No. 03-4382

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

ROYAL INDEMNITY COMPANY,
Defendant-Appellant

v.

MBIA INSURANCE CORPORATION and WELLS FARGO BANK MINNESOTA, N.A.,
Plaintiffs-Appellees

On Appeal From The United States District Court
for the District of Delaware
Civil Action No. 02-1294
(Honorable Joseph J. Farnan)

BRIEF OF THE AMERICAN SECURITIZATION FORUM AS *AMICUS CURIAE* IN SUPPORT OF PLAINTIFFS-APPELLEES AND IN SUPPORT OF AFFIRMANCE

George Miller
American Securitization Forum
360 Madison Avenue
New York, NY 10017

Robert D. Aicher
T.K. Khan
SIDLEY AUSTIN BROWN & WOOD LLP
10 S. Dearborn Street
Chicago, IL 60603

Roger J. Hawke*
SIDLEY AUSTIN BROWN & WOOD LLP
787 Seventh Avenue
New York, NY 10019
(212) 839-5300
*Counsel of Record

Counsel for *Amicus Curiae* the American Securitization Forum

June 2, 2004

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

DISCLOSURE STATEMENT

Pursuant to Rule 26.1 of the Federal Rules of Appellate Procedure, the American Securitization Forum certifies that it is a non-profit trade association. It has no parent corporation, and no publicly-held corporation owns 10 percent or more of its stock.[1]

PRELIMINARY STATEMENT

The American Securitization Forum (the "ASF") respectfully submits this *amicus curiae* memorandum of law in support of plaintiff-appellees MBIA Insurance Corporation ("MBIA") and Wells Fargo Bank Minnesota, N.A. ("Wells Fargo"). The ASF urges this Court to affirm the decision of the District Court (Farnan, J.) granting MBIA and Wells Fargo summary judgment and enforcing the insurance policies (collectively, the "Policies") issued by defendant Royal Indemnity Company ("Royal"), insuring the payment of principal and interest in the event of a default on certain, specified student loans. A motion for leave to file this brief is submitted herewith.

---

[1] The American Securitization Forum is an adjunct forum of The Bond Market Association (the "Association"), which is a non-profit trade association having no parent corporation or stock ownership by any publicly-held company. Pursuant to the by-laws of the Association, forums (such as the American Securitization Forum) are groups of persons organized to promote a specific purpose not inconsistent with the objectives of the Association. Additional information concerning the American Securitization Forum, its members and activities may be accessed from the organization's internet site, located at www.americansecuritization.com.

STATEMENT OF INTEREST OF THE *AMICUS CURIAE*

The ASF represents a broad range of professional participants in the securitization markets, including issuers, investors, financial intermediaries, servicers, trustees, rating agencies, legal and accounting firms and financial guarantors, among others. The ASF represents its members' collective interest in promoting the efficient growth and development of the securitization markets by engaging in a wide range of legal, regulatory, market practice and educational initiatives. Among other goals, the ASF seeks to 1) build consensus on issues material to the securitization industry; 2) mount focused efforts to advance the Forum's substantive positions, mainly by interacting with appropriate governmental, regulatory, legislative, judicial and other policy-making bodies, and 3) inform and educate the securitization industry and related constituencies about the operation and function of the securitization markets, and the benefits that securitization provides to consumers and businesses throughout the United States.

From its inception, the ASF has worked with its member firms, Congress, the Securities and Exchange Commission, federal bank regulatory agencies, accounting standards-setters and other policymaking bodies to foster effective and efficient regulation, to enhance the liquidity and efficiency of the securitization markets, to encourage sound business practices and promote the highest levels of professional standards and conduct in those markets. Among other activities, the

ASF provides a market-based perspective on securitization-related legislation, regulation and litigation and has undertaken numerous initiatives to enhance market practices and promote efficiency.

