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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., **Plaintiffs,**	)	
v.	)	Adv. Case No. 13-01262 (MG)
ALLSTATE INSURANCE COMPANY, et al., **Defendants.**	)	

MOTION OF AIG ASSET MANAGEMENT (U.S.), LLC, THE ALLSTATE ENTITIES, MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY, AND THE PRUDENTIAL ENTITIES FOR SUMMARY JUDGMENT

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TABLE OF CONTENTS

Page

INTRODUCTION 1

PRELIMINARY STATEMENT 1

STATEMENT OF FACTS 4

A. The Structure of Mortgage-Backed Securities 4

B. The Investors' Misrepresentation Claims 6

STANDARD FOR SUMMARY JUDGMENT 7

ARGUMENT 8

I. SECTION 510(a) DOES NOT APPLY TO THE INVESTORS' CLAIMS 8

II. SECTION 510(b) DOES NOT APPLY TO THE INVESTORS' CLAIMS 11

A. The Trust's Certificates Are Not Securities "of" the Debtor 11

B. Section 510(b) Does Not Apply Because the Trusts Are Not "Affiliates" of the Debtors As Defined by the Bankruptcy Code 17

1. The Trust Is Not a "Person" Under the Bankruptcy Code 18

2. Neither the Trust's Business Nor Its Property Is Operated by a Debtor 20

(a) Servicing the Loans Was *RFC's* "Business," Not the Trust's Business 20

(b) The *Actual* Function of the Trust Was Not to "Operate" At All 23

3. No Debtor Operated Substantially All of the Trust's Property 25

4. The Trust Is Not Party to a Lease or Operating Agreement 26

5. Commercial Financial Services Is Distinguishable 28

C. Debtors' Argument Ignores the Policies Underlying Section 510(b) and Seeks to Undermine the Entire Structure and Purpose of Special Purpose Entities Like the Trust 31

1. Debtors' Arguments Undermine the Very Purpose of the Trust 31

2. Debtors' Arguments Result In Recharacterization 32

3. The Purposes of Bankruptcy Code Section 510(b) Would Not Be Served by Subordinating the Investors' Claims.....33

III. THERE IS NO BASIS FOR CATEGORICAL OR NO-FAULT EQUITABLE SUBORDINATION OF THE INVESTORS' CLAIMS UNDER SECTION 510(c).....35

TABLE OF AUTHORITIES

Page

Cases

80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.),
169 B.R. 832 (Bankr. S.D.N.Y. 1994) 36

In re ASI Reactivation, Inc.,
934 F.2d 1315 (4th Cir. 1991) 35

In re Am. Home Mortg., Inc.,
379 B.R. 503 (Bankr. D. Del. 2008) 21, 22

In re Baker & Getty Fin. Servs.,
974 F.2d 712 (6th Cir. 1992) 36

Benjamin v. Diamond (In re Mobile Steel),
563 F.2d 692 (5th Cir. 1977) 36, 38, 39, 40

In re Calpine Corp.,
No. 05-60200 (BRL), 2007 WL 4326738 (Bankr. S.D.N.Y. Nov. 21, 2007) 35

Capital Ventures Int'l v. J.P. Morgan Mortg. Acquisition Corp.,
Civ. A. No. 12-10085-RWZ, 2013 WL 535320 (D. Mass. Feb. 13, 2013) 7

In re Century Inv. Fund VII Ltd. P'ship,
96 B.R. 884 (Bankr. E.D. Wis. 1989) 23

In re Consol. Cos.,
113 B.R. 269 (Bankr. N.D. Tex. 1989) 23

Demko v. United States,
216 F.3d 1049 (Fed. Cir. 2000) 3

Emps.' Ret. Sys. of the Gov't of the Virgin Islands v. J.P. Morgan Chase & Co.,
804 F. Supp. 2d 141 (S.D.N.Y. 2011) 10

In re Enron Creditors Recovery Corp.,
380 B.R. 307 (S.D.N.Y. 2008) 8

In re First Alliance Mortg. Co.,
471 F.3d 977 (9th Cir. 2006) 36

First Fid. Bank v. Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.),
134 B.R. 528 (Bankr. S.D.N.Y. 1991) 8

Gordon Sel-Way, Inc. v. United States,
217 B.R. 221 (E.D. Mich. 1997) 39

In re Granite Partners, L.P.,
208 B.R. 332 (Bankr. S.D.N.Y. 1997) 16

In re Gurney's Inn Corp. Liquidating Trust,
215 B.R. 659 (Bankr. E.D.N.Y. 1997).....19

Hedged-Securities Assocs., LP v. The Bronze Group, Ltd. (In re Hedged-Investments Assocs., Inc.),
380 F.3d 1292 (10th Cir. 2004) 38

In re Interlink Home Health Care, Inc.,
283 B.R. 429 (Bankr. N.D. Tex. 2002).....27

Jenkins v. Tomlinson (In re Basin Res. Corp.),
190 B.R. 824 (Bankr. N.D. Tex. 1996).....23

Jezerian v. Raichle (In re Stirling Homex Corp.),
579 F.2d 206 (2d Cir. 1978).....39, 40

Lamie v. U.S. Trustee,
540 U.S. 526 (2004).....28

In re Lemco Gypsum, Inc.,
911 F.2d 1553 (11th Cir. 1990) 37

In re Lifschultz Fast Freight,
132 F.3d 339 (7th Cir. 1997) 36

Lone Star Fund V (US), LP v. Barclays Bank PLC,
594 F.3d 383 (5th Cir. 2010) 10

In re M&S Grading, Inc.,
541 F.3d 859 (8th Cir. 2008) 36

In re Med Diversified, Inc.,
461 F.3d 251 (2d Cir. 2006).....34, 35

In re Medallion Realty Trust,
103 B.R. 8 (Bankr. D. Mass. 1989) 30

In re Merrimac Paper Co.,
420 F.3d 53 (1st Cir. 2005).....36

In re Minton Grp., Inc.,
27 B.R. 385 (Bankr. S.D.N.Y. 1983).....23

In re Missionary Baptist Found. of Am., Inc.,
712 F.2d 206 (5th Cir. 1983) 18

In re Montgomery Ward Holding Corp.,
272 B.R. 836 (Bankr. D. Del. 2001).....41

Nationsbank, N.A. v. Commercial Fin. Servs., Inc. (In re Commercial Fin. Servs., Inc.),
Adv. Pro. 98-0356 (Bankr. N.D. Okla. July 11, 2003).....29, 30, 31, 32

New Jersey Carpenters Health Fund v. Residential Capital, LLC,
Nos. 08 CV 8781(HB), 08 CV 5093(HB), 2011 WL 2020260 (S.D.N.Y. May 19, 2011) 10

Northcross v. Bd. of Educ.,
412 U.S. 427 (1973).....16

Official Comm. of Unsecured Creditors v. Morgan Stanley & Co. (In re Sunbeam Corp.),
284 B.R. 355 (Bankr. S.D.N.Y. 2002).....37

Official Committee of Unsecured Creditors of Hydrogen, L.L.C. v. Blomen (In re Hydrogen, L.L.C.),
431 B.R. 337 (Bankr. S.D.N.Y. 2010).....39

Overton v. New York State Div. of Military and Naval Affairs,
373 F.3d 83 (2d Cir. 2004).....8

In re Patriot Aviation Services, Inc.,
396 B.R. 780 (Bankr. S.D. Fla. 2008) 34

Pepper v. Litton,
308 U.S. 295 (1939).....40

Picard v. Flinn Invs., LLC,
463 B.R. 280 (S.D.N.Y. 2011).....16

Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. Partnership,
123 L. Ed. 2d 74, 113 S. Ct. 1489 (1993).....33

In re Residential Capital, LLC,
No. 12-12020 (MG), Bankr. S.D.N.Y. Feb. 19, 2013..... 9, 10, 15, 16, 17, 19, 20, 29, 39

Residential Capital, LLC, SEC No-Action Letter,
2009 WL 3634705 15

In re Reynolds,
13 B.R. 658 (Bankr. N.D. Ga. 1981) 23

In re SemCrude L.P.,
436 B.R. 317 (Bankr. D. Del. 2010) 28

Shawmut Bank Conn. v. First Fidelity Bank (In re Secured Equip. Trust of E. Air Lines),
38 F.3d 86, 215 B.R. at 90 (2d Cir. 1994) 19, 20

Sloan v. Zions First Nat'l Bank (In re Castletons, Inc.),
990 F.2d 551 (10th Cir. 1993) 36

Smith v. City of Jackson,
544 U.S. 228 (2005).....16

In re Southeast Banking Corp.,
93 N.Y.2d 178 (1999) 8

In re Stylesite Mktg., Inc.,
2001 Bankr. LEXIS 2299 (Bankr. S.D.N.Y. Jan. 2, 2001).....40

In re The 1031 Tax Group, LLC,
439 B.R. 47 (Bankr. S.D.N.Y. 2010).....7

United States v. CF&I Fabricators of Utah, Inc.,
518 U.S. 213 (1996).....37, 38

United States v. Noland,
517 U.S. 535 (1996).....37, 38, 39, 40

In re Washington Mutual, Inc.,
462 B.R. 137 (Bankr. D. Del. 2011).....13-15

In re Winstar Communications, Inc.,
554 F.3d 382 (3d Cir. 2009).....36

In re Worldcom, Inc.,
329 B.R. 10 (Bankr. S.D.N.Y. 2005).....35

Rules/Statutes

70 Fed. Reg. 1506-01 (Jan. 7, 2005).....17

70 Fed. Reg. 1526 (Jan. 7, 2005).....17

11 U.S.C.
§ 101.....27
§ 101(2).....18, 26, 27. 28
§ 101(2)(c).....18, 20, 23, 26. 28, 29
§ 101(41).....19
§ 101(9)(A)(v).....19
§ 102(2).....33
§ 330.....28
§ 510.....2
§ 510(a).....2, 8, 10, 11, 41
§ 510(b).....2, 11, 13, 15-16, 20, 27-28, 30, 32, 34-36, 40-41
§ 510(c).....2, 35, 36, 37, 41
§ 541(b)(4)(B).....29
§ 541(d).....28
§ 546.....16

17 C.F.R.
§ 230.191(a).....17
§ 230.191(b).....17, 18
§ 240.3b-19(a).....17

Bankruptcy Rule
901(3).....27
7056.....7
7056-1.....1

Fed. R. Civ. P.
56.....7
56(a).....7, 8

H.R. Doc. No. 93–137, pt. 4, at 580 n. 4 (1973).....27

Pub. Law 95-598 (Nov. 6, 1978) 28

PUHCA, § 8 27

SEC Rule 191 25

SEC ABS Final Rule 17
§ I.A 17, 25
§ I.E 25
§ II 25
§ III.A.2.a 25

Other Authorities

2 Collier on Bankruptcy ¶ 101.41 20

4 Bankruptcy Reform Act of 1978 § 1-102 (16th ed.) 27

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Securities Exchange Act of 1934 17

Securities Act of 1933 16

INTRODUCTION

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," and, with AIG, Allstate, and MassMutual, the "Investors"), holders of general unsecured claims against Residential Capital, LLC and its debtor-subsidiaries ("the Debtors"), by and through their undersigned counsel, hereby file this motion ("Motion") seeking summary judgment dismissing all counts asserted by the Debtors in their Complaint filed on February 19, 2013 (the "Complaint"). In accordance with Local Rule 7056-1, annexed hereto as Exhibit A is the Local Rule 7056-1 Statement of Stipulated Undisputed Facts and Agreed-to Exhibits (the "Joint Stipulation"). Unless otherwise noted, citations to documents in this Motion are citations to exhibits to the Joint Stipulation.

