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

MEMORANDUM OF JEFFERSON COUNTY WARRANTHOLDERS CONCERNING THE STANDARD OF REVIEW APPLICABLE TO FGIC'S PLAN OF REHABILITATION

KRAMER LEVIN NAFTALIS & FRANKEL LLP
1177 AVENUE OF THE AMERICAS NEW YORK NY 10036

Preliminary Statement

Certain entities (the "JeffCo Holders") holding more than $330 million in principal amount of sewer warrants issued by Jefferson County, Alabama and supported by insurance policies issued by Financial Guaranty Insurance Company, respectfully submit this memorandum setting forth the standard by which the Court should evaluate the Rehabilitator's proposed Plan of Rehabilitation.

As set forth below and as the Rehabilitator has himself acknowledged, the purpose of the Plan is to "treat FGIC's Policyholders in a fair and equitable manner while at the same time removing the causes and conditions that made the Rehabilitation Proceeding necessary." (Disclosure Statement at 49). Whether the proposed Plan satisfies that objective is assessed according to an "arbitrary and capricious" standard of review. This standard affords the Rehabilitator deference but not unbridled discretion. Rather, there are clear red lines that the Rehabilitator must not transgress, and the Court's duty is to ensure that any plan provides for an equitable outcome and does not violate the law.

Argument

A. The Rehabilitator's Duties and the Objectives of the Plan

As the court-appointed fiduciary charged with overseeing the rehabilitation of insolvent insurers, the Rehabilitator's regulatory mandate is to "maximize assets and resolve liabilities, return rehabilitated companies to the marketplace or distribute the proceeds of the company in a timely manner to creditors." New York Liquidation Bureau Mission Statement, http://www.nylb.org/mission.html. In achieving this goal, the Rehabilitator must propose a plan of rehabilitation that is "fair and equitable" to policyholders. *Cf. Carpenter v. Pac. Mut. Life Ins. Co. of Cal.*, 10 Cal. 2d 307, 317 (1937) (Ex. A) (affirming finding that plan of rehabilitation is "fair and equitable"), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938); *In re Transit*

Cas. Co., 79 N.Y.2d 13, 20-21 (1992) (Ex. B) (The "over-all purpose" of liquidation proceedings "is not only to preserve available assets for the benefit of creditors, but to protect the interest of persons who purchased insurance policies from a company which has become insolvent."). The Rehabilitator has acknowledged this standard, declaring in the Disclosure Statement that the "Goal of the Plan" is "to treat FGIC's Policyholders in a fair and equitable manner while at the same time removing the causes and conditions that made the Rehabilitation Proceeding necessary." (Disclosure Statement at 49). *See also* V. Pet. at ¶ 23 (Rehabilitator will propose a plan that will "best provide fair and equitable treatment of FGIC's policyholders and other creditors"); Rehabilitator's Proposed Order at 2 ("The relief requested is in the best interests of, and fair and equitable to, all of FGIC's Policyholders and other claimants").

B. Standard of Review

Whether the Rehabilitator has proposed a plan that is fair and equitable to policyholders is subject to an "arbitrary and capricious" standard of review. The court will disapprove of a rehabilitator's actions where such actions "are shown to be arbitrary, capricious or an abuse of discretion." *Callon Petroleum Co. v. Superintendent of Ins. of State*, 53 A.D.3d 845, 845 (3d Dep't 2008) (Ex. C). *See also Mills v. Florida Asset Fin. Corp.*, 31 A.D.3d 849, 850 (3d Dep't 2006) (Ex. D) (same). An action is arbitrary and capricious if it is "without sound basis in reason and without regard to the facts." Weinstein, Korn & Miller *New York Civil Practice* ¶ 7803.03[1] at 78-67 (quoting *Scherbyn v. Wayne-Finger Lakes Bd. of Cooperative Educ. Servs.*, 77 N.Y.2d 753, 759 (1991) (Ex. E). *See also Pell v. Bd. of Educ.*, 34 N.Y.2d 222, 231 (1974) (Ex. F) ("[a]rbitrary action is without sound basis in reason and is generally taken without regard to the facts.").

Critically, courts defer to a rehabilitator's business judgments only insofar as those judgments are exercised within legal parameters. *In re Frontier Ins. Co.*, 36 Misc. 3d 529,

541-42 (Sup. Ct. Albany County 2012) (Ex. G). Thus, while the Court may defer to the Rehabilitator's business judgments as to the *factual* appropriateness of plan provisions in achieving a plan that is fair and equitable to policyholders, determinations as to whether certain plan provisions are *legally permissible* remain the exclusive province of the Court. "While the Court recognizes the deferential standard of review applicable to the Rehabilitator's actions, a plan of rehabilitation cannot be approved where it is inconsistent with law." *Id.* In other words, a plan that violates the law cannot be approved under any standard.

