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January 22, 2013

VIA HAND DELIVERY

Hon. Doris Ling-Cohan
New York Supreme Court
New York County
60 Centre Street, Room 629
New York, New York 10007
Attn: Monica Cheng, Esq.

Re: *In the Matter of the Rehabilitation of Financial Guaranty Insurance Co.*, Index No. 401265/2012

Dear Judge Ling-Cohan:

We represent U.S. Bank National Association and U.S. Bank Trust National Association (collectively, "U.S. Bank") in the above referenced matter. Enclosed please find a copy of U.S. Bank's Amended Objection to the Plan of Rehabilitation of Financial Guaranty Insurance Company.

Respectfully submitted,

Edward H. Tillinghast, III /SJK

for SHEPPARD, MULLIN, RICHTER & HAMPTON LLP

Enclosure

cc: Gary T. Holtzer, Esq. (via Hand Delivery with enclosures)
Joseph T. Verdesca, Esq. (via Hand Delivery with enclosures)

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 I.A.S. Part 36 Justice Doris Ling-Cohan Motion Sequence 004

AMENDED OBJECTION OF U.S. BANK NATIONAL ASSOCIATION AND U.S. BANK TRUST NATIONAL ASSOCIATION, EACH IN ITS CAPACITY AS TRUSTEE, TO PLAN OF REHABILITATION OF FINANCIAL GUARANTY INSURANCE COMPANY

U.S. Bank National Association and U.S. Bank Trust National Association, each in its capacity as trustee or similar role (collectively, "U.S. Bank") for certain residential mortgage backed securities ("RMBS"), municipal debt securities, and any other affected transactions (collectively, the "Trusts"), file this amended objection ("Amended Objection") to the proposed Plan of Rehabilitation for Financial Guaranty Insurance Company dated September 27, 2012, as amended by the First Amended Plan of Rehabilitation for Financial Guaranty Insurance Company dated December 12, 2012 (collectively, the "Plan"), filed by the Benjamin M. Lawsky, Superintendent of Financial Services of the State of New York, as the court-appointed rehabilitator (the "Rehabilitator") of Financial Guaranty Insurance Company ("FGIC"). Except as otherwise defined in this Amended Objection, all capitalized terms shall have the meanings ascribed to such terms in the Plan.

I. PRELIMINARY STATEMENT

Although certain provisions of the Plan were amended after U.S. Bank and other parties filed their original objections, the Plan still contains problematic provisions and, thus, should not be approved. Most notably, the Plan continues to abrogate policyholders' statutory and common law rights of setoff, while at the same time maintaining and even expanding those rights for FGIC. Moreover, the Plan still imposes, without business justification, upon U.S. Bank and the other trustees new duties that are in contradiction to the governing documents, impracticable, or overly burdensome. Although the Rehabilitator attempts to downplay the significance and scope of the objections by arguing that he is trying to be fair to all creditors, the simple facts are that (a) the Plan provisions that impermissibly attempt to strip creditors of rights protected by statute *are outside the scope of his authority*, and (b) FGIC's major trustee group, which collectively represents the interests of thousands of beneficiaries of FGIC insurance policies, *do not* support the manner in which the Plan attempts to wind down FGIC.[1] Accordingly, by this Amended Objection, U.S. Bank restates those of its objections that have not yet been resolved and responds to the arguments made by the Rehabilitator in his omnibus reply (the "Omnibus Reply") to the original Plan objections.

