SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

- X		
	:	Index No. 401265/2012
In the Matter of the Rehabilitation of	:	
FINANCIAL GUARANTY INSURANCE	:	Doris Ling-Cohan, J.
COMPANY.	:	
	:	Motion Sequence No. 4
- X		

MEMORANDUM OF LAW IN SUPPORT OF APPROVAL OF PLAN OF REHABILITATION FOR FINANCIAL GUARANTY INSURANCE COMPANY

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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 memorandum of law (the "**Memorandum**") in support of the Rehabilitator's motion for an order, substantially in the form annexed as **Exhibit A** to the affirmation (the "**Affirmation**"), dated September 27, 2012, of Gary T. Holtzer of Weil, Gotshal & Manges LLP, attorneys for the Rehabilitator of FGIC, (i) approving the proposed Plan of Rehabilitation for FGIC, dated September 27, 2012, attached to the Affirmation as **Exhibit B**, together with all exhibits and the Plan Supplement[1] thereto (collectively and as the same may be revised, the "**Plan**"),[2] including approving the Novation Agreement and the CDS Commutation Agreements (each as defined in the Plan) and consummation of the transactions contemplated thereby, (ii) terminating the above-captioned rehabilitation proceeding (the "**Rehabilitation Proceeding**") on the effective date of the Plan and (iii) granting such other and further relief as this Court may deem just and proper.

PRELIMINARY STATEMENT

The Rehabilitator has determined that approval of the Plan is the fairest and most equitable means to remove the causes and conditions that made this Rehabilitation Proceeding necessary. FGIC's inability to achieve statutory solvency prior to this Rehabilitation Proceeding was the principal cause and condition that made this Rehabilitation Proceeding

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

[2] A detailed summary of the Plan, including additional information about the Novation Agreement and the CDS Commutation Agreements, is set forth in the Disclosure Statement. The summaries of the Plan, the Novation Agreement and the CDS Commutation Agreements in the Disclosure Statement and herein are qualified in their entirety by reference to the Plan, the Novation Agreement and the CDS Commutation Agreements. In the event of any conflict between the descriptions set forth in this Memorandum or the Disclosure Statement and the terms of the Plan, the Novation Agreement or the CDS Commutation Agreements, the terms of the Plan, the Novation Agreement or the CDS Commutation Agreements, as applicable, govern.

necessary. The Plan provides for FGIC's return to statutory solvency. Thus, on the effective date of the Plan, the purpose of the Rehabilitation Proceeding will be accomplished. Accordingly, the Rehabilitation Proceeding should be terminated as of the effective date of the Plan, pursuant to Section 7403(d) of the NYIL.

In formulating the Plan, the Rehabilitator considered three key challenges. First, based on the Rehabilitator's projections, FGIC will not have enough assets to pay in full in cash all claims expected to arise under its insurance policies over the next 40 years (which is the remaining term of some of the policies). Second, FGIC's policies are held by a diverse group of holders, including policyholders with outstanding claims, policyholders with claims expected to materialize in the next five years and policyholders with claims not expected to arise for decades. Absent an appropriate rehabilitation plan, policyholders with claims that may not arise for decades risk receiving lower payments compared to policyholders with earlier claims. Third, if enforced, "*ipso facto*" provisions in certain of FGIC's insurance policies or related agreements triggered by the Rehabilitation Proceeding, FGIC's financial condition or FGIC's compliance with an order of its regulator (referred to below as the "1310 Order") or the Plan could cause FGIC to forfeit important "control" rights and suffer potentially billions of dollars in additional claims.

The Plan addresses these challenges. The Plan restructures FGIC's policy obligations so that FGIC will pay on each policy claim an amount in cash consistent with its financial condition, and thus will provide policyholders with short-term and long-term claims with the same percentage of cash payment on account of their allowed policy claims under the Plan. The Plan also preserves significant estate assets by authorizing entry into certain transactions that eliminate FGIC's potential exposure to policies with an aggregate par outstanding of approximately $142 billion. Under one transaction, another insurance company will replace FGIC as the party obligated to pay claims under policies (*i.e.* a "novation") having an aggregate par outstanding of approximately $138 billion. Under other transactions, FGIC will terminate its obligations under policies (*i.e.* "commutations") having an aggregate par outstanding of approximately $4 billion. In addition, the Plan prohibits policyholders from exercising certain rights (referred to as "FGIC Rights") triggered by the Rehabilitation Proceeding, FGIC's financial condition or FGIC's compliance with the 1310 Order or the Plan. This prohibition (i) prevents waste and dissipation of FGIC's assets, (ii) prohibits certain policyholders from taking advantage of *ipso facto* clauses to increase their own recoveries at the expense of other FGIC policyholders and (iii) prevents immediate and irreparable harm to FGIC's policyholders and other claimants.

The interests of FGIC's policyholders and other claimants are best served, in the judgment of the Rehabilitator, by implementing the Plan, including consummating the transactions contemplated by the novation and the commutations, granting the injunctive relief and terminating the Rehabilitation Proceeding when the Plan becomes effective. The Rehabilitator is in the best position to assess and balance the differing interests of policyholders and other claimants. While policyholders and other claimants may appropriately advocate for their own best interests, only the Rehabilitator is in a position to balance those interests in a fair and equitable manner – which the Rehabilitator has done in proposing the Plan. Longstanding authority grants the Rehabilitator's judgment in this regard broad deference.

SUMMARY OF THE PLAN

Policy Restructuring

The Plan modifies FGIC's policies to obligate FGIC to pay a certain percentage of each allowed policy claim in cash. The remaining payment obligation with respect to each allowed policy claim will be treated as a deferred payment obligation (or "DPO") under the applicable policy. The Rehabilitator estimates that FGIC will initially pay 15% of all policy claims allowed under the Plan in cash. This cash percentage is based on assumptions designed to ensure that all allowed policy claims, whether currently outstanding or arising later, will receive at least this amount in cash.

The Plan generally requires FGIC to reevaluate annually the percentage of policy claims it can pay in cash. The Rehabilitator expects this cash payment percentage to increase as FGIC adjusts its projections of anticipated future claims and claims-paying resources to reflect actual experience. Accordingly, the Rehabilitator currently estimates that ultimate recoveries to policyholders under the Plan will approximate 24% to 25% of each policy claim, on a net present value basis using a discount rate of 20% and 10%, respectively.

The cash/DPO structure thus provides fair and equitable treatment of FGIC's policyholders as a whole. All policyholders will receive the same percentage of cash on policy claims allowed under the Plan, whenever arising. In addition, each policy that has an allowed claim will accrue (on a simple, and not compound, basis) an amount ("DPO Accretion") equal to 3% of the outstanding DPO, if any, for such policy. FGIC will pay a portion of accrued DPO Accretion in cash if and when it determines it can increase the percentage of policy claims it can pay in cash. In this way, the Plan treats policyholders fairly and equitably by providing a measure of compensation to policyholders with short-term policy claims that are paid an initial cash payment percentage that is lower than the increased percentage that FGIC determines can be paid on policy claims arising in the future (which claims cannot be estimated with certainty at this time) on account of the conservatism built into the initial cash payment percentage and the methodology for increasing that percentage.

The Plan also modifies policy provisions that could relieve policyholders from paying premiums and other amounts owed to FGIC based on the Rehabilitation Proceeding, the financial condition of FGIC or FGIC's compliance with the 1310 Order[3] or the Plan. In assessing whether a policyholder owes a payment to FGIC under a policy or related transaction document, the Plan (i) disregards as a potential triggering event the Rehabilitation Proceeding, events leading up thereto (such as the issuance of the 1310 Order) and any failure of FGIC to pay claims in full as a result of the 1310 Order or the Plan and (ii) assumes that FGIC has paid in full in cash all policy claims that it has received at the time of the assessment.

