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Via Hand Delivery

August 7, 2013

The Honorable Doris Ling-Cohan, J.S.C.
IAS Part 36
Supreme Court of the State of New York, County of New York
60 Centre Street
New York, NY 10007

Re: *In the Matter of the Rehabilitation of Financial Guaranty Insurance Company*, Index No. 401265/2012; Motion Sequence No. 016

Dear Justice Ling-Cohan:

We represent the Superintendent of Financial Services as the Rehabilitator of FGIC and write in response to the request by the Court during yesterday's hearing to send to the Court the source of a quote that I read during argument.

Specifically, at yesterday's hearing, in responding to an argument made by counsel for the Monarch group that the Rehabilitation Court does not have jurisdiction to make the proposed findings, I read from the redacted objection of Freddie Mac to the Settlement filed in connection with 9019 proceeding. In that pleading Freddie Mac states:

> This Court should defer the Proposed Findings related to Freddie Mac's FGIC-insured RMBS to the N.Y. State Court presiding over the Rehabilitation Proceeding. Such claims arise under the Policies and are against FGIC—an insurer who cannot be a debtor under Bankruptcy Code § 109(b)(2)—and therefore must be resolved in the Rehabilitation Proceeding, by the N.Y. State Court.

Freddie Mac 9019 Obj at 19, ¶ 30. An excerpt of this filing is attached to this letter.

Please let us know if the Court has further questions.

Respectfully submitted,

Richard W. Slack

Encl.

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	)	Case No. 12-12020 (MG)
RESIDENTIAL CAPITAL, LLC, *et al.*,	)	Chapter 11
Debtors.	)	Jointly Administered

FEDERAL HOME LOAN MORTGAGE CORPORATION'S OBJECTION TO DEBTORS' MOTION PURSUANT TO FED R. R BANKR. P. 9019 FOR APPROVAL OF THE SETTLEMENT AGREEMENT AMONG THE DEBTORS, FGIC, THE FGIC TRUSTEES AND CERTAIN INSTITUTIONAL INVESTORS

REDACTED

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each Trust and each Such Trust in agreeing to the Settlement Agreement" and (ii) "The Settlement Agreement and the transactions contemplated thereby, including the releases given therein, are in the best interests of . . . the Investors in each such Trust . . . " set forth in Proposed Order ¶¶ C and D.[22]

OBJECTION

1. This Court Should not Make Findings Regarding the Rights and Obligations of Parties in the Rehabilitation Proceeding

24. The Debtors are seeking findings from this Court that the Settlement Agreement is in the best interest of the FGIC Beneficiaries (as Investors). Such findings are wholly inappropriate here: what is in the best interests of the FGIC Beneficiaries is a matter to be determined by the N.Y. State Court, not this Court. Moreover, there is nothing in the record to support such findings, and all the evidence uncovered to date suggests exactly the opposite. Indeed, Freddie Mac will show that the evidence compels a conclusion diametrically opposed to the Proposed Findings: the Settlement Agreement is not in the best interests of the FGIC Beneficiaries; and the FGIC Trustees did not act reasonably, in good faith, without negligence and in the FGIC Beneficiaries' best interests.

25. As an initial matter, the cornerstone of the Settlement Agreement is the N.Y. State Court's approval of the FGIC Commutation, which would prevent any Investor from making claims additional against FGIC. The FGIC Commutation is a matter solely between FGIC and the FGIC Beneficiaries. As this Court has recognized, the N.Y. State Court will

[22] The Proposed Order, which incorporates the defined in the Settlement Agreement (footnote 1), defines "Trust" as the FGIC-Insured Trusts and the "Investors" in such "Trusts" as the holders of securities in each Trust. (Settlement Agreement, Preamble, § 1.08.)

evaluate the Settlement Agreement under an entirely different standard than this Court.[23] This Court will consider whether the Settlement Agreement is in the best interests of the Debtors and their creditors; the N.Y. State Court, by contrast, will address whether the Settlement Agreement and, in particular, the FGIC Commutation, is appropriate with respect to FGIC's policyholders and is not otherwise in violation of New York Insurance Law and the Rehabilitation Plan. While the findings this Court will be called to make with respect to the Debtors and their creditors, the N.Y. State Court will focus particularly on the rights of the FGIC Beneficiaries. *Compare Motorola, Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 462 (2d Cir 2007) (considering, *inter alia*, the "paramount interests of the [debtor's] creditors" when determining whether to approve settlement under Bankruptcy Rule 9019), *with Frontier Ins. Co.*, 36 Misc.3d 529, 541-42 (N.Y. Sup. Ct. 2012) (recognizing as relevant considerations whether a rehabilitation plan will provide claimants less favorable treatment than liquidation, and whether all policyholders/creditors of similar priority are treated the same).

