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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	Case No. 12-12020 (MG)
RESIDENTIAL CAPITAL, LLC, et al.,	Chapter 11
Debtors.	Jointly Administered
RESIDENTIAL CAPITAL, LLC, et al.,	Adv. Case No. 13-01262 (MG)
Plaintiffs,	
v.	**MEMORANDUM OF LAW IN SUPPORT OF DEBTORS' MOTION FOR SUMMARY JUDGMENT**
ALLSTATE INSURANCE COMPANY, et al.,	
Defendants.	



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The debtors and debtors-in-possession (collectively, the "Debtors") in the above-captioned jointly administered Chapter 11 cases,[1] and as plaintiffs in the above-captioned adversary proceeding (this "Adversary Proceeding"),[2] pursuant to Federal Rule of Civil Procedure 56, made applicable here by Rule 7056 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), respectfully submit this Memorandum of Law in support of their Motion for Summary Judgment.

PRELIMINARY STATEMENT

The Debtors seek an order: (i) declaring that to the extent the securities claims asserted by the defendants (the "Investor Claims") are allowed, if at all, they are subordinated pursuant to Section 510 of title 11 of the United States Code (the "Bankruptcy Code") to all general unsecured claims asserted against the Debtors' estates; and/or (ii) granting subordination,

---

[1] The Debtors are listed in the Affidavit of James A. Whitlinger, sworn to on May 14, 2012, *In re Residential Capital, LLC*, No. 12-12020 (MG) (Bankr. S.D.N.Y.) [Docket No. 6].

[2] Defendants AIG Asset Management (U.S.), LLC and affiliated entities (collectively, "AIG"), Allstate Insurance Company and affiliated entities (collectively, "Allstate"), Massachusetts Mutual Life Insurance Company ("MassMutual"), and Prudential Insurance Company of America and affiliated entities (collectively, "Prudential") filed the *Investors' Motion for an Order Under Bankruptcy Rule 3013 (i) Classifying RMBS Fraud Claims in the Same Class as the Securitization Trusts' Claims for Purposes of any Chapter 11 Plan for the Debtors and (ii) Directing That Misrepresentation Claims Cannot Be Placed in a Plan Class That Will Be Subordinated Under Bankruptcy Code Section 510(b)*, dated Nov. 27, 2012 [Docket No. 2284] (the "Rule 3013 Motion" or "Rule 3013 Mot."). Defendant National Credit Union Administration Board (collectively with AIG, Allstate, MassMutual, and Prudential, the "Investors") then joined the Rule 3013 Motion [Docket No. 2555]. On February 19, 2013, the New Jersey Carpenters Health Fund ("Lead Plaintiff") and the certified class represented by Lead Plaintiff, the Union Central Life Insurance Company, Ameritas Life Insurance Corporation, and Acacia Life Insurance Company, and Cambridge Place Investment Management Inc. also joined the Rule 3013 Motion. [Docket Nos. 2962, 2964, 2966]. Also on February 19, 2013, the Debtors filed an opposition to the Rule 3013 Motion [Docket No. 2953], and also commenced this Adversary Proceeding to address the dispute underlying the Rule 3013 Motion pursuant to Bankruptcy Rule 7001. *See* Complaint, filed on Feb. 19, 2013, *Residential Capital, LLC v. Allstate Ins. Co.*, Case No. 12-12020, Adv. Pro. 13-01262 (MG) (Bankr. S.D.N.Y.) [Docket No. 2970, Adv. Pro. Docket No. 1] (the "Complaint"). A number of other parties likewise filed oppositions to the relief sought in the Rule 3013 Motion. [Docket Nos. 2954, 2955, 2957, 2959, 2967, 2954, 2968].

pursuant to Section 510 of the Bankruptcy Code, of the Investor Claims, to the extent (if any) that they are allowed. The Debtors also seek an order denying the Investors' Rule 3013 Motion.

There are three independent grounds for subordination of the Investor Claims:

- ***First,*** under Section 510(b) of the Bankruptcy Code, the Investor Claims arise out of the purchase of securities of the Debtors (*see* Section I.A). Alternatively, the Investor Claims arise out of the purchase of securities of "affiliates" of the Debtors as that term is defined by the Bankruptcy Code (*see* Section I.B);

- ***Second,*** Section 510(a) of the Bankruptcy Code requires subordination in order to enforce the subordination agreements among Certificateholders (defined below), by ensuring that recovery flows through the agreed-upon waterfall (*see* Section II); and

- ***Third,*** "no fault" equitable subordination pursuant to Section 510(c) is appropriate in order to prevent a series of inequitable consequences that would result absent subordination (*see* Section III).

Because these issues can be resolved on the basis of the contractual documents that govern the securitizations and a limited number of undisputed facts, this matter is ripe for summary judgment and the Debtors' motion should be granted.

Subordination is necessary to prevent the Investors from getting two bites at the apple. As explained below, failure to subordinate the Investor Claims would result in all general unsecured claims being diluted so the Investors can receive two recoveries. The Investors seek to achieve this result by claiming that the Debtors are issuers of their securities insofar as is necessary to give rise to the securities claims that the Investors have asserted against the Debtors, but not when it comes to the Bankruptcy Code's requirement that such securities claims be subordinated. The Investors cannot have it both ways.

The Investors do not dispute that the claims they have asserted against the Debtors are for damages and/or rescission arising from the purchase or sale of securities within the meaning of Section 510(b). (Rule 3013 Mot. at 2) Nonetheless, they attempt to evade

subordination by arguing that their securities are not "of" the Debtors or "of an affiliate" of the Debtors, because the securities represent interests in non-Debtor trusts. This argument fails, because the securities at issue were created by the Debtors, marketed by the Debtors, and backed by assets originated or purchased and serviced by the Debtors. In short, the Debtors are the issuers of the residential mortgage-backed securities ("RMBS" or "Certificates") in every meaningful sense, and they are recognized as such under the securities laws and in the Investors' own allegations. Thus, the securities are "of" the Debtors. In addition, the RMBS securitization trusts (each a "Trust" and collectively, the "Trusts") are "affiliates" of the Debtors as defined in Section 101(2)(C) of the Bankruptcy Code, because at the time that the Investor Claims arose, the Debtors operated the business or substantially all of the property of the Trusts as servicers of the mortgage loans in the Trusts pursuant to Pooling and Servicing Agreements. The Investor Claims are thus subordinated claims pursuant to the terms of Section 510(b) of the Bankruptcy Code.

Subordination is also required under Section 510(a) of the Bankruptcy Code, in order to enforce the Certificateholders' contractually agreed-upon waterfall of payments among tranches. This waterfall constitutes an enforceable subordination agreement under Section 510(a).

Not only is subordination required, it is the only fair and equitable result. Contractual claims by the trustees on behalf of the RMBS Trusts based upon alleged breaches of representations and warranties concerning the mortgage loans (the "Trust Claims") are expected to be included within the pool of general unsecured claims. Each Certificateholder will receive its pro rata portion of the Trust Claims' recovery according to the priority scheme expressly agreed to among Certificateholders within each securitization waterfall. The Investors are

seeking a further recovery for investment losses on many of the same Certificates, based upon complaints of fraud that mirror the Trust Claims. As a result, elevating the Investors Claims to the same priority as general unsecured creditors will have numerous inequitable effects if those contingent and disputed securities fraud litigation claims are ever allowed in any amount.

First, proceeds available to pay general unsecured creditors will be divided among more claimants, thereby diminishing recovery for all general unsecured creditors, except for current Certificateholders with Investor Claims. Those Certificateholders will receive two recoveries (one for their securities claim, and the other based on the Trust Claims) stemming from losses on the same Certificates. Each of these current Certificateholder recoveries would be based upon similar allegations that the Debtors made misrepresentations concerning the loans sold into the securitizations.

Second, treating the Investor Claims and Trust Claims as claims of equal priority would violate the express subordination agreement between junior and senior tranches of Certificates because the junior holders would recover on their securities claims on equal priority with all other general unsecured creditors, before more senior tranches are made whole.