If, pursuant to the above assessment, an amount is determined to be owing to FGIC, the Plan addresses how to calculate the portion of such amount that FGIC is entitled to receive under the Plan. With respect to premiums, fees, other charges and expense reimbursements so determined to be owing to FGIC, FGIC is entitled to 100% thereof. With respect to recoveries, reimbursements, settlements and other amounts (which are intended to reimburse FGIC for payments made with respect to policy claims) so determined to be owing to FGIC, FGIC is entitled (subject to certain exceptions in the Plan, including the exception in the next paragraph)

[3] The "1310 Order" was issued by the New York State Insurance Department (the "**NYSID**"), the predecessor to the New York State Department of Financial Services (the "**NYSDFS**") on November 24, 2009, pursuant to Section 1310 of the NYIL, and supplemented on March 25, 2010. The 1310 Order, among other things, ordered FGIC to stop paying claims as of November 24, 2009 and to present a plan for restructuring FGIC's obligations that would return it to statutory solvency.

to a percentage thereof equal to the percentage of policy claims FGIC is paying in cash at the time of the calculation of the amount of such payment owed to FGIC.

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 determined to be owing to FGIC pursuant to the above assessment, until it is reimbursed in full for any claims paid in respect of such policy prior to November 24, 2009. The Plan provides that FGIC will reduce cash distributions under the Plan if and to the extent policyholders fail to pay to FGIC any such amounts owed.[4] The Plan's modification of policyholders' payment obligations is fair and equitable because it strikes a balance between maximizing FGIC's claims-paying resources while limiting FGIC's right to reimbursement based on the amount of cash it pays, or has paid, with respect to policy claims.

Cure of Defaults

The Plan further seeks to prevent policyholders from gaining an advantage relative to other policyholders by exercising "*ipso facto*" clauses in their policies or related agreements. Accordingly, the Plan cures, or deems not to have occurred, any defaults arising from, among other things, the Rehabilitation Proceeding, the financial condition of FGIC or FGIC's compliance with the 1310 Order or the Plan, subject to certain exceptions.

Novation Agreement and Novation of Related Reinsurance

As part of the approval of the Plan, the Rehabilitator is seeking the Court's approval of a transaction with another insurance company, National Public Finance Guarantee

[4] An example illustrating the Plan's treatment of policyholders' payment obligations is attached hereto as an Addendum. A more general example illustrating how allowed policy claims will be treated under the Plan is attached to the Disclosure Statement as **Exhibit E**.

Corporation ("**National Public**"), which will be effectuated by the "Novation Agreement." Pursuant to the Novation Agreement, 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 $138 billion in aggregate par outstanding as of December 31, 2011. Currently, both FGIC and National Public are obligated to make payments under the policies covered by the Novation Agreement (although policyholders may not recover more than 100% of claims under such policies). The Novation Agreement will relieve FGIC of any potential liability under those policies, resulting in a higher initial cash payment percentage with respect to policy claims, and higher overall recoveries for policyholders.

FGIC is also a party to contracts with insurance companies that "reinsure" a portion of its obligations under the policies covered by the Novation Agreement. Pursuant to these "reinsurance" agreements, insurance companies, as "reinsurers," agreed to reimburse FGIC for certain portions of any claims under those policies, in exchange for a portion of the premiums FGIC collected from such policies. As FGIC is transferring all of the liability for such policies to National Public pursuant to the Novation Agreement, the Plan provides that all of these reinsurance agreements, to the extent such reinsurance agreements provide reinsurance on the policies covered by the Novation Agreement, will concurrently be novated to National Public.

As a result, with respect to the policies covered by the Novation Agreement, National Public will replace FGIC as the insurance company whose policies are reinsured under the reinsurance agreements. While the Plan changes the counterparty to such reinsurance agreements (from FGIC to National Public), with respect to the policies covered by the Novation Agreement, the risks reinsured by the reinsurers will not change. The novation of the reinsurance agreements to National Public, as discussed above, will ensure that reinsurance protection previously purchased by FGIC with respect to the policies being novated to National Public will continue in force (albeit now for the benefit of National Public) rather than being potentially extinguished as a result of the novation under the Novation Agreement.

CDS Commutation Agreements

As part of the Plan, the Rehabilitator is also seeking court approval of transactions with certain policyholders that will be effectuated by the "CDS Commutation Agreements." These agreements provide for FGIC to terminate its obligations under certain policies it issued to counterparties to credit default swaps ("**CDS**") entered into by FGIC Credit Products LLC ("**FGIC CP**"), a subsidiary of FGIC, and for FGIC CP to terminate its obligations under the CDS.

As of the date of the filing of this Memorandum, three CDS Commutation Agreements have been executed. Pursuant to these three CDS Commutation Agreements, FGIC will make an aggregate payment of $59.65 million to terminate all its obligations with respect to policies with approximately $4 billion par outstanding and enable FGIC to avoid litigating approximately $1.7 billion in potential claims against FGIC that could arise from termination of the CDS by the counterparties to the CDS Commutation Agreements based on FGIC's financial condition or the commencement of the Rehabilitation Proceeding.

The Rehabilitator is negotiating additional CDS Commutation Agreements between FGIC and other CDS counterparties, which (if agreements are reached) may terminate policies with up to an aggregate of approximately $1.7 billion of additional par outstanding and eliminate approximately $1.4 billion of additional potential claims against FGIC that could arise from the termination of the CDS based on FGIC's financial condition or the commencement of the Rehabilitation Proceeding. The Rehabilitator will file all then-executed CDS Commutation Agreements with the Court (in redacted form) for approval in an update to the Plan Supplement.

Injunctive Relief

To preserve FGIC's claims-paying resources and prevent waste and dissipation of FGIC's assets when the Plan becomes effective, the Plan contains certain permanent injunctive relief. This relief prohibits a number of actions, including withholding or setting-off any payments owed to FGIC under the Plan, as described above, or exercising certain contractual rights triggered by FGIC's rehabilitation, financial condition or compliance with the 1310 Order or the Plan. These rights include, among other things, the right to direct a trustee to take certain actions with respect to securities, instruments or other obligations insured by FGIC, such as commencing or prosecuting a litigation or other legal proceeding or liquidating underlying collateral.

In addition, the Plan includes release, exculpation and indemnity provisions, with appropriate exceptions for willful misconduct, gross negligence and certain other actions.

Priority Scheme

In making sure that the Plan is fair and equitable to policyholders as a whole and to other claimants, the Rehabilitator designed the Plan so that policyholders receive more under the Plan than they would be expected to receive in a liquidation of FGIC. Accordingly, the Plan tracks, to the extent possible, the priority scheme for distributing assets in a liquidation in Section 7434 of the NYIL. Secured claims (if any) will be paid in full from the collateral securing such claims and administrative expense claims (*i.e.* claims for fees and expenses necessary for operating FGIC's business during the Rehabilitation Proceeding and administering the Rehabilitation Proceeding) will be paid in full in cash. Policy claims allowed under the

Plan will be paid pursuant to the cash/DPO structure described above. No claimants junior to holders of policy claims (*i.e.* holders of non-policy claims, late-filed claims or equity interests in FGIC) will receive any payment under the Plan unless and until all policy claims (and other senior claims, as applicable) are paid in full in cash or fully reserved for. FGIC will resolve and pay claims (other than policy claims) that arise after the effective date of the Plan in the ordinary course of business.