PRELIMINARY STATEMENT

This case poses a significant statutory interpretation question affecting the treatment of modern financial instruments in bankruptcy. It is commonly understood (and even acknowledged in the Bankruptcy Code) that companies, rather than incur secured debt backed by a pledge of assets, sometimes opt to create structures that remove such assets and attendant liabilities from their balance sheet. Doing so allows the company, for the benefit of its creditors and shareholders, to borrow money at a lower cost than issuing their own securities. In turn, investors bargain for the benefits and burdens of investing directly in a discrete pool of financial assets rather than investing in the company. The relationship between the investors and the company is made clear to all parties doing business with the company. This is the case at bar.

The Bankruptcy Code requires the subordination of fraud claims of investors who made a choice to invest in a debtor's capital structure. And in order to ensure no loopholes arise from

technical distinctions of which specific entity within an affiliated group was the subject of the investment, Congress provided that claims arising from rescission of securities of either the specific debtor in bankruptcy or an "affiliate" of that debtor would be subordinated below the level of investment chosen. The Bankruptcy Code does not subordinate claims arising from an investment made outside the capital structure of a debtor or its affiliates.

The Debtors employ a kitchen-sink approach, invoking every sub-section of section 510 of the Bankruptcy Code as an alleged basis to subordinate claims. Section 510(a) does not work to alter or enlarge a "waterfall" provision governed by nonbankruptcy law and the analysis of the Debtors' claim under that sub-section ends there. Likewise, section 510(c) cannot be used to categorically subordinate claims of innocent creditors under a twisted concept of "equity" that actually turns principles of fairness on their head. The real crux of this case is whether section 510(b) of the Bankruptcy Code does, or does not, apply to certificates of securitization trusts that are 100% owned and controlled by third parties unaffiliated with the Debtors.

To achieve their ends, the Debtors have to prove the trust is a "person," an agreement to service or supervise the servicing of mortgage loans is an "operating agreement," and the trust's own business (if any) or property was "operated" by a debtor. Beginning with the very first requirement, the Debtors ignore controlling precedent that securitization trusts are not "affiliates" under the Bankruptcy Code because they are not "persons." That is the law of this Circuit, full stop, and the failure to prove the trusts here are "persons" is fatal. To squeeze into the balance of the "affiliate" definition, the Debtors would have the Court adopt a statutory construction consistent with the integrity of Cinderella's stepmother. Knowing the slipper would never fit naturally, Cinderella's stepmother told her daughters to remove parts of their feet to make it

fit.[1] This, of course, is an inappropriate way to read a statute.[2] Confounded by the natural reading of the words, the Debtors take out a knife and cut the words "operating" and "operate" from the statute to try to make it broader.

Only one reading of "person whose business is operated under a lease or operating agreement" or "whose property is operated under an operating agreement" is natural. It requires an operating business, or at least property that can be operated. Further, that business or property must be operated under either a lease or an operating agreement. The Debtors ignore the context of words in the phrase, and suggest ***any*** business or property is capable of operation and ***any*** agreement is a lease or operating agreement. The undisputed facts show that the purpose of the trusts is merely to hold mortgage loans and conserve the trust *res*; the trusts have no operating business, nor do they have any property that is capable of being operated. They never even acquired the rights to service the mortgage loans they own, as those valuable rights were expressly retained by the sponsor entity that pooled the mortgages. Put simply, and consistent with the Second Circuit's own rationale why securitization vehicles are not even "persons," the trusts were established for the limited purpose of passively holding mortgage loans, which are

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[1] According to Brothers Grimm:

> [H]er mother gave her a knife and said, "Cut the toe off; when thou art Queen thou wilt have no more need to go on foot."
>
> The maiden cut the toe off, forced the foot into the shoe, swallowed the pain, and went out to the King's son.
>
> ….
>
> He turned his horse round and took the false bride home again, and said she was not the true one, and that the other sister was to put the shoe on. Then this one went into her chamber and got her toes safely into the shoe, but her heel was too large.
>
> So her mother gave her a knife and said, "Cut a bit off thy heel; when thou art Queen thou wilt have no more need to go on foot."

[2] *Demko v. United States*, 216 F.3d 1049, 1053 (Fed. Cir. 2000) ("When a statute is as clear as a glass slipper and fits without strain, courts should not approve an interpretation that requires a shoehorn.").

non-operating or financial assets. That is why they have no employees. That is why the trusts' functions are limited in scope and cannot be changed without a vote of the owners of the trusts.

The Debtors fare no better by changing how the words "security of the debtor" are written or naturally understood. They urge a position that requires deletion of the words "of the debtor," and insertion of the words, "of which the debtor may be deemed an issuer." The SEC regulations that deem a depositor to be the relevant "issuer" for reporting and other obligations under the securities laws have no bearing on whose securities are represented by the trust certificates. Those regulations themselves even make this clear. There can be no doubt that the trust certificates are securities "of" the trusts, and no other entity.

This matter is ripe for summary judgment. For the Debtors to prevail, they must show that a trust specifically created to be unaffiliated with the Debtors nevertheless is an "affiliate" of the Debtors. They urge the Court to disregard binding precedent, and then to either cut commonly understood words completely out of the statute, or assign unnatural meanings to those words, to make the statute fit a transaction that is simply not covered. The Court should reject these invitations and apply the statute as written and plainly understood.

STATEMENT OF FACTS

A. The Structure Of Mortgage-Backed Securities

Residential mortgage-backed securities ("RMBS") are investments derived from pools of mortgage loans that are packaged for securitization through bankruptcy-remote trusts. Here, in connection with the RALI Series 2006-QO3 trust,[3] debtor Residential Funding Corporation ("RFC" or "Sponsor") pooled and assigned approximately $650 million in loans to debtor Residential Accredit Loans, Inc. ("RALI" or "Depositor"). When the Sponsor conveyed the

[3] Generally the Debtors' transactional documents relating to the RMBS Certificates were similar in form, and for administrative ease the parties have agreed to use one representative example of such documentation.

mortgage loans to the Depositor, it retained the right to service them, including any rights to receive servicing fees and servicing income relating to the loans. March 30, 2006 Assignment and Assumption Agreement (the "Assignment Agreement") § 2. The Depositor, in turn, sold whatever rights in the mortgage loans it had acquired (which did *not* include the servicing rights) to a trust created to hold the loans and related contract rights (the "Trust Fund") for the benefit of the certificateholders. Joint Stipulation, Exhibit 1 (March 1, 2006 Standard Terms of Pooling and Servicing Agreement, Mortgage Asset-Backed Pass-Through Certificates Series 2006-QO3 ("PSA") § 2.01). Under the PSA, the Sponsor, which had retained the servicing rights pursuant to the Assignment Agreement, was appointed the Master Servicer (the "Servicer") of the mortgage loans, and Deutsche Bank Trust Company Americas was appointed as the Trustee (the "Trustee").

In order to finance the acquisition of the loans, the trust created under the PSA (the "Trust") issued approximately $650 million in certificates (the "Certificates") representing 100% of the beneficial ownership of the Trust. These Certificates entitle the holders to payments from the loan pool and pursuant to any remedies that may be exercised by the Trustee. The RMBS offering involved multiple classes, or "tranches," of Certificates, and the PSA governed the priority of payment from the Trust Fund's assets through a "waterfall." Because it is the flow of cash from the pool of mortgages held by the Trust that determines an investor's return, the risk/return on Certificates is dependent upon the underlying homeowners' performance of their mortgage obligations. *E.g.*, Joint Stipulation, Exhibit 3 (Prospectus Supplement ("Pro. Supp.")) at S-16-23.

As set forth in the PSA, the purposes and powers of the Trust were to "sell the Certificates," to "enter into and perform its obligations under [the PSA]," to "engage in those activities that are necessary, suitable or convenient to accomplish the foregoing," and to "engage

in such other activities as may be required in connection with conservation of the Trust Fund and the making of distributions to the certificateholders." PSA at § 2.08. Accordingly, the transactional documents charge the Trust with responsibility for a number of limited tasks consistent with its purpose of holding non-operating assets and ensuring that certificateholders receive the amounts that should be passed through to them from those assets.[4]

For its part, the role of the Servicer was to "service and administer the Mortgage Loans in accordance with the terms of [the PSA] and the respective Mortgage Loans," and to that end, the Servicer was granted "full power and authority . . . to do any and all things which it may deem necessary or desirable in connection with such servicing and administration." PSA at § 3.01. Although the Servicer performs many duties, those duties all relate to servicing or administering the Mortgage Loans, for which it is duly compensated.

B. The Investors' Misrepresentation Claims

In order to market the Certificates, potential investors were given information jointly prepared, vetted, authorized, and distributed by, among others, the Sponsor, the Depositor, and underwriters. This information is contained in draft and final term sheets, a free-writing prospectus, prospectuses and prospectus supplements, registration statements, and other materials (the "Offering Materials"). Between 2005 and 2007, the Investors purchased billions of dollars of RMBS certificates issued by trusts similar to the Trust, in reliance on

[4] Such responsibilities include, among others: managing the short-term investment of the received funds between the time they are received (from the Servicer that collects homeowners' payments) and distributed (to the certificateholders); examining all documents required to be provided by the Depositor and Servicer to ensure they are complete; making available reports on the loans and mailing paper reports to those who request them; modifying the distribution process when necessary; maintaining a website for investors to access the Trust's SEC filings; delivering the Certificates in a specified form; maintaining a registry of the holders of the Certificates; responding to certificateholders' demands to exchange Certificates; replacing mutilated, lost, or stolen Certificates; declaring Events of Default and responding to certificateholders' demands regarding Events of Default; paying all applicable taxes; and delivering to the Depositor reports on litigation involving the Trustee. *See* PSA at §§ 2.02, 4.01, 4.03, 5.01, 5.02, 7.01, 8.01, 12.03.

representations regarding the key risk features of the underlying mortgage loans contained in Offering Materials.

