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 Doris Ling-Cohan, J. Motion Sequence No. 4

AMENDED[1] OMNIBUS REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT OF APPROVAL OF FIRST AMENDED PLAN OF REHABILITATION FOR FINANCIAL GUARANTY INSURANCE COMPANY

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[1] This amended version of the omnibus reply memorandum of law is being submitted pursuant to the Court's order, dated December 19, 2012, to reflect only those objections that remain unresolved as of January 25, 2013.

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Benjamin M. Lawsky, Superintendent of Financial Services of the State of New York (the "**Superintendent**"), as the court-appointed rehabilitator (the "**Rehabilitator**") of Financial Guaranty Insurance Company ("**FGIC**"), respectfully submits this omnibus reply memorandum of law (the "**Reply**") in further support of the Rehabilitator's motion for approval of the proposed First Amended Plan of Rehabilitation for FGIC, dated December 12, 2012, together with all exhibits and the Plan Supplement[2] thereto (collectively and as the same has been and may be revised, the "**Plan**").[3] Attached as **Exhibit 1B** to this Reply is an amended version of the chart summarizing the objections to the Plan (the "**Omnibus Response Chart**").[4] For each objection raised and described in the Omnibus Response Chart, there is a corresponding entry that lists whether (i) the Rehabilitator is compromising on a point by revising the Plan, (ii) the Rehabilitator has a substantive response on a discrete issue (in which case it is explained in the chart), or (iii) the objection is addressed in this Reply. In addition, in further support of the Reply, the Rehabilitator has filed a separate compilation of documents including: (a) an Affidavit of Michael W. Miller, dated December 12, 2012 (the "**Lazard Aff.**"); (b) an Affidavit of John S. Dubel, dated December 12, 2012 (the "**Dubel Aff.**"); and (c) an Index of Plan Related Documents (the "**Index**"), which contains, among other things, (1) the amended Plan and (2) a revised proposed Plan Approval Order.

[2] Capitalized terms not otherwise defined herein shall have the meanings ascribed to them in the Plan.

[3] The summaries of the Plan herein are qualified in their entirety by reference to the Plan. In the event of any conflict between the descriptions set forth herein and the terms of the Plan, the terms of the Plan shall govern.

[4] The amended version of the Omnibus Response Chart is being submitted pursuant to the Court's order, dated December 19, 2012, to reflect only those objections that remain unresolved as of January 25, 2013.

PRELIMINARY STATEMENT

The Rehabilitator's primary goal is to restore FGIC to statutory solvency in a way that treats policyholders fairly. Armed with broad statutory authority, the Rehabilitator endeavored to restructure FGIC's liabilities under its insurance policies consistent with the fundamental principles of equity underlying insurance insolvency law. To accomplish this goal, the Rehabilitator devoted significant time and resources to develop and propose a Plan that provides economically equivalent recoveries to creditors and avoids preferential treatment. Along the way, the Rehabilitator considered many different alternatives, negotiated with multiple constituents, and balanced the divergent interests of FGIC's claimants, ultimately formulating a structure that marshals and protects FGIC's limited assets and will distribute them quickly and ratably among claimants.

Only one party opposes (in summary fashion) the run-off of FGIC outside of the Rehabilitation Proceeding, a key feature of the Plan. The remaining objections are largely self-serving and challenge certain implementing provisions and administrative aspects of the Plan. The objections to the implementing provisions are geared toward enabling individual creditors to increase their own recoveries – at the expense of other creditors. Altering or removing these challenged provisions will likely decrease and/or reallocate recoveries to and among policyholders and in the Rehabilitator's judgment would render the Plan less fair and more inequitable to policyholders as a whole than it can or should be. Therefore, the Rehabilitator submits that the objections should be overruled.

As set forth in the Omnibus Response Chart, the remaining objections include filings by four trustees of securitization trusts insured by FGIC and certain entities holding warrants or bonds insured by FGIC. The objecting parties are: (i) The Bank of New York

Mellon and The Bank of New York Mellon Trust Company, N.A., each in its capacity as indenture trustee (collectively, "**BNY**"); (ii) Deutsche Bank National Trust Company and Deutsche Bank Company Americas, each in its capacity as trustee for certain asset-backed securities trusts insured by FGIC (collectively, "**Deutsche Bank**"); (iii) U.S. Bank National Association and U.S. Bank Trust National Association, each in its capacity as trustee or similar role for certain RMBS, municipal debt securities, and other affected transactions (collectively, "**U.S. Bank**"); (iv) Wells Fargo Bank, N.A., in its capacity as trustee for certain RMBS certificate holders ("**Wells Fargo**"); (v) certain entities holding sewer warrants issued by Jefferson County, Alabama (collectively, the "**JeffCo Holders**"); (vi) CQS ABS Master Fund Ltd., CQS Select ABS Master Fund Ltd. and CQS ABS Alpha Master Fund Ltd., holders of instruments insured by FGIC (collectively, "**CQS**"); (vii) Childrens Health Partnership Holdings Pty Ltd, in its capacity as trustee of the CHP Holdings Unit Trust, for itself and on behalf of Childrens Health Partnership Holdings Pty Ltd in its capacity as trustee of the CHP Unit Trust and Ancora (RCH) Pty Ltd as beneficiaries of instruments guaranteed by FGIC (collectively, "**CHP**"); and (viii) Aurelius Capital Management, LP, in its capacity as manager of entities that hold RMBS insured by FGIC, which filed a joinder to the objections of U.S. Bank and BNY.

The Rehabilitator, in his discretion, determined that certain of the objecting parties' proposed changes were inappropriate, in many instances because such changes would implicate issues of overall fairness. To the extent that these involve minor issues, the bases for the Rehabilitator's determinations are set forth in the Omnibus Response Chart. In addition, the chart includes the Rehabilitator's responses to discrete legal arguments raised by some of the objecting parties under New York law and federal insurance, constitutional and bankruptcy law relating to priority and payment of claims, due process and subrogation/reimbursement rights.

The balance of the objections, addressed at length herein, raise legal arguments on essentially two important – albeit limited – points. First, the objectors take issue with the Rehabilitator's proposed contract modifications, which are designed to preserve FGIC's entitlement to receive premiums and reimbursements and continue exercising "control rights" with respect to insured transactions (*e.g.*, to give direction to indenture trustees and other parties). In addition, the objecting parties challenge the Plan's treatment of setoff and recoupment rights to enforce payment of premiums and reimbursements.

The Rehabilitator found that these Plan provisions were necessary to provide economically equivalent payments to policyholders, consistent with public policies underlying insurance insolvency law. By contrast, the objectors seek to circumvent this key feature of FGIC's rehabilitation under the Plan – the restructuring of FGIC's obligations so as to provide equivalent payments – by, among other things, offsetting their premium and reimbursement payments against FGIC's original policy obligations, in order to obtain greater recoveries for themselves. Permitting this inequitable result would jeopardize the overall fairness of the Plan that the Rehabilitator has worked so hard to achieve.

In addition to the foregoing, two parties objected to the Novation Agreement. Under the Novation Agreement, National Public Finance Guarantee Corporation ("**National Public**") will replace FGIC as the party obligated to make payments with respect to claims under policies covered by that agreement, which had approximately $110.5 billion par of coverage outstanding as of November 30, 2012. The Rehabilitator carefully reviewed options available to FGIC with respect to the existing reinsurance arrangement with National Public. As set forth in Section III of the Memorandum of Law in Support of Approval of the Plan, filed on October

25, 2012 (hereinafter, the "**Memo of Law**") and herein, the Rehabilitator determined that the interests of FGIC and its policyholders are best served by the Novation Agreement.

At the end of the day, nothing in the objections provides any basis for denying approval of the Plan. Many policyholders have waited years for FGIC to resume paying claims. This court should approve the Plan with the modifications proposed by the Rehabilitator.

ARGUMENT

I. THE REHABILITATOR, WITH COURT APPROVAL, HAS AUTHORITY TO MODIFY FGIC'S POLICIES AND OTHER CONTRACTS TO REMOVE THE CAUSES AND CONDITIONS THAT MADE THE REHABILITATION PROCEEDING NECESSARY

Pursuant to Section 7403(a) of the New York Insurance Law ("**NYIL**") and the Order of Rehabilitation, the Rehabilitator was tasked with removing the causes and conditions that made FGIC's rehabilitation necessary. *In re Rehab. of Fin. Guaranty Ins. Co.,* Order of Rehabilitation, Index No. 401265/2012, ¶ 5 (Sup. Ct. N.Y. County June 28, 2012) (the "**Order of Rehabilitation**"). The Rehabilitator sought to maximize recoveries to policyholders, provide distributions quickly and treat claimants fairly. In considering how best to structure a plan to accomplish this goal, the Rehabilitator carefully analyzed FGIC's policies and related transaction documents and determined that certain provisions must be modified. In particular, the Plan necessarily reduces FGIC's payment obligations under its policies by implementing the CPP/DPO structure. *See* Memo of Law at 4-5.

In addition, to protect the interests of FGIC and its policyholders as a whole, Section 3.5 of the Plan deems defaults under FGIC's policies and related contracts not to have occurred to the extent such defaults arise from, among other things, FGIC's rehabilitation, insolvency or failure to pay policy claims pursuant to an order of its regulator (referred to below as the "1310 Order"). These defaults otherwise could (i) impair FGIC's right to receive reimbursements and premiums (which are among the amounts referred to in the Plan as "FGIC Payments"), or (ii) trigger a loss of certain of FGIC's rights under transaction documents, including rights to direct a trustee with respect to, among other things, commencing or prosecuting a legal proceeding or liquidating underlying collateral (which rights are among the rights referred to in the Plan as "FGIC Rights").[5]

Certain objectors challenge the Plan's cure of payment defaults and the provisions related to turnover of FGIC Payments and retention of FGIC Rights that would be affected by such defaults. As set forth in the Memo of Law and described in further detail below, these proposed Plan provisions are (i) within the Rehabilitator's broad authority pursuant to the Order of Rehabilitation and Section 7403(a) of the NYIL,[6] (ii) supported by case law in multiple jurisdictions upholding a rehabilitator's right to alter contract terms for the benefit of all policyholders[7] and (iii) consistent with the principles followed in other insolvency proceedings.[8] Absent the Plan's modification of policyholders' contractual rights in the limited instances described above, certain policyholders may be able to use the Rehabilitation Proceeding, FGIC's financial condition or FGIC's compliance with the 1310 Order, the Order of Rehabilitation or the Plan as grounds for increasing their own recovery, to the detriment of other policyholders. The

[5] Certain FGIC Rights (including rights under its insurance and indemnity agreements) are unaffected by any default clauses that might be triggered by the Rehabilitation or any of the Rehabilitation Circumstances, including any default clauses invoked by the objectors. Those FGIC Rights are therefore not at issue and are separate and distinct rights belonging to FGIC, which are in addition to the subset – albeit an important subset – of FGIC Rights under the Transaction Documents that would be impaired by such default clauses. (Dubel Aff. ¶ 7).

[6] Order of Rehabilitation ¶ 5; Memo of Law at §II.A; Section I.A *infra*.

[7] *See* Memo of Law §II.B and Section I.A *infra*.

[8] *See* Memo of Law § IV.A and Section II *infra*.

Rehabilitator is obligated to implement a plan that treats policyholders as a whole fairly. His proposed means of doing so should be afforded broad deference.[9]

A. The Rehabilitator Has Clear Authority, with Court Approval, to Modify FGIC's Contracts

The primary source of the Rehabilitator's authority to modify FGIC's contracts is Section 7403(a) of the NYIL, as implemented by the Order of Rehabilitation. Order of Rehabilitation ¶ 5 (directing the Rehabilitator to "*take such steps* toward the removal of the causes and conditions which have made [this Rehabilitation Proceeding] necessary *as the Rehabilitator may deem prudent and advisable*.") (emphasis added); N.Y. Ins. Law § 7403(a) Courts construe Section 7403(a) of the NYIL broadly. *See* Memo of Law §II.A *citing e.g. Gallin v. Burdick*, 273 N.Y.S. 456, 459 (Sup. Ct., Kings Co. 1934), *aff'd*, 271 N.Y.S. 1086 (2d. Dept 1934), *aff'd*, 265 N.Y. 492 (1934) (construing a rehabilitator's broad authority under Section 7403(a) of the NYIL to include "every conceivable right which it might be necessary for [a rehabilitator] to assert tending toward the removal of the causes and conditions which brought about the rehabilitation order"). Modifying certain targeted contract terms to restore FGIC to statutory solvency for the benefit of policyholders as a whole is well within this Court's mandate. Further, the Court should defer to the Rehabilitator's judgment in carrying out this directive, unless his actions are arbitrary, capricious or an abuse of discretion.[10]

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9 *See* Memo of Law § I *citing e.g. Minor v. Stephens*, 898 S.W.2d 71, 76 (Ky. 1995), citing *Matter of Liquidation of Integrity Ins. Co.*, 555 A.2d 50, 53 (N.J. Super. Ct. Ch. Div. 1988) (The Rehabilitator "is the best qualified to perform the rehabilitation . . . process as he has no special interest in the outcome except to administer the matter for the maximum benefit of all interested parties.").