Third, granting equal priority to the Investor Claims (brought on behalf of only a subset of senior Certificateholders) would violate the allocation of rights within the most senior tranches. Including those Investor Claims in the same pool would reduce the recovery that other senior holders receive from the Trusts, leading to unequal recovery within the same tranche even though the governing agreements provide for pro rata distribution within each tranche.

Fourth, failure to subordinate the Investor Claims would prejudice secondary purchasers of Certificates. Under the Certificates' governing agreements, current holders are entitled to receive any recovery for past losses. Absent subordination, the current

Certificateholders' recovery on account of the Trust Claims would be diluted so that former Certificateholders who sold the right to recover past losses on the instruments could nevertheless share in the funds by virtue of the Investor Claims, thus depriving the secondary purchasers of the Certificates from obtaining the benefit of their bargain.

Section 510 of the Bankruptcy Code expressly provides for the subordination of claims as the means to prevent these sorts of inequitable consequences. The Debtors' Motion for Summary Judgment should, therefore, be granted.

UNDISPUTED FACTS

The undisputed facts upon which this summary judgment motion is based are set forth in the accompanying Local Rule 7056-1 Statement of Stipulated Undisputed Facts and Agreed-To Exhibits (the "Local Rule 7056-1 Statement").[3]

STANDARDS ON THIS MOTION

Federal Rule of Civil Procedure 56 applies in adversary proceedings pending in bankruptcy court. *See* Fed. R. Bankr. P. 7056. A court should grant summary judgment under Rule 56 where "the pleadings, the discovery and disclosure materials on file, and any affidavits show that there is no genuine issue as to any material fact and that the movant is entitled to judgment as a matter of law." *Beyer v. Cnty. of Nassau*, 524 F.3d 160, 163 (2d Cir. 2008) (citing Fed. R. Civ. P. 56(a)). Non-material fact issues will not prevent a court from awarding a party summary judgment. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247-48 (1986) ("[T]he mere existence of *some* alleged factual dispute between parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact.") (emphasis in original). Facts are material only if they "might affect the

[3] The exhibits cited herein with the prefix "Ex. __" are part of the agreed-to exhibits attached to the Local Rule 7056-1 Statement.

outcome of the suit under the governing law." *Overton v. N.Y. State Div. of Military & Naval Affairs*, 373 F.3d 83, 89 (2d Cir. 2004) (citing *Anderson*, 477 U.S. at 248).

On a summary judgment motion, the movant bears an initial burden "to come forward with evidence on each material element of his claim or defense, demonstrating that he is entitled to relief." *Isaac v. City of N.Y.*, 701 F. Supp. 2d 477, 485 (S.D.N.Y. 2010). Once the movant has made this initial showing, however, the nonmoving party then must provide evidence of a genuine issue of fact in order to defeat the motion. *See Gorzynski v. Jetblue Airways Corp.*, 596 F.3d 93, 101 (2d Cir. 2010) (citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586 (1986)). The non-movant needs to demonstrate more than "some metaphysical doubt as to the material facts," and come forward with "specific facts showing that there is a *genuine issue for trial*." *Matsushita*, 475 U.S. at 587 (citations omitted) (emphasis in original). Otherwise, "the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a).

The Complaint raises no triable issues of fact. The issue of whether, under Section 510 of the Bankruptcy Code, the Investor Claims should be subordinated can be decided based on how the securities laws define the "issuer" of an RMBS security, along with the undisputed securitization documents (*see* Local Rule 7056-1 Statement), which set forth the legal structure and relative rights and roles of the parties vis-à-vis the RMBS securitizations.

ARGUMENT

The Debtors are entitled to summary judgment on their Complaint. First, Section 510(b) of the Bankruptcy Code requires subordination of the Investor Claims because they seek damages and/or rescission and "arise from" the purchase of securities that the Debtors or affiliates of the Debtors issued. (*See* Section I.) Second, the Investor Claims should be subordinated pursuant to Section 510(a) to enforce the express and implied subordination agreements among Certificateholders. (*See* Section II.) Third, to the extent that the Investor

Claims are not subordinated pursuant to Sections 510(a) or 510(b), they should alternatively be equitably subordinated pursuant to Section 510(c) to prevent the series of inequitable consequences that would otherwise result. (*See* Section III.) At bottom, the Investors are seeking two bites at the apple: a general unsecured claim based on their securities fraud claims and a separate recovery on equal priority based on the Trust Claims. The Bankruptcy Code does not permit this result. Last, the Investor Claims are fundamentally different from the Trust Claims, and therefore cannot be similarly classified pursuant to 11 U.S.C. § 1122 of the Bankruptcy Code. (*See* Section IV.)

I. THE INVESTOR CLAIMS ARE SUBORDINATED PURSUANT TO SECTION 510(B) OF THE BANKRUPTCY CODE

Under Section 510(b) of the Bankruptcy Code, any claim for rescission or for "damages arising from the purchase or sale of" a "security of the debtor or of an affiliate of the debtor" is "subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security." 11 U.S.C. § 510(b).[4] The Investors concede that their claims arise from the purchase or sale of a security, but dispute that their securities are "of" a Debtor or "of an affiliate" of a Debtor. (*See* Rule 3013 Mot. at 17-22.) The Investors are wrong.

Congress enacted Section 510(b) of the Bankruptcy Code to preclude holders of securities from elevating their claims to that of unsecured creditors through securities fraud claims for damages or rescission. *See SeaQuest Gen. Holdings LLC v. S & J Diving Inc. (In re*

[4] The Investors do not (and cannot) dispute that the Certificates are "securities." (Rule 3013 Mot. at 18; *see also* 11 U.S.C. § 101(49)(A) (defining "security" to include not just equity but also any note, bond, debenture, transferable share, or "other claim or interest commonly known as a 'security'"); *Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 260 B.R. 517, 525-26 (10th Cir. BAP 2001) (affirming bankruptcy court decision to subordinate under Section 510(b) claims arising from purchase or sale of notes); *NationsBank, N.A. v. Commercial Fin. Servs., Inc. (In re Commercial Fin. Servs., Inc.)*, 268 B.R. 579, 600 (Bankr. N.D. Okla. 2001) (finding that a note issued by a trust on account of certificates, which were issued by an asset-backed trust to the trust, constituted a "security" for purposes of Section 510(b).

Seaquest Diving LP), 579 F.3d 411, 418-19 (5th Cir. 2009); *Rombro v. Dufrayne (In re Med Diversified, Inc.)*, 461 F.3d 251, 256 (2d Cir. 2006). Section 510(b) subordinates securities claims to enforce the "absolute priority rule," under which securities holders who enjoy the benefits of ownership of a security – benefits beyond those of a general unsecured creditor – must also bear greater risk of insolvency. *CIT Grp. Inc. v. Tyco Int'l Ltd. (In re CIT Grp. Inc.)*, 460 B.R. 633, 640 (Bankr. S.D.N.Y. 2011) (citing *Baroda Hill Invs., Ltd. v. Telegroup, Inc. (In re Telegroup, Inc.)*, 281 F.3d 133, 139-40 (3d Cir. 2002)). "While the expectation of a general unsecured creditor is merely to be paid for a good or service, or to be repaid with interest, the expectation of a purchaser of a security can include an interest in proceeds or profits or other benefits unavailable to general unsecured creditors." *NationsBank, N.A. v. Commercial Fin. Servs., Inc. (In re Commercial Fin. Servs., Inc.)*, 268 B.R. 579, 592 (Bankr. N.D. Okla. 2001). Section 510(b) is, consistent with Congressional intent, to be given "a liberal construction." *In re Einstein/Noah Bagel Corp.*, 257 B.R. 499, 508 (Bankr. D. Ariz. 2000).

