**AURELIUS CAPITAL MANAGEMENT, LP**
535 MADISON AVENUE
22ND FLOOR
NEW YORK, NEW YORK 10022
TEL.: (646) 445-6500

May 4, 2009

TO: ISDA Determinations Committee

FROM: Aurelius Capital Management, LP
Mark Brodsky (mbrodsky@aurelius-capital.com)
Eleanor Chan (echan@aurelius-capital.com)

With the assistance of Chadbourne & Parke LLP
John J. Sarchio, Esq. (jsarchio@chadbourne.com)
Richard Liskov, Esq. (rliskov@chadbourne.com)
Carey Child, Esq. (cchild@chadbourne.com)

RE: MBIA Insurance Corporation Succession Event (Issue #2009042701)

On April 27, we notified ISDA of our belief that a Succession Event had occurred on February 17, 2009 with regard to MBIA Insurance Corporation. We are submitting this memorandum in order to anticipate analytical questions you may have. We request the opportunity to be interactive with the Determinations Committee as it proceeds with its analysis. Terms defined in our April 27 notice are used here with the same meaning.

The Succession Event entailed MBIA Corp's transfer of its obligations in respect of certain financial guaranty insurance policies to MBIA Illinois pursuant to the Assignment and Assumption Agreement. The policies in question are unconditional guaranties of various municipal bonds, quintessential examples of Qualifying Policies. These Qualifying Policies were originally issued by Financial Guaranty Insurance Company ("**FGIC**"), but the economic benefits and burdens of the Qualifying Policies were acquired by MBIA Corp last year pursuant to the FGIC Reinsurance Agreement. We refer to these policies as the "**Acquired Policies**." The essence of the Succession Event at issue here is that the Acquired Policies were Qualifying Policies of MBIA Corp immediately prior to the February 17 transaction; that the Acquired Policies constituted more than 25% of the Relevant Obligations; and that MBIA Illinois succeeded to those Qualifying Policies as a result of that transaction.

## I. PERTINENT CONTRACTUAL PROVISIONS

### A. MBIA CORP'S ACQUISITION OF THE ACQUIRED POLICIES IN 2008

In contrast to typical reinsurance arrangements, the FGIC Reinsurance Agreement contains so-called "cut-through" provisions (Section 13), pursuant to which MBIA Corp became directly obligated to the policyholders under the Acquired Policies, as if MBIA Corp had been the original insurer. Pertinent excerpts from Section 13, paragraphs (a) and (c), appear below (emphasis added):

> "(a) ***The Reinsurer [i.e., MBIA Corp] will pay***, in accordance with the Covered Policy [*i.e.*, the pertinent Acquired Policy], ***directly to the applicable holder of the insured securities*** or obligations thereunder ('Bondholder'), to the trustee, paying agent or other third party fiduciary acting on behalf of such Bondholder, to the Company's fiscal agent under such Covered Policy, on behalf of the Company, or to such other Person that is entitled to receive payment under the terms of the applicable Covered Policy (any such Bondholder or other Person, a 'Payee'), ***100% of any claim*** due and payable by the Company [i.e., FGIC] ***under such Covered Policy*** …. All notices, claims and suits or actions on such Covered Policy may be made directly to the Reinsurer ***as though it had originally issued such Covered Policy***."
>
> "(c) The parties hereto acknowledge and agree that ***a Payee*** shall be entitled, ***as an express third-party beneficiary, to enforce against the Reinsurer its obligations to make payment directly to such Payee*** in the circumstances described in this Section 13 to the same extent ***as if such Payee were a party hereto***, it being understood that the third-party beneficiary right of any Payee hereunder pertains solely to the payment obligations under the related Covered Policy and does not pertain to any other provisions of this Agreement."

Pursuant to the Notice to Policyholders, the insureds under the Acquired Policies were (i) notified of these cut-through provisions, (ii) directed to send insurance claims directly to MBIA Corp, and (iii) advised that payments on those claims would be made directly by MBIA Corp.

