payover/Setoff Provisions Constitute an Unconstitutional Taking of the JeffCo Holders' Property

The Plan's Forced Payover/Setoff Provisions also constitute a taking of the JeffCo Holders' property in violation of the Fifth and Fourteenth Amendments to the United States Constitution, as well as Article 1, §§ 6 and 7 of the New York Constitution. As explained above, both the United States and New York State Constitutions prohibit the taking of private property for public use without just compensation. *See Chicago, Burlington & Quincy R.R. Co. v. City of Chicago*, 166 U.S. 226, 235-41 (1897); *Gangemi v. City of New York*, 13 Misc. 3d 1112, 1130 n.3 (Kings Cnty. 2006).

Before rehabilitation, FGIC would have been subrogated to the rights of the JeffCo Holders only when those warrantholders were actually "made whole" under the JeffCo Sewer Warrants. This was consistent with the parties' expectations and the "made whole" doctrine. The imposition of extra contractual obligations through the Forced Payover/Setoff Provisions would be no different than the forced payment of unearned premiums that was found unconstitutional in *Hager v. Anderson-Hutchinson Ins. Agency*, discussed in detail above. 1989 U.S. Dist. LEXIS 13614, at *56-59 (S.D. Iowa July 19, 1989) (forced payment of unearned premiums was unconstitutional as "completely contrary to contract law, basic insolvency law and perhaps most importantly contrary to the agents' prior experiences and expectations").

Consequently, the Forced Payover/Setoff Provisions constitute an unconstitutional taking under the Fifth and Fourteenth Amendments to the United States Constitution, as well as the New York Constitution. Under established principles of statutory construction, New York's insurance laws should not be construed to yield such an unconstitutional result. *See, e.g., In re Vanderbilt's Estate*, 281 N.Y. 297, 313 (1939) ("A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score.") (citation omitted); *People ex rel. Brown v. McNeill*, 35 Misc. 2d 53, 578-58 (Dutchess Cnty. 1962) (stating that court should construe statute to avoid the conclusion that it is unconstitutional, and that statute should be construed as to be freed from constitutional doubts).

D. The Forced Payover/Setoff Provisions Conflict with Federal Bankruptcy Law and Interfere with Claims Administration in the Jefferson County Bankruptcy Proceeding

The Plan's Forced Payover/Setoff Provisions also purport to require Jefferson County (in addition to the JeffCo Indenture Trustee) to make payments to FGIC in accordance with the Plan. Those provisions, however, ignore that, as a Chapter 9 debtor, Jefferson County is subject to the Bankruptcy Code, which does not permit it to make the payments contemplated by the Rehabilitator's Plan.

Section 509 of the Bankruptcy Code, which governs Jefferson County's Chapter 9 proceeding, creates a distinct right of subrogation for co-debtors such as FGIC – entirely apart from principles of equitable subrogation – and subordinates FGIC's subrogation claims to payment in full of the JeffCo Holders' claims. It provides, in relevant part:

> (a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on . . . a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.
>
> [. . .]
>
> (c) The court shall subordinate to the claim of a creditor and for the benefit of such creditor an allowed claim, by way of subrogation under this section, or for reimbursement or contribution, of an entity that is liable with the debtor on . . . such creditor's claim, until such creditor's claim is paid in full . . . .

11 U.S.C. § 509(a), (c).[13]

In *In re Mulberry Chesterton Inn*, a guarantor of revenue bonds asserted a subrogation claim even though it had not satisfied its obligations in full. *See Days Inn of Am., Inc. v. Citizens and S. Trust Co. (In re Mulberry Chesterton Inn, L.P.)*, Adv. No. 91-4020, 1992 WL 489775, at *4 (Bankr. S.D. Ga. Apr. 1, 1992). Because Section 509(c) of the Bankruptcy Code creates a right of subrogation separate from the remedy of equitable subrogation, the bankruptcy court permitted the guarantor to be subrogated "to the extent of" the partial payments it had made. *Id.* at *8-9. It emphasized however, that the subrogation claim was subordinated to the underlying creditor claim under Section 509(c) of the Bankruptcy Code. As such, any remaining claim of a creditor had to be satisfied in full before the guarantor could receive a distribution. *Id.* at *10.

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[13] Section 502(e)(1)(C) of the Bankruptcy Code further provides that:

> [T]he court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that . . . such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

11 U.S.C. § 502(e)-(e)(1)(C). The effect of this provision is to prevent a party asserting subrogation rights under section 509 of the Bankruptcy Code from asserting any alternate claim for reimbursement, such that a subrogated party's claim will always be subordinated pursuant to Section 509(c). Put differently, FGIC will have no claim with respect to the JeffCo Holders' warrants in Jefferson County's bankruptcy except a claim that would be subordinated under Section 509(c).