In February 2011, Allstate filed suit against certain Debtors and non-debtor Ally Securities in Minnesota state court, seeking to recover on theories of common-law and statutory fraud. Discovery was ongoing when the Debtors filed these bankruptcy cases. On February 9, 2011, MassMutual commenced a civil action in the United States District Court for the District of Massachusetts against certain Debtors and other parties in connection with the sale of the RMBS to MassMutual. On February 14, 2012, the court entered an order granting in part a motion to dismiss MassMutual's claims.[5] AIG and Prudential have not yet filed lawsuits against the Debtors.[6]

STANDARD FOR SUMMARY JUDGMENT

Rule 56 of the Federal Rules of Civil Procedure, made applicable to this adversary proceeding by Bankruptcy Rule 7056, provides the standard for granting summary judgment. *In re The 1031 Tax Group, LLC*, 439 B.R. 47, 58 (Bankr. S.D.N.Y. 2010). Rule 56(a) provides that a court "shall grant summary judgment if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." Fed. R. Civ. P. 56(a). Facts are material if they "might affect the outcome of the suit under the governing law." *Overton v. New York State Div. of Military and Naval Affairs*, 373 F.3d 83, 89 (2d Cir.

[5] The district court's interlocutory order dismissed MassMutual's claims against the Debtors. MassMutual believes it has a strong basis to seek reversal of this dismissal order on appeal based upon relevant legal decisions in which courts have sustained claims against sponsor and depositor defendants. *See, e.g., Capital Ventures Int'l v. J.P. Morgan Mortg. Acquisition Corp.*, Civ. A. No. 12-10085-RWZ, 2013 WL 535320 (D. Mass. Feb. 13, 2013).

[6] Each of the Investors has filed proofs of claims in these cases. Attached as Exhibit 31 to the Joint Stipulation is a list of all of the proofs of claims that the Investors have filed (by individual creditor and Debtor entity).

2004). The moving party is entitled to judgment as a matter of law "'[w]here the record taken as a whole could not lead a rational trier of fact to find for the non-moving party.'" *Id.*

ARGUMENT

I. SECTION 510(a) DOES NOT APPLY TO THE INVESTORS' CLAIMS

That section 510(a) does not apply to subordinate the Investors' claims requires little discussion. Section 510(a) provides:

> A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

11 U.S.C. § 510(a). This provision does not create priorities among claims against a debtor; it merely confirms that bankruptcy law does not alter subordination agreements that are enforceable under bankruptcy law. *See, e.g., First Fid. Bank v. Midlantic Nat'l Bank* (*In re Ionosphere Clubs, Inc.*), 134 B.R. 528, 533 (Bankr. S.D.N.Y. 1991) (holding that the enactment of section 510(a) means that the enforcement of subordination provisions is no longer a matter committed to the bankruptcy courts' notions of what may (or may not) be equitable). Under New York law, subordination agreements are interpreted by traditional contract principles. *See, e.g., In re Enron Creditors Recovery Corp.*, 380 B.R. 307, 322 (S.D.N.Y. 2008) ("Moreover, New York does not have any special rules of interpretation for subordination agreements; its courts apply general principles of contract law.") (internal citations omitted).[7]

There is no provision in the PSA (or any other document) that subordinates the Investors' fraud or statutory-based claims against the Debtors, and the Debtors do not contend there is. The

[7] In *In re Southeast Banking Corp.*, 93 N.Y.2d 178, 186 (1999), the New York Court of Appeal, on certification from the Court of Appeals for the Eleventh Circuit, held that the "Rule of Explicitness"—requiring subordination agreements to explicitly alert junior creditors of enhanced risks—applies under New York law. This Court, however, need not reach this issue because, just as the Offering Documents do not subordinate the Investors' extracontractual claims under New York's general rules of contract interpretation, they would also fail to do so under this more stringent principle of interpretation.

inquiry should end there. The PSA unambiguously does *not* impose any form of subordination on investors suing for fraud, consumer protection violations, or securities law violations.

Debtors have nevertheless attempted to argue that the Investors' claims are subordinated by (1) "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 (2) "the implied subordination of former certificateholders to subsequent purchasers, inherent in the sale of the Certificates." *In re Residential Capital, LLC*, No. 12-12020 (MG), Opp. to Mot. of AIG Asset Mgmt. (U.S.), LLC, the Allstate Entities, Mass. Mut. Life Ins. Co. & the Prudential Entities for an Order Under Bankr. R. 3013 Concerning Subordination of Investors' Secs. Claims (D.E. No. 2953) (Bankr. S.D.N.Y. Feb. 19, 2013) ("3013 Opp.") at 25. Neither of these purported "subordination agreements" applies to the Investors' fraud claims.

The tranches and waterfall structure provide for subordination among payments from the Trust's assets based on ownership of Certificates, as made clear by the provisions Debtors cite. *See, e.g.*, Pro. Supp. at S-10-13 (describing priority of distributions on the offered certificates); *id.* at S-64-69 (describing distribution of principal and excess cash flow and coverage of realized losses). The tranches and waterfall structure do not apply to any extra-contractual claims an investor might have and to treat them otherwise would be to rewrite the investors' agreements.

Similarly, the "implied subordination" that the Debtors contend "is a natural consequence of warranties and duties that the common law and New York's Uniform Commercial Code impose on all sales of securities" does not apply to the Investors' fraud-based claims. The clear, unambiguous language of the Offering Materials and Certificates indicates the various investors' agreement to subordinate some classes of securities to others with respect to the payment of principal and interest and the allocation of loss from insufficient value of the Trust's assets in accordance with the PSA. Thus, while the PSA allocates the "Available Distribution Amount"

(defined therein) among various tranches of Certificates, the Available Distribution Amount consists exclusively of funds derived from the collection on mortgage loans; payments in respect of fraud claims are not captured by this term, and the PSA priority waterfall does not apply to such payments. Any "implied" covenants to effect the purpose of that agreement do not extend to the Investors' non-contractual claims.[8]

The Debtors appear to suggest that the only remedy available to investors in RMBS are contractual "put-back" claims, asserted by the Trusts. But the case on which the Debtors would be relying, *Lone Star Fund V (US), LP v. Barclays Bank PLC*, 594 F.3d 383, 389 (5th Cir. 2010), has been rejected by many courts, including "the overwhelming majority of courts in this Circuit[.]" *New Jersey Carpenters Health Fund v. Residential Capital, LLC*, Nos. 08 CV 8781(HB), 08 CV 5093(HB), 2011 WL 2020260, at *6 (S.D.N.Y. May 19, 2011); *see also Emps.' Ret. Sys. of the Gov't of the Virgin Islands v. J.P. Morgan Chase & Co.*, 804 F. Supp. 2d 141, 155 (S.D.N.Y. 2011) (declining to follow *Lone Star* and noting that "*Lone Star* is in significant tension with the well-established rule that 'individual security holders may not be forced to forego their rights under the federal securities laws due to a contract provision.'").

Courts have repeatedly held that RMBS investors are not limited to "put back" remedies exercised by trustees. The sole question on this motion is whether any claims for common law fraud or statutory damages of the Investors are subject to the contractual priority of tranches contained in the documents governing the certificates. They are not, by their terms, and the Debtors cannot use section 510(a) to enlarge the subordination agreement among creditors.

[8] Notably, Debtors do not so much argue that these implied duties trigger section 510(a) so much as they argue that "to ensure that recovery flows . . . without dilution" the Court *should* subordinate the Investors' claims pursuant to section 510(a). *See* 3013 Opp. at 29. That is simply a misuse of section 510(a), which does not provide an independent basis to subordinate claims.

Because the Investors' claims are entirely outside the confines of the parties' agreement, the argument that the Investors' direct claims are subordinated under section 510(a) fails.

II. SECTION 510(b) DOES NOT APPLY TO THE INVESTORS' CLAIMS

Section 510(b) provides:

> [A] claim arising from rescission of a purchase or sale of a ***security of the debtor or of an affiliate of the debtor,*** for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, ***shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security***, except that if such security is common stock, such claim has the same priority as common stock.

11 U.S.C. § 510(b) (emphases added). The Debtors assert that the Investors' claims must be subordinated under section 510(b) as claims arising from the purchase or sale of a security "of" a debtor or "of an affiliate of the debtor." Compl. ¶¶ 92-98. The Debtors, however, are very casual (as they must be) with their approach to statutory construction. As demonstrated below, an investment does not magically become a security "of" the Debtor that acted as Sponsor merely because that Debtor had a role in marketing the security, nor because the Securities and Exchange Commission ("SEC") has deemed the Debtor that acted as Depositor to take on responsibilities as the "issuer" for certain purposes under the Securities Act and Securities Exchange Act. Similarly, an impartial reading of the definition of "affiliate" under the Bankruptcy Code reveals that the Trust is not an affiliate of the Debtor that is the Servicer.

A. The Trust's Certificates Are Not Securities "of" the Debtor

The Debtors implicitly ask the Court to adopt a rule that securities can be "of" more than one entity. It is undisputed that the Certificates exclusively represent ownership interests only in the Trust, and do not represent any interest in or obligation of the Debtors. Nevertheless, relying on an admittedly "technical definition" (Compl. ¶ 78) under regulations promulgated by the

SEC, the Debtors suggest being deemed a statutory issuer of a security is the same as making that security one's own. The Offering Materials for the Trusts' securities expressly refute this most anomalous conclusion, however, by making clear that the Certificates are anything but securities "of" the Debtors:

- Residential Accredit Loans, Inc. Form S-3A, at 66 (emphasis added): "***The certificates do not represent an interest in or an obligation of the depositor***. The depositor's only obligations with respect to a series of certificates will be to repurchase certain items of mortgage collateral upon any breach of limited representations and warranties made by the depositor.") (Joint Stipulation, Exhibit [32]; and

- Pro. Supp. at S-22 (emphasis added): "Payments on the mortgage loans are the sole source of payments on your certificates. ***The certificates represent interests only in the RALI Series 2006-QO3 Trust. The certificates do not represent an ownership interest in or obligation of the depositor***, ***the master servicer or any of their affiliates.***"

Moreover, the risk disclosures in the Offering Materials confirm that the Certificates are paid solely from the assets acquired from the Depositor, and there is no recourse against any of the Debtors. Pro. Supp. at S-22 (emphasis added): "If proceeds from the assets of the RALI Series 2006-QO3 Trust are not sufficient to make all payments provided for under the pooling and servicing agreement, investors will have ***no recourse to the depositor, the master servicer or any other entity***, and will incur losses."

Indeed, far from identifying a risk of "affiliate" status for purposes of the Bankruptcy Code, the only "bankruptcy risks" disclosed were (a) the risk that homeowners (*i.e.*, the borrowers of the mortgage loans) might become subjects of bankruptcy proceedings, increasing the risk of loss on mortgage loans, and (b) the risk that "if Residential Funding were to become bankrupt, a trustee in bankruptcy could attempt to recharacterize the sale of the mortgage loans [to the depositor] as a loan secured by the mortgage loans or to consolidate the mortgage loans with the assets of Residential Funding," which could cause "delay in or reduction of collections

on the mortgage loans available to make payments on the certificates." Pro. Supp. at 22. There is no mention of the risk that, if RFC or any other Debtor were to file bankruptcy, such Debtor might assert that the Trust is an affiliate of the Debtor and seek to subordinate, under Bankruptcy Code section 510(b), claims against RFC arising from the purchase or sale of the Certificates.

