COURT OF APPEALS OF WISCONSIN
DISTRICT IV

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

Appeal No. 2010-AP-1291,
2010-AP-2022

SEAN DILWEG and OFFICE OF THE COMMISSIONER OF INSURANCE,

Plaintiffs-Respondents,

AMBAC ASSURANCE,

Interested Party-Respondent,

v.

WELLS FARGO BANK/Trustee of Bondholders, BANK OF NEW YORK MELLON and DEUTSCHE BANK NATIONAL TRUST COMPANY,

Defendants,

FEDERAL HOME LOAN MORTGAGE CORPORATION,

Defendant-Petitioner-Co-Appellant,

AURELIUS CAPITAL MANAGEMENT LP, FIR TREE, INC., KING STREET CAPITAL MASTER FUND, LTD., KING STREET CAPITAL, L.P., MONARCH ALTERNATIVE CAPITAL, LP and STONEHILL CAPITAL MANAGEMENT LLC,

Defendants-Petitioners-Appellants,

EATON VANCE MANAGEMENT, NUVEEN ASSET MANAGEMENT,

RESTORATION CAPITAL MANAGEMENT, LLC, STONE LION CAPITAL PARTNERS, LP,

Defendants-Co-Appellants-Petitioners.

APPEAL FROM THE ORDER OF THE CIRCUIT COURT OF DANE COUNTY CASE NO. 10 CV 1576 THE HONORABLE WILLIAM D. JOHNSTON PRESIDING

REPLY BRIEF OF RMBS POLICYHOLDERS

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AAC's business was to provide financial guaranties, including for the securities purchased by the RMBS Policyholders.[1] With the decline in financial markets, AAC has increasingly been called upon to honor its contractual obligations. Fearing that it will be unable to pay claims as they become due, AAC and OCI developed a plan to rehabilitate AAC. The burden of that plan, however, is not shared by all policyholders. Instead, a group of AAC policies were transferred to a "segregated account" that was immediately placed in rehabilitation. Claims under those policies will not be paid entirely in cash, and the value of the policies will be dramatically reduced by the rehabilitation. The policies remaining in the General Account will be honored without modification.

Insurance rehabilitations conducted by OCI take place under judicial supervision. Upon the commencement of the rehabilitation proceeding, AAC and OCI obtained an *ex parte* Circuit Court injunction that prohibited any person from initiating any proceeding against the Segregated Account, AAC, and OCI. That injunction also barred policyholders from collecting

[1] Capitalized terms shall have the meaning ascribed to them in the RMBS Policyholders' initial brief.

on policies allocated to the Segregated Account, though they were required to continue to pay premiums on those policies.

Under the scheme orchestrated by OCI and AAC, the General Account retained AAC's claims-paying assets, while the Segregated Account was left with nothing but a revocable promise that the General Account will provide money to pay claims in the future, and a reinsurance policy issued by AAC. The General Account remains free to dissipate its assets (and, necessarily, those of the Segregated Account) by entering into large-scale commutations. In one such deal, the CDS Settlement, the General Account distributed $2 billion in cash and $2.6 billion in notes.

Injured by OCI's action, and enjoined by the Circuit Court's *ex parte* injunction from taking any steps to remedy this wrong either in litigation or by administrative review of these actions, the RMBS Policyholders sought to intervene in this case. This was the only avenue left open to the RMBS Policyholders to obtain review of OCI's regulatory actions. They asked for limited discovery, challenged OCI's actions, and asked the Circuit Court to reject the CDS Settlement.

In the order now before the Court, the Circuit Court abdicated its statutory mandate to oversee the rehabilitation and approved OCI's actions. The order immunizes OCI's regulatory actions from administrative or

judicial review. And it leaves OCI as the sole safeguard of policyholders, despite the fact that OCI has evidenced an unwillingness to protect *all* policyholders. To fulfill the statutory purpose, affected parties should be allowed to intervene so that they may demonstrate the Segregated Account lacks adequate capital and the CDS Settlement is not in the interests of policyholders.

In their response, OCI and AAC assert that the Circuit Court acted appropriately and its actions were supported by evidence. OCI and AAC ignore the character of the proceedings in the Circuit Court. The Circuit Court refused to permit any policyholder to intervene as a party and denied every request to review the legality of OCI's actions. The Circuit Court refused discovery, which prevented the parties challenging OCI's actions from reviewing the basis for OCI's conduct and from developing support for their positions. The Circuit Court heard no testimony and admitted no evidence. Despite failing to perform any factual investigation or legal analysis, the Circuit Court adopted wholesale OCI's proposed findings of fact and conclusions of law, which had been submitted to the Circuit Court and the RMBS Policyholders only days before.

