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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)
RESIDENTIAL CAPITAL, LLC; DITECH, LLC; DOA HOLDING PROPERTIES, LLC; DOA PROPERTIES IX (LOTS-OTHER), LLC; EPRE LLC; EQUITY INVESTMENTS I, LLC; ETS OF VIRGINIA, INC.; ETS OF WASHINGTON, INC.; EXECUTIVE TRUSTEE SERVICES LLC; GMAC – RFC HOLDING COMPANY, LLC; GMAC MODEL HOME FINANCE I, LLC; GMAC MORTGAGE USA CORPORATION; GMAC MORTGAGE, LLC; GMAC RESIDENTIAL HOLDING COMPANY, LLC; GMAC RH SETTLEMENT SERVICE, LLC; GMACM BORROWER LLC; GMACM REO LLC; GMACR MORTGAGE PRODUCTS, LLC; HFN REO SUB II, LLC; HOME CONNECTS LENDING SERVICES, LLC; HOMECOMINGS FINANCIAL REAL ESTATE HOLDINGS, LLC; HOMECOMINGS FINANCIAL, LLC; LADUE	Adv. Pro. No. 13-01262 (MG)

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ASSOCIATES, INC.; PASSIVE ASSET TRANSACTIONS, LLC; PATI A, LLC; PATI B, LLC; PATI REAL ESTATE HOLDINGS, LLC; RAHI A, LLC; RAHI B, LLC; RAHI REAL ESTATE HOLDINGS, LLC; RCSFJV2004, LLC; RESIDENTIAL ACCREDIT LOANS, INC.; RESIDENTIAL ASSET MORTGAGE PRODUCTS, INC.; RESIDENTIAL ASSET SECURITIES CORPORATION; RESIDENTIAL CONSUMER SERVICES OF ALABAMA, LLC; RESIDENTIAL CONSUMER SERVICES OF OHIO, LLC; RESIDENTIAL CONSUMER SERVICES OF TEXAS, LLC; RESIDENTIAL CONSUMER SERVICES, LLC; RESIDENTIAL FUNDING COMPANY, LLC; RESIDENTIAL FUNDING MORTGAGE EXCHANGE, LLC; RESIDENTIAL FUNDING MORTGAGE SECURITIES I, INC.; RESIDENTIAL FUNDING MORTGAGE SECURITIES II, INC.; RESIDENTIAL FUNDING REAL ESTATE HOLDINGS, LLC; RESIDENTIAL MORTGAGE REAL ESTATE HOLDINGS, LLC; RFC – GSAP SERVICER ADVANCE, LLC; RFC ASSET HOLDINGS II, LLC; RFC ASSET MANAGEMENT, LLC; RFC BORROWER LLC; RFC CONSTRUCTION FUNDING, LLC; RFC REO LLC; and RFC SFJV- 2002, LLC,

Plaintiffs,

v.

ALLSTATE INSURANCE COMPANY; ALLSTATE LIFE INSURANCE CO.; ALLSTATE NEW JERSEY INSURANCE CO.; AIG ASSET MANAGEMENT (U.S.), LLC;

Defendants.

REPLY IN FURTHER SUPPORT OF MOTION OF LEAD PLAINTIFF, FOR ITSELF AND ON BEHALF OF THE CERTIFIED CLASS, FOR SUMMARY JUDGMENT

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New Jersey Carpenters Health Fund, the court-appointed lead plaintiff (the "Lead Plaintiff") in the consolidated securities class action styled as *New Jersey Carpenters Health Fund, et al., on Behalf of Themselves and All Others Similarly Situated v. Residential Capital, LLC, et al.*, pending in the United States District Court for the Southern District of New York (the "District Court"), Case No. 08-CV-8781 (HB) (the "Class Action"), for itself and on behalf of the class of purchasers defined and certified in the Class Action (the "Certified Class" and collectively with the Lead Plaintiff, the "Class Action Parties"), hereby submits this reply (the "Reply") in further support of the *Motion of Lead Plaintiff, for Itself and on Behalf of the Certified Class, for Summary Judgment* (the "Lead Plaintiff Summary Judgment Motion") [Docket No. 29]. In support of this Reply, Lead Plaintiff respectfully states as follows:

BACKGROUND

1. Residential Capital, LLC and certain of its affiliated debtors and debtors-in-possession (collectively, the "Debtors") commenced this adversary proceeding on February 19, 2013, seeking entry of a judgment or order subordinating securities-law and related claims against certain of the Debtors arising from the purchase or sale of residential mortgage-backed securities ("RMBS") for which certain Debtors served as sponsor, depositor or master servicer (the "Investor Claims") under section 510(a), (b), or (c) of the Bankruptcy Code. On April 2, 2013, the Debtors filed a motion for summary judgment on the issue of subordination of Investor Claims (the "Debtors' Summary Judgment Motion") [Docket No. 25], and Lead Plaintiff filed the Lead Plaintiff Summary Judgment Motion. On April 23, 2013, the Debtors filed a brief in opposition to summary judgment motions by Lead Plaintiff and others (the "Debtors' Opposition") [Docket No. 42], and Lead Plaintiff filed its opposition to the Debtors' Summary Judgment Motion [Docket No. 46].

2. Other background and relevant procedural history of the Class Action, this adversary proceeding, and the Debtors' Summary Judgment Motion are set forth in the Lead Plaintiff Summary Judgment Motion.

JOINDER

3. Lead Plaintiff hereby joins in and incorporates by reference the arguments and factual assertions set forth in the *Reply in Support of Motion of AIG Asset Management (U.S.), LLC, the Allstate Entities, Massachusetts Mutual Life Insurance Company, and the Prudential Entities for Summary Judgment* [Docket No. 54] as if fully set forth herein.

FURTHER REPLY

4. Regardless of the statutory rubric into which the Debtors strain to shoehorn their attempt to subordinate Investor Claims, the simple reality is that there is no basis in law for subordination. The Debtors' arguments for subordination under sections 510(a) and (c) of the Bankruptcy Code would stretch the statutory text so far as to border on frivolity, and have been adequately addressed in prior briefing. There are two issues that Lead Plaintiff would like to discuss in the context of this Reply: (a) the policy underlying section 510(b) of the Bankruptcy Code and the fact that subordinating Investor Claims would do absolutely nothing to serve that purpose, and (b) the language of SEC Rule 191, which makes clear that asset-backed securities for which a depositor is deemed an issuer for limited SEC compliance purposes do not somehow morph into securities "of" that depositor.

A. Subordination Under Section 510(b) Is Neither Appropriate Nor Warranted

5. The fundamental purpose of section 510(b) is to prevent investors in securities from using claims related to their purchase of a debtor's securities to "bootstrap" their way up that debtor's capital structure by asserting claims entitled to higher priority than the underlying

securities themselves. See, e.g., In re Enron Corp., 341 B.R. 141, 158 (Bankr. S.D.N.Y. 2006) ("'Congress enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding.'") (quoting In re Telegroup Inc., 281 F.3d 133, 142 (3d Cir. 2002)); see also In re Granite Partners, L.P., 208 B.R. 332, 336 (Bankr. S.D.N.Y. 1997) ("Any discussion of Section 510(b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke. . . ."); John J. Slain and Homer 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, 268 (1973). Notably, the purpose of section 510(b) has never been interpreted (until perhaps now by the Debtors) so as to subordinate securities law or other independent tort claims against a debtor by investors in securities wholly and intentionally placed outside of that debtor's capital structure. Such an interpretation falls far afield of the purpose of section 510(b). Dating back to the Slain and Kripke article, the purpose of subordination is to prevent investors in securities in the lower tiers of a debtor's capital structure from "jumping up the ladder" to parity with holders of higher-ranked claims based upon claims in connection with the purchase of those securities. No such risk is implicated here.