The court in *Washington Mutual* squarely rejected similar contentions that securities of a non-debtor trust should be treated as securities "of" the depositors' and sponsors' debtor parent companies for purposes of subordination because they sold the securities. *In re Washington Mutual, Inc.*, 462 B.R. 137 (Bankr. D. Del. 2011). Seeking to subordinate the claim of an investor in trust certificates, the debtors in *Washington Mutual* contended the trusts' securities were securities "of" the debtors because "the word 'of' only requires that the debtor or affiliate be the *seller* of the securities and does not require that it be the *issuer*." *Id.* at 146. The creditors' committee argued that "equitable considerations support this interpretation of section 510(b) because it is unreasonable to shift 'even a small portion of the risk of illegality' of the issuance of a security to the creditors who did not agree to accept such a risk," invoking the Slain & Kripke article endorsed by Congress in section 510(b)'s legislative history. *Id.* at 146-47 (citing J. Slain & H. Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. Rev. 261 (1973) (the "Slain & Kripke Article")).

The *Washington Mutual* court rejected the debtors' and creditors' committee's arguments based on persuasive reasoning that applies here with the same force:

> The article and case law cited by the Debtors and Creditors' Committee address the competing interests of creditors and the buyers of securities issued by a debtor. ***Neither the Debtors nor their affiliates are the issuers of the Certificates.***
>
> Even if the language in 510(b) was ambiguous, equitable concerns weigh against subordinating Tranquility's claim. ***Tranquility did***

> ***not purchase a security of the Debtors and did not assume the risk (and potential rewards) that a shareholder of the Debtors assumed.***

Id. at 146-47 (emphases added) (citations omitted). The *Washington Mutual* court rejected the equitable considerations argument where (as there and as here) the investor did not purchase securities "of" the *debtor* but of a third party (a trust), using a hypothetical to illustrate the point:

> The example cited . . . in oral argument illustrates this. If Tranquility bought stock of [debtor] WMI from WMI, it would be assuming the risks normally associated with that stock, including the risk that WMI could become insolvent. If WMI had committed fraud in that sale, Tranquility would have a claim for that fraud, but it would be inequitable to treat Tranquility like the other creditors if WMI becomes insolvent because Tranquility assumed that risk.
>
> The analysis changes, however, where Tranquility buys stock of another company, say Apple, from WMI. Tranquility is assuming the risks associated with owning stock in Apple, including that Apple may become insolvent but not that WMI may become insolvent. If WMI defrauded Tranquility in the sale of Apple stock, therefore, Tranquility should be treated like any other creditor of WMI because Tranquility never assumed the risks of a WMI shareholder. If this were not the case, then all claims of customers defrauded by a broker/dealer would be subordinated and treated as if they were shareholders of that broker/dealer rather than customers or creditors. That would extrapolate section 510(b) far beyond its intent or plain language.

Id. at 147. The same holds true here; the Investors did not gamble on whether the Debtors would fail or succeed; they did *just the opposite* by purchasing certificates that only represented ownership interests in the Trust, whose assets were mortgage loans made by third-party homeowners. As such, the *Debtors'* financial performance has as little to do with whether those mortgages are paid off (or not) as it does with the return on Apple stock. The Certificates are no more securities "of" the Debtors than are shares of Apple.[9]

[9] Similarly, in a no-action letter to the SEC in 2009, the Debtors acknowledged that none of the RMBS Certificates were "securities of" any Debtors, stating that "ResCap has no securities outstanding other than (i) its common equity interests, (ii) the registered notes discussed above and (iii) the notes that

Having expressly disclaimed that the Certificates are securities "of" the Debtors in the Offering Materials, the Debtors now argue section 510(b) nevertheless applies to the Investors' claims based on SEC regulations providing that the Depositor should be deemed an issuer for certain purposes under the Securities Act and Securities Exchange Act. *E.g.*, 3013 Opp. at 14-16. Although the *Washington Mutual* court did not have occasion to consider this argument, it too can be swiftly rejected.

On its face, Debtors' contention fails: A regulation providing that a debtor is *deemed* to be an issuer of a security for limited purposes under the securities law does not transform that security into a security "of the debtor" under the Bankruptcy Code. Indeed, the very fact that a regulation "deems" a debtor to be an issuer is clear evidence that absent a regulation to that effect, *the debtor would not be an issuer*. In any event, the cases that certain parties have cited for the proposition that section 510(b) should be interpreted with reference to the securities laws and regulations[10] are inapplicable here because they either concerned laws that were far more

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were issued in transactions exempt from the registration requirements of the Securities Act" and that "[t]he Guarantor Subsidiaries have no securities outstanding other than (i) common equity that were issued in transactions exempt from the registration requirements of the Securities Act and owned directly or indirectly ResCap and (ii) guarantees of ResCap's notes referred to in (iii) of the preceding sentence." Residential Capital, LLC, SEC No-Action Letter, 2009 WL 3634705. The Debtors further stated that "[e]xcept as described above, neither ResCap nor the Guarantor Subsidiaries has any requirements under Section 13(a) or Section 15(d) to file reports with the Commission with respect to any of these securities." *Id.*

[10] *See, e.g.*, *In re Residential Capital, LLC*, No. 12-12020 (MG), Obj. of Wilmington Trust, Nat'l Ass'n to the Mot. of AIG Mgmt. (U.S.), LLC, the Allstate Entities, Mass. Mut. Life Ins. Co. & the Prudential Entities for an Order Under Bankr. R. 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 Bankr. Code Section 510(b) (D.E. No. 2959) at ¶ 23; *id.*, RMBS Trustees' Obj. to Mot. of AIG Mgmt. (U.S.), LLC, the Allstate Entities, Mass. Mut. Life Ins. Co. & the Prudential Entities for an Order Under Bankr. R. 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 Bankr. Code Section 510(b) (D.E. No.2967) at ¶¶ 30-31; *id.*, Obj. of Assured Guar. Mun. Corp. & Certain Affiliates to Investors' Mot. for Order Classifying Investors' Secs. Claims in Same Class as Securitization Trusts' Contract Claims &

similar in origin, history, and purpose than the securities laws and the Bankruptcy Code or they considered *and rejected* using the securities laws to interpret the Bankruptcy Code. *See, e.g.*, *Smith v. City of Jackson*, 544 U.S. 228, 233-34 (2005) (using Title VII civil rights legislation to interpret age discrimination statute because relevant language in statute was adopted verbatim from Title VII); *Northcross v. Bd. of Educ.*, 412 U.S. 427, 428 (1973) (using Civil Rights Act's discretionary attorneys' fees provision to interpret similar language in Emergency School Aid Act); *Picard v. Flinn Invs., LLC*, 463 B.R. 280, 285-86 (S.D.N.Y. 2011) (*not* "interpreting [11 U.S.C. § 546] by reference to securities laws" but rather withdrawing bankruptcy referral because application "depend[ed] on how [the court] resolves numerous questions of securities law"); *In re Granite Partners, L.P.*, 208 B.R. 332, 339-42 (Bankr. S.D.N.Y. 1997) (concluding that securities laws *did not* "provide persuasive authority for limiting [11 U.S.C. § 510(b)]'s like language in a like manner").

Even considering the Debtors' securities law-based argument, it crumbles upon review of the very SEC regulations on which Debtors rely to manufacture it.[11] These regulations expressly distinguish between asset-backed securities for which a Depositor is *deemed* an issuer and the securities of the Depositor itself. For example, Debtors cite to section 230.191(a) of Title 17 of the Code of Federal Regulations for the proposition that "[t]he depositor for the asset-backed

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Directing that Such Secs. Claims Cannot Be Subordinated Pursuant to Bankr. Code Section 510(b) (D.E. No. 2968) at ¶ 3.

[11] Indeed, the SEC adopted new and amended rules effective March 2005 to address "comprehensively" the registration, disclosure, and reporting requirements for asset-backed securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. *See* Asset-Backed Securities, SEC Final Rule, Securities Act Release No. 8518, Exchange Act Release No. 50905, 70 Fed. Reg. 1506 (Jan. 7, 2005), available at: http://www.sec.gov/rules/final/33-8518.htm#VIIIhttp://www.sec.gov/rules/final/33-8518.htm#VIIIhttp://www.sec.gov/rules/final/33-8518.htm#VIIIhttp://www.sec.gov/rules/final/33-8518.htm#VIII (the "SEC ABS Final Rule"). In so adopting, the SEC made clear its view that "[t]he structure of asset-backed securities is intended, among other things, to insulate ABS investors from the corporate credit risk of the sponsor that originated or acquired the financial assets." SEC ABS Final Rule at § I.A.

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." 3013 Opp. at 14. Subsection (b) of the same regulation, however, expressly cautions against confusing those securities with the depositor's *own* securities. 17 C.F.R. § 230.191(b) ("The person acting in the capacity as the depositor specified in paragraph (a) of this section is a different 'issuer' from that same person acting as a depositor for another issuing entity or ***for purposes of that person's own securities***.") (emphases added); *see also* 70 Fed. Reg. 1506-01, 1526 (Jan. 7, 2005) ("By clarifying that the person acting as the depositor in its capacity as depositor to the issuing entity is a ***different 'issuer' from that person in respect of its own securities***, we are making clear our longstanding position that any applicable exemptions from registration that person may have ***with respect to its own securities*** are not applicable to the asset-backed securities.") (emphases added); *see also id.* at 1526-27 ("Similarly, the reporting history with respect to a particular class of asset-backed securities does not affect Form S-3 eligibility ***with respect to the depositor's or sponsor's own securities***[.]") (emphases added).[12] The Debtors' efforts to conflate an entity's status as a deemed "issuer" of securities with those securities being that "of" the entity itself is completely misguided and contrary to the regulations relied upon.[13]

B. Section 510(b) Does Not Apply Because the Trusts Are Not "Affiliates" of the Debtors As Defined by the Bankruptcy Code

Next, the Debtors argue that the Trust's RMBS are securities of "an *affiliate* of the debtor." However, this argument hinges on the Trust itself being an "affiliate" of the Debtors,

[12] This regulation and associated commentary relate to the 1933 Securities Act. Debtors have also previously cited the parallel regulation for the 1934 Securities Exchange Act, which is identical in all relevant respects. *See* 17 C.F.R. § 240.3b-19(a); 70 Fed. Reg. at 1526 n.155 ("We are adopting an identical rule for purposes of the Exchange Act.").