Termination of Rehabilitation Proceeding

To minimize expenses and maximize assets available for distribution to policyholders, the Plan provides for the termination of the Rehabilitation Proceeding on the effective date of the Plan. At that time, FGIC will resume possession of its property and the conduct of its business to administer and implement the Plan, subject to certain limitations, including continued oversight by the NYSDFS and enhanced reporting requirements.

The Rehabilitator has sought both to obtain input from policyholders and other interested persons and to aid such persons in understanding the terms of the Plan and the Rehabilitator's formulation of those terms. In connection therewith, the Rehabilitator has prepared, filed with the Court, posted on www.fgicrehabilitation.com and distributed a Disclosure Statement, which provides a more detailed description of the Plan and the features described above. The Disclosure Statement also explains FGIC's current and projected financial outlook, outlines the alternatives to the Plan the Rehabilitator considered, explains the principal reasons the Rehabilitator selected the Plan, identifies material risk factors associated with the Plan and discusses the ways in which the Plan is expected to provide for greater recoveries to policyholders than a liquidation. The Rehabilitator has mailed a notice to all known policyholders and other claimants, and published a notice in The Wall Street Journal and

The Bond Buyer, indicating that the Disclosure Statement and other documents filed with the Court in support of the Plan are posted at www.fgicrehabilitation.com. In addition, prior to filing the Plan, the Rehabilitator and his advisors engaged in discussions with various constituents regarding the content of the Plan and took feedback from such constituents into account in formulating the Plan.

ARGUMENT

I. THE REHABILITATOR'S PLAN IS ENTITLED TO BROAD DEFERENCE

The Rehabilitator has determined that implementation of the Plan, which includes consummation of the transactions contemplated by the Novation Agreement and the CDS Commutation Agreements, is the best way to return FGIC to statutory solvency, maximize the value of FGIC's estate and provide fair and equitable treatment of FGIC's policyholders as a whole and of other claimants. The Rehabilitator's determination in this regard is entitled to broad deference. *See Matter of Dinallo v. DiNapoli*, 877 N.E.2d 643 (N.Y. 2007) (noting that, as to the Superintendent's role as court-appointed receiver on behalf of distressed insurers, "the Legislature, by statutory enactment, bestowed upon the Superintendent broad fiduciary powers to manage the affairs of distressed domestic insurers and to marshal and disburse their assets."); *Mills v. Florida Asset Fin. Corp.*, 818 N.Y.S.2d 333, 334 (App. Div. 3d Dep't 2006) ("The Legislature has granted [the rehabilitator] plenary powers and broad discretion to manage, as a fiduciary, the affairs of an insolvent insurer."); *Foster v. Mut. Fire, Marine and Inland Ins. Co.*, 614 A.2d 1086, 1091 (Pa. 1992) (noting that, in Pennsylvania, a rehabilitator is charged to "take such action as he deems necessary or expedient to correct the condition or conditions which constituted the grounds for the order of the court to rehabilitate the insurer" and holding that "[t]his mandate explicitly defers all actions to the skill of the Rehabilitator and implicitly recognizes her expertise in these matters."); 1 *Couch on Insurance*, § 5:22 (3d ed. 2009) (explaining that a rehabilitator "has broad discretion to structure a plan of rehabilitation").

Notably, 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." *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). Thus, while policyholders may have differing views of the Plan based on their own, understandable self-interest, the Rehabilitator is unencumbered by self-interest and can balance the competing interests of all policyholders and other claimants in a fair and equitable manner. Accordingly, the Court should approve the Rehabilitator's actions or determinations unless they are arbitrary, capricious or an abuse of discretion. *Callon Petroleum Co. v. Superintendent of Ins.*, 863 N.Y.S. 2d 92, 93-4 (App. Div. 3d Dep't 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") (citing *Mills*, 818 N.Y.S.2d at 334); *Callon Petroleum*, 863 N.Y.S.2d at 94 ("A party contesting the rehabilitator's actions bears the burden of showing arbitrary conduct by the rehabilitator.").[5]

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[5] *See also LaVecchia v. HIP of N.J., Inc.*, 734 A.2d 361, 364 (N.J. Super. Ct. Ch. Div. 1999) (noting that although, pursuant to New Jersey insurance law, a "plan for rehabilitation cannot be implemented without a court finding that it is fair and equitable, deference is given to the means the [Rehabilitator] chooses to utilize in going forward with rehabilitation. As such, the Rehabilitator's determination concerning the manner in which to proceed will not be set aside unless it is shown to be arbitrary or unreasonable."); *Foster*, 614 A.2d at 1091 (noting that, in reviewing a plan of rehabilitation, "it is not the function of the courts to reassess the determinations of fact and public policy made by the Rehabilitator. Rather, the involvement of the judicial process is limited to safeguarding the plan from any potential abuse of the Rehabilitator's discretion."); *Kueckelhan v. Federal Old Line Ins. Co. (Mut.)*, 444 P.2d 667, 674 (Wash. 1968) ("[a]s the program of rehabilitation takes form and the steps unfold, the trial court in its supervisory and reviewing role may not substitute its judgment for that of the Commissioner, but may and should only intervene or restrain when it is made to appear that the Commissioner is manifestly abusing the authority and discretion vested in him and/or is embarking upon a capricious, untenable or unlawful course.").

FGIC presented a proposed plan of rehabilitation to the NYSID, the predecessor to the NYSDFS,[6] in early 2011. Since that time, the Rehabilitator, first in his capacity as the Superintendent of NYSDFS and subsequently in his capacity as Rehabilitator, has been working with the New York Liquidation Bureau and its professional advisors and has received input from various constituents, including policyholders and holders of, and corporate trustees for, securities, instruments and other obligations insured by FGIC, concerning a possible plan of rehabilitation for FGIC. The Plan proposed by the Rehabilitator is the product of this lengthy and deliberate process and is based on FGIC's proposed plan, but modified to best provide, in the Rehabilitator's view, fair and equitable treatment of FGIC's policyholders and other claimants. As described in greater detail in Section VII.F of the Disclosure Statement, the Rehabilitator considered and rejected alternative restructuring options as not in the best interests of FGIC's policyholders and other claimants. Ultimately, the Rehabilitator decided that the Plan provides the best option for restoring FGIC to statutory solvency and treats all policyholders and other claimants fairly and equitably. The Court should defer to this determination.

II. THE RESTRUCTURING OF FGIC'S POLICIES IS FAIR AND EQUITABLE TO FGIC'S POLICYHOLDERS

The Plan restructures all remaining insurance policies in force as of the effective date of the Plan (after giving effect to the novation and commutations contemplated by the Plan). FGIC's obligations under its policies will be modified so that, among other things, FGIC will be obligated to pay upfront in cash a percentage of each policy claim allowed under the Plan. The

[6] As of October 3, 2011, the NYSID and the New York State Banking Department were consolidated and merged into the NYSDFS, and the functions and authority of the NYSID were transferred to the NYSDFS. References in this Memorandum to any actions taken by the NYSDFS prior to October 3, 2011 refer to such actions taken by the NYSID during that time.

remainder of each policy claim will be treated as a deferred payment obligation (or "DPO," as defined more fully in the Plan) under the applicable policy.