A. The Certificates Purchased by the Investors Are Securities "of" the Debtors

The Certificates are securities "of" the depositor-Debtors.[5] The securities laws recognize that the depositor-Debtors (against whom the Investors have asserted securities law

[5] The Debtors and the Investors have agreed to use the example deal, RALI Series 2006-QO3, for illustrative purposes. Certain of the governing documents for this example deal are attached to the Local Rule 7056-1 Statement, including the Prospectus for Mortgage Asset-Backed and Manufactured Housing Contract Pass-Through Certificates, dated March 3, 2006 ("Prospectus" or Pros.") (Ex. 2) and the Prospectus Supplement, dated March 28, 2006 ("ProSupp") (Ex. 3). The Debtors and the Investors agree that their respective rights are set forth in the governing documents for RALI Series 2006-QO3, and that, other than changes in the identity of the Debtor entity acting in the roles of depositor, sponsor or servicer, none of the documents for other Debtor RMBS securitizations differ in any respect material for purposes of this Adversary Proceeding from the RALI Series 2006-QO3 documentation. (Local Rule 7056-1 Statement ¶ 22.)

claims), not the passive Trusts created by them, are the relevant parties issuing the securities, and the facts unambiguously support the same conclusion.

1. The Depositor-Debtors Are the Issuers of the Certificates

For purposes of Section 510(b), securities are securities "of a debtor" if the securities were "issued by the debtor." *Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 281 F.3d 1173, 1177 (10th Cir. 2002); *Brown v. Owens Corning Inv. Review Comm.*, 541 F. Supp. 2d 958, 970 (N.D. Ohio 2008), *aff'd*, 622 F.3d 564 (6th Cir. 2010); *see also Alfa, S.A.B. de C.V. v. Enron Creditors Recovery Corp. (In re Enron Creditors Recovery Corp.)*, 422 B.R. 423, 437 (S.D.N.Y. 2009), *aff'd*, 651 F.3d 329 (2d Cir. 2011) ("The securities laws, and their interpretations, are thus a natural and logical place to turn for definitions of terms within the Bankruptcy Code that are otherwise undefined."). In the context of mortgage-backed securities, the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") both provide that the "'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued." Securities Act § 2(a), 15 U.S.C. § 77b(a)(4); Exchange Act § 3(a)(8), 15 U.S.C. § 78c(a)(8) (verbatim). The federal regulations promulgated under both the Securities Act and the Exchange Act, SEC Rules 191 and 3b-19, respectively, similarly provide that "[t]he depositor for the asset-backed securities acting solely in its capacity as depositor to the issuing entity is the 'issuer' for purposes of the asset-backed securities of that issuing entity." 17 C.F.R. § 230.191(a); 17 C.F.R. § 240.3b-19(a) (verbatim).[6]

[6] *See also* 2002 Uniform Securities Act § 102(17)(A) ("The 'issuer' of a collateral trust certificate . . . or share in an investment [trust] without a board of directors or persons performing similar functions, is the person performing the acts and assuming the duties of depositor or

Furthermore, almost every state's blue sky law defines the term "issuer," in the context of collateral trust certificates or certificates of interest or shares in an unincorporated investment trust not having a board of directors, as the person performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the security is issued. *See, e.g.*, Ariz. Rev. Stat. § 44-1801(13)(a) (adopting a substantially identical definition for the term "issuer"); Cal. Corp. Code § 25010(a) (same); Conn. Gen. Stat. § 36b-3(13)(A) (same); 815 Ill. Comp. Stat. 5/2.2 (same); Iowa Code § 502.102(17)(a) (same); Ky. Rev. Stat. § 292.310(13) (same); La. Rev. Stat. § 51:702(8) (same); Mass. Gen. Laws ch. 110A § 401(f) (same); Miss. Code § 75-71-105(i) (same); Mont. Code § 30-10-103(13) (same); Neb. Rev. Stat. § 8-1101(9) (same); Nev. Rev. Stat. § 90.255(1) (same); N.J. Stat. § 49:3-49(h) (same); N.C. Gen. Stat. § 78A-2(5)(a) (same); N.D. Cent. Code § 10-04-02(12)(a) (same); Or. Rev. Stat. § 59.015(9) (same); 70 Pa. Cons. Stat. § 1-102(l) (same); Wash. Rev. Code § 21.20.005(10) (same); W. Va. Code § 32-4-401(i) (same); Wyo. Stat. § 17-4-113(a)(vi) (same). Thus, while the Trusts are also "issuing entit[ies]" (*id.*), the securities laws recognize that the depositor, not the passive Trust, is the responsible entity. *See also Fed. Hous. Fin. Agency v. UBS Americas, Inc.*, 858 F. Supp. 2d 306, 333-34 (S.D.N.Y. 2012) (holding that mortgage depositor (and not RMBS trust) is the proper defendant for alleged violations of securities laws).

The legislative history confirms Congress's view that "the depositor is the person responsible for the flotation of the issue" and "information relative to the depositor and to the basic securities is what chiefly concerns the investor." H.R. Rep. No. 85, 73 Cong., 1st Sess. 13 (1933). "[T]he duty of furnishing this information is placed upon the actual manager of the trust

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manager pursuant to the trust or other agreement or instrument under which the security is issued.").

and not the passive trustee, and this purpose is accomplished by defining 'issuer' as in such instances referring to the depositor or manager." *Id.* The caselaw also recognizes that it is the depositors in securitizations who are the issuers, and the Investors concede as much. *See, e.g.*, *United States v. York*, 112 F.3d 1218, 1219-20 (D.C. Cir. 1997) ("The banking institutions that originate mortgage loans and issue mortgage-backed securities are known as 'issuers.'"); Ex. 16 (First Am. Compl., *Allstate Ins. Co. v. GMAC Mortg., LLC*, No. 27-cv-11-3480 (Minn. Dist. Ct. Apr. 15, 2011) ("Allstate FAC")) ¶ 20 ("The Depositors are considered issuers of the Certificates within the meaning of Section 2(a)(4) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(4), and in accordance with Section 11(a), 15 U.S.C. § 77k(a).").

The depositor-Debtors are issuers not just by the technical definition. The depositor-Debtors "acquired and pooled the mortgage loans, *created the securities*, and marketed and sold the Certificates at issue." (Ex. 16 (Allstate FAC) ¶ 64 (emphasis added); *see also id.* ¶ 37.) After the loans are placed into tranches, "the issuing trust passes the securities or certificates back to the depositor, *who becomes the issuer of the securities*." (*Id.* ¶ 38 (emphasis added).) "The depositor then passes the securities to one or more underwriters, who offer and sell the securities to investors in exchange for cash that is passed back to the depositor." (*Id.*) The depositor-Debtors prepared the prospectus, the prospectus supplement, and other offering documents for each of their securitizations.

The ProSupp provides that:

- The depositors established the Trusts to issue the Certificates. (Ex. 3 (ProSupp) at S-9.)
- The depositors filed the registration statement with the United States Securities and Exchange Commission and "[t]he depositor and each issuing entity are also subject to some of the information requirements of the" Exchange Act. (*Id.* at S-105 ("Additional Information" section).)

- "Substantially all of the net proceeds to be received by the depositor from the sale of certificates will be applied by the depositor to finance the purchase of, or to repay short-term loans incurred to finance the purchase of, the mortgage collateral underlying the certificates or will be used by the depositor for general corporate purposes." (*Id.* at S-104 ("Use of Proceeds" section).)

- The depositor controlled how the Certificates were offered. (*Id.* at S-104-105 ("Methods of Distribution" section).)

In short, as acknowledged by Allstate and MassMutual, the Debtors "controlled . . . every aspect of the securitization process, from loan origination through sale to Allstate." (Ex. 16 (Allstate FAC) ¶ 64; *see also* Ex. 17 (Am. Compl., *Mass. Mutual Life Ins. Co. v. Residential Funding Co.*, No. 3:11-cv-30035-MAP (D. Mass. May 17, 2012) [Docket No. 86] ("MassMutual AC")) ¶ 219 ("The Sponsor (Residential Funding), Depositors (RALI, RAMP, and RASC), and Underwriters (Residential Securities and UBS) *qualify as sellers of the Certificates* because they *issued*, marketed and/or *sold* the Certificates to the public." (emphasis added)).) The depositor-Debtors were the issuers of the RMBS in every meaningful sense.