[13] Moreover, 17 C.F.R. § 230.191(b) itself recognizes that the securities to which it pertains remain "asset-backed securities *of that issuing entity*," not of the "deemed" issuer. 17 C.F.R. § 230.191(b) (emphasis added).

and it is not. Under the Bankruptcy Code,

> "affiliate" means—
>
> (A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor [with certain exceptions];
>
> (B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor [with certain exceptions];
>
> (C) person whose business is operated under a lease or operating agreement by a debtor, or [a] person substantially all of whose property is operated under an operating agreement with the debtor; or
>
> (D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.

11 USC § 101(2). "By using the word 'means' rather than 'includes,' Congress enacted a precise and restricted definition." *In re Missionary Baptist Found. of Am., Inc.*, 712 F.2d 206, 210 (5th Cir. 1983). The Debtors contend that the Trust falls with section 101(2)(C)'s definition of "affiliate" because it is a "person whose business is operated under a lease or operating agreement by a debtor, or [a] person substantially all of whose property is operated under an operating agreement with the debtor[.]" *E.g.*, Compl. ¶¶ 95-97; 3013 Opp. at 17 . This argument fails because it ignores Second Circuit law and does violence to the plain language of the statute by excising portions of the statutory language and reading the balance in the most tortured way.

1. *The Trust Is Not a "Person" Under the Bankruptcy Code*

As a threshold matter, before reaching the issue of whether the Debtors operate the Trust's business or its property under an operating agreement (they do not), the Debtors must show that the Trust is a "person" within the meaning of the Bankruptcy Code. Unlike an "entity," the Bankruptcy Code more narrowly defines "person" to include an "individual,

partnership, and corporation," but not a trust. 11 U.S.C. § 101(41). In turn, the Bankruptcy Code defines "corporation" to include a "business trust." 11 U.S.C. § 101(9)(A)(v). The Trust is not a business trust.

The Second Circuit has squarely addressed the issue. In *Shawmut Bank Conn. v. First Fidelity Bank (In re Secured Equip. Trust of E. Air Lines)*, 38 F.3d 86, 87-88 (2d Cir. 1994), the court was confronted with the "sole issue" of whether a "trust created in order to secure the payment of certificates issues in connection with a secured financing" was a "business trust" within the meaning of the Bankruptcy Code. There the court was not persuaded by the fact that the trust's collateral trustee "carried on the business of leasing and selling the [collateral sold to it by the debtor]." *Id*. at 89. Nor was the court concerned with the legal possibility—which it determined unnecessary to its analysis—that the interest the certificate holders were entitled to could be considered "profit," because, in any event, the trust was not responsible for "generat[ing]" such payment. *Id.* at 90. Rather, it was confined to "preserv[ing]" such right to payment. *Id.* The court went further, finding that the trust was not designed to "transact business" in view of the fact that it was created merely as a vehicle to facilitate financing for the debtor. *Id.*; *see also In re Gurney's Inn Corp. Liquidating Trust*, 215 B.R. 659, 668-669 (Bankr. E.D.N.Y. 1997) (holding that trust which was "established to collect mortgage payments" on account of mortgage received at time of formation and which had issued "freely transferable" certificates was not a business trust under the Bankruptcy Code); 2 Collier on Bankruptcy ¶ 101.41, at 101-176 ("It is important to note that the definition of 'person' does not include an estate or nonbusiness trust. . . . An estate and nonbusiness trust are included in the definition of 'entity.'").

The foregoing cases are directly on point. The Trust here was designed simply to preserve the certificateholders' right to payment, not to "transact business." Moreover, *Shawmut*

instructs that the "inquiry must focus on the trust documents and the totality of the circumstances, not solely on whether the trust engages in a business," which the Trust here does not do in any event. 215 B.R. at 90-91. Nowhere in the relevant documents is it provided that the Trusts are business trusts. Indeed, the Debtors have not even asserted as much. Under *Shawmut*, because the Trust is not a business trust, and therefore not a corporation, it is not an affiliate of the Debtors. This puts an end to the balance of the Debtors' improper reading of section 510(b).

2. *Neither the Trust's Business Nor Its Property Is Operated by a Debtor*

(a) Servicing the Loans Was *RFC's* "Business," Not the Trust's Business

Debtors' misplaced arguments are premised on the artifice that the Trust's "business" is "manag[ing] every aspect of the mortgage loans under the PSAs" and their equation of management of the loans with operating them, and operating with servicing. *See* 3013 Opp. at 18. The "management" of the loans, however, was *never* the business of the Trust. This error is the next of many cracks in the foundation of the Debtors' section 101(2)(C) "affiliate"-based argument.

In the Assignment Agreement, a critical document that initiated the chain of ownership of the mortgage loans, debtor RFC—identified in that agreement as both the owner and the master servicer—assigned certain rights in the pooled mortgage loans to debtor RALI. Assignment Agreement at § 2. Key among these rights was the right to all interest and principal received on the loans after that date. *Id.* § 2. However, the Assignment Agreement also expressly provided that "***the Master Servicer [RFC] shall retain all servicing rights*** (including, without limitation, primary servicing and master servicing) relating to or arising out of the Mortgage Loans, and all rights to receive servicing fees, servicing income and other payments made as compensation for

such servicing granted to it under the Pooling and Service Agreement." *Id.* (emphases added).[14] The rights to service the loans *remained with RFC* and were never conveyed to RALI. RALI, in turn, could not convey any rights to service the loans to the Trust, since it never had those rights to convey.

In addition to the Assignment Agreement's clear acknowledgement that the rights in the mortgage loans themselves were separate and apart from the right to service the mortgage loans, the plain meaning of the rights conveyed to the Trust do not include the right to service the mortgage loans. Specifically, under the PSA, RALI conveyed to the Trusts "all the right, title and interest of [RALI] in and to the Mortgage Loans, including all interest and principal received on or with respect to the Mortgage Loans" after a specific date. PSA at § 2.01. Applying the terms' plain meanings, neither the "Mortgage Loans" nor the "interest . . . in and to the Mortgage Loans" includes the right to service the loans. *See, e.g.*, *In re Am. Home Mortg., Inc.*, 379 B.R. 503, 522-23 (Bankr. D. Del. 2008) ("[I]t is contrary to the plain meaning of the words to include the servicing of mortgage loans within the meaning of 'mortgage loan' or 'interest in a mortgage loan.'").[15] Likewise, the Bankruptcy Code treats "servicing" and "interests in a mortgage loan" as separate and distinct concepts. *See id.*

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[14] The Assignment Agreement also provides that the servicing rights are not included in the collateral in which RFC granted RALI a security interest. Assignment Agreement at § 2.

[15] The *American Home Mortgage* court continued:

> [W]hether the servicing of mortgage loans is a mortgage loan [] hardly deserves mention. . . . [W]hether the servicing of [a] mortgage loan constitutes an interest in a mortgage loan, 'interest' in this context means 'a financial share or stake in something; the relation of being one of the owners or beneficiaries of an asset, company, etc.' As the right to control servicing of a mortgage loan is separate and distinct from ownership of that mortgage, it simply cannot constitute an ownership interest in the underlying mortgage.

379 B.R. at 522-23.

Moreover, the Assignment Agreement's treatment of the servicing rights related to a mortgage loan as separate and distinct from other rights and interests in that mortgage loan is consistent with industry practice. *See, e.g.*, *Am. Home Mortg.*, 379 B.R. at 521 ("[M]ortgage servicing is viewed as an entirely separate asset and that asset is traded separately and accorded distinct accounting treatment.").

The Debtors have acknowledged repeatedly that the servicing of mortgage loans was not only RFC's retained business, it was a substantial part of the Debtors' operations prior to the platform sale authorized by this Court. *See., e.g.*, Debtors' Motion to Sell Servicing Platform, dated May 14, 2012 [D.E. No. 61], at 22 ("The Debtors' residential mortgage loan servicing function has since 2008 been the Debtors' main source of ongoing revenue."); *id.* at ¶ 3 ("The Debtors' mortgage origination and servicing platform is one of the largest in the United States. These operations consist of servicing mortgage loans for investors and homeowners, including loans originated by the Debtors, non-debtor Ally Bank, and other third-party lenders."); Affidavit of James Whitlinger, Chief Financial Officer of Residential Capital, LLC in Support of Chapter 11 Petitions and First Day Pleadings [D.E. No. 6], ¶ 14 ("As of March 31, 2012, the Debtors were servicing over 2.4 million domestic loans with an aggregate UPB of approximately $374 billion."). In servicing mortgages, the Debtors operated their *own* business, not that of the Trust.

The Debtors' authorities in support of their contention that they "operated substantially all of the business and property of the Trusts" do not support their position. Even assuming *arguendo* that financial assets are capable of being "operated," none of Debtors' cases stands for the proposition that an entity that retains and exercises servicing rights relating to mortgage loans owned by another entity becomes an "affiliate" of the owner within the meaning of section 101(2)(C). Each case cited is easily distinguishable from the case at bar, based on the level of management and control the debtor exercised over every aspect of the business and property of

the "affiliate" or the context in which an entity was deemed an affiliate. *See, e.g.*, *Jenkins v. Tomlinson (In re Basin Res. Corp.),* 190 B.R. 824, 825-27 (Bankr. N.D. Tex. 1996) ("Joint Venture Agreement" provided that debtor had "full, exclusive and complete charge of all affairs of the Joint Venture and of the management and control of the Joint Venture" and evidence showed "properties of the joint ventures were turned over to the Debtor as the joint venture manager"; *In re Consol. Cos.*, 113 B.R. 269, 272-73 (Bankr. N.D. Tex. 1989) (control exercised pursuant to "Joint Operating Agreement" that allowed entity to shut down debtor's operations, replace debtors' employees with its own, and operate debtor's business); *In re Century Inv. Fund VII Ltd. P'ship*, 96 B.R. 884, 892 (Bankr. E.D. Wis. 1989) (property-managing affiliate was wholly owned subsidiary of debtor's general partner); *In re Minton Grp., Inc.*, 27 B.R. 385, 389 (Bankr. S.D.N.Y. 1983) (finding that limited partnership, of which debtor was general partner, was "affiliate" of debtor); *In re Reynolds*, 13 B.R. 658, 659 (Bankr. N.D. Ga. 1981) (entity was affiliate of debtor where debtor's contract gave her "full and absolute discretion as to the operation of the Business"). Unlike the debtors in these cases, the "business" Debtors here were "operating"—the servicing of the mortgages—at all times belonged to RFC and RFC alone.