Restructuring FGIC's policies is necessary to achieve fair and equitable treatment of FGIC's policyholders as a whole. In addition to currently outstanding policy claims, the Rehabilitator expects significant additional claims to arise over the remaining term of FGIC's policies, which last up to 40 years. Because the Rehabilitator cannot predict with certainty at this time the amount and timing of these claims, the Rehabilitator has determined that the best way to fairly and equitably treat long-term and short-term claimants is to adopt a level of conservatism in setting the initial cash payment percentage that ensures that FGIC will be able to pay at least this initial percentage of cash with respect to all policy claims, regardless of when they arise. At the same time, providing a DPO under the policy will ensure that FGIC has a mechanism to pay additional cash recoveries to policyholders, if and when FGIC (with input from an advisor and approval of the NYSDFS) determines it can increase the percentage of policy claims it can pay in cash. The cash/DPO structure of the Plan is designed so that all policyholders (no matter when their claims may arise) will receive the same cash percentage of their allowed claims under the Plan.[7] It is also the Rehabilitator's judgment that modifying policyholders' payment obligations as described above, and allowing FGIC to setoff against cash distributed to policyholders any payments owed to it under the Plan that have not been paid by

[7] As explained in the Plan Summary above and in Section VI.B.1. of the Disclosure Statement, because the initial cash payment percentage is designed so that FGIC will be able to pay both short-term and long-term policy claims as they arise over the next 40 years, the Plan provides that each policy that has an outstanding allowed claim will accrue an amount equal to 3% of its outstanding DPO (if any) ("DPO Accretion"). DPO Accretion is primarily intended to provide a measure of compensation for holders of short-term policy claims on account of the conservatism built into the establishment of the initial cash payment percentage and the methodology for increasing the cash payment percentage.

such policyholders, is the fairest and most equitable approach to avoid allowing certain policyholders to benefit disproportionately at the expense of other FGIC policyholders.

In addition, the restructuring of FGIC's policies should be approved because, as further described below, (i) it is necessary to remove the causes and conditions that have made the Rehabilitation Proceeding necessary, (ii) precedent in multiple jurisdictions, including New York, supports this relief and (iii) policyholders will recover at least what they would be expected to receive in a liquidation of FGIC, and likely more.

A. Restructuring FGIC's Policies Is Necessary to Remove the Causes and Conditions that Made this Rehabilitation Proceeding Necessary

In the Order of Rehabilitation, this Court, pursuant to Section 7403(a) of the NYIL, directed 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." *In re Rehabilitation of Financial Guaranty Insurance Company*, Order of Rehabilitation, Index No. 401265/2012, ¶ 5 (N.Y. Sup. Ct. June 28, 2012) (the "**Order of Rehabilitation**"). Courts construe this broad authority 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." *Gallin v. Burdick*, 273 N.Y.S. 456, 459 (Sup. Ct. 1934), *aff'd*, 271 N.Y.S. 1086 (App. Div. 2d. Dep't 1934), *aff'd*, 265 N.Y. 492 (1934); *see also Callon*, 863 N.Y.S.2d at 94 (finding Superintendent's broad powers under Section 7403(a) of the NYIL included responsibility to negotiate, compromise, pay or otherwise resolve payment obligation to judgment creditor); *Mountain Funding, Inc. v. Frontier Ins. Co.*, 2003 WL 21518556, *5 (E.D. Ill. July 1, 2003) (citing Section 7403(a) of the NYIL, and noting that under New York law, "there is a broad range of what rehabilitation proceedings may entail – everything from a simple change of management to a merger with another, more stable insurer to a specialized claims proceeding for the purpose of uniform claim resolution"); *Koken v. Fidelity Mut. Life Ins. Co.*, 907 A.2d 1149, 1156 (Pa. Commw. Ct. 2006) (the rehabilitator is given "great deference" to "evaluate, plan, devise and implement a program which, in [her] best judgment and in keeping with [her] expertise in the field of insurance, will accomplish the objective of the rehabilitation proceeding") (citing *Foster*, 614 A.2d at 1093); *Kueckelhan*, 444 P.2d at 674 (noting that the rehabilitator "must be afforded that freedom of action in the over-all management of the company which will permit him to knowledgeably evaluate, plan, devise, and implement a program which in his best judgment and in keeping with his expertise in the field of insurance will accomplish the objective of the proceeding").

The Rehabilitator has determined that restructuring FGIC's policies is necessary to rectify FGIC's deficit in policyholders' surplus, the underlying cause of this Rehabilitation Proceeding.[8] Absent the policy restructuring, FGIC's payment obligations with respect to claims under its policies will continue to greatly exceed the amount of assets available to pay such claims. Thus, the restructuring of FGIC's policies is necessary to avoid a liquidation of FGIC and instead restore it to statutory solvency, while enabling FGIC to provide ongoing coverage to its policyholders.

[8] As set forth in greater detail in Section IV of the Disclosure Statement, since the fourth quarter of 2007, FGIC's business, results of operations and financial condition have been adversely affected by, among other things, significant losses on policies relating to RMBS and collateralized debt obligations of asset-backed securities backed primarily by subprime RMBS. As a result, during the period from 2008 to November, 24 2009, FGIC paid claims on its insurance policies far in excess of historical levels. Since November 24, 2009, FGIC has continued to receive (but has not paid due to the 1310 Order) claims far exceeding historical levels. These losses on FGIC's policies substantially reduced FGIC's statutory policyholders' surplus. After FGIC was unable to restore itself to statutory solvency outside of the Rehabilitation Proceeding, the Superintendent determined that the Rehabilitation Proceeding was necessary and filed the Rehabilitation Petition on June 11, 2012.

B. Precedent in Multiple Jurisdictions, Including New York, Supports the Policy Restructuring

The restructuring of FGIC's policies is consistent with rehabilitation plans approved by courts in multiple jurisdictions, including New York. In the seminal case, *Carpenter v. Pacific Mutual Life Ins. Co*, the United States Supreme Court upheld an order confirming a plan of rehabilitation of a California life, health and accident insurance company under which a new company was formed to take over most of the liabilities of the insurance company, and to pay certain of those liabilities on a substantially modified basis (reducing the insurer's obligations thereunder by 10 to 80 percent, depending on the year of issue), while policyholders were required to continue paying existing premiums in full. 74 P.2d 761, 768 (Cal. 1938), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938). In affirming modifications to Pacific Mutual Life's insurance policies, the California Supreme Court noted that because "the business of insurance is affected with a public interest [and] [t]he state has an important and vital interest in the liquidation or rehabilitation" of an insurance company, "[n]either the company nor a policyholder has the inviolate rights that characterize private contracts. The contract of the [insurance] policyholder is subject to the reasonable exercise of the state's police power." *Carpenter*, 74 P.2d at 774-75. *See also Minor*, 898 S.W.2d at 80 (same); *Vickodil v. Commonwealth*, 559 A.2d 1010, 1013 (Pa. Commw. Ct. 1989) ("when an insurance company is under threat of insolvency, or in a financially 'hazardous' condition, individual interests may need to be compromised in order to avoid greater harm to a broader spectrum of policyholders and the public").

More recently, in *In re Mutual Benefit Life Ins. Co.*, involving the rehabilitation (and ultimate liquidation) of a New Jersey insurance company that provided life, health and annuity products, the court approved a rehabilitation plan that provided for the immediate 12 percent reduction of principal account values on all policies, along with other impairments. 1993 N.J. Super. Lexis 940, at *20-21, *132-33 (N.J. Ch. Aug. 12, 1993). In approving the policy modifications, the *Mutual Benefit* court found that "the plan is generally fair and equitable to all parties." *Id.* at *142.

