IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	)	Chapter 11 Cases
	)	Case No. 08-12229 (MFW)
WASHINGTON MUTUAL, INC., et al.,	)	Jointly Administered
	)	
Debtors.	)	

SUPPLEMENTAL BRIEF OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF WASHINGTON MUTUAL, INC. ET AL. IN SUPPORT OF THE DEBTORS' SUPPLEMENTAL OBJECTION TO THE AMENDED PROOF OF CLAIM OF TRANQUILITY MASTER FUND LTD. (CLAIM NO. 3925)

The Official Committee of Unsecured Creditors (the "Creditors' Committee") of Washington Mutual, Inc. ("WMI") and WMI Investment Corp. ("WMI Investment") (collectively, the "Debtors") submits this Supplemental Brief in Support of the Debtors' Supplemental Objection to the Amended Proof of Claim of Tranquility Master Fund Ltd. (Claim No. 3925) ("Debtors' Supplemental Objection") (D.I. # 6426), in accordance with the Court's direction during oral argument on June 28, 2011.[1]

INTRODUCTION

1. In this matter, Tranquility Master Fund, Ltd. ("Tranquility") asserts that WMI, through a complicated structure of subsidiaries including WaMu Asset Acceptance Corp. ("WAAC"), was responsible for effectuating the issuance of the mortgage-backed securities that Tranquility purchased. Tranquility concedes that these subsidiaries–including WAAC–were

[1] Terms not separately defined herein shall have the meanings set forth in Debtors' Supplemental Objection. This brief does not expand upon the Debtors' well-reasoned argument based on Bankruptcy Code section 101(2)(C) that the asset trusts described herein were affiliates because the mortgage assets at issue were operated by WMB. This brief addresses section 101(2)(B) as an independent basis for the Court to hold that Tranquility's claims, if allowed, are subordinated under section 510(b).

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wholly-owned or indirectly wholly-owned by WMI (Summary In Support Of Tranquility Master Fund, Ltd.'s Amended Proof Of Claim ("Amended Proof Of Claim"), ¶¶ 5, 29-33)), which qualifies the subsidiaries as "affiliates" under the Bankruptcy Code. 11 U.S.C. § 101(2). The logical implication of these arguments is that if the securities Tranquility purchased are securities of a WMI affiliate, then Tranquility's claims are subject to subordination under section 510(b) of the Bankruptcy Code. Faced with this inescapable conclusion, Tranquility advances the untenable position that while WMI "controlled" all of the subsidiaries involved in issuing these securities for purposes of securities fraud liability, the securities are not securities "of" the WMI affiliates because the issuers were trusts.

2. This Court should reject Tranquility's effort to circumvent Congress's mandate that claims for securities fraud arising from the purchase or sale of securities of the debtor or its affiliates should not dilute the recoveries of general unsecured creditors. Nothing about the trust structure utilized by WAAC changes the analysis. Nor is there any conceivable reason for shifting to WMI's true creditors even a small portion of the risk of defects in the securities' issuance. Tranquility's claims, if allowed against WMI, necessarily arise from the purchase or sale of the securities of an affiliate of WMI and must be subordinated to the general unsecured creditors of WMI.

BACKGROUND

3. WAAC, a wholly-owned subsidiary of Washington Mutual Bank ("WMB"), itself a wholly-owned subsidiary of WMI, securitized pools of mortgage loans that it owned by placing them into trusts and selling certificates in the trusts, in several "tranches" with varying degrees of risk, to investors. The certificates entitled the investors to a certain portion of the cash flow of the mortgages held by WAAC in trust.

4. Tranquility invested in the lowest-tier tranches of these securities, assuming by contract the first losses in the mortgage pools. Tranquility filed a claim against WMI alleging violations of California and federal securities laws arising from its purchase of the securities.

5. The facts surrounding the collapse of WMI and its subsidiaries are well known to the Court and not relevant to the question of whether Tranquility's claims, if allowed, must be subordinated under section 510(b) of the Bankruptcy Code.

ARGUMENT

6. 11 USC § 510(b) states:

> For the purpose of distribution under this title, 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.