## B. TRANSFER OF ACQUIRED POLICIES

Pursuant to the Assumption and Assignment Agreement dated February 17, 2009, MBIA Corp assigned to MBIA Illinois all of its "rights, interests and obligations" under the FGIC Reinsurance Agreement, and MBIA Illinois assumed "all of the liabilities and obligations of MBIA Corp" thereunder. (Assumption and Assignment §§ 1 and 2.) Section 2 of the Assumption and Assignment makes clear that MBIA Corp is to have no further liability under the FGIC Reinsurance Agreement:

> "(i) MBIA Illinois shall be substituted for MBIA Corp under each of the FGIC Reinsurance Agreement and the FGIC Trust Agreement, in MBIA Corp's name, place and stead;
>
> "(ii) MBIA Corp shall be deemed to have ceased to be a party to the FGIC Reinsurance Agreement and the FGIC Trust Agreement, and shall be discharged from all obligations and liabilities to FGIC and/or the Trustee, as applicable, thereunder; and
>
> "(iii) FGIC and the Trustee, as applicable, will look solely to MBIA Illinois for performance of any and all obligations and liabilities owed to it under each of the FGIC Reinsurance Agreement and the FGIC Trust Agreement."

FGIC had consented in advance to this substitution of MBIA Illinois for MBIA Corp. Section 21(f) of the FGIC Reinsurance Agreement provides that "the Reinsurer [*i.e.*, MBIA Corp] shall have the right to assign its rights, interests and/or obligations hereunder (whether through an assumption and assignment, reinsurance transaction or otherwise) at any time without the consent of FGIC to MBIA Insurance Corp. of Illinois," subject to certain conditions that have been satisfied in this instance. This Section 21(f) is specifically invoked in the sixth "Whereas" clause of the Assignment and Assumption Agreement.

Likewise, the Notice to Policyholders (second paragraph) expressly contemplated that MBIA Corp could assign its position to MBIA Illinois or another affiliate, in which event "all obligations of MBIA [Corp] under the Reinsurance Agreement, including MBIA's obligation to make direct payment to the Payees in accordance with the procedure set forth below, shall be assumed by such affiliate of MBIA (the 'Assignee') ***and the obligations of MBIA to the Payees shall terminate upon such assignment***." (Emphasis added.)

## II. THE ACQUIRED POLICIES WERE QUALIFYING POLICIES OF MBIA CORP PRIOR TO THE FEBRUARY TRANSACTION

We explain below why the Acquired Policies were "Qualifying Policies" of MBIA Corp immediately prior to the February transaction. "Qualifying Policy" is defined in the 2005 Monoline Supplement as follows:

> "'Qualifying Policy' means a financial guaranty insurance policy or similar financial guarantee pursuant to which a Reference Entity irrevocably guarantees or insures all Instrument Payments (as defined below) of an instrument that constitutes Borrowed Money (modified as set forth below) (the 'Insured Instrument') for which another party (including a special purpose entity or trust) is the obligor (the 'Insured Obligor'). Qualifying Policies shall exclude any arrangement (i) structured as a surety bond, letter of credit or equivalent legal arrangement or (ii) pursuant to the express contractual terms of which the payment obligations of the Reference Entity can be discharged or reduced as a result of the occurrence or non-occurrence of an event or circumstance (other than the payment of Instrument Payments). The benefit of a Qualifying Policy must be capable of being Delivered together with the Delivery of the Insured Instrument."

### A. IN LIGHT OF THE CUT-THROUGH PROVISIONS, THE ACQUIRED POLICIES HAD THE SAME "QUALIFYING POLICY" STATUS IN MBIA'S HANDS AS IN FGIC'S

We believe it is commonly accepted that the Acquired Policies satisfied the definition of Qualifying Policies when issued by FGIC. This makes sense, since we understand that the Acquired Policies all relate to municipal bond issuances; municipal bond insurance is highly uniform; and the definition of Qualifying Policies is satisfied by typical municipal bond insurance. Although one could theoretically test this understanding by researching every municipal bond covered by the Acquired Policies, it would be inappropriate to do so without similarly researching all the other policies (including municipal bond policies originated by MBIA Corp) our April 27 notice counted when calculating the percentage of Relevant Obligations succeeded to.

As noted in Section I.A above, the FGIC Reinsurance Agreement – unlike typical reinsurance agreements – contains "cut-through" provisions. Pursuant to these provisions, MBIA Corp made a contractual undertaking directly to the policy payees, for the full amount due them under the policies.[1] Any claims or suits could be made directly against MBIA Corp "***as though it had originally issued such Covered Policy***" (Section 13(a); emphasis added). Each policy payee could enforce MBIA Corp's undertaking "to the same extent ***as if such Payee were a party hereto***." (Section 13(c); emphasis added.) MBIA undertook to them that it would make all payments due them under the Acquired Policies.[2]

MBIA Corp did not merely agree to make payment if FGIC failed to do so. Rather, MBIA Corp undertook the role of primary obligor under the Acquired Policies. Indeed, in the Notice to Policyholders, policyholders were advised to submit all claims directly to MBIA Corp, and to expect all payments thereon to come directly from MBIA Corp. It follows that if (as we understand) the Acquired Policies were Qualifying Policies when issued by FGIC, they became Qualifying Policies of MBIA Corp by operation of these provisions.[3]