The ASF's focus on the securitization markets reflects the central and growing importance of this sphere of financial and capital market activity to the U.S. and global economy.[2] As a general matter, securitization enables businesses to isolate and use their valuable assets to obtain funding at a more favorable rate than they would be able to obtain through other financing methods and to access a broader base of investors. Securitization has allowed many companies to raise capital more cheaply and efficiently by facilitating the issuance of debt obligations that carry a credit rating that is higher than ratings that would be assigned to the direct short-term or long-term debt obligations of those companies. Securitization has also enabled banks, finance companies and others to extend more credit, at more favorable rates, to consumers, including consumers who otherwise might

[2] To provide an overall sense of the size and importance of securitization market activity in the United States, over $3 trillion of mortgage-backed securities ("MBS") and $584 billion of asset-backed securities ("ABS") were issued in 2003. As of December 31, 2003, total MBS outstanding was $5.3 trillion and total ABS outstanding was $1.69 trillion. (TBMA Bond Market Research Quarterly, May 2004). At the end of the same period, outstanding residential and commercial mortgage debt totaled $9.4 trillion, and outstanding consumer credit (including both revolving and non-revolving debt) totaled $2.03 trillion. (Federal Reserve Board). Based on these data, it can be inferred that a very significant percentage of both mortgage and non-mortgage consumer debt is securitized.

have been unable to obtain credit at any price. At the same time, asset-backed securities have provided safe and secured investments not only for banks, insurance companies and other businesses, but also for millions of retired people whose pension funds routinely purchase a wide range of securitized debt instruments.[3]

The interest of the ASF in this litigation stems from its strong concern for maintaining the integrity, depth and efficient operation of the securitization and bond markets in this country. These markets depend for their continued effective functioning on the ability of issuers, investors and other market participants to rely on agreed-upon commitments that have definite and assured legal consequences. In challenging the validity of its Policies in this case, Royal attacks the conceptual underpinning of a major component of the securitization, municipal bond and broader structured credit markets – the explicit and contractually agreed allocation of risk among different parties to a securitization or bond transaction. Similarly, Royal's arguments regarding the state of knowledge of a trustee that is the beneficiary of the policy, if accepted, would shift risks of the underlying

[3] The securitization investor base is overwhelmingly institutional in nature. Collectively, investment management firms, insurance companies, commercial banks, mutual funds, hedge funds and other institutional investors account for in excess of 95% of all direct investments in securitized debt instruments. (The Bond Market Association estimate). As with pension plans, many of these institutions invest funds on behalf of consumer/retail account holders and beneficiaries.

transaction to the innocent investors for whom the trustee acted. Investors in the bond and securitization markets do not expect that they will bear the burden of institutional knowledge of a trustee that is merely acting as their proxy. In this regard, it is unreasonable for Royal to state that it needs discovery (or any other action on Royal's part that delays payment) because Royal has a right to find out "who knew what" or "what exactly happened" before making payment. Timeliness of payment is a critical expectation of investors in the securitization and broader bond markets. In this case, the Royal policies stated that the policies were "absolute" and "unconditional" and not in "any way" affected, mitigated or eliminated by "any failure on the part of the insured or the beneficiary to observe or perform any covenant or condition contained in the Insurance Policy, including a breach of any representation or warranty made by the insured". Royal knew that the loans its policy credit-enhanced were being securitized. The procurement of an absolute and unconditional policy is intended to assure this timely payment.

The investors who purchase securities in the capital markets in reliance upon an absolute and unconditional promise by a credit enhancer to pay upon default typically do not have the resources to conduct costly due diligence regarding the issuers of those securities or the state of knowledge of their trustee; instead, such investors reasonably rely upon the explicit agreement of credit enhancers, such as

Royal, to absolutely and unconditionally make agreed payments upon the occurrence of specified defaults.

Certainty of payment and timeliness of payment are the core promises made to investors by the words "absolute and unconditional" in an insurance policy. A decision by this Court reversing the District Court and allowing Royal to escape its absolute and unconditional obligations under the Policies would increase market uncertainties regarding financial guaranty and similar insurance policies, permit sophisticated parties to avoid or delay their contractually agreed performance to the detriment of innocent purchasers[4] of securities in these markets and other participants in securitization transactions who rely on the language of the insurance undertaking, and adversely affect the efficiency and liquidity of these important capital markets.