7. Section 510(b) codifies Congress's judgment that state and federal securities law claims related to the purchase or sale of securities of a debtor or its affiliates should have a lower priority than claims of a debtor's general unsecured creditors. *Baroda Hill Invests. v. Telegroup (In re Telegroup),* 281 F.3d 133, 138 (3d Cir. 2002). In *Telegroup,* the Third Circuit described the policy rationale behind Congress's decision to enact section 510(b), and explained the legislature's reliance on the seminal article by Professors 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 (1973) ("Slain and Kripke"). More specifically, the court in *Telegroup* recounted Congress's adoption of Slain and Kripke's view that the risk of illegality in the issuance of

securities (*i.e.*, securities fraud, such as that alleged by Tranquility here) should be borne by the purchasers of those same securities, and not by the debtor's general creditors:

> Analyzing the second risk–the risk of illegality in the issuance of stock–Slain and Kripke argued that this risk, too, should be born [sic] by shareholders. "It is difficult to conceive of any reason for shifting even a small portion of the risk of illegality from the stock-holder, since it is to the stockholder, and not to the creditor, that the stock is offered." Slain and Kripke therefore concluded that shareholder claims alleging illegality in the issuance of stock should be subordinated to the claims of general unsecured creditors.

Id. at 140 (citation omitted).

8. This principle also applies to debt securities such as those at issue here. Section 510(b) does not apply solely to equity securities of a debtor or its affiliates, but to "all securities of the debtor and of the debtor's affiliates." 11 U.S.C. § 510(b) (emphasis added). As the court in *In re Mid-American Waste Systems, Inc.* explained, "[t]he Bankruptcy Code defines the term 'security' to include a 'note,' 'bond,' or 'debenture'…. Thus, by its plain terms § 510(b) is intended to apply to both debtholders and equityholders." 288 B.R. 816, 825 (D. Del. 1999) (citations omitted). Congress's intention in applying section 510(b) to securities generally was to avoid a situation where "investors in stock or in subordinated debentures may be able to bootstrap their way to parity with, or preference over, general creditors even in the absence of express contractual rights." *Telegroup*, 281 F.3d at 141 (*quoting* Slain and Kripke at 268); *see also In re Geneva Steel Co.*, 281 F.3d 1173, 1179-81 (10th Cir. 2002) (affirming 510(b) subordination of bond holder's fraud claim, and noting that "'creditors stand ahead of investors on the receiving line'" and "'[w]hen an investor seeks *pari passu* treatment with other creditors, he disregards the absolute priority rule [ ] and attempts to establish a contrary principle that threatens to swallow up this fundamental rule of bankruptcy law.'" (quotation omitted)).

9. Congress, cognizant of the multiplication of easily-asserted "control person" theories of liability under the state and federal securities laws, provided in section 510(b) that all "claims arising from rescission of a purchase or sale of a security of . . . an affiliate of the debtor" also must be subordinated. 11 U.S.C. § 510(b). This language broadly encompasses alleged control person liability in the issuance and sale of securities by a corporation, by its subsidiaries or by a parent company. Thus, the rights and expectations of the purchasers of different types of securities in a group of related companies, which might not be reflected on the balance sheet of the debtor, do not overwhelm the general unsecured creditors of each debtor.

10. The Bankruptcy Code defines "affiliate" in terms of control. Section 101(2) provides several definitions of affiliate, one of which relates to wholly owned subsidiaries such as WAAC:

> The term "affiliate" means . . . 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 . . . .

11 U.S.C. § 101(2)(B). Tranquility admits that WAAC, the entity that owned the securitized assets and effected the issuance of the securities that Tranquility purchased, was a wholly owned subsidiary of WMB, which was a wholly owned subsidiary of WMI and, therefore, was an affiliate of WMI. Amended Proof of Claim, ¶ 5. But Tranquility attempts to avoid the inevitable conclusion that its claims are subordinated by raising an irrelevant technicality: that WAAC segregated the pooled mortgages in a trust that it established for the purpose of issuing the securities and that such trusts are not affiliates of WMI. It is on this basis that Tranquility asserts that its run-of-the-mill subordinated fraud claim based on securities of the trust miraculously

becomes a general unsecured claim against WMI and may dilute the recovery of direct creditors of WMI.

11. But for purposes of section 510(b) subordination, the structure is a distinction without a difference and does not remove Tranquility's claims from well within "claims arising from rescission of a purchase or sale of a security of . . . an affiliate of the debtor." A trust is a means of holding title to property (in this case, the pooled mortgages) for the beneficial interest of another (in this case, the investors). *See* BLACK'S LAW DICTIONARY 1261-62 (8th rev. ed. 2005). For administrative convenience in paying dividends, the asset trusts in these cases were administered by professional trustees. But the owner, depositor, and servicer of the mortgage assets, and the entities that established the trusts and securitized the mortgages, were all affiliates of the Debtors. Although WAAC contributed the mortgage assets to a trust for the purpose of securitizing them, the securities were, nevertheless, securities of the Debtors' affiliate WAAC.