26. Furthermore, federal statutes and case law recognize that state statutes (such as New York's) granting jurisdiction over insurers' rehabilitation or liquidation proceedings reverse-preempt the exercise of jurisdiction by federal authorities or courts, including bankruptcy courts, because it would impede or supersede the state processes regulating the business of insurance. The McCarran-Ferguson Act, *codified as* 15 U.S.C. 1011-1015, exempts the business of insurance from most federal regulation, providing that "no Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . ." 15 U.S.C. § 1012(b); *see also, e.g., In re Amwest Ins. Group, Inc.*,

[23] *See Order Concerning the Use of Discovery Obtained in Connection with the Rule 9019 FGIC Settlement Hearing* [ECF No. 4191] ("All parties acknowledge that there are different standards for approval of the FGIC Settlement by each court.").

285 B.R. 447, 451 (Bankr. C.D. Cal. 2002); *Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 595 (5th Cir 1998); *Davister Corp. v. United Republic Life Ins. Co.*, 152 F.3d 1277, 1281 (10th Cir 1998); *Advanced Cellular Systems, Inc. v. Mayol*, 235 B.R. 713, 724-25 (Bankr. D.P.R. 1999).

27. Specifically, the McCarran-Ferguson Act provides states with preemptive authority over the regulation of "the business of insurance." The McCarran-Ferguson Act "'overturned the normal legal rules of preemption' by imposing a rule 'that state laws enacted for the purpose of regulating the business of insurance do not yield to conflicting federal statutes unless the federal statute specifically provides otherwise.'" *Am. Deposit Corp. v. Schacht*, 84 F.3d 834, 837-38 (7th Cir. 1996) (quoting *United States Dep't. of Treasury v. Fabe*, 508 U.S. 491, 507 (1993)). In other words, the McCarran-Ferguson Act reverses the normal supremacy of federal law over state law, so long as the activity in question falls under the heading of "the business of insurance." *Advanced Cellular*, 235 B.R. at 718.[24]

28. Bankruptcy proceedings and insurance company insolvency proceedings are indeed similar in that their goal is either to reorganize or liquidate the debtor. *See Advanced Cellular*, 235 B.R. at 717-18. The object of both is to group the assets of the debtor or the insolvent insurance company into one estate for distribution to creditors according to certain priorities. *Amwest Ins. Group*, 285 B.R. at 452. But, while the Bankruptcy Code governs bankruptcy cases, which expressly exempts insurance companies from its reach (Bankruptcy Code § 109(b)(2)), state law governs insurance insolvency cases. *See id.* And while the focus of

[24] In effect, the McCarran-Ferguson Act reverses the ordinary rules of preemption, which holds that federal law preempts state law by virtue of the supremacy clause in Article VI of the U.S. Constitution. *Fabe*, 508 U.S. at 500.

the Bankruptcy Code is upon *debtors and their creditors*, the focus of state insurance law is upon the relationship between the *insurance company and its policyholders*. *Id.*

29. Courts consider a federal statue (such as the Bankruptcy Code) to be reverse-preempted under the McCarran-Ferguson Act if (i) the federal statute in question does not specifically relate to the business of insurance, (ii) the state statute was enacted for the purpose of regulating the business of insurance, and (iii) the federal statute would invalidate, impair or supersede the state statute. *Fabe*, 508 U.S. at 501. Courts have consistently held that "it is clear that the Bankruptcy Code in general . . . does not relate to the business of insurance." *Id.* (citing *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25 (1996)) (bankruptcy statutes do not "specifically relate" to insurance). Further, the New York insurance law governing the FGIC Rehabilitation Proceeding does not merely have an impact on the insurance industry; it is aimed at it. As the Supreme Court held in *Fabe*, the liquidation and rehabilitation of insurance companies is "integrally related to the performance of insurance contracts after bankruptcy," and is thus "regulation of the business of insurance." *Fabe*, 508 U.S. at 504. The first two prongs are therefore easily satisfied.