Indeed, it is precisely because the depositor-Debtors are the "issuers" of the RMBS that the Investors have asserted federal securities claims against the Debtors. For purposes of their securities fraud claims, the Investors acknowledge that the Debtors are the issuers of the RMBS. However, for purposes of Section 510(b) subordination, the Investors take the contrary position – that the Certificates are *not* of the Debtors (or their affiliates), and that the federal securities laws are "irrelevant." (Rule 3013 Mot. at 19.) The Investors cannot have it both ways.

2. The Investors' Contrary Position is Misguided

Ignoring both the securities laws and their own allegations, the Investors maintain that the RMBS are not securities "of" any Debtor, because the Trusts themselves are not Debtors and because the Certificates represent an ownership interest in the Trusts. But that makes no

difference. The Trusts were passive vehicles that the Debtors used to structure the RMBS. The Trusts did not have employees. They did not originate mortgage loans or make any decisions as to how the mortgage loans would be pooled or securitized, nor did they prepare any of the offering materials. The Trusts do not service the underlying mortgages.

In re Washington Mutual, Inc., 462 B.R. 137 (Bankr. D. Del. 2011) does not support the Investors' position, both because that opinion was subsequently called into question by the court that issued it, and because it is factually inapposite. First, the *Washington Mutual* court itself declined to follow the opinion when denying other claimants' motion to reclassify claims based on the same underlying securities. (*See* Hr'g Tr., May 7, 2012, *In re Wash. Mut., Inc.*, No. 08-12229 (MFW) (Bankr. D. Del.) [Docket No. 10154], attached as Ex. 8 to the *Decl. of Bryan M. Kotliar in Supp. of Debtors' Opp. to Mot.*, dated Feb. 19, 2013, *In re Residential Capital, LLC*, No. 12-12020 (MG) (Bankr. S.D.N.Y.) [Docket No. 2958] (the "Kotliar Decl."), at 125:8-15 ("I don't think the MBS plaintiffs can rely on that. . . . [I]t was not a final decision at all because of the pendency of the motion for reconsideration. I did not get the chance to address that motion or make any ruling on those arguments. So, quite frankly, it is not law of the case. If it were, I would exercise my discretion not to apply it to this claim."); *see also* Order Approving Stipulation and Agreement, *In re Wash. Mut., Inc.*, No. 08-12229 (MFW) (Bankr. D. Del. Feb. 16, 2012) [Docket No. 9698], attached as Ex. 9 to the Kotliar Decl., at 2; Order Den. Classification, *In re Wash. Mut., Inc.*, No. 08-12229 (MFW) (Bankr. D. Del. May 16, 2012) [Docket No. 10182], attached as Ex. 10 to the Kotliar Decl., at 3.)

Second, in *Washington Mutual*, the securities claimant invested in residential mortgage-backed securities sponsored by the debtor's *non-debtor* subsidiaries. 462 B.R. at 139. In other words, the Washington Mutual entities that structured and sold the RMBS – *i.e.*, the

issuers – were not debtors. Here, however, the depositor/issuers that solicited, offered, and sold the RMBS are all Debtors.[7]

B. If the Certificates Purchased by the Investors Are Not Securities of the Debtors, They Are Securities of Affiliates of the Debtors

If the Certificates purchased by the Investors are viewed only as securities "of" the Trusts and not "of" the Debtors, the Investor Claims should nonetheless be subordinated under Section 510(b), because the Trusts were "affiliates" of the Debtors when the Investor Claims arose. Under the Bankruptcy Code, an "affiliate" includes a "person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor." 11 U.S.C. § 101(2)(C). Under this definition, the Trusts were affiliates, because the Debtors operated substantially all of the business and property of the Trusts under an operating agreement. *See* H.R. Rep. No. 85, 73 Cong., 1st Sess. 13 (1933) (noting that the "depositor" is "the actual manager of the trust").

The property being held in trust for the benefit of the Certificateholders consists primarily of a pool of mortgage loans, and the business of each Trust is to manage that property for the benefit of the Certificateholders. At issuance, the Debtors managed every aspect of the mortgage loans under the Pooling and Servicing Agreements (each a "PSA" and collectively, the "PSAs").[8] (Ex. 1 (PSA) § 3.01(a).) In the RALI 2006-QO3 offering, Debtor Residential

[7] The *Washington Mutual* court also premised its reasoning on the notion that the investors "did not assume the risk (and potential rewards)" of a security holder. 462 B.R. at 147. Putting aside whether that was an accurate statement in the case before that court, it is certainly not the case here for the reasons explained below. (*See infra* at 19-23.) In addition, the hypothetical posed by the *Washington Mutual* court (462 B.R. at 147) – a scenario in which Washington Mutual sold a customer Apple stock – has no applicability here. The Debtors did not sell stock in an unrelated third-party company.

[8] The PSA for the RALI Series 2006-QO3 example deal is attached as Exhibit 1 to the Local Rule 7056-1 Statement.

Funding Corporation ("RFC"), as master servicer, (the "Master Servicer") was responsible for "servic[ing] and administer[ing] the Mortgage Loans in accordance with [the terms of the PSA] . . . and [had] full power and authority . . . to do any and all things which it may deem necessary or desirable in connection with such servicing and administration." (*Id.*)[9]

These servicing and subservicing duties included essentially all tasks that one might think of as management of the property throughout the life of the loans. The Debtors were responsible for everything from communicating with borrowers and pursuing the collection of payments, to approving loss mitigation strategies such as loan modifications and managing the foreclosure and loan liquidation process. (Ex. 3 (ProSupp) at S-87-88.) The Debtors were also responsible for investor reporting, including calculating remittance amounts to Certificateholders, sending remittances to trustees for distribution to Certificateholders, and investor and tax reporting. (*Id.*) Specifically:

- The Master Servicer (a Debtor) is required to establish a custodial account into which it must deposit all payments of principal, interest, and insurance proceeds for the benefit of Certificateholders. (*See* Ex. 1 (PSA), § 3.07 (Article III, Administration and Servicing of Mortgage Loans).)

- The Master Servicer or the paying agent (both on behalf of the trustee) may be required to make periodic distributions to Certificateholders. (*See id.* § 4.02 (Article IV, Payments to Certificateholders).)

- The Master Servicer (a Debtor), and not the trustee, shall determine the total amount of realized losses on the trust res. (*See id.* § 4.05 (Article IV, Payments to Certificateholders).)

[9] The Master Servicer also has the right to assign a subservicer. (Ex. 1 (PSA) § 3.02.) In the RALI Series 2006-QO3 offering, RFC appointed Debtor Homecomings Financial Network, Inc. ("Homecomings") to act as "Subservicer." (Ex. 3 (ProSupp) at S-88.) As Subservicer, Homecomings is responsible for a variety of tasks related to operating the mortgage loans including, among others, communicating with borrowers, collecting borrower payments, calculating and reporting payoffs and liquidations, and maintaining insurance. (*Id.*)

- The Master Servicer (a Debtor) shall take action to protect the properties securing the mortgage loans, including maintaining fire insurance. (*See id.* § 3.12 (Article III, Administration and Servicing of Mortgage Loans).)

- The Master Servicer (a Debtor) shall foreclose on the mortgage loans that are in default. (*See id.* § 3.14 (Article III, Administration and Servicing of Mortgage Loans).)

- The Master Servicer (a Debtor) pays the fees of and indemnify the trustee. (*See id.* § 8.05 (Article VIII, Concerning the Trustee).)

The Debtors also prepared for investors comprehensive deal information including monthly reports for each Trust that report on such key metrics as, among others, principal and interest distributions, loan delinquencies, modifications, foreclosures, prepayments, and repurchases. (*See* Ex. 8 (June 2006 Distribution Report for RALI 2006-QO3).) In short, the Debtors performed virtually all of the functions necessary to manage the Trust business and property.