The New York Court of Appeals has also previously found that a rehabilitator has the authority to modify policy terms under a plan of rehabilitation. In *In re National Surety Co.*, 268 N.Y.S. 88, 91 (App. Div. 1st. Dep't 1933), *aff'd*, 191 N.E. 521 (N.Y. 1934), the Court of Appeals upheld an order confirming a plan of rehabilitation which established three new companies: (i) the first, which assumed all profitable business of the old company and paid the claims of policyholders holding such assumed policies in full as they matured, (ii) the second, which was organized to take care of obligations under poorly performing mortgage guaranties issued by the old company out of certain assets transferred to it and (iii) the third, which received certain frozen assets of the old company that would be used to pay certain obligations not assumed by the other two new companies. The plan was approved despite the fact that this rehabilitation scheme impaired the rights of persons entitled to payments under the mortgage guaranties because they could look only to the limited assets of the second new company for payment of their claims, rendering it unlikely they would be paid in full. In affirming the plan's approval over the objection of a creditor, the appellate court noted that "[w]hile it is true that one creditor or a few creditors may not be entirely satisfied, numerous other creditors and those dealing with the [insurer] will most likely be saved millions of dollars" and "[t]he plan suggested seems feasible and to be for the benefit of all concerned, especially the creditors." *Id.* at 96.

Other courts have also affirmed the authority of state insurance regulators to modify policy terms under a plan of rehabilitation.[9] Most recently, in *In re Rehab. of Segregated Account of Ambac Assurance Corp.* (the "**Ambac Proceeding**"), the only other court-supervised rehabilitation proceeding filed to date involving a financial guaranty insurance company, the Wisconsin Circuit Court confirmed a plan of rehabilitation providing for payments of policy claims through a mix of cash and interest-bearing surplus notes. In confirming the initial cash percentage payment of 25% of each allowed claim, the court noted that "[t]he initial cash-note split fairly balances the interests of short-tail policyholders who wish to be paid immediately, and long-tail policyholders concerned about Ambac having adequate resources to cover their future claims."[10]

Consistent with *Carpenter* and its progeny, the restructuring of policies in the Plan is fair and equitable to policyholders as a whole because, as explained above, it restructures insurance policies in a manner that enhances recoveries to policyholders and provides for uniform treatment of both short-term and long-term claimants. The Plan is also feasible in that the initial cash payment percentage is based on assumptions intended to ensure FGIC's ability to pay in cash at least that initial percentage with respect to all policy claims expected to be allowed under the Plan over the next 40 years, so as to benefit all policyholders.

[9] *See Grode v. Mutual Fire, Marine and Inland Ins. Co.*, 572 A.2d 798 (Pa. Commw. Ct. 1990), *aff'd in part sub nom. Foster*, 614 A.2d 1086 (citing *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983)) (affirming the approval of a plan of rehabilitation over the objection of policyholders who alleged their contractual rights were impaired by plan provisions based on a finding that the alleged impairments were (i) insubstantial because they were necessary "to achieve the desired consequence of satisfying all claims in an equitable and orderly manner" and (ii) reasonably necessary because they served the "legitimate public purpose of safeguarding the public interest from the potentially innumerable consequence of Mutual Fire's insolvency").

[10] Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation, With Findings of Fact and Conclusions of Law, Case No. 10-CV-1576, ¶104 (Wis. Cir. Ct. Jan 21, 2011) (appeals pending), *available at* http://ambacpolicyholders.com/court-filings/.

C. Policyholders Will Recover at Least What They Would Receive in a Liquidation of FGIC

In addition, the policy restructuring is also fair and equitable because it provides policyholders with more value than they would receive in a liquidation. As explained more fully in Section VIII of the Disclosure Statement, policyholders are expected to receive present value recoveries of approximately 24% to 25% of their policy claims allowed under the Plan, rather than only approximately 9.3% to 15.9% in a liquidation.[11] In addition, the Plan provides that FGIC will begin making payments with respect to allowed policy claims within five months after the effective date of the Plan, which is years earlier than such payments would be made in a liquidation.[12] Finally, the Plan provides that, aside from secured claims (which will be paid in full from the collateral securing such claims) and administrative expense claims (which will be paid in full in cash), policy claims will be paid in full, or fully reserved for, before other creditors receive a distribution, and holders of equity interests in FGIC will receive no distributions unless and until all claims of policyholders and other creditors have been paid in full in cash, or fully reserved for. In this respect, the Plan tracks the priority scheme governing the distribution of assets in New York liquidation proceedings set forth in Section 7434 of the NYIL and further demonstrates that holders of policy claims will receive at least what they would have received in a liquidation.

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[11] These ranges of recoveries under the Plan and in a liquidation are calculated on a net present value basis using discount rates of 20% and 10% and are based on the Run-Off Projections and Liquidation Analysis attached to the Disclosure Statement as **Exhibit C** and **Exhibit D**, respectively.

[12] Based on the Rehabilitator's experience and practice in making distribution payments in liquidation proceedings pursuant to Section 7434 of the NYIL, the Rehabilitator estimates that the first distribution in a liquidation of FGIC would occur approximately 15 years after the commencement of the liquidation. The Liquidation Analysis attached to the Disclosure Statement as **Exhibit D** provides a further explanation of the anticipated timing of claims payments in a hypothetical liquidation of FGIC.

III. THE REHABILITATOR HAS AUTHORITY TO CONSUMMATE THE TRANSACTIONS CONTEMPLATED BY THE NOVATION AGREEMENT AND THE CDS COMMUTATION AGREEMENTS

To mitigate FGIC's liabilities and increase recoveries for policyholders, the Rehabilitator seeks to consummate the transactions contemplated by the Novation Agreement and the CDS Commutation Agreements. Consummation of those transactions is within the Rehabilitator's authority, pursuant to the Order of Rehabilitation and Section 7403(a) of the NYIL, 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," and should be approved. Order of Rehabilitation ¶ 5.

<u>Novation Agreement and Novation of Related Reinsurance</u>

Pursuant to the Novation Agreement, FGIC and National Public have agreed that National Public will replace FGIC as the party obligated to make payments with respect to claims under policies having an aggregate par outstanding as of December 31, 2011 of approximately $138 billion. As a result, National Public will be directly responsible for all obligations under the policies covered by the Novation Agreement, and FGIC will be released from all obligations thereunder. Prior to the commencement of the Rehabilitation Proceeding, National Public had already agreed to make all payments directly to policyholders with respect to claims under the policies covered by the Novation Agreement, pursuant to a reinsurance agreement with FGIC. Under that reinsurance agreement, policyholders could look directly to National Public for payment of such claims and it was anticipated that National Public would pay all such claims regardless of whether the claims were submitted to National Public or FGIC or both. Policyholders needed to look to FGIC for payment only if and to the extent National Public was unwilling or unable to make a payment with respect to a policy claim (which has not happened to date).

Based on National Public's credit ratings and publicly-available financial statements, the Rehabilitator believes that National Public will continue to pay 100% of the claims asserted under the policies covered by the Novation Agreement in full as they arise. Accordingly, although these policyholders will no longer be able to look to FGIC for payment of claims, the Novation Agreement will not have any meaningful impact on them. Further, the Novation Agreement will relieve FGIC of any potential liability under those policies, resulting in a higher initial cash payment percentage with respect to policy claims, and higher overall recoveries for policyholders. Thus, the Novation Agreement is consistent with the Rehabilitator's authority to modify private contract rights pursuant to a plan of rehabilitation for the benefit of all policyholders.[13]

In conjunction with the Novation Agreement, the Plan also provides that National Public will replace FGIC as a party to certain reinsurance agreements FGIC had entered into with other insurance companies (referred to herein as the "reinsurers") to the extent such reinsurance agreements provide reinsurance on the policies covered by the Novation Agreement. Under those agreements, the reinsurers agreed to bear a portion of FGIC's liability under some of the policies that will be covered by the Novation Agreement, in exchange for a portion of the premiums FGIC collected from such policies. As FGIC is transferring all of the liability for such policies to National Public pursuant to the Novation Agreement, the Plan provides that all of these reinsurance agreements, to the extent such reinsurance agreements provide reinsurance

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[13] *See* Section II.B *supra*; *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 result of which they were no less bound than if their names had appeared as actual parties to that suit").

on the policies covered by the Novation Agreement, will concurrently be novated from FGIC to National Public.