Policyholders of Wisconsin-domiciled insurance companies are entitled to meaningful protection before an insurer may modify their

policies, dissipate the few assets that remain to pay their losses, and favor a syndicate of foreign banks over policyholders. Because the Circuit Court failed to provide even minimal protections to the RMBS Policyholders, the Court should reverse the Circuit Court's May 27, 2010 Order.

ARGUMENT

I. The Circuit Court Erred In Denying The RMBS Policyholders' Motion to Intervene.

This is an appeal from the Circuit Court's denial of the RMBS Policyholders' motion to intervene. If this Court agrees that the Circuit Court's denial of intervention was improper, the Court may review the remainder of the Circuit Court's May 27 Order. Wis. Stat. §809.10(4). The order denying the RMBS Policyholders' motion to intervene stripped them of procedural rights. While the Circuit Court permitted the RMBS Policyholders to speak, it never permitted discovery or the other rights. Because the Circuit Court's actions directly affected the RMBS Policyholders, they should have been permitted to intervene.

A. This Court Has Already Held That The Denial Of Intervention Was Appealable.

OCI argues the Circuit Court's denial of intervention is neither final nor appealable. (OCI Br. 32-33.) This Court already held that the denial of the motion to intervene was appealable. (6/18/2010 Order 3.) OCI cites

the Court's November 12, 2010 Order denying a different party's petition for leave to appeal. (OCI Br. 32-33.) The November 12 Order is irrelevant. That order specifically stated that it was not addressing "whether the order may be final and appealable as to those parties who were denied the right to intervene" (No. 2010AP2721 11/12/2010 Order 3 n.1, Reply-App. 3), and the RMBS Policyholders were not parties to that appeal.

B. The RMBS Policyholders Are Entitled To Intervene.

It is clear that the RMBS Policyholders are entitled to intervene. First, the RMBS Policyholders demonstrated that the intervention statute applies unless it is expressly overridden. (RMBS Br. 21-22.) In response, AAC argues that because only Chapter 645's subchapter for Summary Proceedings provides a mechanism for judicial review, the legislature did not authorize intervention in these formal rehabilitation proceedings. (AAC Br. 21.) AAC ignores that Chapter 645 supplies *no* intervention procedure. As a result, there is nothing in the rehabilitation chapter to override, either directly or by implication, the general intervention statute, Wis. Stat. §803.09(1). Wis. Stat. §801.01(2); *In re Commitment of Brown*, 215 Wis. 2d 716, 721-22, 573 N.W.2d 884, 886 (Ct. App. 1997). Had the legislature meant for Chapter 645 to override §803.09, it would have done so

expressly. This Court should decline AAC's invitation to read language into the statute that does not exist.

Second, the RMBS Policyholders demonstrated that they satisfy the requirements for intervention as of right. OCI's conclusory statement (OCI Br. 39) that OCI adequately represents the RMBS Policyholders is belied by OCI's actions. OCI has opposed policyholders at every turn and continues to assert that the RMBS Policyholders may not participate at all. (AAC Br. 14-21; OCI Br. 45-47.) OCI cannot claim to represent the RMBS Policyholders' interests when it contends that the RMBS Policyholders have no interest in the proceeding.

Third, intervention is significant in this case because the injunction prevented the RMBS Policyholders from exercising their statutory right to obtain review of OCI's regulatory actions in the normal administrative process. *See* Wis. Stat. §227.42. OCI and AAC argue (OCI Br. 48, 50-54; AAC Br. 19), and the Circuit Court held, that OCI acted in its regulatory capacity when it approved the CDS Settlement. If that is correct, and unless the RMBS Policyholders must forfeit their review rights altogether, the Circuit Court should have permitted them to intervene as adverse parties with all the rights they would have enjoyed had there been no injunction.

Fourth, OCI argues the RMBS Policyholders suffered no prejudice from the denial of intervention. (OCI Br. 38.) Prejudice to the intervenor is irrelevant. If a party meets the four criteria for intervention, it may intervene as of right. *Armada Broad., Inc. v. Stirn*, 183 Wis. 2d 463, 471 n.2, 516 N.W.2d 357, 359-60 (1994). Even if it was appropriate to consider prejudice, the RMBS Policyholders were prejudiced because as non-parties they were denied discovery. OCI and AAC recognize the prejudice that has resulted from the lack of discovery. While refusing to provide discovery, they repeatedly fault the RMBS Policyholders for not presenting evidence or their own findings during the May 25 hearing. (OCI Br. 25, 42; AAC Br. 56, 57.)

