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**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

In re:

RESIDENTIAL CAPITAL, LLC, *et al.*,

Debtors.

Chapter 11

Case No. 12-12020 (MG)

Jointly Administered

**STATEMENT OF THE UNITED STATES OF AMERICA
CONCERNING DEBTORS' MOTION FOR ORDERS
AUTHORIZING AND APPROVING SALE PROCEDURES
AND AUTHORIZING THE SALE OF CERTAIN FHA LOANS**

The United States of America (the "United States" or the "Government"), by its attorney Preet Bharara, United States Attorney for the Southern District of New York, respectfully submits this Statement in response to *Debtors' Motion Pursuant to 11 U.S.C. §§ 105, 363(b), (f), and (m) and Fed. R. Bankr. P. 2002, 6004, and 9007 for Orders: (A)(I) Authorizing and Approving Sale Procedures; (II) Scheduling Bid Deadline and Sale Hearing; (III) Approving Form and Manner of Notice Thereof; and (IV) Granting Related Relief and (B)(I) Authorizing the Sale of Certain FHA Loans Free and Clear of Liens, Claims, Encumbrances, and Other Interests;*



(II) Authorizing and Approving Mortgage Loan Purchase and Interim Servicing Agreement; and (III) Granting Related Relief [Docket No. 2544], filed on January 2, 2013 (the “Motion”).¹

The Motion seeks the approval of bidding procedures for a contemplated sale of certain loans insured by the Federal Housing Administration of the United States Department of Housing and Urban Development (“FHA” or “HUD”) free and clear of all liens, claims encumbrances, and other interests. The Government is concerned that such a sale would extinguish important setoff rights held by the United States and its agencies, including HUD, with respect to any claims for insurance submitted by the Purchaser in connection with those loans. Because the deadline to object to approval of the sale of the FHA loans, including that the sale shall be free and clear, is April 4, 2013, the United States is not filing a formal objection at this time. However, the Government wishes to place all interested parties on notice of its position with respect to the sale prior to the commencement of bidding, in order to ensure that any proposed sale agreement protects the Government’s rights. In the event those rights are not protected, the United States will object to the sale.

BACKGROUND

1. Under FHA’s Single Family insured loan program, approved lenders make mortgage loans to finance the purchase of 1 to 4 family residences, and HUD/FHA insures the lender against loss should a borrower default on the loan and foreclosure of the property does not repay the outstanding balance in full. In

¹ Capitalized terms not defined herein have the same meaning as in the Motion.

consideration of FHA's insurance of the mortgage loans, lenders and their servicers are responsible for paying periodic mortgage insurance premiums to HUD for each loan so insured. HUD has promulgated extensive guidelines and regulations to ensure that only creditworthy borrowers are being insured, and HUD relies on certifications by FHA-approved lenders that the loans they submit for insurance comply with HUD standards and guidelines specifically designed to mitigate the risk to HUD.

2. By protecting lenders against defaults on mortgages, FHA mortgage insurance encourages lenders to make loans to millions of creditworthy borrowers who might not otherwise satisfy conventional underwriting criteria. FHA mortgage insurance also makes mortgage loans valuable in the secondary markets. Eligible FHA-insured mortgage loans may be pooled and securitized into mortgage-backed securities ("MBS") guaranteed by the Government National Mortgage Association ("Ginnie Mae"), and which carry the full faith and credit of the United States.

3. According to the Motion, Debtors hold approximately \$1 billion (unpaid principal balance) of loans insured by FHA or guaranteed by the United States Department of Veterans Affairs. Motion at ¶ 6. Debtors seek approval of sale procedures with respect to a proposed sale of \$130 million (UPB) of FHA-insured loans (the "FHA Loans"). *Id.* Debtors indicate that these FHA Loans previously were sold into Ginnie Mae securitizations, but were subsequently repurchased pursuant to Ginnie Mae's guidelines because the loans became non-performing. Motion at ¶¶ 5-6. Rather than hold the FHA Loans until completion of the

foreclosure process and submission of an insurance claim to FHA, or until the loan becomes eligible for resale into Ginnie Mae securitization pools, Debtors seek to sell the loans in order to expedite the monetization of the loans. *Id.* at ¶¶ 7-8.

4. The relevant FHA Loans were chosen, according to the Motion, because “collateral documentation is readily available and [the FHA Loans] ha[ve] been reviewed to confirm that such loans adhere to acceptable industry standards.” *Id.* at ¶ 7. Debtors contend that the Successful Bidder for the FHA Loans “can be assured that the FHA Loans will qualify for the FHA insurance payment in the event the collateral securing the loan does not fully cover the loan.” *Id.*

5. Debtors seek approval of a sale of the FHA Loans under Section 363 of the Bankruptcy Code, free and clear of all claims, liens, encumbrances, or other interests. *See* Motion at ¶¶ 25-27. The Sale Notice, which is attached to the proposed Sale Procedures Order as Exhibit 2, indicates that “the order approving the Sale will provide that the FHA Loans shall be transferred to the Purchaser (as defined in the [Mortgage Loan Purchase and Interim Servicing Agreement]), and such transfer shall be free and clear of all claims, liabilities, interests, liens, obligations, and encumbrances of any person or entity.” Sale Notice, § C.