BACKGROUND

Issuers of securitization instruments and other debt securities often elect to obtain credit enhancement of those securities (or of the underlying assets being securitized) from a third party. In each such case, the issuer pays for the agreement of a third party (the "credit enhancer") timely to pay all (or some other agreed

[4] As noted above, the direct investor base for securitized debt consists almost entirely of large financial institutions. However, an estimated 5.1 million households own municipal bonds in some form, either directly or indirectly (http://www.investinginbonds.com/info/QandA.htm (citing the Internal Revenue Service)(last visited May 28, 2004)).

portion of) the principal and interest on those securities (or of the underlying assets being securitized) in the event that the issuer does not make such payments. Such credit enhancement may take various forms, including letters of credit, guarantees, insurance, surety bonds, credit default swaps or financial guaranty insurance. Each of these forms of credit enhancement has the same basic purpose: to lower the cost of borrowing for an issuer by substituting (in effect) the credit quality and claims paying ability of the credit enhancer for the issuer of the securities. Market acceptance of credit enhancement by issuers, credit enhancers, rating agencies and investors is evident.[5]

Moreover, rating agencies explicitly base their ratings of debt securities with credit enhancement on the credit quality and claims paying ability of the credit enhancer.[6] Accordingly, an issuer that might otherwise find that its debt would be unrated or low rated, can purchase credit enhancement to achieve a rating or higher rating than if the issuer had relied solely on its own credit quality and paying ability. In sum, investors considering purchasing an issuer's debt are explicitly

---

[5] The members of the Association of Financial Guaranty Insurers alone insured $392 billion of par volume of securities in 2003. (http://www.afgi.org/whoweare.htm (last visited May 28, 2004)).

[6] *E.g.*, "When a guarantor issues a financial guaranty policy which wraps an obligation, the insured obligation generally receives the credit rating of the guarantor, if the guarantor's rating is higher than the transaction's unenhanced or standalone rating." *Financial Guaranty Policies – What is Needed for Credit Substitution?*, published by Moody's Investors Service, May 2000.

induced by credit enhancement to purchase such debt at a cost that reflects the credit quality of the credit enhancer, not of the issuer. Without credit enhancement, investors would have demanded a significantly higher interest rate. Some investors who are subject to "legal investment" laws, which limit the amount of securities not rated highest quality, might not have been able to purchase the securities at all.

The benefits of credit enhancement accrue significant advantages and savings to a wide variety of issuers, including securitizations sponsored by a broad range of financial and industrial corporations, as well as many municipal entities and projects funded by credit enhanced municipal bonds.[7] Credit enhancement also accrues benefits to consumers, since a wide variety of consumer loans, including debt incurred on credit cards and loans to purchase cars, motor homes and other large ticket items, may be made at more affordable cost because the originator may fund them in the securitization market. Credit enhancers also

[7] In 2003, the Association of Financial Guaranty Insurers ("AFGI") reported that its members insured $165 billion of mortgage-backed securities and asset-backed securities. (AFGI). In the municipal securities market in 2003, over one-half of all long-term issuance was insured (approximately $207 billion of a total $383 billion issued). (Thomson Financial). AFGI has estimated that since 1971, municipalities and their taxpayers alone have saved approximately $35 billion in interest costs as a result of the credit enhancement of municipal bonds through insurance. (http://www.afgi.org/who-fact.htm (last visited May 28, 2004)).

accrue economic advantage by receiving premiums and other fees for issuing and maintaining credit enhancement.

Investors purchasing credit enhanced securities do not expect that they need to conduct costly due diligence on the issuer of such securities or the underlying receivables, nor do they expect to assume risks related to the performance of the issuer, any servicer or other party to the transaction. Investors reasonably expect that the credit enhancer, since it is assuming the liability of paying (depending upon the nature of the policy) either on the receivables if the obligor defaults or on the securities if the issuer defaults, will have undertaken such due diligence as part of its normal and prudent business practices.[8] In other words, investors are taking credit risk of the credit enhancer, but the credit enhancer is assuming all other deal risk (including the risk that an obligor, issuer, servicer or other entity will fail to perform or has engaged in fraudulent conduct).

Which form of credit enhancement is used in a particular transaction will depend on a variety of facts and circumstances. However, regardless of the form of credit enhancement used (whether an insurance policy or a letter of credit), in

---

[8] This assumption is encouraged by some providers of financial guarantee insurance. *E.g.*, Financial Security Assurance, Inc., an active insurer in this market, states on its web-site regarding "Structuring and Due Diligence": "Our experienced underwriters thoroughly review the credit, legal and structural elements of each transaction, relieving investors of these tasks." (http://www.fsa.com/solutions/investors.php (last visited May 28, 2004)).

each case the investors securities that benefit from credit enhancement (either directly or of the underlying receivables) expect that the credit enhancer will promptly honor its payment obligations pursuant to the plain terms of the agreement or instrument evidencing the credit enhancement (in the instant case, the Policies).