Because the Debtors operated substantially all of the business and property of the Trusts at the time the Investor Claims arose, the Trusts were affiliates of the Debtors for purposes of Section 510(b) subordination.[10] *See Jenkins v. Tomlinson (In re Basin Res. Corp.)*, 190 B.R. 824, 825-27 (Bankr. N.D. Tex. 1996) (holding that joint venture is affiliate of debtor where debtor was manager of joint venture's properties); *In re Consol. Cos.*, 113 B.R. 269, 272-73 (Bankr. N.D. Tex. 1989) (property management company that managed debtor's properties and business was affiliate); *In re Century Inv. Fund VII Ltd. P'ship*, 96 B.R. 884, 892 (Bankr. E.D. Wis. 1989) (CMG was affiliate of debtor, because CMG managed all of debtor's property); *In re Minton Grp., Inc.*, 27 B.R. 385, 389 (Bankr. S.D.N.Y. 1983), *aff'd*, 46 B.R. 222 (S.D.N.Y.

[10] *See In re Wash. Mut., Inc.*, 442 B.R. 314, 363 (Bankr. D. Del. 2011) ("the relevant time for determining whether the security was issued by an affiliate, is at the time the claim arose (*i.e.*, when the security was bought or sold)") (citing *In re VF Brands, Inc.*, 275 B.R. 725, 728 (Bankr. D. Del. 2002)); *see also In re Wisconsin Barge Line, Inc.*, 76 B.R. 142, 144 (Bankr. E.D. Mo. 1987) (same).

1985) (limited partnership was affiliate of debtor where debtor operated business and managed property under limited partnership agreement); *In re Reynolds*, 13 B.R. 658, 659 (Bankr. N.D. Ga. 1981) (non-debtor business was affiliate where debtor was general manager of, and designated to operate, the business).[11]

The Investors assert that the PSAs are not operating agreements because the trustees purportedly "retained material responsibilities." (Rule 3013 Mot. at 22.) First, even assuming that is true, the retention by the Trusts of certain material responsibilities is entirely consistent with their being an "affiliate" for purposes of the Bankruptcy Code. The statutory definition expressly includes an entity whose business *or* "substantially all of whose property is operated" by a debtor (11 U.S.C. § 101(2)(C)), leaving open that some responsibilities might be retained. For example, in *Consolidated Companies*, the court found that an entity operated substantially all of a debtor's business and therefore was an affiliate, even though the debtor had its own employees and continued to undertake certain actions on its own. 113 B.R. at 272.

Second, while trustee retains some responsibilities with respect to the Trust – including "examining documents provided by the depositor and servicer to ensure they are complete," and "making available reports on the mortgage loans [prepared by the Debtors] and mailing them to those who request them" (*see* Local Rule 7056-1 Statement ¶ 64) – these functions are clearly administrative when compared to the active and daily management of the billions of dollars of assets in the Trusts, which was performed by a Debtor. None of the trustee's responsibilities involves operating or managing the property of the Trusts (*i.e.*, the underlying mortgage loans). The PSAs allocated the substantive control over the property of the

[11] It makes no difference whether the PSAs are titled "operating agreements." Courts look beyond the title and examine whether the agreement provides for the management of substantially all of the property or business of the trusts. *See Consol. Cos.*, 113 B.R. at 272-73.

Trust to the Debtors. For example, the trustee is limited to selling the Certificates to the depositor at the Trust's inception, entering into and performing its limited obligations under the PSA, and engaging only in related activities in connection with conservation of the Trust. (Ex. 1 (PSA) § 2.08; *see also id.* § 8.01 (itemizing duties of the trustee with respect to enumerated circumstances).) Importantly, the trustee is not permitted to act with the powers of the Master Servicer—*i.e.*, to manage or control the Trust res—unless the Master Servicer is unable to perform the services or an event of default occurs. (*See id.* § 3.06.)

In re Commercial Fin. Servs. Inc. is directly on point. There, the court subordinated, pursuant to Section 510(b), securities claims involving bankruptcy-remote securitization trusts formed by, and serviced by, the debtors. (*See* Order Granting Mot. for Summ. J., *In re Commercial Fin. Servs. Inc.*, Case No. 98-05162-R, Adv. Case No. 98-0356-R (Bankr. N.D. Okla. July 11, 2003) [Docket No. 174], attached as Ex. 11 to the Kotliar Decl.) Just as here, the underlying assets – loans and credit card receivables – were securitized:

> through a series of transactions in which [the debtors] packaged the [l]oans and transferred such packages to an affiliate of [the debtor], which in turn sold the [l]oan packages to a trust. [The debtor] and its affiliate agreed to sell securities backed by the [l]oan packages to specific investors or to a placement agent. [The debtor] simultaneously contracted to service the [l]oans in all respects and to manage the operations of the securitizations that it had established and sponsored. [The debtor], or one of its affiliates, received the net proceeds from the sale of the securities, a fee for servicing the [l]oans, and a right to any residual value of the [l]oans when and if the securities were paid in full.

Id. at 15.

After the debtors filed for bankruptcy, a purchaser of the securities brought an adversary proceeding seeking to rescind the purchase to establish a constructive trust over certain sale proceeds it asserted were traceable to a specific account of the debtor. *See id*. at 4. The

purchaser's claims were "based upon [its] allegation that fraud infected the disclosures upon which it based its decision to purchase securities." *Id*. at 49.

The court subordinated the claims pursuant to Section 510(b), because the securitization trusts were affiliates of the debtors. *Id*. at 84.[12] In reaching that conclusion, the court noted that the debtor was "contractually obligated to perform not only all duties of the Servicer," but also that "[v]irtually all other activities contemplated by the [trust] were performed by the [debtor]." *Id*. at 81. As a result, the debtors were "operating the 'property' of the [trust]" under "an operating agreement." *Id*. at 83. For all the same reasons, Section 510(b) mandates subordination of the Investor Claims here.

Here, again, *Washington Mutual* is not to the contrary. The debtor in that case "was not a party to [the Pooling and Servicing] agreements." *Wash. Mut.*, 462 B.R. at 146. Thus, the court observed that the agreements were "between two non-debtors," and "cannot provide a basis for subordination." *Id.* That is not the case here. Moreover, the *Washington Mutual* court did *not* conclude that PSAs were not operating agreements. Rather, the court concluded only that it had not yet been proven, at the early stages of the litigation, that the particular PSAs at issue were operating agreements. 462 B.R. at 145-46.

C. Subordination of the Investor Claims Comports with the Policies and the Purpose of Section 510(b) of the Bankruptcy Code

The principles underlying Section 510(b) confirm why subordination of the Investor Claims is required. In enacting Section 510(b), Congress endorsed the view that risk of fraud or other illegality in the issuance of securities should be borne by securities holders, not other creditors. (*See* H.R. Rep. No. 95–595, at 196 (1978) ("The bill generally adopts the Slain/Kripke position."); John J. Slain & Homer Kripke, *The Interface Between Securities*

[12] The court did not address whether the securities were also securities "of" the debtor.

Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 N.Y.U. L. Rev. 261, 288 (1973) (("Slain & Kripke"), attached as Ex. 12 to the Kotliar Decl.) ("It is difficult to conceive of any reason for shifting even a small portion of the risk of illegality from the stockholder, since it is to the stockholder, and not to the creditor, that the stock is offered.").) Slain and Kripke gave two central reasons for this rule. First, "allowing equity-holders to become effectively creditors – by treating these two classes as though they were one – gives investors the best of both worlds . . ." – upside potential and downside protection. *Geneva Steel Co.*, 281 F.3d at 1176 (citing Slain & Kripke). Second, it "dilutes the capital reserves available to repay general creditors, who rely on investment equity for satisfaction of their claims." *Id.*

Notably, Slain and Kripke focused solely upon equity and subordinated debt securities because the authors assumed that holders of securities representing general unsecured debt would not attempt to use a securities claim to better their position vis-à-vis other general creditors.[13] Nonetheless, in enacting Section 510(b), Congress chose language that made clear its intention to cover securities claims brought by *all* securities of a debtor (or of an affiliate) – including securities that already enjoyed the same priority as general unsecured debt.