6. The United States did not learn of the contemplated sale until the filing of the Motion. Once the motion was filed, the Government requested that Debtors provide a full list of the FHA Loans, which Debtors provided on January 7 and 8, 2013. The Government is currently reviewing that list and reserves the right

to make additional requests for information concerning the FHA Loans as necessary.

**THE GOVERNMENT’S RIGHTS OF SETOFF
WITH RESPECT TO FHA INSURANCE CLAIMS**

7. At the threshold, the Government notes a representation by Debtors in the Motion that the Successful Bidder “can be assured that the FHA Loans will qualify for the FHA insurance payment.” Motion at ¶ 7. Notwithstanding any assurances by Debtors, the determination of whether an FHA-insured loan qualifies for an insurance payment rests with the Government, specifically FHA, upon submission of an insurance claim in connection with the loan.

8. In addition, the Motion indicates that the FHA Loans will be sold free and clear of all claims, liens, encumbrances, or other interests. *See* Motion at ¶¶ 25-27; Sale Notice, § C (“any person or entity holding any such claims, liabilities, interests . . . shall be enjoined and forever barred from asserting such claims, liabilities, interests . . . against the Purchaser or any of its affiliates”). Accordingly, the Motion purports to extinguish the Government’s setoff rights with respect to the debts of the seller against any insurance claims submitted by the Purchaser in connection with the FHA Loans.

9. Generally speaking, “[t]he right of setoff . . . allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A.” *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 18 (1995) (citation and internal quotation marks omitted).

Recoupment is a demand arising from the same transaction as a plaintiff’s claim to

abate or reduce that claim, and thus is the means used to determine the proper liability on the amount owed. *See Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993). Section 553 of the Bankruptcy Code recognizes and preserves setoff rights that exist under non-bankruptcy law and expressly provides that nothing in the Code affects a creditor's setoff rights unless provided in that section, or in sections 362 or 363.

11 U.S.C. § 553(a). The Code is silent with respect to recoupment; however, recoupment rights also are determined under non-bankruptcy law. *See Westinghouse Credit Corp. v. D'Urso*, 278 F.3d 138, 149 n.5 (2d Cir. 2002). In general, the agencies of the United States constitute a "unitary creditor," *i.e.*, a single government unit, for setoff purposes. *See, e.g., In re Whimsy, Inc.*, 221 B.R. 69, 74 (S.D.N.Y. 1998).

10. The Government need not file a proof of claim in order to preserve setoff rights. *See In re Davidovich*, 901 F.2d 1533, 1539 (10th Cir. 1990) (proof of claim not a prerequisite to retention of setoff right). As the Second Circuit has noted, "[t]he rule allowing setoff . . . is not one that courts are free to ignore when they think application would be unjust." *In re Applied Logic Corp.*, 576 F.2d 952, 957 (2d Cir. 1978); *see also* 5 Collier on Bankruptcy § 553.02[3] ("The Bankruptcy Code provides no general equitable mechanism for disallowing rights of setoff that are expressly preserved by section 553.").

11. There are a variety of ways that the Government may offset a debt against a prospective payment to debtor. By way of example, under certain circumstances, HUD may offset a lender's existing debt to the agency against a

subsequent claim for FHA insurance, or may refer certain unpaid debts to the Treasury Offset Program, which the United States Department of the Treasury (“Treasury”) would then offset against any subsequent federal payment to the debtor, including FHA insurance claims. *See* 24 C.F.R. § 17.65. In addition, because the United States is a unitary creditor for setoff purposes, debts owed to one agency may be offset under certain circumstances against federal payments authorized by a different agency, *e.g.*, payments of insurance claims in connection with FHA-insured loans.

12. The Government is concerned about the contemplated sale of the FHA Loans because a free-and-clear sale of those loans conceivably would bar the Government from offsetting a debt of the Debtors against a claim by the Purchaser for insurance in connection with the loans. In addition, to the extent the FHA Loans include loans that have been modified under the FHA’s Home Affordable Modification Program (FHA-HAMP) and qualified for payment of financial incentives under Treasury’s Making Home Affordable Program, a free-and-clear sale may impair Treasury’s rights to recover amounts paid out in error. The Government is currently reviewing the information provided by the Debtors, together with the Government’s records, to determine the extent of any potential impairment.

13. While the proposed Sale Procedures Order provides that the deadline for objections to approval of the Sale, including that the Sale shall be free and clear, is April 4, 2013, the Government raises the foregoing issues at this time to put all

interested parties, including potential purchasers, on notice of the Government's position with respect to the interplay between the contemplated sale and the Government's setoff rights. The United States reserves all of its rights to object to a motion approve the sale of the FHA Loans for the reasons stated herein, or any other appropriate ground.

Dated: New York, New York
January 10, 2013

Respectfully submitted,

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