As a result, with respect to the policies covered by the Novation Agreement, National Public will replace FGIC as the insurance company whose policies are reinsured under the reinsurance agreements. While the Plan changes the counterparty to such reinsurance agreements (from FGIC to National Public), with respect to the policies covered by the Novation Agreement, the risks reinsured by the reinsurers will not change. The novation of the reinsurance agreements to National Public, as discussed above, will ensure that reinsurance protection previously purchased by FGIC with respect to the policies being novated to National Public will continue in force (albeit now for the benefit of National Public) rather than potentially being extinguished as a result of the novation under the Novation Agreement. Accordingly, substitution of National Public for FGIC as a party to such reinsurance agreements, as discussed above, is appropriate and necessary to preserve protection that FGIC has previously obtained with respect to risks under such policies, and is consistent with the Rehabilitator's authority to modify private contract rights pursuant to a plan of rehabilitation for the benefit of all policyholders.[14]

CDS Commutation Agreements

As of the date of the filing of this Memorandum, three CDS Commutation Agreements have been executed. These CDS Commutation Agreements concern CDS entered into by FGIC's subsidiary, FGIC CP, and the policies FGIC issued to FGIC CP's counterparties to guarantee FGIC CP's payments under the CDS. These CDS Commutation Agreements will terminate those policies (as well as the underlying CDS) in exchange for payments by FGIC

[14] *See* Section II.B *supra*.

aggregating approximately $59.65 million. In exchange for those payments, FGIC will (i) eliminate all of its insured exposure (approximately $4 billion par outstanding) with respect to the CDS and certain other obligations covered by the three CDS Commutation Agreements, (ii) significantly reduce its statutory loss reserves (by approximately $361 million) and (iii) avoid any uncertainty, delay and costs that could arise from litigating approximately $1.7 billion in potential claims against FGIC that could arise from the termination of the CDS based on the Rehabilitation Proceeding or the financial condition of FGIC.

These CDS Commutation Agreements will cancel or "tear up" FGIC's policies for less than what the counterparties to the CDS Commutation Agreements would potentially receive under the Plan on account of allowed policy claims, if the CDS with such counterparties were not "torn up" or terminated early. The Rehabilitator continues to negotiate additional, similar CDS Commutation Agreements with counterparties to other CDS to further reduce FGIC's liabilities. The Rehabilitator will file these three CDS Commutation Agreements any additional CDS Commutation Agreements for Court approval in an update to the Plan Supplement (if executed by then). These additional CDS Commutation Agreements should be approved for the same reasons as the foregoing.

The Novation Agreement and the CDS Commutation Agreements preserve a significant amount of FGIC's assets, which will maximize recoveries for all policyholders and facilitate FGIC's return to statutory solvency. Accordingly, the Court should approve the consummation of the transactions contemplated by the Novation Agreement and the CDS Commutation Agreements as important steps towards removing the causes and conditions that made the Rehabilitation Proceeding necessary.

IV. THE INJUNCTIVE RELIEF IN THE PLAN IS NECESSARY AND AUTHORIZED BY THE NYIL

Section 7.8 of the Plan provides for certain permanent injunctive relief, including a prohibition on the exercise of certain contractual rights under FGIC's policies or related transaction documents that are triggered by FGIC's rehabilitation, financial condition or compliance with the 1310 Order or the Plan. The injunctive relief in the Plan falls within the Rehabilitator's authority pursuant to the Order of Rehabilitation and Section 7403(a) of the NYIL 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." Order of Rehabilitation ¶ 5. The injunctive relief in the Plan also falls squarely within the Court's authority under Section 7419(b) of the NYIL to "at any time during a proceeding under [Article 74] issue such other injunctions or orders as it deems necessary to prevent interference with the superintendent or the proceeding, or waste of the assets of the insurer, or the commencement or prosecution of any actions, the obtaining of preferences, judgments, attachments or other liens, or the making of any levy against the insurer, its assets, or any part thereof." N.Y. Ins. Law § 7419(b).

Further, granting permanent injunctive relief in a plan of rehabilitation is consistent with precedent in other jurisdictions. *See e.g. Ambac*, Plan of Rehabilitation, Case No. 10-CV-1576, § 8.01 (Wis. Cir. Ct. Jan. 24, 2011) (appeals pending), *available at* http://ambacpolicyholders.com/court-filings/ ("all Holders of Claims shall be permanently barred and enjoined from . . . commencing or continuing in any manner any action or other proceeding on account of [a] Claim, or the property to be distributed under the terms of [the] Plan"); *Grode v. Mutual Fire, Marine & Inland Ins. Co.*, Plan of Rehabilitation, Case No. 3483 1986, § XIII(E) (Pa. Commw. Ct. 1989) (ordering that "[a]ll persons, firms, governmental and business entities and corporations are hereby permanently restrained and enjoined from . . . interfering with or taking steps to interfere with Mutual Fire, its officers and agents or the operation of the properties or the conduct of the business of Mutual Fire, by reason or on account of any obligation or obligations incurred by Mutual Fire, except the obligations imposed upon Mutual Fire by the Plan or by the Order approving and confirming the Plan"); *Muir v. Transp. Mutual Ins. Co.*, 523 A.2d 1190, 1193-94 (Pa. Commw. Ct. 1987) (ordering that "[a]ll persons, firms, governmental and business entities and corporations are . . . permanently restrained and enjoined from instituting, prosecuting or pursuing, or attempting to institute, prosecute or pursue, any suits or proceedings, at law or in equity or otherwise" against the insurance company being rehabilitated or its successors or assigns or against any of the insurance company's assets or property).

The injunctive relief in the Plan is necessary to, among other things, prevent certain policyholders from using the commencement or continuation of the Rehabilitation Proceeding or FGIC's compliance with the 1310 Order or the Plan as grounds for increasing their own recovery, to the detriment of other FGIC policyholders. Absent such injunctive relief, recoveries to policyholders under the Plan could be significantly lower than anticipated.

A. Prohibiting the Exercise of FGIC Rights By Persons Other Than FGIC Is Necessary

One provision of injunctive relief in the Plan that affects potential recoveries to policyholders concerns "FGIC Rights."[15] Section 7.8(e) of the Plan prohibits all persons from,

[15] Section 7.8(e) of the Plan prohibits: "exercising or taking any action to exercise, including by asserting any defense based on the Rehabilitation or the occurrence or existence of any of the Rehabilitation Circumstances, any approval, consent, direction, determination, appointment, request, voting, veto, waiver or other right that [FGIC or FGIC CP] have (through the right to direct or grant or withhold consent with respect to such exercise or otherwise) (or that [FGIC or FGIC CP] would have but for the Rehabilitation or the occurrence or existence of any of the Rehabilitation Circumstances) under or with respect to any FGIC Contract or any Transaction Document executed in connection with the issuance of

among other things, exercising FGIC Rights, which are rights that FGIC has pursuant to various policies and other agreements that allow FGIC to, among other things, direct a trustee to take, or refrain from taking, certain actions with respect to securities, instruments or other obligations insured by FGIC, including actions relating to commencing or prosecuting legal proceedings or liquidating underlying collateral. Some of FGIC's policies and related agreements have *ipso facto* provisions, however, that suspend or terminate FGIC's right to direct a trustee with respect to these actions if FGIC is the subject of a rehabilitation proceeding or fails to make payments with respect to policy claims (even if ordered to cease paying claims by the NYSDFS). Allowing policyholders to exercise these provisions to take away FGIC's rights could result in significantly lower recoveries to policyholders under the Plan than anticipated.