II. SUMMARY OF OBJECTION

While the Rehabilitator has broad discretion under Article 74 of the New York Insurance Law ("NYIL") to propose a plan, the plan must recognize the legal and contractual rights of policyholders, particularly those rights that are expressly protected by Article 74 itself. *See New York Tit. & Mtge. Co. v. Irving Trust Co.*, 241 A.D. 246 (N.Y. App. Div. 1934) (an injunction that deprived claimant of right of setoff was invalid because it exceeded powers conferred upon court by statute). Instead of proposing a fair plan for payment of its obligations to policyholders, the Rehabilitator seeks to, among other things, use its "rehabilitation" plan to strip the policyholders of their legal rights, while at the same time retaining – and even increasing – it

[1] Although this is a rehabilitation proceeding, the Rehabilitator does not presently anticipate that FGIC will operate as a going concern or write new policies. The Plan, is therefore, essentially a liquidating plan that simply seeks to administer the rights and claims of policyholders arising from or relating to FGIC's defaulted policies.

own rights. Accordingly, U.S. Bank requests that the Court deny approval of the Plan as arbitrary, capricious, and an abuse of the Rehabilitator's discretion. *See Callon Petroleum Co. v. Superintendent of Ins. of State*, 53 A.D.3d 845 (3d Dep't 2008).

U.S. Bank filed its objection to the Plan dated September 27, 2012 ("Initial Objection"). The Rehabilitator made certain revisions to the Plan in an attempt to address the objections filed by U.S. Bank and other parties. By Order dated December 19, 2012, the Court directed the objecting parties to file an amended objection to the Plan as revised on December 12, 2012. The following summarizes U.S. Bank's objections that remain unresolved:

- Sections 3.5 and 7.8(c) of the Plan prohibit policyholders from exercising setoff rights, both prospectively and retroactively, while Section 4.9 permits FGIC not only to retain its setoff rights, but to expand such rights by offsetting against the smaller amounts FGIC proposes to pay under the Plan. These Sections must be modified to recognize policyholders' common law and statutory rights of setoff on a parity basis.

- Sections 3.5 and 7.8(e) would permit FGIC to immediately regain all direction and control rights – including, among others, the right to consent to any amendments, modifications, or waivers of the terms of the transactions or actions under the transaction documents, the right to declare or waive events of default, termination events, rapid amortization events or similar rights, and the right to direct the exercise of remedies following an event of default – under any trust for which a claim has been submitted regardless of whether FGIC has paid such claim or otherwise complied with its contractual obligations. These Sections should be deleted or, at a minimum, modified to ensure that FGIC is permitted to exercise Control Rights solely in proportion to the actual cash payments it makes to policyholders.

- Certain of the Plan provisions, as currently drafted, would be unnecessarily burdensome and, in some instances, impossible to implement. Moreover, the additional costs of implementation would not be borne by FGIC, but rather by the trustees, securityholders, and issuers under individual trusts. Section 7.5(b) of the Plan should be revised to provide that, in addition to the indemnification provided thereunder, FGIC will compensate and reimburse trustees for all actions taken as a result of the Rehabilitation, including the Plan and the Restructured Policy Terms, as an administrative expense, regardless of the sufficiency of funds available under any individual trust.

- That portion of Section 7.5(b) permitting FGIC to assume U.S. Bank's defense and deeming FGIC's indemnity adequate for all purposes should be stricken. The rights and duties of U.S. Bank as trustee are strictly defined and limited to the express terms of the various indentures, trust agreements, and pooling and servicing agreements that govern each of the trusts for which U.S. Bank is trustee. These contracts provide that the trustee has no obligation to take any action unless such trustee has been furnished an indemnity that, under the particular facts and circumstances, is *satisfactory to it in its discretion.*[2] Moreover, notwithstanding the adequacy of any proffered indemnity, a trustee retains the absolute right to decline to take any action it determines would unjustly prejudice non-directing parties or would subject the trustee to personal liability. The Plan cannot and should not fundamentally alter the bargained-for, contractual indemnification rights of trustees under the transaction documents governing individual trusts. Such provisions represent critical, bargained for protections for trustees like U.S. Bank who would not undertake to administer trusts like the ones insured by FGIC, if doing so would require them to incur personal liability or take action without first determining for themselves the sufficiency, under the circumstances, of any proffered indemnity.

The Plan should be denied approval for all of the above-stated reasons; however, U.S. Bank will focus its Amended Objection on the abrogation of claimants' setoff rights as the clearest violation of controlling law and fundamental fairness to policyholders.