6. Here, RMBS sponsored by the Debtors were—as they were designed to be—entirely outside of the Debtors' capital structure. See Debtors' Opposition at 3 ("To be sure, the Trusts are designed to be bankruptcy remote . . . ."). As the Debtors have acknowledged, the RMBS represented only beneficial interests in the securitization trusts, not interests in or obligations of the Debtors. See Debtors' Opposition at 3 ("[T]he Certificates do not represent an ownership interest in the Debtors or a direct obligation of the Debtors."). Purchasers of Debtor-

sponsored RMBS purchased only beneficial interests in a stream of future cash flows defined by the terms and performance of the underlying mortgage loans (which are not property of the Debtors' estate), not interests defined in any way by the Debtors' own financial performance.[1] RMBS purchasers did not assume the downside risk of the Debtors' insolvency in exchange for uncapped potential upside gain based on the Debtors' financial performance, as would a shareholder. Just as a positive year of earnings for the Debtors would have no upside impact on the value of the RMBS, the Debtors' bankruptcy should have no bearing on the priority of Investor Claims related to the purchase of RMBS. The bootstrapping issue which section 510(b) was designed to prevent is, therefore, nonexistent here, and the Investor Claims should remain general unsecured claims with no lesser priority than any other tort claims against the Debtors.

B. 17 C.F.R. §230.191 ("SEC Rule 191") Clearly Supports the Appropriate Meaning of "Securities of…"

7. One need go no further than the actual language of SEC Rule 191, relied upon so heavily by the Debtors, to end the debate created by the Debtors as to the appropriate meaning of the language "…securities of the debtor…" in 11 U.S.C. §510(b). That Rule states:

> (a) The depositor for the asset-backed securities acting solely in its capacity as depositor to the issuing entity is the "issuer" for purposes <u>of the asset-backed securities of that issuing entity</u>.
>
> (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 <u>or for purposes of that person's own securities</u>.

[1] The Debtors' argument that because servicer risk factored into rating agencies' ratings of the RMBS, RMBS purchasers were buying a piece of the "operational performance and financial condition", <u>see</u> Debtors' Opposition at 7-8, is an unavailing straw man. The ability of the master servicer to fulfill its ongoing contractual servicing duties undoubtedly bears on the expected risk of default on the RMBS because an interruption in servicing and resulting transition to a new master servicer appointed by the trustee could cause a temporary delay in payment. However, the master servicer's ability to continue performing its contractual duties related to collecting and remitting payments does not somehow transform the RMBS into obligations of the master servicer itself. The same would be true regardless of who served as master servicer. Moreover, if that were the case, any counterparty to a significant contract with the entity issuing securities would be placed in that same position.

See 17 C.F.R. 230.191 (emphasis added).

8. Thus, despite the designation of the depositor as the "issuer" for SEC registration, disclosure, and reporting requirements, the nature of the asset-backed securities as securities "of that issuing entity" is expressly unaffected by SEC Rule 191. If the intention were otherwise, the SEC would not have made clear the distinction between securities for which the depositor is deemed an issuer for certain purposes and the depositor's own securities. See *Motion of AIG Asset Management (U.S.), LLC, the Allstate Entities, Massachusetts Mutual Life Insurance Company, and the Prudential Entities for Summary* (the "AIG Summary Judgment Motion") [Docket No. 27] at 16–17.

RESERVATION OF RIGHTS

9. Lead Plaintiff reserves all rights with respect to the Debtors' bankruptcy cases, the claims of the Class Action Parties, and the Class Action, including but not limited to the rights to oppose (a) any motion or adversary proceeding seeking expungement, disallowance, subordination, or other modification of any claims asserted against the Debtors by or on behalf of the Class Action Parties and (b) confirmation of any chapter 11 plan filed in these cases that proposes to disallow or subordinate such claims. Lead Plaintiff further reserves the right to reply to any arguments raised (by the Debtors or otherwise) in opposition to (a) the Lead Plaintiff Summary Judgment Motion or (b) the AIG Summary Judgment Motion, or in support of or opposition to any other motion relating to the subject matter hereof.

[signature page follows]

CONCLUSION

The Class Action Parties respectfully request that the Court deny the Debtors' Summary Judgment Motion in its entirety and grant the Lead Plaintiff Summary Judgment Motion in all respects.

Dated: May 7, 2013
New York, New York

Respectfully submitted,

/s/ Michael S. Etkin

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