In fact, a number of the major insurers providing insurance as credit enhancement clearly state in their publicly available web-sites that such insurance policies guarantee or assure timely payment of principal and interest.[9] Purchasers of securities that benefit from a form of credit enhancement reasonably expect, and have typically made their purchase of such securities on the assumption, that the credit enhancer shall make payments as agreed in the credit enhancement,

[9] *E.g.*, (1) the American Municipal Bond Assurance Corporation ("AMBAC") states: "For the first time bondholders were offered an unconditional, irrevocable guarantee that principal and interest payments would be received in full and on time." (http://www.ambac.com/aboutus.html (last visited May 28, 2004)); (2) Financial Security Assurance, Inc. ("FSA") states: "FSA guarantees municipal bonds, asset-backed securities...and other structured issues in markets throughout the world. Our irrevocable Aaa/AAA/AAA guaranty assures timely payment of scheduled principal and interest if an issuer defaults for any reason." (http://www.fsa.com/solutions/investors.php (last visited May 28, 2004)); and (3) XL Capital Assurance, Inc. states that: "Our triple-A credit enhancement provides investors with the peace of mind that the transactions we enhance will make timely payment of interest and principal. Our guarantee is unconditional and irrevocable." (http://www.xlca.com/xlca/xlca/xlca.jsp (last visited May 28, 2004)).

regardless of the existence or non-existence of conditions.[10] In other words, investors who purchase credit enhanced securities: (i) believe and expect that, if there is non-payment on the underlying security, the credit enhancer will pay no matter what the cause of the non-payment; (ii) rely upon the credit enhancer to ensure that investors will receive timely payment on such securities; and (iii) expect that the only risk that they bear in the transaction is the risk that the credit enhancer will be insolvent and financially unable to honor its commitments.

ARGUMENT

THE DISTRICT COURT PROPERLY HELD THAT THE POLICIES PROVIDE AN ABSOLUTE, UNCONDITIONAL AND IRREVOCABLE AGREEMENT BY ROYAL AS CREDIT ENHANCER TO PAY ON THE POLICIES.

In the instant matter, consistent with the respective roles of the parties and the nature of such capital markets transactions, each of the Policies explicitly provides that Royal's payment obligation thereunder is "absolute", "irrevocable"

[10] It can be noted that Royal is a so-called multi-line insurer and is not one of the so-called monoline insurers (*e.g.*, MBIA, AMBAC or FSA). But this distinction, while relevant to state insurance licensing statutes and regulations, is irrelevant to determining what market expectations are regarding the intended effect of the Policies. As the instant case demonstrates, multi-line insurers are very active in the market for credit enhancement and have marketed their insurance policies as competing directly with financial guaranty policies issued by the mono-line insurers.

and "unconditional", thereby evidencing a complete waiver of defenses.[11] Each of the Policies also explicitly waives various defenses that Royal might otherwise seek to assert to avoid payment. Six of the Policies state that Royal's payment obligation shall not in any way be affected, mitigated or eliminated by, among other things, (x) defenses relating to a breach of any representation or warranty made by the insured, Student Finance Corporation, the beneficiary of the Policies and certain others or (y) the failure of the insured or Student Finance Corporation to comply with Royal's underwriting policies. Two of the Policies state that Royal's payment obligation is absolute and unconditional irrespective of (among other things) any fraud with respect to the student loans, the enforceability of any insurance agreement or student loan or any other rights or defenses that may be available to Royal to avoid payment of its obligations under such Policies. There is no ambiguity in these words. They reflect a clear commitment by Royal to pay as and when agreed in the Policies after a default, regardless of various defenses that the insurer might have otherwise had.

What Royal has agreed to in the Policies is consistent with what the bond and securitization markets expect of such insurance products. The ability to assert

[11] The inclusion of the phrase "absolute and unconditional" should be viewed as prima facie evidence of a complete waiver of defenses, although those precise terms are by no means a prerequisite to a complete waiver of defenses, as it is understood by the capital markets that the same result can be achieved through a variety of forms of contractual language that evidence the same intent.

defenses is incompatible with what the capital markets expect and need from credit enhancement. The capital markets place great importance on the enforceability of agreements evidencing credit enhancement purchased from credit enhancers like Royal. The failure of a credit enhancer to honor its contractual commitments would cause substantial market uncertainty and would disrupt the market's efficient pricing mechanisms.