12. Furthermore, even if the securities were as a technical matter issued by a trust, they are nevertheless "a security of . . . an affiliate of the debtor" within the meaning of section 510(b) because they were securities of WAAC. If Congress had meant to restrict subordination to claims arising from affiliate entities that were issuers, instead of the broader phrase "security of" an affiliate of the debtor, it would have used the word "issuer" as it did in other sections of the Bankruptcy Code. *Compare*, 11 U.S.C. §510(b) *with* § 1145(a)(3) (exempting from certain securities laws, "the offer or sale, other than under a plan, of a security of an issuer other than the debtor or an affiliate, if (A) such security was owned by the debtor on the date of the filing of the petition; (B) the issuer of such security is (i) required to file reports under section 13 or 15(d) of the Securities Exchange Act of 1934; and (ii) in compliance with the

disclosure and reporting provision of such applicable section . . . .") (emphases added); *and* § 364(f) (exempting an "issuer of" securities from certain registration requirements). Congress, using different terms to mean different things, did not restrict section 510(b) subordination to claims based on affiliate issuers only. 11 U.S.C. § 510(b).

13. To the extent that section 510(b) is ambiguous, equitable considerations support interpreting section 510(b) to favor subordination. WAAC's use of a trust structure to effect the securities issuance had no bearing on the risks that Tranquility agreed to accept by purchasing subordinated tranches of securities or the reasonable expectations of WMI's general unsecured creditors that their claims would not be diluted by common securities law claims. Tranquility accepted the risks associated with the securities that it purchased, including that it would have recourse only according to the terms of the securities, and "[i]t is difficult to conceive of any reason for shifting even a small portion of the risk of illegality" to the creditors, who did not accept such risks. *Telegroup*, 281 F.3d at 140 (quoting Slain and Kripke at 268). Each set of creditors should be bound by the risks that it chose to accept.

14. And, as the Third Circuit opined in *Telegroup*, Congress's intent weighs clearly in favor of subordination because nothing about the trust structure changed the bargain made by Tranquility, the role (if any) of WMI in that bargain, or the reasonable expectations of WMI's on-balance-sheet creditors. *See Telegroup*, 281 F.3d at 138, 140-42 (explaining Congress's intent in enacting section 510(b)). The only difference between this transaction and commonly subordinated control person claims is the formal trust structure. Insertion of a commonly employed trust structure for issuing securities is no basis for Tranquility to circumvent the statutory scheme and dilute the recoveries of WMI's true creditors.

15. Finally, Tranquility relies on *In re SemCrude, L.P.*, 436 B.R. 317 (Bankr. D. Del. 2010) for its argument that the securities it purchased are not securities of an affiliate of the Debtors. That reliance is misplaced, however, because *SemCrude* dealt with the narrow question of whether shares in a limited partnership could be deemed securities of an affiliate under section 101(2). *See id.* at 320. The court held that a limited partnership cannot be an affiliate under 101(2)(B), because 101(2)(B) applies only to "corporations", and the definition of "corporation" in 101(6)(B) specifically excludes limited partnerships. *Id*. *SemCrude* does not deal with the questions of whether a trust may ever be deemed an affiliate or whether securities of an indirect subsidiary, issued through a trust for tax purposes, can be deemed to be securities "of an affiliate" for purposes of section 510(b). Neither those questions, nor any like them, were examined in *SemCrude*. *See generally* 436 B.R. 317.

CONCLUSION

For the foregoing reasons, the Creditors' Committee respectfully requests that if the Court allows all or any part of Tranquility's claim, that it subordinate such claim under section 510(b) of the Bankruptcy Code.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I, David B. Stratton, hereby certify that on the 8 day of July, 2011, I did serve the foregoing by causing a copy of **SUPPLEMENTAL BRIEF OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF WASHINGTON MUTUAL, INC. ET AL. IN SUPPORT OF THE DEBTORS' SUPPLEMENTAL OBJECTION TO THE AMENDED PROOF OF CLAIM OF TRANQUILITY MASTER FUND LTD. (CLAIM NO. 3925)** to be served via United States mail, first class, postage pre-paid, upon those parties listed on the attached service list.

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