III. ARGUMENT

As noted in its Initial Objection, the Rehabilitator's unlawful elimination of policyholders' setoff rights, while at the same time expanding his own setoff rights against policyholders, abrogates controlling case law, ignores Section 7427 of the NYIL, and is fundamentally unfair to security holders of the trusts, who are the ultimate beneficiaries of the Plan. In the Omnibus Reply, the Rehabilitator relies on a broad and amorphous concept most

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[2] In contrast to the transaction agreements, which were drafted to give trustees flexibility and discretion to determine the appropriate indemnity under the particular circumstances, Section 7.5(b) of the Plan provides a general, unsecured, non-cash indemnity to trustees for certain "Losses" incurred by a trustee in complying with the Plan or any direction received from FGIC. Moreover, Section 7.5(b) provides that:

> The indemnity provided in this Section 7.5(b) shall be deemed to satisfy for all purposes any requirement under any provisions of a FGIC Contract or Transaction Document that the Indemnified Trustee be provided with an indemnity to or for its benefit (including any requirement that such indemnity be "adequate," "sufficient," "reasonable," "acceptable" or similar terms) prior to performing any action required under the Plan, including complying with any direction given to it by FGIC pursuant to the relevant FGIC Contract or Transaction Document, and including provisions that allow the Indemnified Trustee to refrain from performing any action in the absence of such an indemnity.

often found in judicial dicta – equal treatment of creditors – to justify stripping certain policyholders of well-defined setoff rights that are expressly preserved by Article 74. While equality of treatment among *similarly situated* creditors is an important insolvency principle, no state or federal insolvency law – whether under Article 74, the U.S. Bankruptcy Code, or otherwise – mandates equality of treatment among *all* creditors. Indeed, priority schemes recognize the general concept that not all creditors are similarly situated and that some have rights that entitle them to more favorable treatment for all or a portion of their claims.[3]

As to the specific setoff rights at issue here, section 7427 of the NYIL preserves such rights in an Article 74 rehabilitation proceeding. Moreover, the United States Supreme Court and New York state courts have repeatedly upheld policyholders' setoff rights while expressly rejecting the argument advanced by the Rehabilitator. Perhaps in recognition that 7427(a) expressly preserves setoff rights, the Rehabilitator argues that subsection (b) of that section prohibits the exercise of setoff rights with respect to policy claims that "arise" after entry of the 1310 Order. This argument, however, is not supported by the language of section 7427 and is illogical and inconsistent with the Plan provisions.

Accordingly, as discussed in further detail below, the Rehabilitator's arguments in the Omnibus Reply that the Plan can properly strip U.S. Bank and the other trustees of setoff rights are not well-grounded in the law or logic. As such, the Plan should not be approved as contrary to the Rehabilitator's enabling statute. *See Carpenter v. Pac. Mut. Life Ins. Co. of Cal.*, 10 Cal. App. 2d 307, 321 (1937) *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938) (rehabilitation

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[3] For example, a secured creditor, which can include a creditor with a setoff right, will typically receive a full recovery up to the value of its security or setoff right even though other creditors receive less than full recovery on account of their unsecured claims. *See, e.g.,* 11 U.S.C. § 506(a)(1) ("An allowed claim of a creditor . . . that is subject to setoff . . . is a secured claim . . . to the extent of the amount subject to setoff . . . ."); *id.* § 1129(b)(2)(A) (providing that plan of reorganization must provide secured creditor "deferred cash payments totaling the allowed amount of [its secured claim] . . .").

plan must be fair and equitable to policyholders and other creditors and provide at least what policyholders would have received in liquidation of insurer); *Callon Petroleum Co. v. Superintendent of Ins. of State*, 53 A.D.3d 845 (3d Dep't 2008) (rehabilitators actions disapproved "when they are shown to be arbitrary, capricious or an abuse of discretion").