(b) The *Actual* Function of the Trust Was Not To "Operate" At All

By focusing on servicing the mortgages, the Debtors have entirely ignored the function of the Trusts, even though the PSA unambiguously explains the exclusive purposes of the Trust. The PSA defines the Trusts' purpose as follows:

> The purpose of the trust . . . is to engage in the following activities: (a) to sell the Certificates to the Company in exchange for the Mortgage Loans; (b) to enter into and perform its obligations under this Agreement; (c) to engage in those activities that are necessary, suitable or convenient to accomplish the foregoing or are incidental thereto or connected therewith; and (d) subject to compliance with this Agreement, ***to engage in such other activities as may be required in connection with conservation of***

> ***the Trust Fund*** and the making of distributions to the Certificateholders.
>
> The trust is hereby authorized to engage in the foregoing activities. Notwithstanding the provisions of Section 11.01, ***the trust shall not engage in any activity other than in connection with the foregoing or other than as required or authorized by the terms of this Agreement while any Certificate is outstanding***, and this Section 2.08 may not be amended, without the consent of the Certificateholders evidencing a majority of the aggregate Voting Rights of the Certificates.

PSA at § 2.08 (emphases added). Thus, since inception and by careful design to be eligible for certain accounting and tax treatment, the activity of the Trust was to receive and hold *non-operating* assets (*i.e.*, the mortgage loans), conserve those assets, and do very little else.[16] *Accord* 17 C.F.R. § 230.191 (SEC Rule 191); 70 Fed. Reg. 1506-01, 1516, 1526-27 (Jan. 7, 2005) ("SEC ABS Final Rule") (depositor is "issuer" for purposes of Exchange Act reporting because, unlike corporate securities of operating companies, the *actual* "issuing entity" of an asset-backed security is a passive investment vehicle). The "business" of passively holding non-operating assets can hardly be "operated" by anyone, let alone the Servicer who was pursuing its own business objectives. The Debtors' reading of these commonly understood words just doesn't work.[17]

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[16] Indeed, to obtain the preferential accounting treatment made possible by using a qualified special purpose entity ("SPE") like the Trust, the Trust's "permitted activities" must be "significantly limited"; they may hold only limited categories of assets, financial instruments, and cash; and they can sell or dispose of noncash assets as an automatic response to certain limited conditions. *See, e.g.*, Statement of Financial Accounting Standards No. 140, App. A at ¶¶ 35-45, *available at* www.fasb.org/pdf/fas140.pdf, last accessed Apr. 2, 2013. Similarly, the Trust was exempt from the Investment Company Act of 1940 pursuant to Rule 3a-7, which required the Trust to own only "eligible assets," which means "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to securities holders."

[17] The SEC's view of the nature of asset-backed securities is entirely consistent with the Investors' view. The agency has stated that in connection with the offering of asset-backed securities, in contrast to "corporate securities and *operating companies* … there is generally *no business or management to describe*. Instead, information about the transaction structure and the characteristics and quality of the asset pool and servicing is often what is most important to investors." SEC ABS Final Rule at § I.A; *see also id.* at § II (as a general matter, *there is essentially no business or management* (and

3. *No Debtor Operated Substantially All of the Trust's Property*

The Debtors' attempt to shoehorn the Trust into the "affiliate" definition, by contending that "substantially all of [the Trust's] property is operated under an operating agreement" with the Debtors, fares no better. The Trust's property on which the Debtors focus—the mortgage loans—is no more operable than any financial asset.

It bears emphasizing that the affiliate definition was designed to prevent entities that were actually controlled by a debtor from escaping scrutiny as an insider, in the context of preferences, for example. The legislative history surrounding subsection (C), though limited, speaks of remedying abuses from multiple commonly owned corporations or trusts at less than arm's length, and sought not to inadvertently capture special purpose trusts used in financing techniques where equipment could technically be "operated" by a debtor under a lease.[18]

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therefore no management's discussion and analysis of financial performance and condition) of the issuing entity, which is *designed to be a solely passive entity*."). (emphasis added). The distinction is significant, the import of which continues onward with respect to reporting requirements. *Id.* at § I.E. ("As with registration, the ongoing periodic and current reporting requirements under the Exchange Act *applicable to operating companies do not elicit information that would be most relevant for asset-backed securities*.") (emphasis added). And in revisiting the definition of "asset-backed security" after "more than ten years of experience", the SEC "continue[s] to believe that emphasis on certain core principles is appropriate for these purposes, such as that the securities are *primarily backed by a pool of assets*, that there is a discrete pool with *a general absence of active pool management*, and an emphasis on *the self-liquidating nature of pool assets that by their own terms convert into cash*." *Id.*at § III.A.2.a.

[18] As stated in a Senate hearing:

> The apparent objective of the definitions of affiliate and insider and the preference provision is to set aside transfers where the debtor and the affiliate have common ownership and the debtor has utilized multiple corporations or trusts in a bad faith effort to avoid payment of valid obligations. Such objective is meritorious. In such cases, the trustee in bankruptcy should have the power to take appropriate action.
>
> The language of S. 2266 [§ 101(2)] is a vast improvement over the language in H.R. 8200 [§ 101(2)], and I feel the language as now contained in S. 2266 (October 31, 1977) adequately ***protects special-purpose trusts and corporations used in an arm's length transaction to provide needed financing for a lessee-debtor and indeed in other types of special-purpose financing while still preserving the objective of sorting out bad faith use of multiple business structures***.

Perhaps the Trust's most significant property right in addition to the pooled loans themselves was the right to "put back" mortgage loans to the Debtors if such loans were inconsistent with the representations and warranties regarding those loans. PSA § 2.03. It is preposterous to assert that these valuable "put back" rights were controlled, influenced, or "operated" in any way by the Debtors.

4. *The Trust Is Not Party to a Lease or Operating Agreement*

Yet another foundational problem with the Debtors' claim is that the PSA is not a "lease or operating agreement." First, there is no contention that the PSA is a "lease."

Next, it is clear that the PSA is also not an "operating agreement." The Bankruptcy Code does not define the term "operating agreement."[19] The Investors submit the term is not ambiguous—it is an agreement whereby a business or property is operated. To the extent there is any ambiguity regarding what an "operating agreement" is, the legislative history of Bankruptcy Code section 101 reflects that the phrase "lease or operating agreement" was derived from the Public Utility Holding Company Act of 1935 ("PUHCA") by way of Proposed Bankruptcy Rule 901(3). *See, e.g.*, H.R. Doc. No. 93–137, pt. 4, at 580 n. 4 (1973) ("The definition of "affiliate" is an adaptation of the definition in Proposed Rule 901(3), which was derived from the Public Utility Holding Company Act of 1935.") (reprinted in B4-C Collier on Bankruptcy, App. Pt. 4 Bankruptcy Reform Act of 1978 § 1-102 (16th ed.)); *In re Interlink Home Health Care, Inc.*, 283 B.R. 429, 437-38 (Bankr. N.D. Tex. 2002) (same). The definition of "subsidiary company" in PUHCA reveals that Congress was concerned about an entity being

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Bankruptcy Reform Act of 1978: Hearing Before the Subcomm. on Improvements in Jud. Machinery of S. Comm. on the Judiciary (1977) (statement of E. Lowell Dinius, Vice President, American Fletcher Leasing Association), Arnold & Porter Legis. Hist.: P.L. 95-598, BANKR-78-LH 7 (Westlaw) (emphases added**).**

[19] Indeed, the term is only used in section 101(2).

subject to a "controlling influence" of another, and if the subsidiary could demonstrate that it was not subject to a "controlling influence," it would be exempt from PUHCA. *See* PUHCA, § 8.

Similarly, the legislative history of the Bankruptcy Code suggests Congress was seeking to treat as affiliates entities in unique circumstances where the debtor was effectively running the business as if it were the owner (either through operating the entity's business or operating substantially all of the entity's property).[20] The PSA does not fit into the circumstances Congress was concerned with when it enacted section 101(2). Nothing in the governing documents suggests that a Debtor was operating either the business or the property of the Trust as if the Debtor owned the business or such property. To the contrary, to the extent the Debtors undertook any tasks associated with the Trust, the Debtors were operating their *own* business and their *own* assets—namely, the mortgage servicing rights the master servicers retained under the Assignment Agreement. Moreover, the Trust's "business" (if any)—holding mortgage loans and pursuing contractual remedies against the Servicer—was not subject to any controlling influence exerted by the Servicer.

Recognizing that their arguments fail under the law as written, proponents of subordinating the Investors' claims gloss over the significance of the term "operating agreement" as it is used in section 101(2)(C) in the hope that it will encompass the Debtors' relationship with the Trust. This Court should reject this interpretative sleight of hand.

As an initial matter, ignoring statutory language to accomplish a desired end is plainly improper. *See, e.g.*, *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004) (construing 11 U.S.C. § 330) ("Our unwillingness to soften the import of Congress' chosen words even if we believe

[20] Notably, while leasing an operating business does give rise to an affiliate relationship, leasing substantially all of an entity's *property* does not give rise to an affiliate relationship. This makes sense, because it is common for a passive owner of property (such as the owner of equipment) to lease such property to unrelated third parties to generate rental income.

the words lead to a harsh outcome is longstanding. It results from 'deference to the supremacy of the Legislature, as well as recognition that Congressmen typically vote on the language of a bill.'"); *see also In re SemCrude L.P.*, 436 B.R. 317, 322 (Bankr. D. Del. 2010) ("The Debtors have not identified any relevant ambiguity in the text of sections 510(b) or 101(2) which would allow the Court to look beyond the terms of the relevant statutes.").

In any event, it is clear that Congress did not intend the term "operating agreement" to include contracts like the PSA and it had nothing to do with the fact that section 101(2) was drafted in 1978. In the very same legislation by which Congress grafted the PUHCA's definition of "affiliate" into section 101(2), Congress described relationships like the one established by the PSA much more aptly elsewhere in the Code. Specifically, in section 541(d), Congress referred to situations where "the debtor retains legal title to service or supervise the servicing of such mortgage or interest." 11 U.S.C. § 541(d); *see also* Pub. Law 95-598 (Nov. 6, 1978) (adding relevant language in both section 101(2) and section 541(d)). Certainly, Congress knew how to specify the servicing of mortgage loans when it wanted to; Congress simply did not do that in section 101(2)(C) when it chose to use the entirely different term "operating agreement[s]."[21]

5. Commercial Financial Services *Is Distinguishable*

The Debtors have relied heavily on an unpublished order issued by a bankruptcy court in *Nationsbank, N.A. v. Commercial Financial Services, Inc. (In re Commercial Financial Services, Inc.)*, Adv. Pro. 98-0356 (Bankr. N.D. Okla. July 11, 2003) (the "*CFS* Slip. Op.") for the proposition that the Trust is an affiliate of the Debtors. *See* 3013 Opp. at 20-21. Putting aside

[21] Elsewhere in section 541, Congress did use the phrase "operate the property" and elected to distinguish "servicing" from "operating" when referring to mortgage loans. *See* 11 U.S.C. § 541(b)(4)(B)(i) ("the debtor has transferred such interest pursuant to a written conveyance of a production payment to an entity that does not participate in the ***operation of the property*** from which such production payment is transferred") (emphases added).

that the decision is not binding on this Court, and is at odds with Second Circuit precedent, a careful review of the *CFS* Slip Op. demonstrates there are material distinguishing facts and the *CFS* court did not consider issues that are directly implicated here.