C. The RMBS Policyholders' Right To Be Heard Does Not Defeat Their Right To Intervene As A Party.

OCI and AAC argue that intervention was unnecessary because the RMBS Policyholders could be heard as non-parties in subsequent plan confirmation hearings. (OCI Br. 36; AAC Br. 60.) The right to be heard in a rehabilitation proceeding is no substitute for intervention.

The RMBS Policyholders were permitted to speak at the May 25 hearing, but they could do nothing more. Because the Circuit Court refused

intervention, the RMBS Policyholders had no discovery. (R. 127-16, App. 65.) Without discovery, the ability to be heard was meaningless.

The right of an interested party to speak at rehabilitation proceedings is not at issue in this appeal and is separate and distinct from the right to intervene as a party. Indeed, in a recent filing in a related appeal, OCI conceded that even those entities that may not intervene as parties have the right to appear at the hearing on approval of the plan of rehabilitation. (No. 2010AP2721-LV OCI Resp. Br. to Lloyds' Pet. for Appeal 26, Reply-App. 37.)

OCI and AAC argue that the RMBS Policyholders have changed their position on intervention from earlier filings. (OCI Br. 36-37; AAC Br. 58-59.) They are incorrect. The RMBS Policyholders advised the Circuit Court that intervention was unnecessary if the Court would permit them to participate fully, including permitting them to take discovery. (R. 53-3.) The Circuit Court refused to permit non-party policyholders to obtain discovery and refused their request to intervene. (R. 127-16–127-17, App. 65-66.)

D. The RMBS Policyholders Have Standing.

The RMBS Policyholders have established that they are owners of insured securities and that they satisfy the intervention requirements. (*See*

R. 39-2, App. 22; RMBS Br. 14-27.) The Circuit Court never held that the RMBS Policyholders lack standing to be heard in the Circuit Court proceeding. (*See, e.g.*, R. 127, App. 50-66.) Indeed, the Circuit Court permitted the RMBS Policyholders to speak at the May 25 hearing.

OCI and AAC's arguments to the contrary lack merit:

First, OCI and AAC argue that because the RMBS Policyholders did not provide information regarding the RMBS Policyholders' trusts, they do not have standing. (AAC Br. 14; OCI Br. 45.) They argue that the RMBS Policyholders lack standing because of the terms of indenture agreements between the bondholders and their trustees that are not in the record. (AAC Br. 14; *see also* OCI Br. 45.) OCI and AAC's argument is disingenuous. As OCI and AAC are aware, the RMBS Policyholders repeatedly attempted to provide a list of the RMBS Policyholders' trust assets, but were rebuffed on every occasion because OCI and AAC refused to enter into a protective order before receiving the information.

Second, OCI's argument that the RMBS Policyholders lack standing as "indirect" policy beneficiaries (OCI Br. 24) is incorrect. The RMBS Policyholders established that they have standing because they own, or manage funds that own, in the aggregate approximately $1 billion face amount of RMBS insured by AAC that have been placed in the Segregated

Account. (R. 39-2, App. 22.) The RMBS Policyholders hold the insured obligations for those policies. Notably, AAC does not dispute that the RMBS Policyholders own or control bonds insured by AAC. (*See* AAC Br. 14, n.8.)

Third, OCI and AAC waived their standing argument on the basis of the indenture agreements by briefly referencing it in a footnote, or, in the case of OCI, not briefing it at all in the Circuit Court. (RMBS Br. 25-26.) OCI and AAC misconstrue this waiver argument. (AAC Br. 16; OCI Br. 47.) The RMBS Policyholders argued that OCI and AAC failed to sufficiently raise the issue about the indentures *in the Circuit Court* and that therefore this Court should not decide the appeal on this issue. Because OCI and AAC failed to raise this argument below, the parties did not litigate the issue and the Circuit Court did not decide it, which has prejudiced the ability of the RMBS Policyholders to address the issue on appeal. Had the argument been raised, the RMBS Policyholders would have shown that they own securities in pools of mortgage-backed securities whose payments are managed by indenture trustees. As the holders of the securities, the RMBS Policyholders are the holders of the insured obligations. As such, the RMBS Policyholders are the beneficiaries of the insurance policies. (RMBS Br. 26-27.) The RMBS Policyholders

demonstrated that they have standing because the trustees failed to bring a meritorious action. *Klein v. Hartford Life & Accident Ins. Co.*, No. 09-C-562, 2009 WL 2160455, at *2-3 (E.D. Wis. July 17, 2009); (RMBS Br. 24-25.) Instead of addressing this argument, OCI and AAC attempt to distinguish *Klein* by arguing that it requires the beneficiary to provide additional evidence of standing, such as an affidavit. (OCI Br. 46; AAC Br. 17.) This is not the holding of *Klein* and, regardless, the RMBS Policyholders have proved that they have standing.