FGIC is free to assert (and in fact has asserted) claims against Jefferson County in its Chapter 9 proceeding. By its terms, Section 509(c) of the Bankruptcy Code subordinates FGIC's purported claims to the claims of the JeffCo Holders for principal and interest on their warrants. Accordingly, until the JeffCo Sewer Warrants have been paid in full, the Bankruptcy Code does not allow Jefferson County to pay any portion of the distribution on the warrant claims to FGIC. The Supremacy Clause of the United Stated Constitution, in turn, bars this Court from enforcing a different result in this proceeding. *See* U.S. Constitution Art. VI cl. 2; *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 988 (8th Cir. 2009) ("Pursuant to the Supremacy Clause of the Constitution, federal law trumps state law 'where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'") (quoting *North Dakota v. U.S. Dep't of the Army (In re Operation of the Mo. River Sys. Litig.)*, 418 F.3d 915, 919 (8th Cir. 2005)).

While the Rehabilitator may attempt to argue that the McCarran-Ferguson Act preempts the claims allowance process and Section 509(c) of the Bankruptcy Code, that argument would be misguided. The McCarran-Ferguson Act, 15 U.S.C. § 1012, which generally provides that state law regulating insurance company preempts federal law, does not generally apply where, among other things, the federal law (here, Section 509(c) of the Bankruptcy Code) merely impairs the value of the insurer's assets. *See In re First Assured Warranty Corp.*, 383 B.R. 502, 541 n.38 (Bankr. D. Colo. 2007) (for purposes of McCarran-Ferguson, "[t]he fact that a federal action may have a financial impact on the assets of the insolvent insurer's estate does not necessarily indicate a state's liquidation proceeding is 'impaired.'").[14] And as the court in

[14] *See also In re Agway, Inc.*, 357 B.R. 195, 203 (Bankr. N.D.N.Y. 2006) (noting the absence of "a single case in which a bankruptcy court's jurisdiction over a claim filed by a creditor against the bankruptcy estate has been precluded or reverse-preempted by a state insurance statute pursuant to the McCarran-Ferguson Act."); *Koken v. Reliance Grp. Holdings, Inc. (In re Reliance Grp. Holdings, Inc.)*, 273 B.R. 374, 402 (Bankr. E.D. Pa. 2002)

First Assured recognized, "[t]he McCarran-Ferguson Act is not so broad as to allow state insurance liquidators to strip non-insurance entities of their protections under the Bankruptcy Code . . . ." 383 B.R. at 542. But that is precisely what the Plan's Forced Payover/Setoff Provisions would accomplish. Under the Bankruptcy Code, Jefferson County is not permitted to pay any amounts to FGIC until the JeffCo Holders are paid in full. Accordingly, the Plan cannot lawfully require Jefferson County to do otherwise.

Nor can the Rehabilitator circumvent this result by requiring the JeffCo Indenture Trustee (as opposed to Jefferson County) to make such payments or by otherwise creating a non-existent right of setoff to accomplish the same result. It has been well-settled for more than a century that the law does not permit one to do something indirectly which the law prohibits one from doing directly. *See e.g., Bigelow v. Provost*, 5 Hill 566 (N.Y. Sup. Ct. 1843) ("[W]here the law forbids a thing to be directly done, it shall not be done indirectly."); *Employers Claim Control Serv. Corp. v. Workmen's Comp. Bd.*, 35 N.Y.2d 492, 497 (1974) (affirming application of rule preventing representation of self-insurers by controlled subsidiaries or affiliates, as "[o]therwise that would be permitted to be done indirectly what is forbidden to be done directly").

* * *

Accordingly, the Plan should not be approved unless it is amended to remove the Control Rights Impairments and the Forced Payover/Setoff provisions.

("While the outcome of this matter may affect the amount of assets in the [insurer's liquidation] proceeding [and in the Debtor's bankruptcy cases], it will not directly impact the state's regulation of insurers or the state's ability to establish rules for the orderly rehabilitation or liquidation of insolvent insurers."); *Ochs v. Simon (In re First Cent. Fin. Corp.)*, 269 B.R. 502, 519-20 (Bankr. E.D.N.Y. 2001) (bankruptcy trustee's actions against directors and officers not preempted even though actions would impair insurance liquidator's ability to collect on insurance proceeds).

CONCLUSION

For the foregoing reasons, the JeffCo Holders respectfully request that the Court deny approval of the Plan unless the Plan is revised in the respects discussed above.

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