A. Equality of Treatment Among Creditors Does Not Justify Stripping Policyholders of Statutorily-Protected Setoff Rights

Section 7427 of the NYIL provides, in pertinent 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 [Article 74], such credits and debts shall be set off and the balance only shall be allowed or paid . . .

NYIL § 7427(a).

Notwithstanding the fact that section 7427 expressly preserves setoff rights, the Rehabilitator argues that "setoffs would undermine the fundamental principle" of equality among creditors because "policyholders who happen to have amounts to withhold and setoff would realize disproportionately higher recoveries." (Omnibus Reply, at 24). This argument simply ignores well-established holdings of, among others, the United States Supreme Court and courts in New York.[4]

In *Scott v. Armstrong*, 146 U.S. 499, 510 (1892), the Supreme Court considered whether a setoff should be permitted in a bank liquidation over the objection of a receiver who made an argument similar to the one made by the Rehabilitator: that setoff would violate the rule that "the assets shall be ratably distributed among the creditors." The Court rejected the receiver's argument, stating that:

[4] As one commentator has noted, "[f]or nearly two thousand years . . . courts and legislatures have resolved the tension between these competing public policies [pro rata distribution of estate assets to creditors versus setoff rights] in favor of set-offs." Schwab et al., *Onset of an Offset Revolution: The Application of Set-Offs in Insurance Insolvencies,* 95 Dickenson L. Rev. 449, 454 (1991).

> [w]here a set-off is otherwise valid, it is not perceived how its allowance can be considered a preference, and it is clear that 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. The requirement as to ratable dividends is to make them from what belongs to the bank, and that which at the time of the insolvency belongs of right to the [creditor] does not belong to the bank.

Id. After summarizing the history of setoffs under bankruptcy and other insolvency statutes, the Court concluded that:

> [t]he succeeding statutes were but in recognition, in bankruptcy and otherwise, of the practice in chancery in the settlement of estates, and it may be said that in the distribution of the assets of insolvents under voluntary or statutory trusts for creditors the set-off of debts due has been universally conceded. The equity of equality among creditors is either found inapplicable to such set-offs or yields to their superior equity.

Id. at 511. Accordingly, in the seminal case to consider the issue, the Supreme Court flatly rejected the argument that allowing setoffs will violate the principle of equality of treatment among creditors.[5]

Although *Scott v. Armstrong* involved setoff in a bank liquidation proceeding rather than an insurance company insolvency proceeding, New York courts have applied the Supreme Court's holding to setoffs in Article 74 proceedings, first in *New York Tit. & Mtge. Co. v. Irving Trust Co.*,[6] and more recently in *In the Matter of Midland Insurance Company*.[7] As the court in

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[5] Almost 40 years later, the Supreme Court confirmed its *Scott v. Armstrong* analysis and holding. *See Willing v. Binenstock*, 302 U.S. 272, 276 (1937) ("There is nothing in the National Banking Act or in any other federal statute which conflicts with the Pennsylvania rule [permitting setoff]. In the case of an insolvent bank, the National Banking Act . . . simply provides for a 'ratable dividend' on all proved or adjudicated claims. This court held in *Scott v. Armstrong* . . . that the allowance of a valid set-off cannot be considered a preference, and that only the balance, after deduction of the set-off, constitutes part of the assets of the insolvent.") (internal citations omitted).

[6] 241 A.D. 246 (N.Y. App. Div. 1934). In *Irving* the court noted that "[t]he basic contention of the Superintendent of Insurance . . . is that to allow such set-off would violate the provisions of the injunction against preferences." *Id.* at 248. The court rejected the argument, stating that:

> [n]o 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.' There is nothing in the nature of rehabilitation which should upset this

Midland stated, "[a]lthough permitting offsets may conflict with the statutory purpose of providing for the pro rata distribution of the insolvent's estate to creditors, the Legislature has resolved the competing concerns and recognized offsets as a species of lawful preference." 590 N.E.2d at 1191. Thus, New York courts have also rejected the Rehabilitator's position.