These cut-through provisions would cause the New York State Department of Insurance to treat the FGIC Reinsurance Agreement as if it were a financial guaranty insurance policy issued directly by MBIA Corp. The Department of Insurance has taken the position that a cut-through provision in a reinsurance agreement which allows the policyholder to claim directly against the reinsurer is itself an insurance contract which can only be executed legally by a person or entity licensed to write the particular type of insurance involved.[4]

---

1 This direct undertaking to the policyholders is markedly different from a typical contract of reinsurance, in two respects: (1) true reinsurance is a contract of indemnity, meaning that reinsurer's payment obligation is to indemnify the reinsured for amounts paid by the reinsured; and (2) a reinsurance agreement does not create any right of the original insured to claim against the reinsurer. See Jurupa Valley Spectrum, LLC v. National Indem. Co., 555 F.3d 87, 89 (2d Cir. 2009) citing China Union Lines, Ltd. v. American Marine Underwriters, Inc., 755 F.2d 26, 30 (2d Cir. 1985) ("As a general rule, reinsurance contracts are contracts of indemnity, which give the original assured no right of action against the reinsurer.").

2 Solely as between FGIC and MBIA Corp, MBIA Corp's reinsurance obligation is net of certain third-party reinsurance previously procured by FGIC. See Section 6(a). However, this understanding between the two companies has no bearing on the scope of MBIA Corp's direct undertaking to the policyholders described above. Third-party reinsurance, if any, is to be addressed solely by way of a payment from FGIC to MBIA pursuant to Section 13(d).

3 In light of the fact that the FGIC Reinsurance Agreement obligates MBIA Corp as primary obligor to make all payments under the Acquired Policies directly to the underlying policyholders, it is irrelevant to the analysis that FGIC was not released from its original obligations to the policyholders.

4 *See, e.g.,* Opinion of New York Insurance Department Office of General Counsel, May 24, 2004 accessible at http://www.ins.state.ny.us/ogco2004/rg040520.htm (registered service contract provider could obtain insurance coverage for its contractual obligations to consumers from unauthorized insurer but could not provide consumers with a cut-through provision allowing them to make claims directly with the unlicensed insurer); *see also* Opinion of New York insurance Department Office of General Counsel, January 14, 2005, accessible at http://www.ins.state.ny.us/ogco2004/rg040520.htm (reinsurer not permitted to evade licensure requirement through arrangement with direct insurer that involves any activities for which a license would be required); Opinion of New York Insurance Department Office of General Counsel, December 21, 2005 accessible at http://www.ins.state.ny.us/ogco2005/rg051217.htm

Even if MBIA's obligations in respect of the Acquired Policies were not deemed to constitute direct policies of MBIA, they would still constitute, for purposes of the definition of Qualifying Policy, "financial guaranty insurance polic[ies] or similar financial guarantee[s] pursuant to which a Reference Entity irrevocably guarantees or insures all Instrument Payments" – for two reasons. First, the definition does not require that the Reference Entity be the issuer of the policies. Both the language and common sense dictate that a contractual assumption of the original insurer's obligations under the policies should suffice. Second, surely MBIA Corp's undertaking to the policyholders would constitute "similar financial guarantee[s]" if not financial guarantee policies.

Taking a step back, if a cut-through reinsurance arrangement like the FGIC Reinsurance Agreement did not suffice to create in the reinsurer (in this case MBIA Corp) a Qualifying Policy, it would be virtually impossible for insurance companies ever to transfer risk to another insurance company in a fashion that would give cognizance to the transfer of liability for ISDA purposes. If the transferee's direct undertaking to the ultimate payees for the full amounts due does not suffice, what would? [5]

### B. THE TERMINATION AND ASSIGNMENT PROVISIONS ARE IRRELEVANT

By definition, a Qualified Policy must "irrevocably" guarantee the pertinent Instrument Payments and cannot contain bond payments and cannot contain any "express contractual terms [pursuant to] which the payment obligations of the Reference Entity can be discharged or reduced as a result of the occurrence or non-occurrence of an event or circumstance (other than the payment of Instrument Payments)." Similar language appears in the definition of "Qualifying Guarantee" in the 2003 ISDA Definitions. We refer to these qualifications as the "**Non-Cancellation Requirement**." The purpose of the Non-Cancellation Requirement is clear. In both cases, the guaranty obligation itself should be durable, lasting the life of the underlying guaranteed debt, despite intervening events against which the guarantor may have wished to be protected (such as a deterioration in the guaranteed credit) or which would normally relieve a guarantor by operation of law in the absence of contractual language to the contrary (such as a waiver or amendment of the guaranteed obligation).