10 *See* Memo of Law § I *citing e.g. Callon Petroleum Co. v. Super. of Ins.*, 863 N.Y.S.2d 92, 93-94 (3d Dept 2008) ("The courts will generally defer to the rehabilitator's business judgment and disapprove the rehabilitator's actions only when they are shown to be arbitrary, capricious or an abuse of discretion.").

Only Deutsche Bank's objection includes an argument challenging the Rehabilitator's well-established authority to modify an insurer's contracts. (Objection of Deutsche Bank to the Proposed Plan of Rehabilitation for FGIC (hereinafter, "**Deutsche Bank Obj.**") 14-16).[11] Deutsche Bank's attempts to distinguish and discredit this bedrock principle are unconvincing. Although Deutsche Bank argues that the courts in *Carpenter*, *Mutual Benefit* and *National Surety* did not explicitly state that a rehabilitator has the authority to amend contracts, the courts in those cases confirmed that authority by approving plans of rehabilitation which modified the terms of the insolvent insurers' contracts. In *Carpenter*, the court approved a rehabilitation plan that substituted a new company as obligor on an insurance company's policies and reduced certain underlying obligations. *Carpenter v. Pacific Mutual Life Ins. Co.*, 10 Cal.2d 307, 321-22, 74 P.2d 761, 770-71 (1937), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1939).

Deutsche Bank suggests that the basis for this decision was that the rehabilitator had provided policyholders with the option to dissent from the plan and pursue a claim for breach of their policies against the liquidator of the old company and that, had he not, the rehabilitator would have lacked the authority to modify the policies. There is nothing, however, in *Carpenter* or any case (of which the Rehabilitator is aware) that limits a rehabilitator's power to amend contracts to situations where a rehabilitation plan provides a liquidation opt-out. In fact, in *In re Rehab. of Segregated Account of Ambac Assurance Corp.*, the Wisconsin Circuit Court confirmed a plan of rehabilitation that restructured a financial guaranty insurer's obligations under its policies over objectors' arguments that the Plan should include an opt-out.

[11] Even one of Deutsche Bank's fellow trustees, Wells Fargo, correctly recognizes that the Rehabilitator has broad powers to alter contracts that FGIC has signed, including policies and insurance agreements. (Objection to the Proposed Plan of Rehabilitation of Wells Fargo (hereinafter, "**Wells Fargo Obj.**") 8-9).

See Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation, With Findings of Fact and Conclusions of Law, Case No. 10-CV-1576, ¶105 (Wis. Cir. Ct. Jan 21, 2011) (appeals pending), available at http://ambacpolicyholders.com/court-filings/ (accessed Dec. 11, 2012) (overruling objectors' arguments that "the Plan should include an 'opt-out' allowing them to immediately recover the hypothetical liquidation value of their future claims" and noting that requiring an opt-out would be contrary to past practice).

In any event, *Carpenter* recognized that the option to dissent in that case was provided to ensure that policyholders, including those whose policies were being assumed on different and less favorable terms than others, would receive at least what they would have received in an actual liquidation of the insurance company. *See Neblett*, 305 U.S at 304-05. Here, because the restructured policies provide policyholders with uniform treatment and at least what they would receive in a liquidation of FGIC, and likely more (27% to 30%, as opposed to 7% to 14%)[12] *Carpenter* does not require an "opt-out."[13]

Deutsche Bank's characterizations of *Mutual Benefit* and *National Surety* are equally unconvincing. Although the court in *Mutual Benefit* focused on whether the rehabilitation plan complied with New Jersey's statutory priority scheme and the constitutionality of that scheme, the court approved a plan that modified life and health insurance

[12] *See* Lazard Aff. ¶¶ 24, 28 (noting that policyholders are expected to receive present value recoveries of approximately 27% to 30% of their policy claims allowed under the Plan, rather than only approximately 7% to 14% in a liquidation, as set forth in the Updated Run-Off Projections and Updated Liquidation Analysis attached to the Lazard Affidavit as **Exhibit 1** and **Exhibit 2**, respectively).

[13] The Rehabilitator considered and ultimately rejected implementing a structure similar to that found in *Carpenter*, as it could have resulted in potential materially negative tax consequences. The nature and extent of policy amendments and reformation that would have been effected as part of such a structure would raise issues regarding the post-rehabilitation character and treatment of FGIC and the reformed policies for tax purposes, and the continued availability of FGIC's significant tax attributes. The associated exposure to potential additional tax liability has been estimated to be substantial, which additional tax liability could significantly diminish the value of the estate for policyholders.

and annuity contracts by reducing the insurance company's obligations thereunder. The plan also imposed a "significant moratorium charge" on policyholder withdrawals (from accounts associated with the contracts) and prohibited certain life insurance policyholders from exercising certain payment options originally afforded by the contracts. *In re Mutual Benefit Life Ins. Co,* 1993 N.J. Super. Lexis 940, at *22, 23, 129 (N.J. Super. Ct. Ch. Div. Aug. 12, 1993, No. C-91-00109). Likewise, in *National Surety*, the court approved a plan of rehabilitation that modified an insurance company's policies by substituting one of three new companies, each financed by only a portion of the original insurance company's assets, as obligor. Notably, the court in *National Surety*, unlike in *Carpenter*, approved a plan that did not afford policyholders the option to dissent.[14]

Similarly, Deutsche Bank misconstrues the proposition for which the Rehabilitator cites *Vickodil* and *Minor*. These cases uphold the Rehabilitator's authority to take extraordinary measures that a private, solvent insurance company could not take, for the benefit of policyholders as a whole. For example, in *Vickodil*, the court noted the rehabilitator has "the duty to act with a broader view toward minimizing inevitable financial harm to *all* policyholders, creditors and the general public," even if this means compromising certain individual interests. *Vickodil v. Commonwealth*, 126 Pa. Cmwlth. 390, 396. 559 A.2d 1010, 1013 (1989). Likewise, in *Minor*, the court recognized that an insurance commissioner has "substantial" authority when acting in accordance with insurance statutes to rehabilitate or liquidate an insurer

[14] *See also Green v. Am. Life & Accident Ins. Co.*, 112 S.W.2d 924, 928 (Mo. Ct. App. 1938) (holding that policyholders were bound by a reinsurance agreement entered into by the receiver of an insolvent insurer, irrespective of any notice to the policyholders, and explaining "[*t]his is no case of a private reinsurance agreement entered into between two companies where the assent of the policyholders to any change would be required*, but here the reinsurance agreement was entered into by virtue of a court order which was made in the course of the receivership proceeding in which all the policyholders were represented by the superintendent of the insurance department, and by the result of which they were no less bound than if their names had appeared as actual parties to that suit") (emphasis added).

because, in doing so, he is exercising "an aspect of the police powers of the state." *Minor*, 898 S.W.2d at 80 ("[N]either the insurance company nor policyholders have inviolate rights that characterize ordinary private contracts" because "the policyholders' contracts as well as others with interest in the company, are subject to a reasonable exercise of state police power.").[15]

In *Carpenter*, the court elaborated that, although the contract and due process clauses of the Constitution render private insurance companies powerless to change the terms of their existing contracts, "these prohibitions do not apply to the state acting under its police powers." 10 Cal.2d at 331, 74 P.2d at 776. The only restriction on the exercise of state police power is that the state's action must be reasonably related to a public interest (in this case, the rehabilitation of an insolvent insurance company) and must not be arbitrary or improperly discriminatory. *Id.* at 330, 74 P.2d at 775. Accordingly, in exercising the state's police powers at this Court's direction, it is well within the Rehabilitator's authority to implement the targeted, limited contract modifications in the Plan, which are necessary to return FGIC to statutory solvency and maximize recoveries to policyholders in a fair and equitable manner.

B. FGIC Has Rights Under Transaction Documents

Although the remaining objectors do not dispute the Rehabilitator's ability to modify FGIC's contracts, they argue that the transaction documents that are related to FGIC's policies should not be subject to modification because FGIC is not a signatory to the documents. (Deutsche Bank Obj. 16-17; Wells Fargo Obj. 8; Objection of JeffCo Holders to Plan of Rehabilitation (hereinafter, "**JeffCo Holders Obj.**") 11-12). This argument wrongly assumes that these transaction documents and FGIC's policies involve different contractual relationships.

[15] *See also Carpenter*, 10 Cal.2d at 331, 74 P.2d at 776 (explaining that the state acted "under and within its police power" in establishing a statutory scheme providing for the insurance commissioner to operate an insolvent insurance company and to remove the causes leading to its difficulties).

In many instances the rights and obligations forming the contractual relationship between FGIC and its policyholders are not solely embodied in documents that FGIC has signed. Certain aspects of these relationships, including FGIC's entitlements to exercise certain FGIC Rights and collect certain FGIC Payments, are specified in other related documents, generally including pooling and servicing agreements, indentures, trust agreements or servicing agreements[16] (collectively, the "**Transaction Documents**" and, together with the insurance policies and the insurance and indemnity agreements, the "**Governing Documents**"). (Dubel Aff. ¶ 6.)

The Governing Documents for each transaction are contemporaneous writings that should be read together to provide certain material rights and benefits to FGIC. Those documents are therefore assets of FGIC.[17] For each insured transaction, the Governing Documents were all negotiated, drafted, and executed as part of the same transaction and by means of internal reference are clearly related and meant to be read together. (Dubel Aff. ¶6). Where multiple instruments are "executed at substantially the same time, related to the same subject-matter, [and] were contemporaneous writings" they "must be read together." *Nau v. Vulcan Rail & Constr. Co.*, 286 N.Y. 188, 197 (1941); *accord ITT Avis, Inc. v Tuttle*, 27 N.Y.2d 571, 576 (1970) (noting that it is a "well established proposition that instruments which have been executed at substantially the same time, which are related to the same subject matter and which, by means of internal reference, are clearly related, must be read together in order to divine the true intent of the parties to the instruments."); *This Is Me, Inc. v. Taylor*, 157 F.3d 139,

[16] As discussed in footnote 3 *supra*, FGIC has separate rights under its insurance and indemnity agreements that are independent of its rights under the Transaction Documents. (Dubel Aff. ¶ 7).

[17] The argument by BNY and the JeffCo Holders that the Court does not have jurisdiction over these documents (BNY Obj. 10; JeffCo Holders Obj. 11) simply restates their argument that FGIC is not a party to the Transaction Documents. This should be rejected based on the explanation set forth herein.

143 (2d Cir. 1998) (noting that the district court properly instructed the jury that "New York law requires that all writings which form part of a single transaction and are designed to effectuate the same purpose be read together, even though they were executed on different dates and *were not all between the same parties*") (emphasis added).

In applying this longstanding doctrine, courts have specifically held that under certain circumstances a party can be bound by the terms of related agreements, even if the party did not sign one or more of those agreements. *See Consolidated Risk Services, Inc. v. Automobile Dealers WC Self Ins. Trust*, 2010 WL 2735701, at *5 - *6 (N.D.N.Y. July 9, 2010, No. 1:06-CV-871 [FJS/RFT]) (in applying New York law and construing a related trust agreement and contract as binding on plaintiff, the court noted that "it is clear the parties intended that the Trust Agreement would bind Plaintiff" and "the fact that Plaintiff did not sign the Trust Agreement . . . is not dispositive"); *Janover v. Bernan Foods, Inc.*, 901 F.Supp.695, 701 (S.D.N.Y. 1995) (finding, under New York law, that an employer was bound by a severance agreement he did not sign where employer had signed an extension agreement that referenced the severance agreement and holding that "a binding agreement may be assembled from more than one document, even if all the documents are not signed by the party against whom enforcement is sought"); *Nolfi Masonry Corp. v. Lasker-Goldman Corp.* 553 N.Y.S.2d 156, 187 (1st Dept 1990) (it is a well-settled principle that "a binding agreement may be assembled from more than one writing, even if all are not signed by the party against whom enforcement is sought").