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[13] Specifically, Slain and Kripke stated:

> Some securityholders may not benefit from their securities law rights, since their contracts with the issuer often provide for equal or superior remedies. For example, the note evidencing a bank loan made to an issuer is a security, and if the loan has been obtained by misrepresentation, securities law remedies may be available to the bank. Since, however, the bank is already a creditor, these remedies will not ordinarily improve the bank's position vis-à-vis the issuer's general creditors.

Slain & Kripke, at 267-68. Here, in contrast, the Investors are trying to use the securities laws to improve their position vis-à-vis the Debtors' general creditors. Specifically, not content with being the beneficiaries of the Trusts' contractual claims against the Debtors, the Investors seek to assert a duplicative claim for securities fraud that will place them in a better position than the Debtors' general unsecured creditors.

Consistent with the purpose of Section 510(b), the Second Circuit has held that subordination is required if the claimants (i) took on the risk and return expectations of a securities holder, rather than a creditor, or (ii) seek to recover a contribution to the equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor. *Med Diversified*, 461 F.3d at 256. If either of these rationales exist, Section 510(b) subordination is warranted. *See Waltzer v. Nisselson (In re MarketXT Holdings Corp.*), 346 Fed. Appx. 744, 746, 2009 U.S. App. LEXIS 20889 (2d Cir. N.Y. 2009). Here, both rationales are met.

The facts make clear that the Investors took on the risk and return expectations of a securities holder. The Certificates have all the standard features of investment risk. For example, the prospectuses warned that, "[i]f the performance of the mortgage loans is substantially worse than assumed by the rating agencies," that would "reduce the value of th[e] certificates" on the secondary market. (Ex. 3 (ProSupp) at S-21.) Similarly, if prepayments of the loans were higher than expected that could reduce the yield. (*Id.* at S-23.) Conversely, if the loans performed better than expected, that could increase the value of the Certificates on the secondary market and create an opportunity to sell at a profit. That liquidity and potential upside is the "crucial difference between creditor and investor expectations." *CIT Grp.*, 460 B.R. at 640.

Beyond the liquidity and potential upside provided by a secondary market for Certificateholders, the Certificates contained protection that was not available to general unsecured creditors. The Investors could select varying degrees of protection by purchasing different tranches, with correspondingly higher or lower rates of return.

Purchases of the Certificates were also an investment in the Debtors' brand. A primary distinction among the numerous RMBS issuers was the experience and reputation of the

sponsoring and servicing entities. This is demonstrated by the extensive disclosures in the ProSupp concerning Debtor RFC as sponsor and Master Servicer, including a description of its affiliation with other Debtor entities as well as pages of financial data describing RFC's securitization and servicing experience. (Ex. 3 (ProSupp) at S-28-34.) This emphasis on brand is also reflected in the Debtors' marketing materials, which prominently featured the Debtors' branding and actively promoted the Debtors': (i) business structure and vertical integration; (ii) independent credit ratings; (iii) extensive track record of issuing and servicing RMBS; (iv) specific origination and risk management policies; (v) division of securitizations into distinct shelves and sub-classifications by asset-type; and (vi) proprietary data access and analysis services provided to investors. (*See* Exs. 12 (Overview of ABS/MBS Products: 2007 U.S. Markets), 15 ("GMAC-RFC Overview" Investor Presentation).) This is further confirmed by the meetings the Debtors held with certain investors to review their underwriting and servicing operations. (*See* Local Rule 7056-1 Statement ¶¶ 48-49; Exs. 13 (RFG Capital Markets Visits and Conferences Calendar), Ex. 14 (Calendar Entry: Jan. 19, 2006 Meeting with Allstate).)

In addition, the Certificates benefited from the Debtors' ongoing ability to provide servicing advances (Ex. 1 (PSA) § 4.04), as well as the Debtors' mortgage repurchase obligations in the event of a breach of certain representations and warranties. (*Id.* § 2.03.) This reliance on the Debtors' ability to fulfill certain obligations reflects direct exposure to the Debtors' solvency. In short, the value of the Certificates was inextricably tied to the Debtors.

Nonetheless, the Investors seek to have their Investor Claims treated as general unsecured claims. "[H]aving watched [their] investment gamble turn sour, [the Investors] would shift [their] losses to" the Debtors' creditors. *Geneva Steel*, 281 F.3d at 1180. That "effort clashes with the legislative policies that Section 510(b) purports to advance." *Id.* "Congress

enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding." *In re Enron Corp.*, 341 B.R. 141, 158 (Bankr. S.D.N.Y. 2006) (quoting *Baroda Hill Invs.*, 281 F.3d at 142).

Moreover, the funds invested via securitization provided an equity cushion to the debtor's general creditors. *See* Ex. 3 (ProSupp) at S-104 (noting that proceeds may "be used by the depositor for general corporate purposes."); *Commercial Fin. Servs.*, 268 B.R. at 594 (finding that the debtor's "unsecured creditors were dependent upon the proceeds from the [securitization] not only as a 'cushion' but as [the debtor's] principal source of payment of its general operating expenses" and thus "strong arguments exist that provide justification for the subordination of [the securitization investor's] claim as a matter of bankruptcy policy"). As noted by the *Commercial Fin. Servs.* court, when an investor in a securitization provides financing to a debtor in exchange for securities with recourse against certain of the debtors' assets that none of the debtors' general unsecured creditors can reach, it would be "inequitable" to permit the securities claimant "to make a claim against [the debtor/sponsor's] *unsegregated* assets, diluting the general unsecured creditors' recovery yet a second time." *See id.* *Commercial Fin. Servs.*, 268 B.R. at 594 (emphasis in original).

Just as the *Commercial Fin. Servs.* court subordinated under Section 510(b) the claim of an investor in the debtor's securitization of loans and credit card receivables in that case, so too should the Investors Claims be subordinated under Section 510(b).

II. THE INVESTOR CLAIMS SHOULD BE SUBORDINATED PURSUANT TO SECTION 510(A) OF THE BANKRUPTCY CODE

Subordination of the Investor Claims is also required under Section 510(a) as a means of enforcing the subordination agreements *among* Certificateholders. Under Section

510(a), a "subordination agreement is enforceable" in bankruptcy "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." 11 U.S.C. § 510(a). Where a claim holder has agreed that its claim will be junior, that agreement is uniformly enforced in bankruptcy. *See Robinson v. Howard Bank (In re Kors, Inc.)*, 819 F.2d 19, 24 (2d Cir. 1987).

There are two distinct forms of subordination agreements that require subordination of the Investor Claims: (i) the express subordination agreements among senior and junior tranches of Certificates (including the corollary agreement that holders of the same tranche are not subordinate to each other); and (ii) the implied subordination of former Certificateholders to subsequent purchasers, inherent in the sale of the Certificates. A subordination agreement is any "contractual arrangement whereby one creditor agrees to subordinate its claim against a debtor in favor of the claim of another." *In re Best Prods. Co.*, 168 B.R. 35, 69 (Bankr. S.D.N.Y. 1994); *see also Minority Equity Capital Co. v. Jackson*, 798 F. Supp. 200, 202 (S.D.N.Y. 1992) ("The purpose of a subordination agreement is [to] set out the relative positions of lenders in respect to their right to receive payments from the borrower."). Current and former holders of Certificates should not be able to avoid subordination provisions to which they previously agreed through the current pursuit of securities claims.