Not only have courts and legislatures recognized that setoffs, specifically, do not violate the general principle of equality among creditors, but they have also recognized, more generally, that not all creditors are similarly situated and, thus, that some are entitled to greater recoveries than others. As a result, statutory priority schemes – including that which is found in Article 74[8] – applicable to bankruptcy and other insolvency proceedings routinely provide for different classification and treatment among creditors based upon the differing rights and positions of those creditors.

Rather than consistently apply the provisions of Article 74, however, the Rehabilitator seems to arbitrarily pick and choose the provisions to recognize under the Plan. He, on the one hand, refuses to properly apply section 7427 and to preserve setoff rights, arguing that to do so "would undermine the fundamental principle that, 'upon insolvency, assets must be equally distributed to creditors without preference or priority,'" and that "increased value to one claimant is decreased value to the rest." (Omnibus Reply, at 24) (internal citation omitted). But, on the

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> well-established principle. We think that section 420 [now section 7427] was passed to express the legislative intention that the old rule should still be followed.

Id. (quoting *Scott v. Armstrong*, 146 U.S. at 511).

[7] 590 N.E.2d 1186 (N.Y. 1992).

[8] Section 7434(a)(1) provides that "distribution payments shall be made in a manner that will assure the proper recognition of priorities," that "[t]he priority of distribution of claims . . . shall be in accordance with the order in which each class of claims is set forth in [section 7434(a)(1)]," and that "[e]very claim in each class shall be paid in full . . . before the members of the next class receive any payment." NYIL § 7434(a)(1).

other hand, he relies (presumably) on section 7434(a)(1)(i) to pay in full administrative claims of, among others, his professionals even though such payments do not result in equal distribution "to creditors without preference or priority." While U.S. Bank does not dispute the Rehabilitator's ability to pay the valid administrative claims of his professionals, it raises the issue simply to point out the inconsistency in the Rehabilitator's application of Article 74. Instead of recognizing only *some* superior rights that creditors have over other creditors, the Plan should recognize *all* superior rights, including setoff rights protected by section 7427. Until it does, the Plan should not be approved.

B. U.S. Bank's Setoff Rights Do Not Fall Within Subsection (b) of Section 7427

Because section 7427 expressly preserves setoff rights, the Rehabilitator argues that an exclusion in subsection (b) of that section prohibits U.S. Bank and the other creditors from exercising those rights. (Omnibus Reply, at 25-27). Providing almost no analysis of 7427(b), the Rehabilitator picks an arbitrary date – entry of the 1310 Order – and takes the position that claims that "arise" after that date are excluded from setoff. A more detailed analysis of the statute, however, leads to the conclusion that subsection (b) does not apply to U.S. Bank's claims for at least three reasons: (1) 7427(b) does not appear applicable in rehabilitation proceedings – only liquidation proceedings; (2) even if applicable to rehabilitation proceedings, 7427(b) makes no mention of a section 1310 order or of the concept of claims "arising;" and (3) the Rehabilitator's position that 7427(b) excludes from setoff Policy Claims "arising" after entry of the 1310 Order is inconsistent with the treatment of those claim under the Plan.

1. Section 7427(b) Does Not Appear Applicable in Rehabilitation Proceedings

Section 7427(b) states, in relevant part, that:

> [n]o offset shall be allowed in favor of any person, however, where . . . 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 [7405], entitle him to share as a claimant in the assets of such insurer."

NYIL § 7427(b).

The plain language of the statute suggests that the exclusion only applies in proceedings in which a liquidation order is entered. In the Omnibus Reply, the Rehabilitator cites to two cases in support of his conclusion that the "exclusion applies equally to rehabilitation cases." (Omnibus Replay, at 25-26). The two cases do not, however, support the conclusion.