In addition, as the objecting parties recognize, the Governing Documents often specifically provide that FGIC is an express or implied third-party beneficiary of the Transaction Documents. (Deutsche Bank Obj. Ex. A § 11.16(a); Wells Fargo Obj. 6); *see also Assured Gar. Mun. Corp. v. DLJ Mortg. Capital, Inc.*, 37 Misc. 3d 1212(A), 2012 WL 5192752 (Sup. Ct., N.Y. County Oct. 11, 2012) (noting that a financial guaranty insurer, although not a signatory, was an express third-party beneficiary of a pooling and servicing agreement executed in connection with the sale of RMBS to certificate holders, and, as such, the insurer stood in the shoes of, and enjoyed all the rights of, the certificate holders under the pooling and servicing agreement).

Accordingly, to effectuate a comprehensive restructuring of FGIC's contractual relationship with its policyholders, the Rehabilitator determined that merely revising FGIC's insurance policies and insurance and indemnity agreements would not be sufficient to achieve the Court's directive of returning FGIC to statutory solvency in a fair and equitable manner. Limited modifications of the Transaction Documents – with respect to provisions in those documents that specify FGIC's rights and benefits – are also necessary.[18] The provisions the Rehabilitator seeks to modify concededly all relate to FGIC and its rights under the Governing Documents. The Rehabilitator does not seek to modify rights that do not relate to or concern FGIC.

II. THE REHABILITATOR IS EXERCISING HIS AUTHORITY TO MODIFY FGIC'S CONTRACTS IN A TARGETED AND LIMITED MANNER, TO PROVIDE FAIR AND EQUITABLE TREATMENT TO POLICYHOLDERS

The basic premise of an insolvency proceeding, including an insurance insolvency, is that the company lacks sufficient assets to satisfy all of the claims of its creditors in full. The purpose of the insolvency proceeding is to concentrate all of the creditor claims in a single

[18] The JeffCo Holders incorrectly rely on a string of liquidation cases for the proposition that a rehabilitator's authority is limited because"[the Superintendent] steps into the shoes of the insolvent insurer and obtains no greater right than those that the insurer had prior to insolvency." (JeffCo Holders Obj. 10). While a "liquidation order terminates the company's existence," *Bohlinger v. Zanger*, 306 N.Y. 228 (1954), and directs the Superintendent to "liquidate the business," N.Y. Ins. Law § 7405, a rehabilitation order grants the Superintendent far broader powers pursuant to Section 7403(a), as described in greater detail in Section I.A above.

proceeding in equity, so that the company's limited assets may be distributed equally and ratably among all similarly situated creditors. As the Court of Appeals long ago observed in an insurance insolvency case: "The principle that equality is equity is especially applicable to the settlement of insolvent estates. Where equity acquires jurisdiction to distribute the assets of an insolvent fiduciary, distribution is made proportionally to all those having claims against the fund." *In re Empire State Surety Co.*, 214 N.Y. 553, 568 (1915); *accord In re Stoddard*, 242 N.Y. 148, 164 (N.Y. 1926) (noting that the "ordinary rule of distribution of the assets of an insolvent is equality among creditors of the same class"). *See generally* 15A William M. Fletcher, *Fletcher Cyclopedia of the Law of Corporations* § 7620 (2012) ("It has been said that no rule of equity appeals more to the judicial conscience than that which requires the assets of an insolvent corporation to be distributed ratably among the creditors. One who claims a departure from this rule must establish the right clearly.").

The New York Insurance Law incorporates these fundamental principles. "The paramount purpose of Article 74" "is the preservation and enhancement of the [estate's] assets to the end that the interests of all [the insurer's] creditors, policyholders, stockholders and the public will be subserved." *Corcoran v. Frank B. Hall & Co., Inc.*, 545 N.Y.S.2d 278, 281 (1st Dept 1989) (citing *Knickerbocker Agency, Inc. v. Holz*, 4 N.Y.2d 245, 253 (1958)). The Rehabilitator, with Court approval, has broad authority to take action to "remov[e] the causes and conditions which have made [the rehabilitation] proceeding necessary," including to modify and reduce FGIC's payment obligations under its policies. NYIL § 7403; *see supra* § I.A. In carrying out this directive, the Rehabilitator must endeavor to do so in a manner that treats similarly situated claimants, and in particular policyholders, fairly and equitably. *Corcoran*, 545 N.Y.S.2d at 280 (noting that the pre-eminent purpose of Article 74 of the NYIL is to ensure equitable treatment for creditors and to avoid preferences); *Van Schaick v. Lincoln Dye Works,* 263 N.Y.S. 114, 115 (Sup. Ct., Albany County 1933) ("The Insurance Law provides for an orderly procedure in which all creditors are treated alike.").

Pursuant to this authority, the Rehabilitator determined that the most fair and equitable means to return FGIC to statutory solvency, taking into account FGIC's limited assets, substantial liabilities and the diverse interests among its policyholders, was to propose a Plan that would reduce FGIC's policy obligations. Under the Plan, FGIC is required to pay only the CPP of each allowed policy claim in cash, with the possibility (and expectation) that the CPP will increase over time as claims experience develops and matures over the Run-Off Period.[19] This structure is intended to provide equal percentage cash recoveries to all policyholders with allowed policy claims, whether they arise in the short or long term. *See* Memo of Law 1-5.

In addition, the Rehabilitator has proposed, in Section 3.5 of the Plan, that payment and other rehabilitation-related defaults be deemed not to have occurred. Absent Section 3.5 of the Plan, these defaults would impair FGIC's ability to treat policyholders fairly and equitably. Specifically, the defaults could impair FGIC's right to retain premiums and reimbursements and result in (i) certain policyholders or instrument holders self-helping themselves to increased recoveries, at the expense of FGIC's other policyholders, (ii) policyholders receiving disparate treatment based on arbitrary factors such as the presence or absence of future premium payment obligations and the amount and timing of recoveries obtained by the issuer of FGIC-insured securities and (iii) policyholders and FGIC alike bearing

[19] The DPO of a policy claim is contingent and is meant only to account for the remaining portion of a policy claim after the initial CPP is paid. In the event that CPP is increased and additional cash distributions are provided with respect to such unpaid portion, the DPO will be adjusted downward.

the burden of missed opportunities to minimize losses through the exercise by FGIC of FGIC Rights.

Notwithstanding the importance of deeming FGIC cured, the Rehabilitator carefully crafted certain exceptions to the Plan's blanket cure so that the relief is proportionate and targeted, and does not unnecessarily infringe on individual holders' contractual rights. For example, Section 3.5 of the Plan provides that, to the extent the Transaction Documents alter the priorities of distributions *among* instruments insured by a FGIC policy upon a FGIC insolvency or payment default, such contractual terms remain intact. Section 3.5 of the Plan and the exceptions thereto are fair and equitable because they strike an appropriate balance among maximizing recoveries for policyholders as a whole, promoting equality of treatment among policyholders, and preserving individual policyholders' contractual rights.

Furthermore, the default provisions cured by Section 3.5 of the Plan are equivalent to *ipso facto* clauses, the enforcement of which is generally prohibited in bankruptcy and insolvency proceedings, since they can undermine the fundamental principle of equal treatment of creditors.[20] Just like the automatic stay in a chapter 11 bankruptcy case, the 1310 Order, which directed FGIC to cease paying claims because of its unstable financial condition, was intended to preserve the status quo and protect all claimants while FGIC determined how to restore itself to statutory solvency. To now enforce contractual rights-shifting provisions in the Transaction Documents as a result of FGIC's compliance with the 1310 Order would punish

[20] By way of clarification, the Rehabilitator is not arguing, as Deutsche Bank implies, that bankruptcy or banking laws actually apply in this proceeding, nor has the Rehabilitator undertaken to analyze whether Section 7.8(e) of the Plan would or would not "pass muster" under the Bankruptcy Code. (Deutsche Bank Obj. 9-10). The Bankruptcy Code, however, provides useful guidance in the context of the rehabilitation of an insolvent insurer "because that act was designed to rehabilitate entities which have become financially overburdened." *In re Rehab. of Mutual Benefit*, 1993 N.J. Super. Lexis 940, at *113.

FGIC for its financial condition and for obeying directions of its state regulator. As such, the contractual default provisions should not be enforced.

A. Payment of Premiums and Reimbursements Equalizes Distributions Among Policyholders

Under the Plan, FGIC expects to receive approximately $353 million in premiums (Lazard Aff. ¶32) and, assuming that the CPP remains at 17.25%, approximately $260 million in reimbursements from projected cash flows from mortgage loans and other collateral backing FGIC-insured securities (Dubel Aff. ¶22) over the life of its outstanding policies, all of which will inure to the benefit of policyholders as a whole. If the CPP increases over time, as expected, FGIC could collect a substantially higher amount of reimbursements under the Plan. For example, if the CPP increased to 38.6%, the amount of reimbursements FGIC projects it would receive under the Plan would increase to approximately $377 million. *Id*. Nevertheless, certain parties (principally, the ones that owe this money to FGIC) challenge the provisions of the Plan that require payment of such amounts. ((Objection of CQS to Plan of Rehabilitation for FGIC (hereinafter, "**CQS Obj.**") 4; JeffCo Holders Obj. 20; Objections of BNY to the Proposed Plan of Rehabilitation (hereinafter, "**BNY Obj.**") 7). CHP objects generally to payment of premiums, while other parties rely on specific contract default provisions for avoiding payment and reimbursement obligations.[21]

[21] For example, some FGIC-insured transactions arguably tie FGIC's right to reimbursement to fulfillment of its payment obligations. Dubel Aff. ¶23. In addition, the Transaction Documents for certain FGIC-insured transactions provide that a FGIC payment default changes the priority of distributions to FGIC on account of its premium and/or reimbursement rights under waterfall provisions which effectively could result in none of these amounts being paid to FGIC. *Id*. In addition, the JeffCo Holders incorrectly interpret their Governing Documents to provide that FGIC is subrogated to instrument holders' right to receive payments, including reimbursements, only upon payment of claims under the related policy in full in cash. (JeffCo. Obj. 20). *See* Omnibus Reply Chart, Response to JeffCo Holders Obj. (d)(1).

FGIC paid billions of dollars of policy claims in full in cash prior to the 1310 Order. Under the Plan, FGIC will be paying the maximum percentage of policy claims that can be paid, consistent with the principle of equal and ratable distribution, and will distribute all of FGIC's value to policyholders, subject to payment of administrative claims. Enforcing provisions in Transaction Documents that could result in FGIC receiving *no* premiums or reimbursements for such payments would undermine this distribution and would be unfair, particularly to those policyholders that have already paid their premiums in full (or have already paid a greater percentage of their premiums). Allowing policyholders to withhold premiums, as CHP urges, would diminish FGIC's claims-paying resources by approximately $353 million (Lazard Aff. ¶32). In addition, because some policyholders pay their premiums in full, up front, allowing holders who pay premiums in installments over time to withhold such payments would unfairly result in disproportionately higher recoveries for those holders. (Dubel Aff. ¶21).