Moreover, OCI's and AAC's argument that the RMBS Policyholders lack standing is a red herring – they concede that the Federal Home Loan Mortgage Corporation ("Freddie Mac") has joined the appeal, yet nowhere do they challenge Freddie Mac's standing. Thus, this appeal will proceed regardless of the RMBS Policyholders' standing.

II. The Circuit Court Erred In Holding That The Segregated Account Was Lawful.

The Segregated Account was inadequately capitalized and formed in violation of Wisconsin law. (RMBS Br. 27-44.) There was no evidence to support the Circuit Court's finding, which was entered in irregular proceedings in which the parties opposing OCI were deprived of any ability to discover or present evidence. As a result, OCI's actions result in an

unlawful revision of the parties' contracts and work a taking upon the policyholders with policies in the Segregated Account.

A. The May 27 Order Was Unsupported By The Record And Constituted An Abuse of Discretion.

The Circuit Court erred by conducting a one-sided hearing and adopting findings of fact and conclusions of law that were unsupported by the record. (RMBS Br. 29-32.) The Circuit Court ignored the statutory requirement that it review and approve OCI's actions. Wis. Stat. §645.33(2). The procedural history highlights that the Circuit Court rubber-stamped OCI's findings without performing independent review or analysis:

- On March 24, 2010, OCI petitioned the Circuit Court *ex parte* for an order of rehabilitation and injunction. (R. 1, 6.) The Court adopted OCI's proposed orders after holding a hearing with only OCI and AAC present and counsel for the CDS Counterparties listening by telephone, but not appearing. (R. 150-1–150-3.)

- Several parties, including the RMBS Policyholders, moved to intervene, obtain discovery, and modify the Injunction Order. The Circuit Court scheduled a hearing for May 25, 2010. (R. 16, 37, 41, 53, 78, 82, 98.)

- On May 20, 2010, just five days before the hearing, OCI and AAC filed briefs in opposition and OCI filed affidavits and proposed findings of fact and conclusions of law. (R. 69, 72-77.) The RMBS Policyholders requested expedited and targeted discovery on these issues and the Circuit Court denied their request. (R. 127-16, App. 65.)

- On May 25, 2010, the Circuit Court heard oral argument. The Court refused the policyholders' attempts to develop factual support in response to OCI's last minute filings. (*Id.*)

- The Circuit Court heard no testimony and admitted no evidence. (R. 151-125–151-128, App. 42-45.)

- The Circuit Court orally denied the movants' request to intervene as parties. (R. 151-125–151-126, App. 42-43.)

- On May 27, 2010, the Circuit Court entered a written order containing 13 pages of "findings of fact," adopting virtually wholesale OCI's proposed order. (R. 127, App. 50-66.)

OCI and AAC ignore this procedural history and criticize the RMBS Policyholders for failing to rebut OCI's and AAC's evidence or submit their own findings. (OCI Br. 25, 42; AAC Br. 56, 57.) The RMBS Policyholders could not possibly have rebutted OCI's and AAC's proposed findings when (1) the proposed findings were presented shortly before the hearing, (2) OCI and AAC — who are the sole keepers of the relevant information — refused to provide *any* discovery, (3) the Circuit Court denied the RMBS Policyholders requests to obtain discovery, (4) no evidence was presented at the hearing, and (5) the Circuit Court did not take any testimony at the hearing, so the RMBS Policyholders did not have an opportunity to cross-examine any witnesses. The suggestion (AAC Br. 56) that Objectors should have summoned OCI's witnesses out of the

gallery to examine them adversely – with no discovery, documents, or information – demonstrates the unfairness of the proceedings.

The Circuit Court's wholesale adoption of OCI's findings of fact and conclusions of law and its failure to articulate the factors upon which it based its decision constitutes reversible error. *See Trieschmann v. Trieschmann*, 178 Wis. 2d 538, 541-44, 504 N.W.2d 433, 434-35 (Ct. App. 1993).

OCI attempts to escape the holding of *Trieschmann* by arguing that "the factors that the trial court relied upon are explained in the May 27, 2010 Order, in the affidavits and documents that directly support each of the findings of fact, and in the May 25 hearing transcript." (OCI Br. 44 (internal citations omitted).) OCI misconstrues *Trieschmann*, which holds that a trial court must justify its decision to credit one party's version of disputed legal and factual issues over another's. *See Trieschmann*, 178 Wis. 2d at 542-43, 504 N.W.2d at 434-35. OCI and AAC do not identify any place in the record where the Circuit Court justified its decision to rubber-stamp OCI's findings, because they cannot. The Circuit Court's Order reveals no independent factual investigation or legal analysis.