In *New York Tit. & Mtge. Co. v. Friedman*, 276 N.Y.S. 72 (Mun. Ct., Manhattan [2d Dist.] 1934), the court considered the statutory predecessor to section 7427(b), which was section 420(2). However, as quoted by the court in *Friedman*, old section 420 was different than current section 7427(b). Old section 420(2) stated that "[n]o 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." *Id.* at 76 (quoting section 420(2)). Thus, because the old statute made no mention of entry of a liquidation order, the *Friedman* holding is not relevant in interpreting the current statute, which clearly seems applicable only where a liquidation order has been entered.

Nor does the other case cited by the Rehabilitator, *In the Matter of Midland Insurance Company*, 590 N.E.2d 1186 (N.Y. 1992), support the position that section 7427(b) applies in a rehabilitation.[9] Indeed, the *Midland* court could not have held that 7427(b) applies in a rehabilitation because the proceeding at issue in that case was a liquidation. *See id.* at 1188 ("In April of 1986, Midland was placed into liquidation."). In addition, the issue in *Midland* was whether the "same transaction" rule limited setoff under section 7427 and had nothing to do with

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[9] In fact, as noted above, *Midland* squarely rejects the Rehabilitator's argument that setoff violates the principle of equality among creditors. *See* p. 7, *supra*.

the exclusion in subsection (b). *Id.* at 1189-91. Therefore, the *Midland* case, like *Friedman*, does not support the Rehabilitator's position that 7427(b) applies in a rehabilitation.

U.S. Bank has been unable to find any case specifically holding that 7427(b) applies in a rehabilitation proceeding. This is not surprising in light of the clear statutory language, which requires entry of a liquidation order.

2. Even if Applicable in a Rehabilitation Proceeding, the Rehabilitator's Interpretation of Section 7427(b) is Not Supportable

Even if section 7427(b) is applicable in a rehabilitation proceeding, the Rehabilitator's position that section 7227(b) excludes from setoff any claim "arising" after entry of the 1310 Order is not supported by the clear statutory language. Indeed, section 7427(b) makes no mention of either a 1310 order or the concept of when a claim "arises."

First, section 7427(b) says nothing about entry of a section 1310 order. In mentions only a liquidation order. And, even if rehabilitation is read into the statute, the rehabilitation order was not entered until June 28, 2012, which is the earliest possible logical cutoff date under the statute. The Rehabilitator, however, argues that "[e]ffectively, [entry of the 1310 Order] marks the commencement of FGIC's insolvency proceeding." (Omnibus Reply, at 27). This is a fiction, and one that is convenient for the Rehabilitator because the date of entry of the 1310 Order is the date that FGIC stopped paying policy claims. There is absolutely no support, however, for this position.

An analysis of section 1310, as well as the 1310 Order itself, makes clear that, contrary to the Rehabilitator's position, entry of the 1310 Order did not mark the beginning of FGIC's proceeding. Section 1310 permits the Superintendent of Insurance to order an insurance company to eliminate an "impairment" and to stop issuing new policies while the impairment exists, but nothing in the statute suggests that issuing such an order commences a liquidation or rehabilitation proceeding. NYIL § 1310(a). In fact, it is just the opposite: section 1310 states that if after a certain period the "insurer has not satisfied the superintendent that such impairment has been eliminated, the superintendent may proceed against the insurer pursuant to the provisions of [Article 74]." *Id.* Moreover, the 1310 Order itself provides, among other things, that "a successful Surplus Restoration Plan [which FGIC was ordered to submit] is likely to result in a better overall recovery for the policyholders of the Company than what may be expected to be achieved in a rehabilitation or liquidation," and expressly preserves "the Superintendent's ability to seek rehabilitation or liquidation." Therefore, both section 1310 and the 1310 Order make explicitly clear that entry of the order is not the same thing as commencement of a liquidation or rehabilitation proceeding under Article 74. The Rehabilitator's attempt to base his position on entry of the 1310 Order is nothing more than an attempt to strip creditors of setoff rights with respect to policy claims that were not paid during the more than 3 years since the 1310 Order was entered.