CHP has implicitly challenged the Rehabilitator's authority to amend FGIC's policies to reduce its liability to the CPP percentage, by arguing that it is unfair to require continued payment of premiums if claims are not paid in full. (CHP Obj. 6). In most FGIC-insured transactions, FGIC's right to collect premiums under its policies is not tied to FGIC's fulfillment of its payment obligations. (Dubel Aff. ¶ 20). Moreover, requiring continued payment of amounts owed under policies to insurers, notwithstanding an insurer's insolvency, is consistent with plans of rehabilitation that have been approved in other jurisdictions. *See e.g., In re Rehab. of Mut. Benefit Life Ins. Co.*, 1993 N.J. Super. LEXIS 940, at *128 ("The policyholders are forced to continue paying premiums or else have their cash surrender value reduced to support any unpaid premiums."); *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, Plan of Rehabilitation, No. 3483 C.D. 1986, § III.B (Pa. Commw. Ct. Jan. 31, 1989) ("Premiums owed to Mutual Fire shall be paid forthwith in full."); *Carpenter v. Pacific Mut. Life Ins. Co.*, Rehabilitation and Reinsurance Agreement, No. 404673, ¶ 11 (Cal. Super. Ct. July 22, 1936) ("Notwithstanding the . . . limitation on the obligation of the [insurer] to make . . . payments . . . on such policies . . . the policyholder shall be obligated to continue to make premium payments as originally provided in his policy."). To hold otherwise would severely undermine the Rehabilitator's ability to effectuate a restructuring and would result in a contractual arrangement whereby FGIC would be complying with its obligation to pay claims, but policyholders would not be required to provide any consideration in exchange.

Similarly, it would be unfair to allow certain policyholders to take advantage of FGIC's compliance with an order of its regulator or the Plan to disproportionately enhance their own recoveries by retaining amounts that would otherwise go to reimburse FGIC for cash payments actually made by FGIC. This could reduce FGIC's claims-paying resources by at least $260 million, assuming the CPP remains at 17.25% (Dubel Aff. ¶22), and result in disparate treatment of policyholders that happen to receive a recovery that reduces their losses. Due to the vagaries of timing of receipt of reimbursements, it is essential that FGIC account for such recoveries so that it is paying with respect to actual, net losses and not inflated claims.

Accordingly, Section 1.4(A) of the Restructured Policy Terms (along with Section 3.5 of the Plan) requires policyholders (and other persons obligated to make payments to FGIC pursuant to a policy or related Transaction Documents) to turn over all FGIC Payments, for the benefit of policyholders as a whole. To ensure this fair result, the Plan authorizes FGIC to reduce cash distributions to policyholders to the extent FGIC Payments are withheld. *See infra*. Section II.B.2. Furthermore, the Plan provides that, with respect to recoveries, reimbursements, settlements and other amounts intended to reimburse FGIC for policy claim payments, FGIC will receive only the CPP of such amounts as FGIC Payments.[22] Plan at A-6. Thus, while the Plan ensures that FGIC will receive at least a measure of reimbursement for policy claim payments it makes pursuant to the Plan, it stops short of fully restoring FGIC's right to reimbursement (and further ensures that FGIC will not collect more in reimbursements than what it pays out under the Plan). By limiting the amount of reimbursements FGIC will receive under the Plan to a percentage equal to the percentage of policy claims FGIC has already paid or is paying, the Rehabilitator is limiting the modification of contract rights to the minimum extent necessary to ensure a fair and equitable outcome for policyholders.

B. The Plan Provisions Regarding Setoff Are Necessary to Provide Fair and Equitable Treatment to Policyholders

A few objecting parties assert that, pursuant to Section 7427 of the NYIL and applicable common law, they have a right to offset FGIC Payments against policy claims owed by FGIC, and that the Plan cannot impair this right.[23] (Deutsche Bank Obj. 3-6; BNY Obj. 14-17; Objection of U.S. Bank to the Plan of Rehabilitation dated September 27, 2012 (hereinafter, "**U.S. Bank Obj.**") 6-10; Aurelius Obj. 2-3). They further argue that FGIC's setoff rights are unfair. (DB Obj. 5-6; U.S. Bank Obj. 8-9).

Under the Plan, parties' setoff rights against FGIC are appropriately limited to the amount of FGIC's restructured liabilities under its policies (this is clarified by the revisions set forth in the amended Plan, attached as Exhibit A to the Index). The Plan does not, therefore,

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[22] Since FGIC paid all policy claims in full in cash prior to the issuance of the 1310 Order on November 24, 2009, FGIC is entitled under the Plan to receive 100% of the amount of all recoveries, reimbursements, settlements and other amounts relating to any policy that are deemed to be owing to FGIC, until it is reimbursed in full for any claims paid in respect of such policy prior to November 24, 2009.

[23] Deutsche Bank and BNY also claim that the Plan violates a statutory right of recoupment and potentially contractual setoff rights. The Plan will not impair any such rights for the same reasons as discussed herein.

eliminate or impair any purported policyholder setoff right. The Plan's limitation on FGIC's obligations to policyholders also underlies the application of FGIC's setoff rights. The Plan is symmetrical in this regard. These provisions are necessary to ensure that the Plan is consistent with fundamental insolvency principles regarding equality in distribution, as discussed above.

1. The Plan Appropriately Defines Policyholders' Setoff Rights in Terms of FGIC's Restructured Obligations

A few objecting parties seek the right to exercise setoffs that would give them a greater distribution than other policyholders. These parties argue that, even though FGIC will be obligated to pay only the CPP portion of policy claims, policyholders should be entitled to setoff amounts owed to FGIC against the *full, pre-restructuring* amount of policy claims. Such setoffs would undermine the fundamental principle that, "[u]pon insolvency, assets must be equally distributed among creditors without preference or priority." *Southern Indus., Inc. v. Jeremias*, 66 A.D.2d 178, 184, 411 N.Y.S.2d 945, 950 (2d Dept 1978) ("The ordinary rule of distribution of the assets of an insolvent corporation is equality among creditors of the same class.").

Allowing the type of setoffs urged by the objectors would diminish FGIC's claims-paying resources, resulting in a reduction to the initial CPP down from 17.25% to 16.25%, and lower ultimate recoveries to policyholders as a whole (26% - 28% as opposed to 27% - 30%). (Lazard Aff. ¶ 33). Because the Rehabilitator does not expect FGIC to have assets sufficient to pay policy claims in full (*see* Updated Run-Off Projections), increased value to one claimant is decreased value to the rest. Those policyholders who happen to have amounts to withhold and setoff, would realize disproportionately higher recoveries.

This potential unfairness is exacerbated by the nature of the claims at issue here and discrepancies between various claimants' relationships with FGIC. For example:

- Policyholders whose claims arise later in their coverage term would be prejudiced because most of their premiums would have been paid by the time that FGIC would make a payment on such a claim and thus would be unavailable to offset;
- Policyholders who prepaid premiums would be prejudiced because they would not have an outstanding obligation owed to FGIC to offset; and
- Policyholders who happen to receive a recovery or reimbursement would, as compared to policyholders whose deals did not generate reimbursements, have greater funds available to withhold.

On the other hand, permitting setoff against only the CPP of a permitted policy claim is consistent with the policy restructuring set forth in the Plan and the principles of fairness and equity that underlie that restructuring – principles no one has disputed.[24]

The objecting parties do not dispute that they would be receiving preferential treatment if they were allowed to setoff against the pre-restructuring amount of FGIC's policy obligations. Instead, they argue that Section 7427 of the NYIL and applicable case law authorize such treatment. While preferences may be allowed when exceptions to the normal rule of equality are clearly authorized by law, there is no such authorization here.

Section 7427 authorizes setoff rights only for claims against an insolvent insurer that arise *before* the commencement of the insurer's insolvency proceeding. Section 7427 thus has no application to the setoffs at issue here, which relate to claims that arise *after* the FGIC proceeding commenced. Section 7427(b)(1) excludes from the right of setoff otherwise granted by Section 7427, setoff where "the obligation of the insurer to such person would not at the date of entry of any liquidation order . . . entitle him to share as a claimant in the assets of such insurer." N.Y. Ins. Law § 7427(b)(1). This exclusion applies equally to rehabilitation cases.

[24] As a practical matter, a policyholder should never have occasion to exercise setoff rights against the CPP portion of a permitted policy claim because the Rehabilitator expects that FGIC will fully comply with its obligation to pay such amounts. Nevertheless, as a matter of law, policyholders' setoff rights will be fully preserved and could be exercised if FGIC for some reason fails to comply with its restructured obligations.

New York Title & Mortgage Co. v. Friedman, 276 N.Y.S. 72 (Mun. Ct., Manhattan [2d Dist.] 1934) (applying the statutory predecessor of Section 7427(b)(1), Section 420(a)(2), to a rehabilitation and denying offset of an obligation owed by the insurer that had not matured on the date of commencement of the rehabilitation proceeding); *see also Matter of Midland Ins. Co*., 79 N.Y.2d 253 (N.Y. 1992) ("[Section 7427] applies to both rehabilitation and liquidation and requirements remain the same in either case.").

All of the cases cited by the objecting parties in which a court permitted setoff against an insolvent insurer involve claims that arose prior to the commencement of the insurer's insolvency proceeding. *New York Tit. & Mtge. Co. v. Irving Trust Co.*, 241 A.D. 246, 221 N.Y.S. 775 (1st Dept 1934); *Van Schaick v. Astor*, 277 N.Y.S. 394, 154 Misc. 543 (1st Dept 1935); *Pink v. Isle Theatrical Corp.*, 271 N.Y. 390, 390 (1936); *Matter of Midland Ins. Co*., 79 N.Y.2d 253 (N.Y. 1992); *Canale v. N.Y. State Dep't of Taxation & Fin.*, 378 N.Y.S.2d 566, 84 Misc. 2d 786 (N.Y. Ct. Cl. 1975); *Butler Studley v. Boylston Nat'l Bank of Boston*, 229 U.S. 523 (1913).

Equity demands that setoff rights for policy claims arising subsequent to FGIC's insolvency be appropriately defined and realigned consistent with the amount that FGIC actually owes such policyholders under the Plan, so that policyholders as a whole are treated fairly. *Pink v. Title Guarantee & Trust Co.*, 274 N.Y. 167, 8 N.E.2d 321, 325 (1937) (denying setoff of claims arising after the commencement of a rehabilitation proceeding because, upon commencement, "the rights of general creditors intervened, . . . equity requires that the assets of the insolvent party be equally distributed among such general creditors[, and, t]hus, the allowance of the offsets would create a preference"); *Fera v. Wickham* 135 N.Y. 223 (N.Y. 1892) (denying setoff of a debt that became due after the commencement of an assignment for the benefit of creditors, noting that “if there is no right of set-off when an insolvent assignment is made, it cannot arise afterwards,” and explaining that, once an entity commences a proceeding in which the estate is held in trust for distribution among creditors, the former and natural equity of setoff disappears in superior equities vesting in the general body of creditors). The policy claims at issue here all arose or will arise subsequent to the 1310 Order, when FGIC’s regulator deemed FGIC insolvent and demanded that FGIC immediately cease paying claims. Effectively, this marks the commencement of FGIC’s insolvency proceeding, and the policy restructuring applies retroactively to such date.

We know of no case, and none is cited by the objectors, in which a court held that policyholders could continue setting off against pre-restructured obligations even after such obligations were reduced pursuant to a court-approved plan. To allow that would be to nullify the Rehabilitator’s unquestioned authority to restructure an insurer’s obligations in order to treat claim holders equally.

2. FGIC’s Ability to Offset Against Cash Distributions Is Consistent with the Policy Restructuring

For all these same reasons, to the extent that a policyholder fails to turn over FGIC Payments in accordance with the Plan, Section 4.9 of the Plan and Section 1.4(A) of the Restructured Policy Terms provide that the amount of such withheld funds may be deducted from CPP payments that FGIC otherwise would be obligated to distribute on account of related policy claims. Two objecting parties assert that FGIC should not be permitted to exercise this setoff at all but, to the extent it is, FGIC should instead apply the unpaid FGIC Payment amounts against the total, pre-restructured amounts of the relevant policy claims, or in other words, the DPO. (Deutsche Bank Obj. 5-6; U.S. Bank Obj. 8-9). Once again, accepting the objecting parties’ proposal would result in unequal treatment among policyholders.