A. The Express Agreement Among Certificateholders to Each Securitization Requires Subordination of the Investor Claims

The RMBS documentation constitutes subordination agreements among Certificateholders. (Ex. 1 (PSA) § 1.01 (defining classes of Certificates); *id.* § 4.02 (providing for "Distributions" in sequential order); *id.* § 4.05 (allocating "Realized Losses" in reverse order); Ex. 3 (ProSupp) at S-10-13, S-64–69 (describing waterfall of subordinated payment priorities).) Indeed, subordination is a fundamental principle underpinning securitization and the entire purpose of the complex waterfall of payments to the different tranches of certificates. *See*

Wyo. State Treasurer v. Moody's Investors Serv., Inc. (In re Lehman Bros. Mortg.-Backed Secs. Litig.), 650 F.3d 167, 171 n.1 (2d Cir. 2011) ("Subordinating the bonds creates a tiered structure known as a 'waterfall.'"); *see also Republic Bank & Trust Co. v. Bear Stearns & Co.*, 683 F.3d 239, 244 (6th Cir. 2012) ("Often, a single trust issues different levels, or 'tranches,' of certificates, normally based on subordination rights . . . ."); *Anchor Sav. Bank, FSB v. United States*, 597 F.3d 1356, 1359 n.1 (Fed. Cir. 2010) ("Credit enhancement typically occurs through a 'senior-subordinated structure' . . . .").

Enforcing the waterfall structure of the Certificates requires that the Investor Claims be subordinated to the Trust Claims. The Investor Claims are brought on behalf of holders of Certificates throughout the Trust tranches, each seeking to recoup their purported investment losses on equal priority with one another. (*See* Local Rule 7056-1 Statement ¶¶ 7, 90.) If the Investor Claims based on *either* the subordinate *or* the senior Certificates were granted equal priority with the Trust Claims, such a grant would frustrate the allocation of rights set forth in the detailed subordination agreements reflected in the PSAs and other offering documents. For example, if the *junior* Certificateholders' securities claims are not subordinated, they will effectively be paid out in equal priority with the senior tranches under the Trust Claims. That result would be fundamentally at odds with the junior holders' agreement to be subordinate to senior tranches with respect to any "Subsequent Recoveries." (Ex. 2 (Pros.) at 41; *see also* Ex. 1 (PSA) § 1.01.) This result would also be inconsistent with the bankruptcy principle that creditors should be treated equally only where they deserve such treatment. *See, e.g., In re Credit Indus. Corp.*, 366 F.2d 402, 408 (2d Cir. 1966) ("It is, of course, true that 'the theme of the Bankruptcy Act is equality of distribution. The same equitable considerations, however,

require that the concept of equal distribution be applied only to creditors of equal rank, i.e., creditors who are similarly situated.") (internal citations omitted).

The Certificates reflect not only an agreement to be subordinate to (or senior to, as the case may be) other tranches, but also to share "pro rata" with other holders in the same tranche. (Ex. 1 (PSA) § 1.01.) Allowing the Investor Claims to share equally with the Trust Claims would run afoul of this agreement because the Investor Claims do not include all Certificateholders within any particular tranche. (*See, e.g.*, Ex. 16 (Allstate FAC), at Ex. B (representing only the holdings of named plaintiffs).) Therefore, the effect of classifying the Investor Claims on par with the Trust Claims would be to dilute the recovery of all senior Certificateholders through the Trust Claims in order to enhance the recovery of only the subset of them who brought Investor Claims.

In short, subordination of the Investor Claims is the only way to ensure that recoveries for Certificateholders respect the subordination agreements among Certificateholders by having any recovery flow equitably through the Trust according to the express terms of those subordination agreements.

B. The Implied Subordination Agreement Among Former Certificateholders and Subsequent Purchasers Requires Subordination of the Investor Claims

In addition to the inequality among current Certificateholders, granting equal priority to the Investor Claims would violate the implied agreement between former Certificateholders and those to whom they sold their Certificates. This implied subordination agreement is a natural consequence of warranties and duties that the common law and New York's Uniform Commercial Code (the "N.Y.U.C.C.") impose on all sales of securities.

The N.Y.U.C.C. and the common law of contracts impose on a seller the implied covenant of good faith and fair dealing. *See* N.Y.U.C.C. § 1-203 ("Every contract or duty within

this Act imposes an obligation of good faith in its performance or enforcement."); *see also Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163, 167 (N.Y. 1933) ("in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract").

The Certificates reflect an agreement between former and current holders that recoveries for breaches of representations and warranties will be distributed to "only those parties holding Certificates at the time such payments flow through the Trust." (Local Rule 7056-1 Statement ¶ 33.) Specifically, the securitization documents provide that if there is any recovery "in connection with a related breach of a representation or warranty or otherwise, such subsequent recovery shall be distributed to certificateholders in the same manner as repurchase proceeds received in the prior calendar month" and then down the waterfall of tranches to which "Realized Losses"[14] have been allocated. (Ex. 2 (Pros.) at 41; *see also* Ex. 1 (PSA) at 31 (including in definition of "Subsequent Recoveries" any "recoveries in respect of the representations and warranties made by the related Seller").) Presumably, the right to any such recovery was part of the value that the purchaser and seller considered in determining the price of the Certificates. However, if former Certificateholders share in the recovery through Investor Claims, on equal priority with the purchaser of their Certificates, that will dilute the recovery to the subsequent purchaser. Allowing a seller to capture such gain at the expense of the purchaser is fundamentally at odds with any "reasonable commercial standards of fair dealing" (N.Y.U.C.C. § 8-102(a)(10)) and would deprive the subsequent holder of the "fruits of the contract." *Kirke La Shelle Co.*, 188 N.E. at 167.[15]

[14] *See* Ex. 2 (Pros.) at 111 (defining "Realized Loss").

[15] Moreover, beyond the fact that former certificateholders transferred their rights to recoveries based on alleged breaches of representations and warranties, some or all of the former holders

The only way to ensure that recovery flows to the party entitled to receive it, without dilution at the hands of former holders from whom the current Certificateholder reasonably expects to have purchased such right, is to subordinate the Investor Claims so that recovery flows through the Trusts according to the terms of the Certificateholders' agreements.

III. THE INVESTOR CLAIMS SHOULD BE SUBORDINATED PURSUANT TO SECTION 510(C) OF THE BANKRUPTCY CODE

Even if the Investor Claims did not fall within the ambit of Sections 510(a) or 510(b) – which they do – the Investor Claims should still be equitably subordinated under Section 510(c). *See* 11 U.S.C. § 510(c). Equitable subordination typically involves a showing that (i) a creditor has engaged in inequitable conduct, (ii) that such conduct results in injury to other creditors or confers an unfair advantage on the claimant, and (iii) that subordination would not be inconsistent with provisions of the Bankruptcy Code. *See United States v. Noland*, 517 U.S. 535, 538-39 (1996) (citing *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977)); *see also Official Comm. of Unsecured Creditors v. Bay Harbour Master Ltd. (In re BH S&B Holdings LLC)*, 420 B.R. 112, 156 (Bankr. S.D.N.Y. 2009) (Glenn, J.), *aff'd sub nom., Geltzer v. Bay Harbour Mgmt. LC (In re BH S&B Holdings LLC)*, 807 F. Supp. 2d 199 (S.D.N.Y. 2011). However, courts have recognized circumstances involving securities claims in which "no fault" equitable subordination remains appropriate in order to achieve an equitable result. *See In re Emergency Monitoring Techs.*, 366 B.R. 476, 506-08 (Bankr. W.D. Pa. 2007) (no-fault equitable subordination of stock redemption claim that effectively elevated equity interest to debt and diluted distribution to other creditors); *see also SPC Plastics Corp. v. Griffith*

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may have also transferred their standing to bring the Investor Claims to current certificateholders, either explicitly or implicitly. The Debtors expressly reserve the right to object to the allowance of some or all of the Investor Claims on this basis, as well as any other basis.