Moreover, not only does section 7427(b) make no mention of a section 1310 order, but it also does not mention the concept of claims "arising." What the statute says is that creditors cannot setoff claims that "would not at the date of the entry of any liquidation order, or otherwise, *as provided in section [7405], entitle him to share as a claimant in the assets of such insurer*." NYIL § 7427(b)(1) (emphasis added). Section 7405, in turn, states that:

> [t]he rights and liabilities of any . . . insurer and of its creditors, policyholders, shareholders, members and all other persons interested in its estate shall, unless otherwise directed by the court, be fixed as of the date the [liquidation] order is entered in the office of the clerk of the county where such insurer had its principal office of the date the proceeding commenced, *subject, however, to the provisions of section [7433] to the rights of claimants holding contingent claims.*

NYIL § 7405(b) (emphasis added). And section 7433, in turn, states that:

> [n]o contingent claim shall share in a distribution of assets of an insurer adjudicated to be insolvent . . . except that any such claim shall be considered if

> properly presented and may be allowed to share if . . . it becomes absolute against the insurer on or before the last day fixed for filing of proofs of claim . . . .

Id. § 7433(c).

These provisions lead to the conclusion that a claim can "share in the assets of the insurer" if it is absolute on the last date fixed for filing proofs of claim. Under the Plan, Policy Claims must be submitted to FGIC using the Proof of Policy Claim Form "by the later of (i) one year from the date the Policy Claim arose and (ii) ninety (90) days after the Effective Date." (Plan § 4.3(A)). Therefore, so long as a Policy Claim is absolute by the above dates, the Policy Claim entitles the holder to "share in the assets of the insurer" and, thus, does not fall within the setoff exclusion in section 7427(b).

3. Excluding Policy Claims Under 7427(b) is Inconsistent with the Treatment of those Claims Under the Plan

Not only is the Rehabilitator's position on section 7427(b) inconsistent with the above statutory analysis, but it is also inconsistent with the way in which his own Plan treats Policy Claims. The Rehabilitator argues that 7427(b) excludes from setoff claims "arising" after entry of the 1310 Order. Given that FGIC was paying claims until entry of the 1310 Order, all Policy Claims under the Plan would, under the Rehabilitator's application, full within section 7427(b)'s exclusion. And, based on the express language of the statute, to fall within section 7427(b)'s exclusion a claim cannot entitle a creditor "to share as a claimant in the assets" of the insurer. The Plan, however, does entitle holders of Policy Claims to share in the assets of FGIC. Indeed, the very purpose of the Plan is to wind down FGIC in order to distribute its assets among holders of Policy Claims. Thus, the Rehabilitator's treatment of Policy Claims under the Plan is completely inconsistent with the position that section 7427(b) excludes from setoff those Policy Claims.

Holders of Policy Claims *are* entitled to share in the assets of FGIC, both under the plain language of Article 74 and under the Plan. The exclusion to setoff set forth in section 7427(b) does not, therefore, apply to U.S. Bank's Policy Claims. Without an applicable exclusion to section 7427, there is no basis for the Rehabilitator to strip U.S. Bank of its setoff rights.

IV. SETOFF HYPOTHETICAL

The following real world hypothetical will help illustrate the importance of the foregoing legal analysis and will illuminate the way in which the Rehabilitator has attempted to flip the rights of the respective parties are their heads. Assume the following:

- U.S. Bank is trustee of a trust (the "Trust") that has $10 million of obligations to the underlying holders of trust securities ("Secuityholders").
- U.S. Bank and the Secuityholders it represents are the beneficiaries of an insurance policy issued by FGIC, which insures payment to the Secuityholders of the Trust obligations.
- Prior to the entry of the 1310 Order, FGIC paid $1 million of claims made against the insurance policy on account of defaulted Trust obligations.
- After entry of the 1310 Order, but before the effective date of the Plan, FGIC failed to pay $2 million of additional claims that it was obligated to pay under the insurance policy on account of additional defaulted Trust obligations, resulting in a $2 million policy claim for U.S. Bank.
- After the Plan effective date, FGIC made a distribution to holders of policy claims using a CCP of 15%, which resulted in a $300,000 distribution to U.S. Bank on account of its $2 million policy claim.
- FGIC has, therefore, paid a total of $1.3 million to the Secuityholders ($1 million prior to the 1310 Order, plus a $300,000 CCP distribution), which results in a corresponding $1.3 million reimbursement claim held by FGIC, while the Secuityholders are still owed $8.7 million of Trust obligations and U.S. Bank still has a claim against FGIC for $1.7 million of unpaid policy claims.
- There is now a $1 million distribution to be made from the Trust.