Prior to filing for bankruptcy in 1998, beginning in 1995 the debtor in *CFS* began purchasing delinquent credit card receivables from credit card issuers. *CFS* Slip Op. at 14. That same year, the debtor securitized the receivables by packaging the receivables, assigning them to an affiliate, which in turn sold the receivables to a trust. CFS or its affiliate would sell securities backed by the receivables packages to investors. *Id.* at 15. It was stipulated as undisputed that CFS simultaneously "contracted to service the Loans in all respects and to manage the operations of the securitizations that it had established and sponsored." *Id.* The securitizations at issue were accomplished through "Global Rated Eligible Asset Trusts" or "GREAT" *Id.* The GREAT securitizations were executed pursuant to a pooling and servicing agreement pursuant to which the receivables were transferred from the CFS affiliate to the trust. *Id.* at 19. The servicing agreement also granted the servicer the "management of the Assets." *Id.*

As explained on page 28 of the Slip Op., the parties expressly declared the trust in that case to be a "business trust under the Delaware Business Trust Statute." *Id.* at 28.

After the debtors filed for bankruptcy, Bank of America commenced an adversary proceeding seeking to rescind the purchase of a series note and for the imposition of a constructive trust. The court held that the trusts were affiliates of the debtors and thus the claims of Bank of America were subject to subordination under section 510(b).

There are two sets of material facts in *CFS* that distinguish the case from the circumstances here: (1) the parties in *CFS* intended for the trust to be a "business trust"; and (2) the rights and powers of the servicer in *CFS* were substantially greater than the powers of the Master Servicer here and were stipulated to constitute the "management" of the trust's assets.

First, the court concluded the trust was a "business trust" because (a) it was expressly held out as a "business trust" under the Delaware Business Trust Statute, *id.* at 57, 59; and (b) the purpose and powers extended beyond preservation of the trust *res*. *Id.* at 61. The *CFS* court discussed, and opted not to follow, the Second Circuit's holding in *Shawmut*. Rather, the court followed *In re Medallion Realty Trust*, 103 B.R. 8 (Bankr. D. Mass. 1989), by concluding that the essential characteristics that make a trust a "business trust" are that it have some attributes of a corporation and that its beneficiaries have invested capital, *see* Slip Op. at 76, but also identifying whether the trust was in compliance with state law, whether the purpose stated in the trust document precludes the trust from being a business trust, and whether the trust had a business or commercial purpose as "recurring" considerations. *Id.*

Even though the court noted that in 2002 Delaware amended its statute to make clear that "business trusts" formed under Delaware law for securitizations were not intended to be "business trusts" within the meaning of the Bankruptcy Code, the *CFS* court stated that it was relevant that the parties in 1998 had prepared the trust to be in compliance with then-existing Delaware law. *See* Slip Op. at 76 n.37. Although other facts supported the court's conclusion that the trust was a "business trust" it is clear the court placed great emphasis on the language the parties used in the agreement. *See* Slip Op. at 59-60, 78.

Here, there is a complete absence of any intention to treat the Trusts as "business trusts." *First*, there is no language in the PSA that is similar to the "business trust" language used in *CFS*. Further, the "purpose and powers" language in section 2.08 of the PSA is significantly more limited than the "purpose and powers" language in the *CFS* trust documents. *Compare* PSA at § 2.08 *with* Slip Op. at 60.

Second, the rights, powers, and duties of the servicer in *CFS* were significantly greater, and reflected a far more significant circumstance of control, than the powers and duties of the

Master Servicer. It was undisputed in *CFS* that the governing documents expressly stated that the servicer "manage[d] the assets" of the Master Trust and this fact was undisputed. No such language or undisputed fact appears here.

Finally, the *CFS* court treated the "property" of the trust to mean ownership of a certificate reflecting an equity interest in a pool of receivables. *See* Slip. Op. at 81. There was no discussion of any other property. But here there are significant assets of the Trust beyond ownership of the Mortgage Loans that comprise the "Trust Fund." Most significantly, each Trust has a contractual right to "put back" Mortgage Loans. That right may be worth billions, but at minimum the Debtors are willing to allow up to an $8.7 billion claim to compromise such "put back" claims. No such "put back" right was identified in *CFS*.[22] Even if *CFS* were binding precedent (which it is not) and did not conflict with binding Second Circuit precedent (which it does), it does not support a conclusion that the Servicer was operating substantially all of the property of the Trust.

C. Debtors' Argument Ignores the Policies Underlying Section 510(b) and Seeks to Undermine the Entire Structure and Purpose of Special Purpose Entities Like the Trust

By urging the Court to ignore the plain language of the Offering Materials, the Assignment Agreement, the PSA, and the Bankruptcy Code under the guise of "doing equity," Debtors do not further the policies underlying section 510(b) but instead ask the Court to create tremendous commercial uncertainty over treatment of securitization vehicles.

1. *Debtors' Arguments Undermine the Very Purpose of the Trust*

To "deem" the securities to be those of the Debtors or an affiliate of the Debtors, the extensive prophylactic measures taken to make the Trust bankruptcy-remote if not bankruptcy-

[22] This is not surprising, given that the collateral in *CFS* consisted of charged-off credit card receivables, which by their nature already have very poor credit quality characteristics. The collateral securing the RMBS Certificates was supposed to be higher quality mortgage loans.

proof—such as requiring true sales of the mortgages from the Depositor to the Trust—must be ignored. The Certificates become substantively no different from securities secured by Debtors' mortgage loans, a structure eschewed because securitization is a cheaper means of raising capital. *See, e.g.*, J.A. Pearce & I.A. Lipin, *Special Purpose Vehicles in Bankruptcy Litig.*, 40 Hofstra L. Rev. 177, 187-88 (2011) (noting that securitization allows for "inexpensive funding for a company whose credit rating may be lower than the credit rating on its receivables"; "provides originators with a moderately priced source of funds independent from an inelastic supply of receivables"; and can provide "an inexpensive source of funds").

Indeed, the intrinsic value of a special purpose entity is its separateness. For that reason, in hammering out the definition of "affiliate" in section 102(2), Congress adopted a definition that "protects special-purpose trusts and corporations used in an arm's length transaction" from being consolidated with debtors when created and maintained in good faith, as the legislative history confirms.[23] The proposed definition of "affiliate" thus was modified prior to adoption so that it did not capture parties that engaged with a debtor in what undeniably were arm's length transactions. This Court should not stretch the definition of affiliate through unnatural readings of "operate," or "operating agreement" to bring within its scope a special purpose entity that clearly was not under the control of any Debtor and was specifically designed and marketed to investors as *not* being an affiliate of the Debtors. *See Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. Partnership*, 123 L. Ed. 2d 74, 113 S. Ct. 1489, 1495 (1993) (indicating that the words of the Code are intended "to carry their ordinary, contemporary, common meaning") (quotations omitted).

2. *Debtors' Arguments Result In Recharacterization*

[23] *See* Arnold & Porter LLP Legislative History: P.L. 95-598, "Statement of E. Lowell Dinius, Vice President, American Fletcher Leasing, Indianapolis, Ind." (Nov. 28, 1977), quoted supra at note 17.

If the Debtors wish now to "deem" the certificates to be securities of the Debtors or of their affiliates, they are effectively asking the Court to ignore the separation of the financing of the mortgage loans from the Debtors' balance sheet. The question, then, is what type of obligations are created by this? The very purpose of the structure was to remove the mortgage loans from being part of the Debtors' capital structure, but if the certificates are "deemed" securities of the Debtors or affiliates of the Debtors that are supported by collateral supplied by the Debtors, then they should naturally be deemed secured notes of the Debtors, backed by the mortgage loans once owned by the Debtors. This outcome is the only equitable one whether the security is "of the Depositor," or whether the amount of "control" over the Trust's assets is deemed so infectious as to make the Trust an affiliate of the Servicer.

Nor is this outcome merely based on equity, or the notion of an equitable lien for assets held in trust for the certificateholders. Pursuant to the PSA, the Trusts were expressly granted a security interest in the loans as a back-up measure to potential recharacterization. PSA at § 2.01(f). Thus, if the Debtors are correct, then the Investors would be considered secured noteholders of the relevant Debtors or of their affiliates. Pursuant to the literal, but plain, text of section 510(b), fraud or statutory claims arising from rescission of the purchase or sale of such notes would be subordinated—but only to the level of below that of a secured note claim, *i.e.*, general unsecured creditors, in any event. *See In re Patriot Aviation Services, Inc*., 396 B.R. 780, 789 (Bankr. S.D. Fla. 2008) (finding litigation claim arising out of purchase of secured note "is thus properly subordinated to all secured debt claims against the Debtor, which renders the [claimant's] claim (assuming it is ultimately allowed) equal in priority to a general unsecured claim").

3. *The Purposes of Bankruptcy Code Section 510(b) Would Not Be Served by Subordinating the Investors' Claims*

Courts (including the Second Circuit) recognize that the history of section 510(b) confirms that its passage was driven by the "dissimilar risk and return expectations of shareholders and creditors" and the "reliance of creditors on the equity cushion provided by shareholder investment." *In re Med Diversified, Inc.*, 461 F.3d 251, 256 (2d Cir. 2006). Thus, subordination under 510(b) is appropriate only if the creditor "took on the risks of a shareholder, or seeks to recover from an equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor." *Id.* This is true even though section 510(b), by using the Bankruptcy Code's definition of "security," is not limited to equity securities.

Here, subordination of the Investors' claims issued by the Trusts in no way furthers the policies of section 510(b). None of the Investors purchased or sold stock or bonds of any of the Debtors or had any expectation of taking on the risks or returns of a shareholder or bondholder of a Debtor. Indeed, the Investors purchased the Certificates with the understanding that the Certificates were obligations only of the bankruptcy remote Trusts, not RFC or RALI. In fact, as discussed above, the entire purpose of the RMBS structure was to *isolate* the Investors' risks (and rewards) from the Debtors. This is in stark contrast to the traditional way courts analyze whether a claim is one that should be subordinated, *i.e.*, by asking whether the measure of damages would relate to the Debtors' fortunes.[24] *See Med Diversified*, 461 F.3d at 257. Further, no Investor seeks to recover a contribution to the equity pool of any Debtor; rather, each Investor bought Certificates, issued by non-debtors and contractually limited to the proceeds of collateral securing the Certificates. The Debtors reaped huge profits from these transactions, for the

[24] *See In re Worldcom, Inc.*, 329 B.R 10, 14 (Bankr. S.D.N.Y. 2005) (claim for failure to sell stock in reliance on misrepresentations was subordinated because the damage is the loss in value of debtor's stock); *In re Calpine Corp.*, No. 05-60200 (BRL), 2007 WL 4326738, at *1, 13 (Bankr. S.D.N.Y. Nov. 21, 2007) (claim arising from failure to exercise options to acquire stock was subordinated because value of conversion rights vary with the value of common stock).

benefit of their stakeholders. Because the purpose of section 510(b) would not be served here, there is no reason to stretch its plain language to apply subordination to the current facts.