---

(reinsurer could reinsure punitive damages without violating New York prohibition on insuring punitive damages, provided that no cut-through provision allowed policyholders to claim directly against reinsurer for such punitive damages coverage). Pursuant to this line of reasoning, the FGIC Reinsurance Agreement would, by virtue of the cut-through provisions, be treated as if MBIA Corp had issued a financial guaranty insurance policy.

Likewise, the definition of "financial guaranty insurance" under Article 69 of the New York Insurance Law does not turn on whether the form of the agreement is an insurance policy, and includes an indemnity contract "under which loss is payable, upon proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee as a result of any of the following events: (A) failure of any obligor on or issuer of any debt instrument or other monetary obligation… to pay when due to be paid by the obligor. . . when such failure is the result of a financial default or insolvency...." Insurance Law § 6901.

[5] In addition to MBIA Corp's direct obligations to the policyholders constituting Qualifying Policies, we also believe that MBIA Corp's obligations to FGIC under the FGIC Reinsurance Agreement constitute a Qualifying Policy. We have chosen not to burden this submission explaining the latter, but we would wish to do so if the Determinations Committee disagrees with the former.

If (as we understand) the Acquired Policies were Qualifying Policies at issuance, they would satisfy the Non-Cancellation Requirement. Since the cut-through provisions in the FGIC Reinsurance Agreement required MBIA Corp to pay all claims under the Acquired Policies in accordance with their terms, MBIA Corp's obligation to the underlying policyholders are no less absolute.

The Non-Cancellation Requirement was not contravened by the fact that Section 15 of the FGIC Reinsurance Agreement gives FGIC the option of terminating that agreement under certain circumstances, entailing an insolvency or other credit deterioration at MBIA Corp. This option exists solely to afford FGIC protection against a deterioration in MBIA Corp's credit. The Non-Cancellation Requirement could not have been intended to prevent obligees from protecting themselves against a deterioration in the guarantor's credit.

Moreover, paragraphs (b) and (c) of Section 15 make clear that MBIA Corp's direct undertaking to the underlying policyholders ends only if FGIC elects to "reassume" the role of primary obligor under all Acquired Policies. In that event, the Acquired Policies would survive intact, but primary liability thereunder would revert to FGIC – in effect an assignment back to FGIC.

So, too, the Non-Cancellation Requirement was not contravened by the fact that MBIA Corp could be (and indeed was) released upon assignment of its position to MBIA Illinois in the February 2009 transaction. Here again, the Acquired Policies survived intact but with a new primary obligor.

Were the conclusion otherwise – that is, if the provisions permitting release of MBIA Corp upon reassignment back to FGIC or upon assignment to MBIA Illinois – absurdity would result:

- There would be virtually no Qualifying Guarantees of any company in the U.S., since U.S. corporate bond guarantees nearly always provide for substitution of the guarantor entity upon a sale of substantially all the assets.
- There would be virtually no Succession Events involving monoline insurers, since Succession requires that the transferor be released liability on Relevant Obligations that have been succeeded to by the transferee. The very provisions that would allow this to occur would prevent the policies from being Qualified Policies – hence, a "Catch-22."

## III. MBIA ILLINOIS HAS SUCCEEDED TO MBIA CORP'S RELEVANT OBLIGATIONS IN RESPECT OF THE ACQUIRED POLICIES

Having established that MBIA Corp's obligations to the holders of the Acquired Policies constitute Qualifying Policies (hence Relevant Obligations), we turn to whether MBIA Illinois "succeeded" to those obligations for purposes of determining whether an ISDA Succession Event has occurred. In pertinent part, Section 2.2(c) of the 2003 ISDA Definitions (as modified by paragraph (f) of the 2005 Monoline Supplement) provides that succession occurs when (a) "a party other than such Reference Entity (i) assumes or becomes liable for such Relevant Obligations" and (b) "such Reference Entity is no longer an obligor (primarily or secondarily) or guarantor or insurer with respect to such Relevant Obligations." The provisions discussed in I.B above readily establish that these two requirements occurred here. The Assignment and

Assumption Agreement entailed a novation, in which MBIA Illinois assumed MBIA Corp's obligations, and MBIA Corp ceased to have primary or secondary liability therefor.