Against this factual backdrop, we now consider two scenarios: the first assumes that U.S. Bank is entitled to exercise its setoff rights as set forth in section 7427 of the NYIL; the second, like the Plan, ignores section 7427.

If U.S. Bank is entitled to exercise its setoff rights, then all $1 million of trust distributions will go to the Securityholders. This is true because while FGIC has a $1.3 million reimbursement claim that would entitle it to payment out of trust distributions ahead of the Secuityholders, U.S. Bank would be entitled to set off the entirety of that reimbursement claim against U.S. Bank's $1.7 million unpaid policy claim. After the setoff, the $1 million trust distribution would be made pro rata to the Secuityholders.

Under the Plan, however, the full amount of the $1 million would be distributed to FGIC *notwithstanding the fact that there remains $1.7 million of policy claims that FGIC never paid.* This is true because if U.S. Bank is unable to offset FGIC's $1.3 million reimbursement claim against U.S. Bank's $1.7 million claim, then that reimbursement claim would entitle FGIC to payment out of Trust distributions ahead of the Secuityholders. This completely flips the parties' rights on their heads. Instead of a $1 million Trust distribution to the Secuityholders, FGIC – which did not pay any of the $1.7 million that it still owes to U.S. Bank and the Secuityholders – would take the entire $1 million that would otherwise go the Secuityholders and redistribute it among all of FGIC's creditors.

Moreover, to make things even more egregious, the above example does not even account for the insurance premiums that, under the Plan, U.S. Bank would have to continue to pay to FGIC. So not only does FGIC get all $1 million that should otherwise go to the Securityholders, but U.S. Bank must make full premium payments to FGIC. Although the Rehabilitator argues that this result is "fair" to all creditors, it is, in actuality, patently unfair to the Securityholders of the Trust. Indeed, the Rehabilitator's attempt to be "fair" by redistributing assets across all the trusts simply fails to take into account the differences among the trusts and is unfair to those trusts that have greater rights.

Accordingly, as the hypothetical illustrates, if the Plan is approved as currently drafted, and if U.S. Bank and the other trustees are not able to exercise the setoff rights preserved by section 7427, (a) U.S. Bank and the other trustees will continue to pay premiums in full, (b) FGIC will only pay a fraction of unpaid policy claims while the fraction that it is obligated to pay can be fully set off by FGIC against the claims that it holds, and, as if that is not enough, (c) FGIC will be entitled to first distribution from trust assets on account of its reimbursement claims notwithstanding the fact that it has failed to pay a substantial portion of the policy claims. Not only does this result violate section 7427, but it simply runs counter to common sense notions of fairness and logic.

V. JOINDER

U.S. Bank generally joins in the objections of Deutsche Bank National Trust Company, Deutsche Bank Trust Company Americas, The Bank of New York Mellon, The Bank of New York Mellon Trust Company, N.A., Wells Fargo Bank, N.A., each in its capacity as indenture trustee for certain trusts, to the Plan.

VI. CONCLUSION

For the foregoing reasons, U.S. Bank respectfully requests that the Court reject or modify the Plan with such other and further relief which this Court deems just and proper.

Respectfully submitted,

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ATTORNEYS FOR U.S. BANK NATIONAL ASSOCIATION AND U.S. BANK TRUST NATIONAL ASSOCIATION, EACH IN ITS CAPACITY AS TRUSTEE AND ANY OTHER RELEVANT CAPACITY