C. Matters of Law for the Court's Consideration

As demonstrated in the JeffCo Holders' Objection and as will be reiterated at trial, based on these standards the proposed Plan presents several issues of law as to which the Rehabilitator does *not* enjoy the Court's deference. These issues bear on the Rehabilitator's proposals concerning (i) the expansion of FGIC's contractual rights and corresponding interference with other third-party rights, such as the confiscation of policyholders' control rights under trust indentures to which FGIC is not a party, (ii) the imposition of material and new payment obligations on certain policyholders which affect the disposition of property not owned by FGIC, and (iii) the disparate treatment of similarly-situated policyholders.

First, and as set forth more fully in the JeffCo Holders' Objection, the Plan seeks to impair the JeffCo Holders' rights to direct remedial action and other control rights under trust indentures to which FGIC is not a party. That would constitute an unwarranted and legally impermissible expansion of FGIC's rights. (JeffCo Holders' Objection at 7-19). As the New York Court of Appeals has recognized, insolvency does not expand an insurer's rights and the Rehabilitator "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) (Ex. H) (addressing fiduciary's powers in context of liquidation). *See also Kaiser v. Monitrend Invest. Mgm't, Inc.*, 672 A.2d

359, 364 n.5 (Pa. Commw. Ct. 1996) (Ex. I) (in an action to enforce a contract, holding that "the Statutory Liquidator has no greater rights under the contract than the insurer and would be subject to any defenses that may be asserted against the insurer by the other party to the contract").

Second, insofar as the JeffCo Holders' bargained-for contractual rights with third parties constitute property, the Rehabilitator's plan exceeds his statutory authority, which provides that the Rehabilitator may only "take possession of the property of [the] insurer . . . ." N.Y. Insurance Law § 7403; *see also* Order of Rehabilitation at 2 ("The Rehabilitator is authorized and directed to take possession and/or control of FGIC's property and assets . . . ."). The control rights that the Rehabilitator purports to seize are not the "property of [the] insurer." The Rehabilitator thus cannot amend contracts unilaterally to expand an insurer's rights not provided for in the parties' agreements.

Third, and also as set forth in the JeffCo Holders' Objection, the Plan requires that certain policyholders continue to make premium payments in full while receiving only partial coverage in return, and further mandates that such policyholders pay to FGIC a portion of their recoveries under insured instruments. That would be (i) an improper expansion of FGIC's contractual rights and the Rehabilitator's legal authority to affect the disposition of property not belonging to FGIC, (ii) an unconstitutional taking, and (iii) a violation of bankruptcy law. (JeffCo Holders' Objection at 20-27). Because these actions violate the law, once again no deferential review is warranted.

Finally, *fourth*, in violation of the Rehabilitator's stated objective of treating policyholders in a "fair and equitable" manner, certain of the proposed impairments described above are imposed only on certain policyholders and not on others. Whether the Rehabilitator

has the authority to propose such disparate treatment is itself a question of law. *See, e.g.*, *Corcoran v. Hall & Co.*, 149 A.D.2d 165, 169 (1st Dep't 1989) (Ex. J) ("the 'preeminent purpose' of Article 74 'is to ensure equitable treatment for [the insurance company's] creditors and avoid preferences' . . . .") (citation omitted).

Conclusion

While the Rehabilitator's purely business judgments may be entitled to an "arbitrary and capricious" degree of deference, this case presents several questions of law that fall outside the scope of the Rehabilitator's business judgment and thus are not subject to deferential review. Moreover, even to the extent that the Rehabilitator's non-legal determinations as embodied in the Plan are to be reviewed deferentially, the Court, after the full and evidentiary hearing mandated by N.Y. Ins. Law § 7403(d) and CPLR 410, should nonetheless consider whether such determinations are the product of sound reasoning and give due regard to the facts of this case. *Pell*, 34 N.Y. 2d at 231 (Ex. F).

Dated: New York, New York
January 22, 2013

Kramer Levin Naftalis & Frankel LLP

By: _____

Thomas Moers Mayer
Jonathan M. Wagner
Matthew C. Ziegler
1177 Avenue of Americas
New York, New York 10036

Counsel to Certain Jefferson County Warrantholders