30. This Court should defer the Proposed Findings related to Freddie Mac's FGIC-insured RMBS to the N.Y. State Court presiding over the Rehabilitation Proceeding. Such claims arise under the Policies and are against FGIC—an insurer who cannot be a debtor under Bankruptcy Code § 109(b)(2)—and therefore must be resolved in the Rehabilitation Proceeding, by the N.Y. State Court. *Fabe* is instructive. In that case, the U.S. Supreme Court dealt with a conflict between application of claim priority contained in a state insurance insolvency law statute and the priorities embedded in the Bankruptcy Code. Specifically, the U.S. Supreme Court questioned whether the state insurance claim priority statute was preempted by the priority

scheme embedded in the Bankruptcy Code. The U.S. Supreme Court held that the state insurance insolvency law reverse-preempted the Bankruptcy Code insofar as it protected policyholders. *Fabe*, 508 U.S. at 508. In *Fabe*, the U.S. Supreme Court underscored that the principal focus of the phrase "business of insurance" should be between the insurance company and its policyholders. *Id.* at 501. Here, if this Court were to decide that the Settlement Agreement is in the best interests of the FGIC Beneficiaries (and whether the Trustees acted reasonably and in good faith in making that determination), this Court's determination would likely conflict with the N.Y. State Court's ruling on the very same issue. Accordingly, such findings by this Court would impair the progress of the Rehabilitation Proceeding.

31. That is precisely the conclusion the *Amwest Insurance Group* court reached. In that case, a bankrupt insurance holding company and its subsidiary insolvent insurance company were both parties to a tax allocation agreement. The insurance holding company later became a debtor under Chapter 11, and the insurance company was placed into rehabilitation under state law. The question before the court in *Amwest Insurance Group* was whether it should interpret the tax allocation agreement at issue and determine the allocation of a tax refund between the insolvent insurance company and another insurance-company subsidiary of the debtor. (The tax refund belonged to the insolvent insurance company—but was property of the holding company's bankruptcy estate because it was remitted to the holding company as parent.) *Amwest Ins. Group*, 285 B.R. at 453.

32. Citing *Fabe*, the *Amwest Insurance Group* court declined to interpret the tax allocation agreement and allocate the tax refund because such "determination may conflict with the Liquidation Court's ruling regarding the tax allocation between Amwest and Far West [another insurance company subsidiary of the debtor]." *Id.* at 455. Accordingly, this Court

should defer the Proposed Findings and FGIC Commutation to the New York State Court. These are matters affecting FGIC and its policyholders and are properly decided by the N.Y. State Court. Any order on the 9019 Motion should, at minimum, not include the Proposed Findings.

33. The Proposed Findings in connection with the FGIC Trustees' agreeing to the FGIC Commutation are unusual for an indenture trustee to request here: this Court is not being asked to approve the FGIC Commutation. Rather, this Court is called to determine whether entering into the Settlement Agreement is in the best interests of the Debtors and their estates. The merits of the FGIC Commutation is not a matter before this Court, and this Court should defer to the N.Y. State Court on the Proposed Findings. The reality here is that the Proposed Findings have all the indicia of cover and are meant to circumvent the FGIC Trustees' obligations to obtain consent from the FGIC Beneficiaries, as Investors in FGIC-insured RMBS, before endorsing the FGIC Commutation.

2. The FGIC Trustees Did Not Obtain the Required Consent to Enter into the Settlement

34. In any event, the 9019 Motion should be denied and the Settlement Agreement should not be approved insofar as it incorporates the FGIC Commutation because the FGIC Trustees had no authority under the Transaction Documents or Trust Indenture Act § 316(b) to enter into the Settlement Agreement without the consent of the FGIC Beneficiaries.[25] The FGIC Trustees neither obtained nor solicited such consent. This Court should not approve a settlement that was entered into unlawfully or is otherwise contrary to public policy. *In re Rosenberg*, No. 09-46326, 2010 Bankr. LEXIS 371, at *11 (Bankr. E.D.N.Y. Feb. 5, 2010) ("[P]arties cannot enter into a settlement that violates law or public policy"); *In re Levine*, 287 B.R. 683, 691

[25] The Trust Indenture Act of 1939 (the "Trust Indenture Act") is codified as 15 U.S.C. § 77aaa, *et seq.*