Although refusing to honor an insurance policy in a timely manner might be acceptable practice for traditional multiline insurers insuring risks such as fire or property damage, where the presence or absence of specific facts and circumstances may bear on the insurer's obligation to pay under the express terms of the related policy, it is not an expected or bargained-for practice in the capital markets, where the credit insurer's obligation to make timely payment is not so conditioned, and the insurer is expected to pay first and investigate later. Investors who purchase securities in these transactions rely upon the credit enhancer's assurance that it will cover promptly a payment default on the security or underlying obligation. Accordingly, any surety bond or other insurance product that is issued to insure, guarantee or wrap securities or their underlying assets in a capital markets transaction should be treated as falling within the business understanding of the parties and the reasonable expectations of the market as providing an absolute and unconditional promise to timely pay pursuant to the

plain terms of the credit enhancement agreement. Here, the burden of investigating the underlying transaction (here, the student loan program) should properly lie with Royal and not with the innocent purchasers of the securities benefiting from the Policies.[12] In addition, MBIA as the insurer of the securities was similarly entitled to rely on Royal's policies. It is understood in the capital markets that, when a credit enhancer like Royal provides credit enhancement of underlying assets that are to be securitized (including student loans), it, and not the investor or the insurer of the investor's securities, is responsible for non-performance of the asset credit-enhanced; indeed, a principal reason for purchasing credit enhancement in structured transactions is to effectuate this allocation of due diligence responsibilities (and accompanying risks) away from investors and to the credit enhancer of the underlying assets.

In its opening brief, Royal argues that "[h]ad Royal known that the student loans were defaulting at rates wildly in excess of its expectations, or that supercharged default rates were masked by systematic payments made by [the

---

[12] This is also consistent with surety principles: "In general, it is the duty of sureties 'to look out for themselves and ascertain the nature of [their] obligations.' Underlying this duty is the notion that, as stated in *Cam-Ful Industries v. Fidelity & Deposit Co.*, '[t]he policy behind surety bonds is not to protect a surety from its own laziness or poorly considered decision.' As a result, sureties must usually take the initiative and inquire about information they deem important." *Rachman Bag Co. v. Liberty Mut. Ins. Co.*, 46 F.3d 230, 235 (2d Cir. 1995) (quoting *Sec. Nat'l Bank v. Compania Anonima de Seguros*, 190 N.Y.S.2d 820, 823 (Sup. Ct. 1959)(citations omitted)).

Student Finance Corporation] itself, Royal would never have issued the policies MBIA and Wells Fargo have sued on". Appellant's Opening Brief, at 11. However, any failure by Royal to discover these facts in its due diligence of the Student Finance Corporation is not a defense to its obligations under the Policies. Royal should not be permitted to shift the loss resulting from its poor underwriting decisions to either MBIA or investors when Royal had explicitly promised the market that it would protect investors from such risks.

Neither should innocent investors have their legitimate expectations of timely payment by the insurer frustrated by allegations of the state of mind of their trustee, a fact (if true) of which they could not reasonably have been aware. In effect, absolute and unconditional insurance products are similar to another form of credit enhancement, the letter of credit. From the inception of the use of insurance policies in the capital markets by both multi-line and mono-line insurers it has been well understood by both the insurers and the capital markets community that such policies were intended to mimic letters of credit, with which such insurance policies were intended to compete. This was recognized publicly as early as twenty years ago and is still true today.[13] Investors expect that credit enhancement

[13] "[D]ozens of big insurers are quietly moving into the business on their own. In large part, they are seeking to supplant commercial banks, which through letters of credit have long been the dominant private-sector guarantors of debts." *What's Behind the Bittersweet Boom in Financial Guarantees*, BUS. WK., Sept. 17, 1984, at 116.

for securities, regardless of whether a letter of credit or insurance, will provide the same promised result (*i.e.*, prompt payment per the terms of the agreement or letter of credit). And, like letters of credit, here the courts should honor the expectation of the parties that payments pursuant to an absolute and unconditional instrument should not be limited or defeated by facts and defenses extrinsic to that instrument.[14]