FGIC's right to setoff provides an efficient means to marshal withheld assets, thus mitigating inequalities among policyholders' relative recoveries without having to incur the expense and burden of litigating to recover unpaid amounts. This is particularly important to the extent premiums or reimbursement amounts owed to FGIC may have been already distributed to underlying insured security holders.[25]

Further, it is critical that FGIC account for withholdings of FGIC Payments dating retroactively to the entry of the 1310 Order, before which time FGIC paid all claims in full, because there is no basis for distinguishing and treating differently unpaid premium and reimbursement amounts that arose during the period between the issuance of the 1310 Order and the commencement of this Rehabilitation Proceeding. As of the date of issuance of the 1310 Order, FGIC ceased paying claims. Thus, any amounts that became available since that date would provide an additional recovery not afforded other, similarly situated policyholders.[26]

Moreover, because FGIC is obligated to pay only the CPP of permitted policy claims, this is the relevant claim amount that FGIC should use to setoff against unpaid FGIC Payments. To hold otherwise would result in disproportionate percentage recoveries to certain policyholders, who would be incentivized to withhold amounts owed to FGIC. This is easily illustrated with an example:

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[25] *See* Preliminary Analysis of FGIC Payments Not Paid to FGIC and Resulting Reductions of Cash Payments on Certain Permitted Policy Claims, filed with updated Plan Supplement on November 14, 2012 (hereinafter, the "**Preliminary Analysis of FGIC Payments**"). This Preliminary Analysis indicates that four trusts have already received recovery amounts that likely were distributed to underlying security holders, with one trust receiving sums so great as to exceed the amount the policyholders likely would receive from the initial CCP distribution.

[26] Moreover, allowing FGIC to recover, by way of turnover or setoff, all withholdings commencing as of the entry of the 1310 Order has important prospective consequences. If the Court found that such amounts could not be recovered, in future cases where an insurer is declared statutorily insolvent parties would have an incentive to immediately begin withholding all payments due to that insurer. This could disrupt the insurer's operations, prevent an effective restructuring of its obligations, and exacerbate and accelerate the problems that lead to the statutory insolvency.

Assume a policyholder withholds $10 worth of reimbursements owed FGIC, the policyholder later has an insured loss of $100, and the CPP is 15%.[27] Pursuant to Section 4.9 of the Plan and Section 1.4(A) of the Restructured Policy Terms, FGIC would offset the $10 cash the policyholder retained against the $15 cash the policyholder would be entitled to receive for its claim (15% of $100), leaving the policyholder with a distribution of $5 ($15 – $10). The policyholder's recovery on account of its $100 claim equals the percentage recovery it would have received had it properly remitted the FGIC Payment ($15% of $100 = $15 ($10 withheld reimbursements + $5 distribution)).

Under the objecting parties' alternative approach, the $10 owed to FGIC would be offset against the total, pre-restructuring amount of the claim, leaving a claim of $90 ($100 – $10). The policyholder would then receive a distribution of $13.50 on account of that claim (15% of $90) and, thus, an aggregate recovery of $23.50 ($10 cash withheld + $13.50 distribution). The resulting percentage recovery, 23.55%, is substantially higher than the 15% recovery that the policyholder would have received had it complied with the Plan, remitted the proceeds and recovered the CPP for its claim. Importantly, the greater the amount withheld, the greater the percentage recovery.[28] In these circumstances, each policyholder would have an incentive to withhold as much as possible at the expense of other policyholders—this is an unacceptable outcome.[29]

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[27] For the sake of easier math this is the assumed CPP for purposes of this example.

[28] Thus, if in the above example $12 were retained instead of $10, the policyholder would recover $25.20, *i.e.* 25.2% ($100 – $12 = $88; 15% of $88 = $13.20; $12 + $13.20 = $25.20).

[29] This example assumes that the policyholder owes $10 in FGIC Payments. Under the Plan, pursuant to the definition of FGIC Payments, the amount actually owed to FGIC on account of a reimbursement depends on whether FGIC has yet been reimbursed for claims paid in full prior to the 1310 Order. FGIC is entitled to 100% of reimbursement amounts until the full amount of paid-in-full claims are recovered. Thereafter, FGIC is only entitled to recover a portion of reimbursements equal to the then-current CPP.

Based on the foregoing, the Court is justified, as an exercise of its equitable powers, to provide that FGIC may offset amounts withheld after the entry of the 1310 Order against future CPP distributions to the withholding parties.

III. PRESERVING FGIC RIGHTS ENSURES VALUE IS MAXIMIZED FOR THE BENEFIT OF POLICYHOLDERS AS A WHOLE

FGIC Rights include, for example, the right to direct a trustee with respect to commencing or prosecuting a legal proceeding to enforce obligations owed to insured instrument-holders or liquidating collateral securing insured obligations. Importantly, FGIC's retention of its ability to exercise FGIC Rights is warranted because FGIC is the party most capable and best positioned to exercise such rights to protect the collateral underlying FGIC-insured transactions for the benefit of both FGIC and the security holders. As set forth in greater detail in the Dubel Affidavit, as a single entity able to act efficiently and decisively, FGIC has been able to exercise FGIC Rights to benefit security holders, reduce potential losses and thus reduce potential claims on FGIC's policies on numerous occasions. (Dubel Aff. ¶¶ 7-8, 10-12, 14-16).

If FGIC were to lose certain of the FGIC Rights to FGIC-insured security holders, trustees would likely be unable or unwilling to take action without (i) the direction of a requisite number of security holders representing a material amount (and sometimes a super-majority or even 100%) of the principal outstanding under the securities and (ii) adequate indemnification from such security holders (which will often be much more difficult for a diffuse group of security holders to provide). *Id.* Such holders may be unable to organize or to reach a consensus to take action in a timely way. Accordingly, a loss of FGIC Rights likely would stall, and possibly prevent, significant remediation efforts that FGIC would direct the trustee to pursue with respect to a transaction (*e.g.*, changing servicers, approving the sale of assets and bringing or defending necessary litigation). Inaction under these circumstances could result in deterioration in cash flows from of the value of collateral and missed opportunities for recoveries and loss remediation, ultimately harming security holders and increasing claims against FGIC and reducing overall policyholder recoveries. (Dubel Aff. ¶¶ 8-9, 13).

Moreover, as explained in Section IV.A of the Memo of Law, if insured instrument-holders could exercise FGIC Rights, they have an incentive to do so in a manner that enhances their own recoveries, without regard for the interests of other policyholders. For example, certain holders that purchased instruments insured by FGIC at a discount may be inclined to direct a trustee to dispose of collateral at depressed prices in order to obtain a quick and certain return on their investment. (Dubel Aff. ¶ 17). Such actions could crystallize greater losses under an insurance policy than would have resulted if the collateral had not been disposed of early, thereby generating additional policy claims against FGIC and diluting overall policyholder recoveries. *Id*. Further, holders that are inclined to crystallize claims in the short-term have no incentive to preserve value for long-term claimants. *Id*.

FGIC, on the other hand, has an incentive to maximize the value of the collateral underlying secured instruments, so as to minimize claims asserted under FGIC's insurance policies (and benefits the holders of such instruments by minimizing the amount of losses thereunder not paid in full in cash). Even though it is expected that FGIC initially will pay only 17.25% of permitted policy claims (with greater payments likely over time), since FGIC is actually paying such claims, it is always in FGIC's interest to minimize its own obligations by protecting the underlying collateral. Accordingly, FGIC is in a better position than instrument holders seeking quick recoveries to consider how to maximize the value of the collateral underlying secured instruments in the long-term, to the ultimate benefit FGIC's policyholders as a whole. *Id*.

Wells Fargo contends that, in those deals where FGIC only insures senior classes of instruments, FGIC would be motivated to liquidate collateral at "fire-sale prices," resulting in greater losses for holders of uninsured junior securities. (Wells Fargo Obj. § 10). To the extent uninsured junior security-holders have bargained for consent or other control rights under relevant transaction documents, the Plan does not alter those rights. Accordingly, FGIC's retention of FGIC Rights generally puts uninsured holders in no worse a position than if such rights transferred to the insured holders. Further, given that FGIC is in a better position and has a stronger incentive than insured holders to maximize the value of underlying collateral in the long-run, as explained above, FGIC's retention of FGIC Rights may even improve the position of uninsured holders.

To prevent the potential inequitable results described above, and in the Dubel Affidavit, Section 7.8(e) of the Plan (in conjunction with Section 3.5) prohibits all persons, other than FGIC from exercising FGIC Rights (subject to Section 3.7). Section 3.7 of the Plan provides an exception for sharing control of a subset of FGIC Rights related to trust loan repurchase obligations, on the basis that policyholders as a whole may benefit from allowing persons in addition to FGIC to enforce such trust loan repurchase obligations. (*See* Memo of Law § IV.B) These provisions were part of a heavily negotiated compromise the Rehabilitator reached with several holders of FGIC-insured securities who subsequently filed an affirmation in support of the Plan, and are another example of the Rehabilitator's efforts to preserve holders' contractual rights in a manner consistent with providing fair and equitable treatment of policyholders as a whole. (*See* Affirmation of Harold S. Horwich, filed October 11, 2012).

IV. THE NOVATION AGREEMENT SHOULD BE APPROVED

As described in greater detail in Section III of the Memo of Law, the Rehabilitator is seeking approval of the Novation Agreement, pursuant to which FGIC will be relieved of its obligations under municipal bond policies previously reinsured by National Public. The aggregate par exposure under such policies as of November 30, 2012 was approximately $110.5 billion. (Dubel Aff. ¶ 28). The reinsurance agreement provides, among other things, that upon a ratings downgrade of National Public to below BBB- by S&P or Baa3 by Moody's, FGIC has the right to "recapture" the reinsured policies. (*Id.* at ¶ 29). Upon such a recapture, FGIC would be entitled to all unearned premiums under those policies (net of ceding commissions paid to FGIC), and would have the sole responsibility to pay all liabilities under the policies. *Id*. The novation contemplated by the Novation Agreement would supersede the reinsurance agreement and would eliminate the recapture right.

Two parties challenge the Novation Agreement on the ground that, by superseding the reinsurance agreement and thus foregoing this recapture right, the Rehabilitator is depriving the estate of a purportedly valuable asset. (CQS Obj. 4-5; CHP Obj. 7-8). In connection with development of the Plan, the Rehabilitator reviewed the existing National Public reinsurance arrangement and options available with respect to retention, modification, or replacement. The Rehabilitator considered (among other things) the potential value of the recapture right, the likelihood of that right ever becoming exercisable, the risk that unearned premiums may not be recovered if such recapture rights were exercised, and the impact of the exercise of the recapture right on both policyholders whose policies are reinsured by National Public and those whose policies are not so reinsured, such as the parties challenging the Novation Agreement. Based on that review, the Rehabilitator ultimately determined that consummating the novation would best serve the interests of FGIC and its policyholders.

In the absence of the novation, the CPP would need to take into account potential losses under the National Public-reinsured policies, just as it does potential losses under other FGIC policies. As a result, proceeding without the novation would result in an immediate reduction to the initial CPP (down from 17.25% to 15.75%), as well as ongoing downward pressure on future CPP revaluations. (Lazard Aff. ¶ 39). That CPP reduction would be necessary even if National Public were never to be sufficiently downgraded to trigger the recapture right and irrespective of whether FGIC were to exercise that right if triggered.

Under the novation contemplated by the Novation Agreement, FGIC would be relieved of any liability under the reinsured policies. Accordingly, the CPP would no longer need to take into account potential losses under such policies, therefore making available for expeditious payment funds that would otherwise be reserved for $110.5 billion in potential liability. The current run-off projections for the Plan (and the resulting estimate for the initial CPP) assume this result. (Lazard Aff., Ex. 1).

If the novation were abandoned and National Public were sufficiently downgraded to trigger FGIC's recapture right and FGIC were to exercise that right, then FGIC would recapture from National Public the risk on such reinsured policies (aggregating approximately $110.5 billion par of coverage as of November 30, 2012) and would also be entitled to the unearned premium reserve (net of ceding commissions) (of approximately $450 million as of November 30, 2012). (Dubel Aff. ¶ 29). Based on current information, the Rehabilitator anticipates that CPP could be marginally increased as a result of such a recapture (assuming FGIC received payment of the entire unearned premium reserve). The magnitude of that marginal benefit, however, must be weighed against the significant harm that FGIC's policyholders reinsured by National Public would suffer.