Any contractual provision that deprives FGIC of rights due to a commencement of an insolvency proceeding is clearly an *ipso facto* clause that should not be enforced. Because the 1310 Order was issued by the Superintendent in an attempt to rehabilitate FGIC outside of a formal Article 74 proceeding, any provision in a policy or related transaction document that would deprive FGIC of rights by virtue of FGIC's failure to pay policy claims in accordance with the 1310 Order is functionally an *ipso facto* clause that also should not be enforced. In addition, FGIC should not be penalized for following an order of the Superintendent that was intended to address FGIC's deteriorating financial condition for the benefit of its policyholders.[16] Prohibiting the exercise of these contractual *ipso facto* provisions

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or entry into such FGIC Contract or related to such FGIC Contract or any obligations insured or covered thereby (all rights and remedies described in this clause, the "**FGIC Rights**")."

[16] *See In re W.R. Grace & Co.*, 2012 WL 2130981 at *74, n.133 (D. Del. June 11, 2012) (refusing to enforce a contractual provision to increase the interest rate on loans as a result of debtor's failure to repay the principal during the bankruptcy case due to imposition of the automatic stay, and stating that "[t]o now require [the debtor] to pay a higher interest rate as a result of its bankruptcy petition would effectively be punishing [the debtor] for seeking the bankruptcy relief to which it is lawfully entitled").

is crucial to protecting FGIC's interests for the benefit of all policyholders and falls squarely within the Court's authority under Section 7419 of the NYIL.

The Wisconsin court overseeing the Ambac Proceeding granted injunctive relief very similar to Section 7.8(e) of the Plan at the outset of that proceeding. *Ambac*, Order for Temporary Injunctive Relief, Case No. 10-CV-1576, ¶6 (Wis. Cir. Ct. Mar. 24, 2010), *available at* http://ambacpolicyholders.com/court-filings/. In overruling challenges to that relief, the Wisconsin court cited *Carpenter*, *Minor* and *Foster* in support of a rehabilitator's authority to alter contractual rights for the benefit of policyholders and held that "retention of these control rights in the Rehabilitator is vital to the rehabilitation and the carrying out of the Rehabilitator's duty." *Ambac*, Decision On . . . Challenges to the Temporary Injunction Concerning the Exercise of Control Rights, Case No. 10-CV-1576, 11 (Wis. Cir. Ct. Oct. 25, 2012), *available at* http://ambacpolicyholders.com/court-filings/. The Wisconsin court approved a plan of rehabilitation that continued this injunctive relief. *See Ambac*, Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation, With Findings of Fact and Conclusions of Law, Case No. 10-CV-1576, ¶9 (Wis. Cir. Ct. Jan 21, 2011) (appeals pending), *available at* http://ambacpolicyholders.com/court-filings/.

Section 7.8(e) of the Plan is also consistent with other insolvency regimes, such as federal bankruptcy and banking laws, which invalidate contractual *ipso facto* clauses. For example, Section 365(e)(1) of the Bankruptcy Code prohibits the enforcement of contractual *ipso facto* clauses that may otherwise trigger the termination or modification of a contract or lease with a debtor, or rights or obligations thereunder, based on the debtor's insolvency or financial condition or the commencement of a case under the Bankruptcy Code. 11 U.S.C. § 365(e)(1); *see also* 11 U.S.C. §§ 363(*l*) (invalidating *ipso facto* clauses that may otherwise interfere with a debtor's right to use, sell or lease property). Similarly, in the context of a Federal Deposit Insurance Corporation ("**FDIC**") receivership, federal law provides that "the conservator or receiver may enforce any contract . . . notwithstanding any provision of the contract providing for termination, default, acceleration, or exercise of rights upon, or solely by reason of, insolvency or the appointment or exercise of rights or powers by a conservator or receiver." 12 U.S.C. § 1821(e)(13)(A). "In granting the FDIC this power, Congress codified the common law rule that ipso facto provisions are void as contrary to public policy." *Bank of N.Y. v. FDIC*, 453 F.Supp.2d 82, 96 (D.D.C. 2006), *aff'd*, 508 F.3d 1 (D.C. Cir. 2007). Case law further supports the Court's authority to stay, modify or terminate individual contractual rights for the benefit of all policyholders and the public. *See e.g. Carpenter*, 74 P.2d at 774-75 (holding that, in an insurance rehabilitation proceeding, "[n]either the company nor a policyholder has the inviolate rights that characterize private contracts. The contract of the [insurance] policyholder is subject to the reasonable exercise of the state's police power."); s*ee also Minor*, 898 S.W.2d at 80 (same).

Absent Section 7.8(e) of the Plan, certain policyholders and other counterparties could take advantage of, among other things, the Rehabilitation Proceeding, FGIC's financial condition or FGIC's compliance with the 1310 Order or the Plan and exercise FGIC Rights to further their particular interests to the detriment of policyholders generally. For example, holders of bonds insured by FGIC who purchased such bonds at a discount could direct a trustee to liquidate collateral underlying instruments insured by FGIC to obtain a quick and certain recovery. Such action could crystallize significantly greater losses with respect to the FGIC-insured instruments than would have resulted if the collateral had not been liquidated early, thereby generating higher policy claims against FGIC and diluting recoveries for policyholders overall. Allowing these holders to exercise FGIC Rights in this manner conflicts with "the paramount purpose of article 74," which "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 (App. Div. 1st Dep't 1989) (citing *Knickerbocker Agency, Inc. v. Holz*, 4 N.Y.2d 245, 253 (1958)). Accordingly, FGIC should be allowed to retain its FGIC Rights and the ability to exercise them, which will benefit policyholders as a whole.

B. The Exception to Section 7.8(e) of the Plan for Exercising Certain FGIC Rights Relating to the Proceeds of Trust Loan Repurchase Obligations Is Reasonable and in the Best Interests of FGIC's Policyholders

Notwithstanding the foregoing, Section 3.7 of the Plan provides an exception to Section 7.8(e) (and certain other provisions) of the Plan for holders of securities, instruments and other obligations insured by FGIC policies and issued directly in connection with any residential mortgage backed securities ("**RMBS**") transaction, during any period of time in which an outstanding DPO exists with respect to such policies. This exception is explained more fully in Section VI.B.8 of the Disclosure Statement. Pursuant to this exception, FGIC will share with those holders certain rights related to "Trust Loan Repurchase Obligations" that are provided for under the express terms and conditions of the transaction documents relating to the insured securities, instruments and other obligations (assuming solely for the purposes of determining these rights that FGIC has not complied with its payment obligations under the related policies).

The Rehabilitator has determined that this exception to Section 7.8(e) is reasonable and in the best interests of FGIC's policyholders for several reasons. The exception in Section 7.8(e) of the Plan is limited to a specific category of FGIC Rights – principally, the right to direct a trust to commence, prosecute and settle a litigation on behalf of a trust against a mortgage originator to compel the originator to comply with its obligation to cure, substitute or repurchase a defective mortgage underlying a security, instrument or other obligation insured by FGIC. FGIC to date has not directed any trust to bring such litigation, opting instead to pursue its own causes of action directly against mortgage originators and other related parties (referred to in the Plan as "FGIC Direct Claims"). The Rehabilitator does not intend to preclude trusts from bringing such litigation, and, accordingly, has determined it appropriate to give holders of securities, instruments and other obligations who would have rights to direct trustees to bring such litigation in the absence of the injunctive relief in Section 7.8(e) of the Plan an opportunity to do so. It is anticipated that any settlements or litigation recoveries so obtained by the trusts should decrease the amount of policy claims asserted against FGIC, thus enhancing overall recoveries for FGIC's policyholders.