A reversal of the District Court's decision would have significant and adverse effects upon the securitization and broader structured credit markets and would insert an un-bargained for uncertainty into every securitization and bond transaction supported by an insurance product. Every security using an insurance policy would be subject to reconsideration and revaluation by the capital markets, particularly by institutional investors who commit large amounts of capital to such transactions. The market price of such securities could be driven down and investors would have an incentive to refrain from purchasing such securities. Such a decision also would have material adverse consequences for a variety of issuers,

---

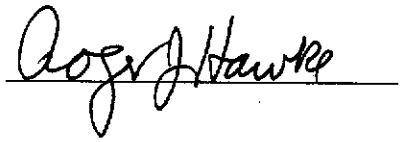
[14] The so-called "independence principle" is well established for letters of credit. *See* Uniform Commercial Code, Section 5-103 cmt. 1 ("[T]he independence principle recognized throughout Article 5 [of the Uniform Commercial Code] states that the issuer's liability is independent of the underlying obligation."). The independence principle states that a letter of credit is a primary (not a secondary) obligation of the letter of credit issuer to the beneficiary of that letter of credit and, therefore, disputes as to the performance or validity of the underlying obligation or contract usually do not provide defenses to payment on the letter of credit.

including industrial and financial corporations, which utilize securitzation to finance their business operations efficiently, as well as municipalities, which rely on the liquidity and marketability of insured securities to finance their various public projects. Higher costs of securitization ultimately translate into a reduction in the availability, and an increase in the cost, of credit for consumers and businesses who benefit from the efficiencies that securitization currently provides.

CONCLUSION

For the foregoing reasons, the ASF respectfully submits that the decision by the District Court awarding summary judgment to Wells Fargo and MBIA should be affirmed.

Respectfully submitted,



George Miller
American Securitization Forum
360 Madison Avenue
New York, NY 10017

Robert D. Aicher
T.K. Khan
SIDLEY AUSTIN BROWN & WOOD LLP
10 S. Dearborn Street
Chicago, IL 60603

Roger J. Hawke*
SIDLEY AUSTIN BROWN & WOOD LLP
787 Seventh Avenue
New York, NY 10019
(212) 839-5300
*Counsel of Record

Counsel for *Amicus Curiae* the American Securitization Forum

June 2, 2004

CERTIFICATE OF BAR MEMBERSHIP

Pursuant to Rule 46.1 of the Rules of the United States Court of Appeals for the Third Circuit, the undersigned hereby certifies that he is a member of the bar of this Court.

Roger J. Hawke
SIDLEY AUSTIN BROWN & WOOD LLP
787 Seventh Avenue
New York, NY 10019
(212) 839-5300

Counsel for *Amicus Curiae* the American Securitization Forum

June 2, 2004

CERTIFICATE OF COMPLIANCE

As required by Fed. R. App. P. 32(a)(7)(C), I certify that this brief is proportionally spaced and contains 3,965 words.

I relied on my word processor to obtain the count and it is: Microsoft Word 97.

I certify that the information on this form is true and correct to the best of my knowledge and belief formed after a reasonable inquiry.

Roger J. Hawke

CERTIFICATE OF SERVICE

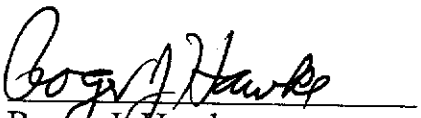
I hereby certify that on June 2, 2004, I filed the foregoing Brief of *Amicus Curiae* with the clerk of the United States Court of Appeals for the Third Circuit by sending one (1) original and ten (10) copies of said Brief via Federal Express to the following address:

Office of the Clerk
United States Court of Appeals for the Third Circuit
21400 U.S. Courthouse
601 Market Street
Philadelphia, PA 19106

I further certify that on June 2, 2004, I sent two (2) true and correct copies of the same Brief by hand delivery to the following:

Ronald S. Rauchberg
Steven E. Obus
Proskauer Rose LLP
1585 Broadway
New York, NY 10036

Michael H. Barr
Sonnenschein Nath & Rosenthal
1221 Avenue of the Americas
New York, NY 10020



Roger J. Hawke

June 2, 2004