Specifically, the recapture would strip the FGIC policyholders subject to the reinsurance arrangement of the 100% coverage that has been provided by a non-FGIC entity since 2008 (or 2009 in some cases), and instead subject those policyholders to the substantially reduced coverage provided by the Plan. In rejecting that alternative, the Rehabilitator is not seeking to prefer the FGIC policyholders whose risks have previously been reinsured, but instead is seeking to avoid stripping those policyholders of the 100% coverage that they have enjoyed for more than three years.

Pursuant to FGIC's reinsurance agreement with National Public, holders of policies covered by that agreement are currently allowed to bring claims directly against National Public for 100% of FGIC's obligations under those policies. To date, National Public has paid 100% of all such claims. If FGIC exercised its recapture right, policyholders covered by the reinsurance agreement with National Public would be limited to recovering only the projected CPP amount of their claims from FGIC. Thus, the Rehabilitator has determined that the benefits of effecting the novation contemplated by the Novation Agreement greatly outweigh the certain economic harm that would result to both the non-reinsured and reinsured policyholders should FGIC forego the novation opportunity.

CQS suggests that the Rehabilitator should consider creating and capitalizing a subsidiary of FGIC, transferring FGIC's rights and obligations under the National Public reinsured policies to that subsidiary and, should the recapture right ever become exercisable, have the National Public-reinsured policies recaptured by the subsidiary instead of by FGIC itself. (*See* CQS Obj. 7). The Rehabilitator considered and ultimately rejected this idea as inferior to the novation. Among other things, such a proposal immediately negatively impacts the CPP and creates potential negative tax implications.

Finally, and contrary to CHP's passing statement that the Rehabilitator is seeking to prefer the National Public-reinsured policyholders, the novation benefits the non-reinsured policyholders by (i) eliminating a very large potential exposure faced by FGIC, (ii) increasing the initial CPP and (iii) relieving long-term downward pressure that would otherwise apply to CPP revaluations. On the other hand, the effect of the novation on the National Public-reinsured policyholders is not to accord them any rights or benefits that they do not currently have, but only to provide that they will no longer be able to look to FGIC for payment of their claims should National Public fail to do so.

CONCLUSION

For the reasons set forth above, this Court should deny the objections and approve the Plan, including the Novation Agreement and the injunctive relief contemplated in the Plan. In addition, because the purposes of the Rehabilitation Proceeding will have been fully accomplished as of the effective date of the Plan, the Court should enter an order terminating the Rehabilitation Proceeding on the effective date of the Plan.

Dated: January 25, 2013
New York, New York

Weil, Gotshal & Manges LLP

Attorneys for the Superintendent of Financial Services of the State of New York, as the Rehabilitator of Financial Guaranty Insurance Company

By: __________________________

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<u>Exhibit 1B</u>

Omnibus Response Chart

EXHIBIT 1B[1]

Amended Omnibus Response Chart[2]

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[1] Capitalized terms not otherwise defined herein shall have the meanings ascribed to them in the Amended Omnibus Reply Memorandum of Law in Further Support of Approval of First Amended Plan of Rehabilitation for Financial Guaranty Insurance Company (the "**Reply Brief**").

[2] This amended version of the Omnibus Response Chart is being submitted pursuant to the Court's order, dated December 19, 2012, to reflect only those objections that remain unresolved as of January 25, 2013.

1. **Objection of BNY**	
Objection	Response
BNY objects as follows:	
(a) Sections 3.5 and 7.8 of the Plan deny certificate holders their contractual control rights in the transaction documents and neither the Court nor the Rehabilitator has the authority under the NYIL to re-write contracts or exercise jurisdiction over third parties' assets;	(a) The objection should be overruled. *See supra* Reply Brief §§ I, II, III.
(b) Sections 3.5 and 7.8 of the Plan are unfair and inequitable and an abuse of the Rehabilitator's discretion to the extent they grant FGIC the right to recover funds that were previously distributed, or will in the future be distributed, to third parties by the trusts based on FGIC's default;	(b) To address this concern, the Rehabilitator has revised Section 1.4(A) of the Restructured Policy Terms to provide that if a FGIC Payment was withheld, offset, or distributed to persons other than FGIC prior to the date of the Order of Rehabilitation in accordance with the terms of a policy or related transaction document, then FGIC's exclusive remedy with respect to such FGIC Payment shall be to reduce cash payments that would otherwise be payable by FGIC in respect of that policy. *See* Plan, Restructured Policy Terms § 1.4(A), Exs. B & B-1 to Index.[3]
(c) Termination of FGIC's consent rights are not unenforceable *ipso facto* clauses because clauses that trigger a remedy upon a payment default are not *ipso facto* clauses;	(c) The objection should be overruled. *See supra* Reply Brief § II.
(d) There is no basis to conclude that FGIC would be a better advocate in exercising control rights than security holders themselves because it is the holders' assets, and not FGIC's, that are at risk;	(d) The objection should be overruled. *See supra* Reply Brief § III.
(e) Section 7.8(c) violates claim holders' common law, statutory and contractual rights to setoff and recoupment;	(e) The objection should be overruled. *See supra* Reply Brief § II.B.
(f) Section 7.8(c) violates the "best interest of creditors" test because policyholders would have had a right to setoff and recoupment had	(f) Assuming policyholders would retain a right to setoff and recoupment in a liquidation, the Plan still provides policyholders with

[3] References herein to "Index" are to the Index of Plan Related Documents, filed on December 12, 2012.

1. **Objection of BNY**	
FGIC been liquidated;	significantly greater recoveries than they would receive in a liquidation of FGIC. *See* Lazard Aff. ¶¶ 27, 28 (assuming policyholders would be able to setoff premium payments against policy claim payments owed by FGIC, policyholders would receive only approximately 7% – 14% in a liquidation compared to 27% – 30% under the Plan, in each case using a discount rate of 20% and 10%, respectively).
(g) The proposed reductions to cash payments to be made to the trustee as policyholder presented in the Preliminary Analysis of FGIC Payments Not Paid to FGIC (included in the Plan Supplement update filed on November 14, 2012) deprive the trustee of its common law recoupment and setoff rights and vary the terms of the transactions documents with respect to those transactions;	(g) The objection should be overruled. *See supra* Reply Brief § II.B.
(h) Section 7.5(b) of the Plan is unfair and inequitable because it compels the trustees to act without any assurance that FGIC could satisfy its indemnification – at a minimum, the Plan should be modified to provide that all administrative expense claims for indemnification should be paid in full in the ordinary course regardless of when such claims arose;	(h) To address this concern, the Rehabilitator has revised the Plan to clarify that claims arising on or after the date of the Order of Rehabilitation that constitute claims for indemnification pursuant to Section 7.5(b) constitute administrative expense claims. In addition, the last sentence of Section 7.5(b) has been revised to provide that the indemnity set forth therein shall only be deemed sufficient for all purposes as long as FGIC has at least $100 million of Admitted Assets. *See* Plan §§ 4.2(B), 7.5(b), Exs. B & B-1 to Index. This compromise is reasonable, given the significant asset threshold proposed, the amount of cash FGIC currently holds and the fact that indemnification claims have administrative expense priority.
(i) Section 3.5 should not be given effect to determine the priority of any distributions under the transaction documents;	(i) The objection should be overruled. *See supra* Reply Brief §§ I, II.A.
(j) Section 3.7(b) should be modified to indicate that a trustee shall not be required to follow any direction issued pursuant to Section 3.7(b) unless and until it receives an indemnification from FGIC pursuant to Section 7.5(b) that such trustee, in its sole discretion, deems reasonably satisfactory;	(j) To address this concern, Section 3.7(b) has been revised to provide that a Trustee shall only be required to follow a direction issued pursuant to Section 3.7(b) if FGIC meets the indemnification qualifications described in the last sentence of Section 7.5(b) (as revised) or FGIC otherwise provides an indemnification to such trustee meeting any applicable requirement under any provisions of a contract

1. **Objection of BNY**	
	or transaction document that mandate that the trustee be provided with an indemnity. *See* Plan § 3.7(b), Exs. B & B-1 to Index.
(k) Section 4.6 of the Plan unfairly places the burden on the holders of claims to challenge FGIC's claim determinations and improperly imposes the payment of attorneys' fees on the non-prevailing party;	(k) To address this concern, the Rehabilitator has revised Section 4.6 of the Plan to provide that any objection to a claim must include a reasonable summary of the bases for the objection, the holder of the claim shall have 60 (instead of 45) days to respond to such objection and the claim holder shall have 90 (instead of 60) days to challenge FGIC's claim determination in court. *See* Plan § 4.6, Exs. B & B-1 to Index. The Rehabilitator has determined, in his discretion, that including the provision for payment of fees by the non-prevailing party is necessary to deter unnecessary and costly litigation of non-meritorious or frivolous claims that may be brought by either FGIC or claim holders.
(l) Section 4.9 of the Plan improperly grants FGIC setoff rights while denying policyholders their setoff rights – the Plan should provide for similar treatment of rights to setoff; and	(l) The objection should be overruled. *See supra* Reply Brief § II.B.
(m) If the Court recognizes FGIC's right to setoff under Section 1.4(A) of the Restructured Policy Terms, the Plan should require the Court to determine the validity of FGIC's claim (through a procedure similar to the Section 4.6 treatment of disputed claims) prior to the exercise of setoff, and FGIC should be required to setoff against the permitted claim amount, not the cash payment amount.	(m) If FGIC is forced to undergo a claims reconciliation process to determine the validity of FGIC's claims prior to exercising setoff, there is a significant risk that, during the pendency of such process, cash distributions would be made, a portion of which may have to be clawed back in the event it was ultimately determined that FGIC has a valid setoff right and, therefore, should have reduced such distributions. This is impractical and not feasible. Section 1.4(A) of the Restructured Policy Terms imposes a good faith requirement on FGIC in making its determination to exercise setoff. To the extent that parties believe FGIC does so improperly at any point, such parties may contest FGIC's compliance with the Plan. If, pursuant to any such challenge, it is determined that FGIC unreasonably withheld funds, FGIC can then correct the matter by making an additional distribution. This is the fairest, most efficient means to avoid any further delay in delivering payments to policyholders.

2. **Objection of Deutsche Bank**	
Objection	Response
Deutsche Bank objects as follows:	
(a) The Plan revokes trustees' setoff and recoupment rights in violation of New York common law and Section 7427 of the NYIL;	(a) The objection should be overruled. *See supra* Reply Brief § II.B.
(b) Provisions in the transaction documents that revert control rights to trust investors upon a FGIC default do not constitute unenforceable *ipso facto* provisions because they do not modify FGIC's rights on account of its insolvency or the commencement of an Article 74 proceeding, but instead condition FGIC's exercise of control rights on full performance of its obligations under its policies;	(b) The objection should be overruled. *See supra* Reply Brief § II, III.
(c) Section 3.7 of the Plan impermissibly rewrites provisions in the transaction documents governing enforcement of loan repurchase obligations by imposing on the trustees and certificate holders significant additional notice and reporting obligations, while conferring upon FGIC rights to which it is not entitled;	(c) The objection should be overruled. *See supra* Reply Brief §§ I, III.
(d) The Plan unfairly limits trustees' indemnification rights by forcing the trustees to accept a determination that the Plan's indemnification satisfies for all purposes any requirement in the transaction documents that the trustees be provided with "adequate," "sufficient," "reasonable," or "acceptable" indemnity;	(d) *See supra* Response[4] to Obj. of BNY (h).
(e) The Plan unfairly limits trustees' indemnification rights by providing that trustees can only seek indemnity from FGIC to the extent that the trusts are not able to provide sufficient indemnity; and	(e) To address this concern, the Rehabilitator has removed the requirement that trustees seek reimbursement pursuant to the transaction documents before seeking indemnification from FGIC. *See*

[4] References to "Response" are to the responses set forth in this chart.

2. **Objection of Deutsche Bank**	
	Plan § 7.5(b), Exs. B & B-1 to Index.
(f) The Rehabilitator has no authority to unilaterally rewrite FGIC's insurance policies or the underlying transaction documents to which FGIC is not a party.	(f) The objection should be overruled. *See supra* Reply Brief § I.