III. THERE IS NO BASIS FOR CATEGORICAL OR NO-FAULT EQUITABLE SUBORDINATION OF THE INVESTORS' CLAIMS UNDER SECTION 510(c)

The Debtors' borderline frivolous claim under section 510(c) is nothing more than a request to re-order priorities on a "no fault" and "categorical" basis. There is no allegation that any Investor has engaged in any inequitable conduct. Rather, the Debtors seek to categorically subordinate all claims of individual certificateholders who asserted claims against any Debtor based upon violations of federal or state securities laws, state consumer protection laws, or common law fraud. This the Debtors cannot do.

The Debtors' claim for equitable subordination flies in the face of Supreme Court precedent and lacks merit in law or fact. It is highly questionable whether "no fault" equitable subordination can be applied to the claims asserted by the Investors, but even if "no fault" equitable subordination is theoretically possible, the Supreme Court has instructed that equitable subordination cannot be applied *categorically*—which is precisely what the Debtors are seeking to do. The Debtors have completely failed to engage in any *individualized* assessment of the claims or conduct of any of the Investors. Moreover, the Debtors have not shown, and cannot show, that the Investors' purchases of the Certificates in any way harmed the Debtors or their creditors. Accordingly, the Debtors' equitable subordination claim fails as a matter of law.

Bankruptcy Code section 510(c) states that "[n]otwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . . ." 11 U.S.C. § 510(c). Congress did not define "equitable subordination when it adopted section 510(c)," but virtually all courts accept the three-prong test

articulated by the Fifth Circuit in *Benjamin v. Diamond (In re Mobile Steel)*, 563 F.2d 692, 699-700 (5th Cir. 1977).[25] The *Mobile Steel* requires a showing of: (1) "inequitable conduct" on the part of the claimant sought to be subordinated; (2) injury to the other creditors of the bankrupt or unfair advantage for the claimant resulting from the claimant's conduct; and (3) consistency with the provisions of the Bankruptcy Code. In respect of the "inequitable conduct" prong, courts have recognized that in the case of non-insiders or non-fiduciaries, the conduct must be "egregious and severely unfair," *Official Comm. of Unsecured Creditors v. Morgan Stanley & Co. (In re Sunbeam Corp.)*, 284 B.R. 355, 364 (Bankr. S.D.N.Y. 2002), and that a heightened standard of wrongdoing applied. *See 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.)*, 169 B.R. 832, 838 (Bankr. S.D.N.Y. 1994). Few cases have ever met the heightened standard for subordinating claims of non-insiders pursuant to section 510(c). *See Sunbeam*, 284 B.R. at 364.

After the adoption of section 510(c), some courts held that equitable subordination was available even in the absence of any inequitable conduct by the creditor. But in 1996, the Supreme Court addressed application of "no fault" equitable subordination in two cases, *United States v. Noland*, 517 U.S. 535 (1996), and *United States v. CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996). In *Noland*, the bankruptcy court equitably subordinated the Internal Revenue Service's claim for a postpetition, noncompensatory tax penalty in the absence of any inequitable conduct by the IRS. The district court and the Court of Appeals for the Sixth Circuit affirmed,

[25] The following circuits have adopted the Fifth Circuit's *Mobile Steel* test: the First Circuit (*In re Merrimac Paper Co.*, 420 F.3d 53 (1st Cir. 2005)); the Third Circuit (*In re Winstar Communications, Inc.*, 554 F.3d 382 (3d Cir. 2009)); the Fourth Circuit (*In re ASI Reactivation, Inc.*, 934 F.2d 1315 (4th Cir. 1991)); the Sixth Circuit (*In re Baker & Getty Fin. Servs.*, 974 F.2d 712 (6th Cir. 1992)); the Seventh Circuit (*In re Lifschultz Fast Freight*, 132 F.3d 339 (7th Cir. 1997)); the Eighth Circuit (*In re M&S Grading, Inc.*, 541 F.3d 859 (8th Cir. 2008); the Ninth Circuit (*In re First Alliance Mortg. Co.*, 471 F.3d 977 (9th Cir. 2006); the Tenth Circuit (*Sloan v. Zions First Nat'l Bank (In re Castletons, Inc.)*, 990 F.2d 551, 559 (10th Cir. 1993)); and the Eleventh Circuit (*In re Lemco Gypsum, Inc.*), 911 F.2d 1553 (11th Cir. 1990).

but the Supreme Court unanimously reversed, holding that a bankruptcy court could not equitably subordinate the entire category of noncompensatory tax penalty claims. *Id.* at 543.

Through *Noland*, the Supreme Court established several rules that are relevant to the claims at issue here. *First*, the Supreme Court held that Congress's failure to include specific criteria for equitable subordination in the language of the statute, and the provision's reference to "principles of equitable subordination," provided clear evidence of "congressional intent at least to start with existing doctrine" that had developed prior to the statute's revision in 1978. *Noland*, 517 U.S. at 539. *Second*, *Noland* recognized that *Mobile Steel* was an "influential opinion" and that the circuit courts and district courts had been generally following its test. *See id.* at 538-39. *Third*, the Supreme Court made clear that equitable subordination is inappropriate when it is done on a categorical basis at the level of policy-making at which Congress operates. Instead, equitable subordination is appropriate only when there is something uniquely inequitable about a particular set of circumstances involving the claimant. *Id.* at 540.

In *CF&I*, the Supreme Court vacated a Tenth Circuit decision holding that a "no fault" exception was at least potentially available for all tax penalty claims, on the basis that the Tenth Circuit's ruling was too close to a "categorical reordering of priorities" that was not permitted under *Noland*. *See CF&I*, 518 U.S. at 229.

Noland and *CF&I* arguably left open the remote possibility that a claim could be equitably subordinated even if the claimant had not engaged in any inequitable conduct. But, given the overwhelming acceptance of the *Mobile Steel* test and the clear prohibition against categorical subordination, virtually all courts have continued to require a showing of inequitable conduct. *See Hedged-Securities Assocs., LP v. The Bronze Group, Ltd. (In re Hedged-Investments Assocs., Inc.)*, 380 F.3d 1292, 1301 (10th Cir. 2004) (holding that post-*Noland* and *CF&I*, "no fault" equitable subordination does not extend to any claims other than tax penalty

claims). As one court recognized, "[a]bsent creditor misconduct it is difficult to apply equitable subordination" and the "mere inequities that the Bankruptcy Code priority schedule produces is not enough for a bankruptcy court to apply equitable subordination." *Gordon Sel-Way, Inc. v. United States*, 217 B.R. 221, 223 (E.D. Mich. 1997).[26]

The Debtors argue that even though post-*Noland* the Second Circuit has not addressed "no fault" equitable subordination, in *Jezerian v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206 (2d Cir. 1978), that court did recognize "no fault" equitable subordination prior to *Noland*, and *Noland* instructs that Congress intended for principles of equitable subordination to follow existing case law. *See* 3013 Opp. at 30 n.16. The Debtors further cite two cases for the argument that "no fault" equitable subordination may be applied to circumstances involving securities claims, claiming that courts have continued to cite *Stirling Homex* when allowing no-fault equitable subordination. *See id.* at 30 and n.16.

This Court should reject this attempt to extend the "no fault" exception (to the extent it does exist) to the Investors' claims. Noticeably absent from the Debtors' submissions are *any* cases from this District that even discuss equitable subordination where the claimant did not engage in inequitable conduct. That is because courts in this District, fully aware of *Noland*, follow the *Mobile Steel* test. Indeed, in *Official Committee of Unsecured Creditors of Hydrogen, L.L.C. v. Blomen (In re Hydrogen, L.L.C.)*, 431 B.R. 337 (Bankr. S.D.N.Y. 2010), Judge Gonzalez held that to "plead equitable subordination . . . , a complaint must contain enough facts to satisfy each part of the following three-part test [including] (1) that the defendant-claimant engaged in inequitable conduct[.]" *Id.* at 360 (citing *Mobile Steel* and *Noland*).

[26] One material flaw in application of "no fault" equitable subordination is that it would, by definition, treat insiders and non-insiders the same, even though the well-establish "principles of equitable subordination" make clear that equitable subordination of non-insider claims is supposed to be exceedingly rare.

The Debtors' reliance on *Stirling Homex* is misplaced. *Stirling Homex* held that claims of defrauded stockholders of a debtor corporation should be subordinated to claims filed by that corporation's ordinary unsecured creditors. *Stirling Homex*, 579 F.2d at 208. The holding of *Stirling Homex* is a paradigm of section 510(b) subordination. Indeed, while the Second Circuit referred to equitable subordination principles under *Pepper v. Litton*, 308 U.S. 295 (1939), the Second Circuit also referenced the Slain & Kripke article (which concerns section 510(b)), and stated: "Finally, we note that the United States Congress is in the process of considering this very question [raised by Slain & Kripke] as part of its review of the entire law of bankruptcy." *Id.* at 214. Not surprisingly, courts in this District have held that the *Stirling Homex* holding has been codified as part of section 510(b). *See In re Stylesite Mktg., Inc.*, 2001 Bankr. LEXIS 2299 (Bankr. S.D.N.Y. Jan. 2, 2001) (stating that *Stirling Homex* is an important pre-Code case "whose holding is codified in § 510(b)").

Even if this Court were to reject the widely-accepted *Mobile Steel* approach and consider the possibility of "no fault" equitable subordination, in this case any consideration necessarily leads to the conclusion the Debtors are seeking prohibited categorical subordination. The Debtors' complaint fails to identify specific circumstances, as required by *Noland*, that justify equitable subordination of the Investors' Claims, but instead merely alleges that a "failure to subordinate the Investor Claims, to the extent (if any) that they are ultimately allowed, would result in injury to other creditors and confer an unfair advantage on the Investors." Compl. ¶ 105. There are no specific facts alleged that addresses the particular facts and circumstances of each Investor; indeed, the Complaint's facts only suggest that the claims of the Investors and other entities that have sued, or may sue, the Debtors on similar theories must have their claims equitably subordinated because all such claims would dilute recoveries to other creditors. *See id.* at ¶¶ 10, 13. Further, every possible allegation in the Complaint justifying equitable

subordination is in no way limited only to the Investors but instead must be applied to the entire ***category*** of similarly situated claimants. *See id.* at ¶¶ 87-90. Under *Noland,* such treatment is not permissible. *See, e.g., In re Montgomery Ward Holding Co.*, 272 B.R. 836, 839, 846 (Bankr. D. Del. 2001) (rejecting similar attempt to equitably subordinate a claim).

CONCLUSION

For all the foregoing reasons, the Investors respectfully request that the Court enter an order granting the Investors' Motion and such other relief as is just and appropriate.

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