(In re Structurlite Plastics Corp.), 224 B.R. 27, 36 (B.A.P. 6th Cir. 1998) (affirming no-fault equitable subordination of redemption of former stockholders' stock interests).[16]

No-fault equitable subordination is appropriate on a case-by-case inquiry into "the nature and origin of the claim" and "the substance of the transaction, as opposed to its form." *Structurlite Plastics*, 224 B.R. at 35-36 (quoting *Envirodyne Indus. Inc. v. Am. Express (In re Envirodyne Indus., Inc.)*, 176 B.R. 825, 831 (Bankr. N.D. Ill. 1995), *aff'd*, 1995 U.S. Dist. LEXIS 8783 (N.D. Ill. June 20, 1995), *aff'd*, 79 F.3d 579 (7th Cir. 1996)). Here, the nature and substance of the Investor Claims clearly favor subordination — they are precisely the sort of claim that Congress intended to subordinate under Section 510(b).

The Investors already occupy a favored position as compared to any general unsecured creditor. First, Certificateholders will receive a recovery through the Trust Claims, so they already start on equal footing subject only to whatever subordination they have agreed to among themselves within each securitization waterfall. Beyond this, the Certificateholders maintain the rights to future payments from the segregated pool of mortgage loans underlying their securities, which remain unavailable to other creditors. Alternatively, the Certificateholders can sell their Certificates (as some have already) to receive the expected value of these collective rights. Now the Investors are seeking a third source of recovery on equal priority with, and thus

[16] The Court of Appeals for the Second Circuit has not addressed no-fault equitable subordination since *Noland*. However, prior to *Noland*, the Second Circuit recognized no-fault equitable subordination and noted that the "fundamental aim" of equitable subordination is to "undo or offset any inequity in the position of a creditor or stockholder which will produce injustice or unfairness to the other creditors or stockholders in terms of reorganization results." *Jezarian v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206, 213 (2d Cir. 1978)) (subordinating stock redemption claims) (citations omitted). *Noland* explained that "Congress 'intended that the term 'principles of equitable subordination' [in Section 510(c)] follow existing case law'" (517 U.S. at 539 (quoting 124 Cong. Rec. 32398, 33998 (1978)), and courts have continued to cite *Stirling Homex* when allowing no-fault equitable subordination. *See, e.g., Structurlite Plastics Corp.*, 224 B.R. at 35-36.

diluting, the only payments that will go to general unsecured creditors. That inequity alone is ample grounds upon which to subordinate the Investor Claims pursuant to Section 510(c).

In addition, as outlined above, failure to subordinate the Investor Claims would lead to myriad inequitable consequences, including: (i) enhanced recovery for subordinate Certificates at the expense of more senior Certificates (*see supra* Section II.A); (ii) unequal recovery within each tranche (*see id.*); and (iii) reduced recovery for subsequent purchasers to the benefit of the seller of that right to recovery (*see supra* Section II.B). Subordination will avoid these inequitable consequences and allow the recoveries to the Certificates to flow through the Trusts pursuant to the expressly agreed-upon distribution waterfall.

IV. THE INVESTOR CLAIMS ARE FUNDAMENTALLY DIFFERENT FROM THE TRUST CLAIMS AND SHOULD NOT BE SIMILARLY CLASSIFIED

The Investors attempt to evade subordination by asserting that their claims are substantially similar to, and thus must be placed in the same class as, the Trust Claims for plan purposes. However, even were the claims substantially similar (which they are not, as explained below), nowhere does the Bankruptcy Code require that substantially similar claims be placed in the same class. *See In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 246 (Bankr. S.D.N.Y. 2007) ("section 1122(a), by its terms, doesn't require that all similarly-situated claims be classified together"); *In re Drexel Burnham Lambert Grp., Inc.*, 138 B.R. 723, 757 (Bankr. S.D.N.Y. 1992) ("Courts have found that the Bankruptcy Code only prohibits the identical classification of dissimilar claims. It does not require that similar classes be grouped together, but merely that any groups be homogenous or share some attributes." (citations omitted)); 7 Collier on Bankruptcy ¶ 1122.03[1][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. rev. 2012) ("[A]lthough the Code requires all claims *within* a class be substantially similar, courts . . . generally do not require that all substantially similar claims be placed in the same class."

(emphasis added)). Rather, "[d]issimilar claims may not be classified together," but "similar claims may be classified separately" if the debtor has "a legitimate reason" or a "legitimate business reason" to do so, and is not motivated solely by a desire to gerrymander an assenting class of impaired creditors. *Aetna Cas. & Sur. Co. v. U.S. Bankr. Court (In re Chateaugay Corp.)*, 89 F.3d 942, 949, 951 (2d Cir. 1996); *see also Adelphia*, 368 B.R. at 246-47 (holding separate classification permissible where a "reasonable basis" exists for doing so).

Here, there are numerous reasons to classify the Investor Claims differently from the Trust Claims. There is also no evidence that separate classification is intended to gerrymander an assenting class of impaired creditors. At a minimum, as explained in Sections I, II and III, *supra*, separate classification (and subordination) is required to prevent inequitable dilution of the Debtors' general unsecured creditors.

But even more fundamentally, the Investor Claims are different from the Trust Claims. While the Investors argue that similar evidence would be used at trial to prove both types of claims, even if that were so, that does not make the claims substantially similar. *See Chateaugay*, 89 F.3d at 949 (holding that claims were dissimilar even though they were all based on the debtor's workers' compensation obligations). The proper focus for classification is "on the nature of the claims," *i.e.*, their "legal attributes." *In re Coram Healthcare Corp.*, 315 B.R. 321, 349 (Bankr. D. Del. 2004).

There are important distinctions between the Investor Claims and the Trust Claims. First, while some of the Investors may overlap with Certificateholders who will benefit from the Trust Claims, the claimants are not identical, so any recovery would not be distributed equally – and some holders of Certificates would recover twice. In addition, the holders of Investor Claims seek to treat Certificateholders of various tranches on equal priority with one

another. Together, these facts place the Investor Claims in the dramatically distinct situation of seeking relief that would frustrate, rather than adhere to, the agreed-upon allocation of funds among Certificateholders. (*See supra* Sections II, III.)

Second, the factual and legal bases of the claims are also different. The Trust Claims are contract claims based on breaches of representations and warranties *and* on claimed servicing breaches after the securities were sold. (*See* Third Am. and Restated RMBS Trust Settlement Agreement with the Steering Committee Group § 7.01 [Docket No. 1887, Ex. 2].) The Investor Claims are tort claims alleging fraud relating to the Debtors' pre-issuance statements and alleged omissions in separate offering documents. (*See, e.g.,* Ex. 16 (Allstate FAC) ¶¶ 83-89.)

The legal elements of the tort claims underlying the Investor Claims are also very different than those of the Trusts' contract claims. In order to prove their contract claims, the Trusts would have to meet four basic elements: a valid contract between the parties, performance by the Trusts, failure of the Debtors to perform, and resulting damages. *See Flomenbaum v. N.Y.U.*, 71 A.D.3d 80, 91 (N.Y. App. Div. 2009), *aff'd*, 929 N.E.2d 403 (N.Y. 2010). The Investors' tort claims, by contrast, require proof of entirely different elements. Allstate, for example, alleges numerous causes of action sounding in fraud, which requires additional proof of knowledge of the purported misrepresentation's falsity, intent to deceive, and justifiable reliance. *See Eurycleia Partners, LP v. Seward & Kissel, LLP*, 910 N.E.2d 976, 979 (N.Y. 2009). And of course, claims for fraud are subject to a heightened pleading standard. *See e.g.,* Fed. R. Civ. P. 9(b).

In short, the Trust Claims and the Investor Claims are asserted for the benefit of dissimilar groups of Certificateholders, assert different theories of liability, involve different

legal elements and pleading standards, and are premised on different underlying conduct. The only similarity – that the Investor Claims seek to recover losses on some of the same underlying Certificates – is precisely why Section 510 requires subordination and does not weigh against it.

CONCLUSION

For the foregoing reasons, the Debtors respectfully request that their Motion For Summary Judgment be granted in its entirety, and that the Rule 3013 Motion be denied for the same reasons.

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