3. **Objection of U.S. Bank**	
Objection	Response
U.S. Bank objects as follows:	
(a) Sections 3.5 and 7.8(c) of the Plan revoke trustees' setoff rights in violation of Section 7427 of the NYIL and common law;	(a) The objection should be overruled. *See supra* Reply Brief § II.B.
(b) There is no business justification for allowing FGIC to exercise control rights pursuant to Sections 3.5 and 7.8(e) of the Plan when it has defaulted on its obligations;	(b) The objection should be overruled. *See supra* Reply Brief § III.
(c) Since trustees will have obligations pursuant to the Plan that extend beyond the original terms of the trust, Section 7.5(b) of the Plan, which provides that FGIC bears related costs to the extent funds under the trusts are insufficient, should be modified to provide that FGIC will compensate and reimburse the trustees for all actions taken as a result of the Rehabilitation as an administrative expense; and	(c) *See supra* Response to Obj. of BNY (h); Response to Obj. of Deutsche Bank (e).
(d) The portions of Section 7.5(b) of the Plan that permit FGIC to assume U.S. Bank's defense and deem FGIC's indemnity adequate for all purposes should be stricken because the Plan should not alter the trustees' contractual indemnification rights.	(d) The Rehabilitator has determined that it is important and reasonable that FGIC be able to assume the defense of any legal proceeding against an indemnified trustee that may result in a loss for which FGIC would be obligated to provide indemnification. However, to address U.S. Bank's concerns, the Rehabilitator has revised Section 7.5(b) to provide

3. **Objection of U.S. Bank**	
	certain limitations on FGIC's ability to settle any action for which it assumes the defense (and, to the extent it does not, the trustee's ability to settle is similarly limited). In addition, the Rehabilitator has made certain other changes to limit the indemnification provision, as described in the Response to BNY's objection and Response to Deutsche Bank's objection above. *See* Plan § 7.5(b), Exs. B & B-1 to Index; *supra* Response to Obj. of BNY (h), (j); Response to Obj. of Deutsche Bank (e).

4. **Objection of Wells Fargo**	
<u>Objection</u>	<u>Response</u>
Wells Fargo objects as follows:	
(a) Sections 3.5 and 7.8(e) of the Plan, which permit FGIC to retain control rights in contravention of the terms of transaction documents, secure rights for FGIC that it did not bargain for, to the detriment of certificate holders, and impermissibly amend the terms of documents to which FGIC is not a party;	(a) The objection should be overruled. *See supra* Reply Brief §§ I, III.
(b) The Rehabilitator has failed to demonstrate that Sections 3.5 and 7.8(e) are necessary to the effective rehabilitation of FGIC;	(b) The objection should be overruled. *See supra* Reply Brief § I, II, III.
(c) Section 4.6 should be revised to remove the prevailing party's entitlement to recover reasonable attorneys' fees and costs from the other party;	(c) *See supra* Response to Obj. of BNY (l).
(d) Section 7.5(b) should be modified to remove FGIC's ability to elect to assume the defense of a legal proceeding against an indemnified trustee; and	(d) *See supra* Response to Obj. of U.S. Bank (d).

4. **Objection of Wells Fargo**	
(e) The last sentence of Section 7.5(b) should be stricken because it arbitrarily limits a trustee's indemnification rights by denying the trustee its right to consider the sufficiency of the indemnification being offered.	(e) *See supra* Response to Obj. of BNY (h).

5. **Objection of JeffCo Holders**	
Objection	Response
JeffCo Holders object as follows:	
(a) The Rehabilitator does not have authority and the Court does not have jurisdiction to amend the terms of the underlying warrant indenture to deem FGIC not to have defaulted under the Jefferson County insurance policies and enjoin the JeffCo Holders from exercising control rights (pursuant to Sections 3.5 and 7.8 of the Plan).	(a) The objection should be overruled. *See supra* Reply Brief § I.
(b) Clauses providing for the transfer of control rights and/or the termination of FGIC's consent rights do not constitute unenforceable *ipso facto* clauses under section 365(e)(1) of the Bankruptcy Code and, therefore, the Rehabilitator's justification for restoring FGIC's control rights lacks merit;	(b) The objection should be overruled. *See supra* Reply Brief § I, III.
(c) The Rehabilitator's argument that Sections 3.5 and 7.8(e) of the Plan are necessary to prevent holders who purchased insured bonds at a discount from taking action with respect to underlying collateral in order to obtain a quick and certain recovery is "unsupported and irrational" – the JeffCo Holders are better positioned and more motivated than FGIC to obtain a favorable treatment of the sewer warrants in Jefferson County's bankruptcy case;	(c) The objection should be overruled. *See supra* Reply Brief § III.

5. **Objection of JeffCo Holders**	
(d) FGIC's retention of control rights constitutes an unlawful taking under the Fifth and Fourteenth Amendments to the United States Constitution and Article 1, Sections 6 and 7 of the New York Constitution because the Plan neither accomplishes a valid public use nor compensates the JeffCo Holders for the taking of their contract rights;	(d) FGIC's retention of control rights and entitlement to receive premiums and reimbursements is not an unconstitutional taking of the JeffCo Holders' property. As explained in greater detail in Section I.A of the Reply Brief, the Rehabilitator has substantial authority when acting in accordance with Section 7403(a) of the NYIL because, in doing so, he is exercising "an aspect of the police powers of the state." *Minor v. Stephens*, 898 S.W.2d 71, 78, 80 (Ky. 1995). "[The] due process clause does not restrict the state's reasonable exercise of its police power in furtherance of the public interest, even though such laws may interfere with contractual relations and commercial freedoms of private parties." *Id. citing Warschauer Sick Support Society v. State of N.Y.*, 754 F.Supp.305 (E.D.N.Y. 1991); *see also Carpenter v. Pacific Mutual Life Ins. Co.*, 10 Cal.2d 307, 331, 74 P.2d 761, 776 (1937), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938) (noting that the contract and due process clauses of the Constitution "do not apply to the state acting under its police powers"). The only restriction on the Rehabilitator's exercise of state police power is that the actions undertaken pursuant to his authority must be reasonably related to a public interest and must not be arbitrary or improperly discriminatory. *Carpenter*, 10 Cal.2d at 330, 74 P.2d at 775: *Minor*, 898 S.W.2d at 82. Although certain of the JeffCo Holders' rights may be compromised as a consequence of the Rehabilitator's determination that FGIC should retain its control rights, premiums and reimbursements, the overall benefit to the estate and policyholders as a whole justifies such determination. *See supra* Reply Brief § II, III.
(e) The requirements that parties turn over to FGIC reimbursement amounts and not offset such amounts against unpaid claims: i. Violate the terms of the Jefferson County policies and sewer warrants indenture;	(e) i. As set forth in detail in the Reply Brief, the Rehabilitator has broad authority to implement the Plan, including to modify contracts and other rights and deem FGIC cured for purposes of recovering reimbursements. *See supra* Reply Brief §§ I, II. Furthermore, the transaction documents governing the JeffCo Holders clearly provide that FGIC has

5. **Objection of JeffCo Holders**	
	a right to reimbursement to the extent it makes payments, regardless of whether the holders' losses are paid in full. First, FGIC has no obligation to make a payment on account of its policy until the JeffCo Holders have provided evidence that FGIC will have the right to reimbursement. Thus, the policy specifically provides that payment is conditioned on "receipt by the Fiscal Agent . . . [of] evidence, including any appropriate instruments of assignment, that all of the Bondholder's rights to payment of such principal or interest Due for Payment shall thereupon vest in in [FGIC]." JeffCo Holder Obj. Ex. B. Second, the JeffCo Holders' indenture provides that FGIC shall be subrogated to the extent that it makes payments, without regard to whether payments are made in full. JeffCo Holder Obj. Ex. A § 17.1(c) ("The Bond Insurer shall to the extent it makes payment of principal of or interest on the Series 1997 Warrants become subrogated to the rights of the recipients of such payments . . . ."). Third, in the event that (i) FGIC has made any payment of principal and/or interest on the transaction securities and is therefore contractually subrogated to the rights of the recipients of such payments in accordance with the express terms of the policy and the indenture, and (ii) the amount available to the respective trustee for such purpose is not sufficient to pay in full an installment of principal and/or interest due, then in accordance with the express terms of the indenture, the trustee is required to apply available funds to the proportionate payment of all such installments, with interest on overdue installments, according to the amounts thereof, without preference or priority of any installment over any other or any discrimination or privilege among the persons entitled thereto. Accordingly, pursuant to the express terms of the policy and the indenture, FGIC, as contractual subrogee and assignee, is entitled to its proportionate share

5. **Objection of JeffCo Holders**	
	of such distributions with respect to such prior payments of principal and/or interest made by FGIC, together with interest thereon without regard to whether all holders have been paid in full. *See* JeffCo Holder Obj. Ex. A § 13.3 (providing that available funds must be applied to pay the outstanding principal of, premium if any, and interest on the transaction securities, with interest on overdue installments thereof, without preference or priority of any installment of principal over interest or of interest over principal, or of any installment of interest over any other installment of interest, or of any transaction security over any other transaction security, in proportion to the amounts for both principal and interest due respectively to the persons entitled thereto, *without any discrimination or privilege among such persons*). Importantly, and consistent with the JeffCo Holders' policy and indenture, Section 1.4(A) and the definition of FGIC Payments clearly provide that FGIC's recovery by subrogation to a policyholder will never exceed the amount FGIC paid that policyholder on account of policy claims. Section 4.13 of the Plan reinforces this point, providing that any right to subrogation that FGIC may have "shall be for an amount equal to the Cash that FGIC ultimately pays . . . ."
ii. Violate New York's "made whole" doctrine;	ii. The Plan and Restructured Policy Terms provide that policyholders must turn over reimbursements to FGIC. The made whole doctrine only applies to instances of equitable subrogation, and does not apply to contractual subrogation rights or other contractual provisions for reimbursement. *See J & B Schoenfeld, Fur Merchants, Inc. v. Albany Ins. Co.*, 109 A.D.2d 370, 372-73, 492 N.Y.S.2d 38, 41 (1st Dept. 1985) ("[W]here the right of an insurer to subrogation

5. **Objection of JeffCo Holders**	
	is expressly provided for in the policy, its rights must be governed by the terms of the policy."); *Fed. Ins. Co. v. Arthur Andersen & Co.*, 75 N.Y.2d 366, 371 (N.Y. 1990) (noting that for "contractual subrogation . . . the subrogee's rights are defined in an express agreement between the insurer-subrogee and the insured-subrogor"); *Lawyers' Fund for Client Prot. of State of N.Y. v. Bank Leumi Trust Co. of New York*, 94 N.Y.2d 398, 403 (N.Y. 2000) (interpreting a contractual subrogation provision to allow recovery of amounts greater than had been paid, notwithstanding the general rule that a subrogee's claim is limited to the amount it paid the subrogor, and noting that "this is not a case dealing with equitable subrogation"). All of the New York cases the JeffCo Holders cite as support that they must be "made whole" recognize that this doctrine is an equitable principle that applies to equitable subrogation, as opposed to contractual subrogation. *See Fasso v. Doerr*, 12 N.Y.3d 80, 86-88 (N.Y. 2009) (noting that the made whole doctrine is "an important limitation on recovery under the doctrine of *equitable subrogation*" and also distinguishing equitable subrogation from the "contract-based theory of subrogation") (emphasis added); *cf. USF&G v. Maggiore*, 299 A.D.2d 341, 343, 749 N.Y.S.2d 555 (2d Dept. 2002) (applying made whole doctrine because, though insurers asserted a right of contractual subrogation, the relevant terms were not part of the record and therefore the court had to rely on equitable subrogation principles). Here, the provisions of the restructured policies are clear: FGIC has the right to recover FGIC Payments, whether they arise through subrogation or otherwise, and without any requirement that the insured first recover its entire loss. Therefore, the made whole doctrine does not apply. Contrary to the JeffCo Holders' assertion, FGIC is not

5. **Objection of JeffCo Holders**	
	seeking to claim any payment based on the DPO or a discharge of the claim, but rather has strictly limited its reimbursement rights to the amount of actual CPP payments. *See supra* Response to JeffCo Holders Obj. (e)(i). *Northwestern Mutual Life Ins. Co. v. Delta Air Lines, Inc. (In re Delta Air Lines, Inc.)*, 608 F.3d 139 (2d Cir. 2010), which the JeffCo Holders cite on this topic, is not a "made whole" case or even a subrogation case. It is a contractual interpretation case and is completely irrelevant here.
iii. Constitute an unconstitutional taking of the JeffCo Holders' property; and	iii. *See supra* Response to JeffCo Holders Obj. (d).
iv. Conflict with federal bankruptcy law and claims administration in the Jefferson County bankruptcy proceeding.	iv. Whether FGIC's claims against Jefferson County in its chapter 9 bankruptcy case are or should be subordinated pursuant to section 509 of the Bankruptcy Code is not an issue before the Court. For all of the reasons discussed in the Reply Brief, the Rehabilitator has authority to require the Jefferson County indenture trustee to turn over FGIC Payments, and doing so is necessary to provide fair and equitable treatment to all policyholders.