Section 3.7(d) of the Plan explicitly provides that nothing in the Plan, including the other provisions of Section 3.7 thereof, will prevent, limit, restrict or otherwise impair FGIC's pursuit of any FGIC Direct Claims, including those related to Trust Loan Repurchase Obligations. Accordingly, the Rehabilitator has determined that FGIC's policyholders have nothing to lose, and in fact may gain, from holders of certain securities, instruments and other obligations exercising FGIC Rights in the limited context related to Trust Loan Repurchase Obligations, as set forth in Section 3.7 of the Plan. Thus, the carve-out in Section 7.8(e) for the exercise of FGIC Rights pursuant to Section 3.7 of the Plan is fair and equitable to policyholders as a whole and should be approved.

V. AN ORDER TERMINATING THE REHABILITATION PROCEEDING ON THE EFFECTIVE DATE OF THE PLAN IS WARRANTED

Section 7403(d) of the NYIL provides that "[t]he rehabilitator . . . at any time, may apply for an order terminating any rehabilitation proceeding and permitting such insurer to resume possession of its property and the conduct of its business." N.Y. Ins. Law § 7403(d).

Further, “no such order shall be granted except when, after a full hearing, the court shall determine that the purposes of the proceeding have been fully accomplished.” *Id.* The Rehabilitator submits that, as of the effective date of the Plan, the purposes of the proceeding will have been fully accomplished. On the effective date of the Plan,[17] the restructuring of FGIC’s policies, as described above, will go into effect. The policy restructuring provides that FGIC will start performing its modified obligations under the Plan, while maintaining at least the minimum policyholders’ surplus required for a financial guaranty insurance company under Section 6902(b)(1) of the NYIL. In addition, the restructuring of FGIC’s policies allows FGIC the flexibility to increase or decrease cash distributions on account of policy claims, with NYSDFS oversight, to maximize recoveries and fair distributions to policyholders over time. Thus, the purposes of this Rehabilitation Proceeding will have been fully accomplished as of the effective date of the Plan. *See State Corp. Comm’n v. Shenandoah Life Ins. Co.*, Final Order Approving Plan of Conversion, Rehabilitation Plan, and Acquisition of Control, and Granting Related Relief, Case No. INS-2011-00155, ¶5 (Va. State Corp. Comm’n Oct. 20, 2011), *available at* https://www.shenlife.com/home/wcm/news/2011-10-20_SC_Order_Approving_Plan_of_ Conversion.PDF (“following the implementation of the Rehabilitation Plan, and upon the last to occur of the Closing, expiration of the Bar Date, and expiration or termination of any Extension of Moratorium on Cash Withdrawals . . . the purposes

[17] Section 6.1 of the Plan provides that the effective date of the Plan will not occur unless and until nine conditions precedents are satisfied in full or waived by the Rehabilitator. These conditions precedent include, among other things, that the order approving the Plan is signed and becomes a final order, the Court approves the Novation Agreement and each CDS Commutation Agreement, the Chapter 11 Plan of Reorganization of FGIC Corporation confirmed by the United States Bankruptcy Court for the Southern District of New York on April 23, 2012 becomes effective and the Rehabilitator receives certain requested rulings from the Internal Revenue Service, in form and substance satisfactory to the Rehabilitator in his sole discretion. Section 6.2 of the Plan provides that once each of the conditions precedent are satisfied or waived, the Rehabilitator will file notice with the Court and post a notice in the Policyholder Information Center indicating the effective date of the Plan.

of the rehabilitation proceeding will be accomplished and Shenandoah can safely and properly resume possession of its property and the conduct of its business.”).

As described in Section VII.F of the Disclosure Statement, the Rehabilitator considered, and ultimately rejected, alternatives to the Plan that would require keeping FGIC in a long-term rehabilitation or liquidation proceeding. The expense of administering a prolonged rehabilitation or liquidation proceeding would reduce the pool of available assets of the FGIC estate and diminish recoveries for all policyholders. Further, a lengthy rehabilitation or liquidation proceeding would unnecessarily delay payments in respect of policy claims, even though some holders of these claims have already waited several years for payment. Thus, the Rehabilitator has determined that termination of the Rehabilitation Proceeding on the effective date of the Plan and the continued run-off of FGIC in accordance with the Plan outside of the Rehabilitation Proceeding, without the overhead costs associated with a court proceeding, is in the best interests of FGIC’s policyholders and other claimants.

CONCLUSION

The Plan is fair and equitable to policyholders as a whole and provides them with at least the recovery they would be expected to receive in a liquidation of FGIC. Therefore, the Court should approve the Plan, including the Novation Agreement, the CDS Commutation Agreements 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: October 25, 2012
New York, New York

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ADDENDUM

Example: Policyholders' Payment Obligations

The following example illustrates how the Plan treats policyholders' payment obligations:

Hypothetical Fact Pattern:

- Prior to the 1310 Order, a trustee, as policyholder, submits a claim for $1.5 million under an insurance policy issued by FGIC which insures the payment of principal and interest under certain RMBS issued by the related issuer.
- FGIC pays the $1.5 million claim in full prior to the 1310 Order, but has not been reimbursed for such claim at any time prior to or after the 1310 Order.
- After the 1310 Order, but prior to the effective date of the Plan, the trustee submits another claim for $5 million under the same insurance policy and then receives $2.5 million as proceeds from the mortgage loans securing the securities issued by the issuer.
- Assume that FGIC would have been entitled to the entire $2.5 million of the proceeds under the terms of the underlying insurance policy and related transaction documents as reimbursement for the $6.5 million of unreimbursed claims (assuming that FGIC paid both the $1.5 million and the $5 million claims in full and no defaults related to the Rehabilitation Proceeding, the financial condition of FGIC or FGIC's compliance with the 1310 Order or the Plan ever existed).
- Trustee fails to remit any of the proceeds to FGIC as required under the related transaction documents.
- At the time FGIC permits the $5 million claim, the cash payment percentage (or "CPP") is 15%.

Application of Plan to Hypothetical Fact Pattern:

- Before making a cash distribution under the Plan on account of the $5 million claim, FGIC would calculate the amount of payments owed to FGIC by the trustee, and the amount of any such payments that are unpaid and may be setoff against the cash distribution.
- Thus, as of the date of such calculation, the payment the trustee would owe FGIC would be comprised of (i) $1.5 million, as reimbursement for the $1.5 million pre-1310 Order claim that FGIC paid in full and (ii) $0.15 million (the CPP (15%) of the $1 million proceeds available after reimbursement of the pre-1310 Order claim), for a total of $1.65 million.
- To the extent the trustee does not pay the $1.65 million to FGIC, FGIC would have the right to setoff the entire unpaid amount (the $1.65 million) against the cash distribution of $0.75 million (the CPP (15%) of the $5 million claim) it would otherwise owe to the trustee on account of the $5 million allowed claim.
- FGIC would also then be entitled to reduce the DPO for the subject policy by the balance of the unpaid amount ($0.9 million ($1.65 million less $0.75 million)) and setoff such balance against any future cash distributions to the trustee under the Plan under the same policy (and increase the DPO for such policy by the amount of any such setoff).