6. **Objection of CQS**	
<u>Objection</u>	<u>Response</u>
CQS objects as follows:	
(a) It is unfair and inequitable to deem FGIC not in default under the policies and permit FGIC to retain control rights and reimbursements (including excess cash flow from insured securities) because FGIC is not paying policy claims in full;	(a) The objection should be overruled. *See supra* Reply Brief § I, II, III.
(b) The Plan benefits certain policyholders at the expense of others by taking cash streams (reimbursements) from those bondholders whose underlying securities are producing excess cash and redistributing it to bondholders whose underlying securities are not;	(b) The objection should be overruled. *See supra* Reply Brief § II.A.
(c) Many bondholders will receive worse treatment under the Plan than under the status quo or a liquidation of FGIC because (i) on a present value basis, the 15% CPP[5] has less value than the value of excess spread such bondholders currently receive from insured securities and (ii) the Plan permits FGIC to collect the excess spread without guaranteeing that additional payments will be made on account of DPO; and	(c) CQS provides no evidence to support its assertion that many bondholders will receive worse treatment under the Plan than under the status quo or in a liquidation of FGIC. Furthermore, CQS provides no explanation of the term "excess spread" or how, if at all, the Plan affects who receives such amounts. The only evidence before the Court is the Updated Liquidation Analysis, which shows that policyholders recover more under the Plan. *See* Lazard Aff. Ex. 2. CQS's comparison to the "Sharps" deal (which FGIC understands to refer to the Sharps SP I LLC offer to exchange) is also misguided. CQS's understanding that the Sharps SP I LLC offer to exchange was rejected because bondholders were better off with the excess spread rather than the cash consent fee and other consideration offer by FGIC is purely speculative. The SP I LLC offer to exchange did not purport to amend policyholders' rights to receive excess spread and any comparison between it and the Plan regarding the excess spread is misplaced.

[5] Since CQS has filed its objection, the initial CPP has increased from 15% to 17.25%. *See* Lazard Aff. ¶ 22.

6. **Objection of CQS**	
(d) Termination (pursuant to the Novation Agreement) of FGIC's right to recapture certain reinsured municipal bond policies from National Public eliminates a valuable asset of FGIC without consideration and is not in the best interest of policyholders.	(d) The objection should be overruled. *See supra* Reply Brief § IV.

7. **Objection of CHP**	
<u>Objection</u>	<u>Response</u>
CHP objects as follows:	
(a) Sections 3.5 and 7.8 of the Plan unfairly deprive CHP of its contractual right to terminate its policies based upon a FGIC ratings downgrade, which right was triggered before FGIC was placed into rehabilitation;	(a) Although CHP may have been able to terminate its policies on account of a ratings downgrade occurring several years ago (before FGIC's financial condition had deteriorated to the point of requiring initiation of an insolvency proceeding), CHP failed to exercise that right. CHP's request amounts to termination based upon the rehabilitation (including policyholders' treatment in the Plan), which is precluded by Section 7.8(d) of the Plan. There is no basis on which to treat CHP differently than other policyholders. As recognized by bankruptcy courts facing analogous situations, where termination of a contract initially is permissible but the holder of the termination right delays and later seeks to exercise such right based upon prohibited reasons (*i.e.* treatment in an insolvency proceeding), the right is waived and termination is prohibited. *See, e.g., In re Lehman Brothers, Inc.*, Case No. 08-13555 (JMP), Transcript [Dkt. No. 5261] at 101-13 (Bankr. S.D.N.Y. Sept. 17, 2009) (finding that, although the Bankruptcy Code granted the right to terminate a swap agreement upon Lehman's bankruptcy filing, this right had been waived because over a year had passed since the filing and the party had attempted to "ride the market" in hopes that its contract would become more valuable); *see also In re Amcor Funding Corp.*, 117 B.R. 549, 550 (D. Ariz. 1990) (prohibiting broker from liquidating a

7. **Objection of CHP**	
	debtor's securities account even though the right to liquidate had been triggered by the commencement of the debtor's bankruptcy case, as permitted by the Bankruptcy Code, where over a year had passed since the commencement date and the decision to liquidate was clearly based on the broker's own financial condition).
(b) The Plan permits the Rehabilitator to "cherry-pick" the benefits of the bargain it struck with CHP (by requiring payment in full of premiums) without having to abide by its burdens (including termination rights);	(b) The objection should be overruled. *See supra* Reply Brief § I, II.
(c) Sections 3.5 and 7.8 of the Plan inequitably permit FGIC to retain control rights over the financing of the insured project;	(c) The objection should be overruled. *See supra* Reply Brief § I, III.
(d) Pursuant to the Novation Agreement, the Plan violates Section 7434 of the NYIL by preferring some policyholders at the expense of others;	(d) The objection should be overruled. *See supra* Reply Brief § IV.
(e) The Plan otherwise contains deficiencies and objectionable provisions, including because:	(e) CHP's remaining contentions were listed as bullet points with little, if any, legal or factual backing. Nonetheless, the Rehabilitator submits the following points:
i. The Plan is nothing more than a disguised liquidation without any court oversight in violation of Section 7405 of the NYIL because after the effective date there will be no business other than the run-off of FGIC's policies;	i. Although the Plan provides for a runoff of FGIC's assets, it entails relief distinct and actually better than what would be available in a liquidation. Under an Article 74 liquidation, as described in the Updated Liquidation Analysis, FGIC would wind down over a 40 year period, during which policy claimants may receive a few small distributions during the proceeding but a significant portion of the claims would remain unpaid until the final distribution (likely in 2052). Lazard Aff. Ex. 2. By contrast, under the Plan, FGIC will pay the CPP of permitted policy claims as they come in and, if possible, additional amounts over time, adjusted as expected recoveries change. By effectuating these distributions outside of a proceeding, the Plan eliminates the legal and administrative expenses that would be associated

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	with a prolonged, court-supervised liquidation process, thus resulting in increased recoveries. Furthermore, by making larger distributions now as claims arise, instead of very limited, periodic disbursements over a substantial length of time, those parties with permitted claims will get the benefit of the time value of recoveries. In any event, the Plan calls for continued oversight by the NYSDFS and has been designed to ensure the fair and equitable treatment of all policyholders, consistent with the purposes of Article 74, and the Court will retain exclusive jurisdiction to hear disputes or enforce the Plan, as necessary. CHP cites no authority whatsoever for its proposition that an insurer's liquidation must occur within a proceeding pursuant to Section 7405 of the NYIL. This requirement cannot be found anywhere in Section 7405, and is inconsistent with numerous provisions in Article 74 granting the Superintendent and the Court broad discretion to determine the most suitable means of winding down an insurer's business. For instance, Sections 7402(i) and 7404 provide that where an insurer has ceased to issue new policies (*i.e.* has begun a voluntary run-off) it is a matter of the Superintendent's discretion whether to order a court-monitored rehabilitation or liquidation proceeding (or no proceeding at all). Furthermore, Article 74 does not require that an insurer that is exiting rehabilitation continues to issue new policies; rather, Section 7403(d) allows a court to terminate a rehabilitation if it determines that "the purposes of the proceeding have been fully accomplished." Contrary to CHP's assertion, the runoff provided by the Plan does not violate any requirements of Section 7405 or Article 74.

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ii. The Rehabilitator has not demonstrated that policyholders would recover more under the Plan than in a liquidation;	ii. CHP has not provided any basis for its conclusory statement that the Rehabilitator has failed to adequately demonstrate that policyholders will receive more under the Plan than in a liquidation. The only evidence on this point is the Rehabilitator's Updated Liquidation Analysis, and CHP offers nothing to rebut this evidence. *See* Memo of Law § II.C; Lazard Aff. ¶ 28, Ex. 2.
iii. Policyholders cannot opt-out of the Plan;	iii. The objection should be overruled. *See supra* Reply Brief § I.A.
iv. The Rehabilitator has failed to provide justification for applying a discount rate of 10-20% in calculating present value recoveries of policyholders and courts have rejected applying discount rates in excess of 10% in the context of bankruptcy valuations;	iv. CHP claims that the discount factors used in the Run-Off Projections and Liquidation Analysis, 10% and 20%, are too high, pointing to a bankruptcy case where a 10% discount rate was found to be too high and another case where an 8.5% discount rate was "reasonable." However, the appropriate discount rate will depend on the riskiness of cash flows being adjusted, and so the fact that one discount rate is appropriate for one set of cash flows does not mean it is appropriate for another. *See* Lazard Aff. ¶ 35. A 3.6% discount rate, for example, would be used to adjust the long-term debt of a strong, investment grade company and would not be appropriate for cash flows with a higher risk, such as FGIC policyholder claims. *See* Lazard Aff. ¶ 38. Yet even with a discount rate as low as 3.6%, the expected policyholder recoveries would remain higher under the Plan than in a liquidation. *See* Lazard Aff. ¶ 37.
v. The Rehabilitator has not demonstrated that the broad injunctions under Section 7.8 of the Plan are necessary for the rehabilitation to be effective or that they satisfy the requirements of Section 7419(b) of the NYIL;	v. This Court has broad powers under Section 7419(b) of the NYIL to enjoin acts that "it deems necessary to prevent . . . waste of the assets of the insurer, or . . . the obtaining of a preference . . . ." The Rehabilitator has exercised discretion in determining the parameters of the injunctive relief provided by Section 7.8 of the Plan. Such injunctions are necessary to implement and enforce the provisions of the

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	Plan, the bases for which are set forth in the Reply Brief and in the Memo of Law. *See supra* Reply Brief §§ I, II, III; Memo of Law § IV. CHP has not provided any example of how Section 7.8 is too broad or explained why this relief should not be granted.
vi. Under Section 7.10 of the Plan, policyholders are deprived of their due process to challenge the NYSDFS's decision to permit FGIC to write new insurance policies (and such decision may have an adverse impact on policyholder recoveries);	vi. Article 74 grants the Superintendent of Insurance discretion, as regulator, to allow or not allow a financial guaranty insurer to continue to issue policies. *See* NYIL §§ 1104(c), 6908 (providing that the superintendent *may* limit the amount of premiums written by a financial guaranty insurer upon determining that such insurer's surplus is not adequate in relation to its outstanding liabilities or financial needs). These provisions were enacted by the New York Legislature, as an exercise of its state police power. *See Carpenter*, 74 P.2d at 776 (explaining that the state acted "under and within its police power" in establishing the statutory scheme embodied in its insurance code and noting that the contract and due process clauses of the Constitution "do not apply to the state acting under its police powers"). Section 7.10 of the Plan, which provides that the decision whether to permit FGIC to write new insurance policies rests solely with the NYSDFS, is consistent with applicable law and does not violate any policyholders' right to due process.
vii. Sections 2.6 and 7.10(b) of the Plan are inconsistent – Section 2.6 provides that equity holders will not be entitled to any distributions unless all claims are paid in cash or fully reserved for, but Section 7.10(b) does not contain the same limitations; and	vii. Section 2.6 provides that equity holders will not receive any distributions until all claims are paid in cash or fully reserved for. Assuming that condition is satisfied, Section 7.10(b) provides that a dividend still will only be made upon prior express written approval of the NYSDFS.
ix. Section 7.8(c) of the Plan enjoins parties from exercising setoff rights in violation of Section 7427 of the NYIL.	ix. The objection should be overruled. *See supra* Reply Brief § II.B.

8. **Objection of Aurelius Capital Management, LP**	
<u>Objection</u>	<u>Response</u>
(a) Aurelius Capital Management, LP joins in the objections filed by U.S. Bank and BNY.	(a) *See* Responses above.