B. OCI And AAC Apply An Incorrect Standard Of Review.

Legal conclusions are reviewed *de novo*. *Kocken v. Wis. Council 40, AFSCME, AFL-CIO*, 2007 WI 72, ¶ 26, 301 Wis. 2d 266, 732 N.W.2d 828. AAC argues the "erroneous exercise of discretion" standard of review should apply to the Circuit Court's conclusion that the Segregated Account was formed in compliance with Wisconsin law because the issue arose in the context of the Court's decision to issue an injunction. (AAC Br. 41-42.) While a court's decision to issue or deny an injunction is reviewed for erroneous exercise of discretion, the law on which the injunction was based is reviewed *de novo*. *Kristi L.M. v. Dennis E.M.*, 2007 WI 85, ¶ 22, 302 Wis. 2d 185, 734 N.W.2d 375.

Moreover, OCI moved for the Injunction Order, not the RMBS Policyholders. (R. 6.) Accordingly, it was *OCI's* burden to prove that the injunction was "necessary and proper." Wis. Stat. §645.05(1). Despite this requirement, the Circuit Court accepted OCI's injunction request based on OCI's unsupported factual conclusions.

The RMBS Policyholders moved to modify the injunction. The Circuit Court's *ex parte* injunction stated that the only permissible filing would be a request to modify the Injunction Order. (*See* R. 9-13–9-14, App. 17-18.) In their first filing in the Circuit Court (R. 37-2), the RMBS

Policyholders requested "[i]mmediate modification of the Order for Temporary Injunctive Relief . . . to preserve the status quo of the General Account . . . by enjoining" the CDS Settlement. (*Id*.) As a party seeking to modify an injunction entered *ex parte*, the RMBS Policyholders were not required to make the showing necessary to obtain an injunction. *Cf. State v. O'Dell*, 193 Wis. 2d 333, 343, 532 N.W.2d 741, 745-46 (1995) (holding that courts retain inherent power to modify injunctions).

C. OCI's Actions Violate The Wisconsin Insurance Code.

The Circuit Court erred by holding that the creation of the Segregated Account and the transfer of the RMBS policies to it was lawful. OCI exceeded its statutory mandate and violated Wisconsin law.

1. The Segregated Account Was Inadequately Capitalized.

The Circuit Court erred by holding that the Segregated Account was legally formed. The limited information presented to the Circuit Court makes clear that the Segregated Account was not adequately capitalized.

First, AAC argues that the Court should not consider the legality of the Segregated Account because the May 27 Order was not a final adjudication. (AAC Br. 39.) This Court already rejected this argument. (6/18/2010 Order 4.)

Second, OCI never proved the Segregated Account was adequately capitalized. OCI admits that the General Account – through the Secured Note and the Reinsurance Agreement – is the sole source of funding for the rehabilitation and that if AAC's statutory surplus falls below $100 million, or such higher amount as OCI determines, the General Account will no longer be obligated to contribute to the rehabilitation. (OCI Br. 65; R. 1-64; R. 1-79.) Thus, the only "evidence" it submitted to the Circuit Court demonstrated that the Segregated Account has *no* real assets. Moreover, the Segregated Account was immediately placed in rehabilitation, demonstrating that it has no capital surplus, let alone an adequate amount. Nor can OCI argue in good faith that there is evidence showing the Segregated Account is adequately capitalized. When they need it the most, the Segregated Account policyholders will have no recourse to the assets in the General Account. The Segregated Account is completely dependent on the General Account, so if the General Account fails, the Segregated Account's funding will completely disappear. (RMBS Br. 47-48.)

Third, OCI and AAC argue that OCI has the "exclusive right" to determine the appropriate level of capital. (AAC Br. 44; OCI Br. 66.) This is not the law. OCI's authority is limited to the powers given by the Wisconsin legislature. *Duel v. State Farm Mut. Auto. Ins. Co.*, 240 Wis.

161, 170, 1 N.W.2d 887, 891 (1942); *see also Aetna Life Ins. Co. v. Mitchell*, 101 Wis. 2d 90, 108, 113-14, 303 N.W.2d 639, 650 (1981). OCI can set the capital and surplus at zero only if the Segregated Account "carries no risks not assumed by the corporation's general account." (OCI Br. 67). That is not the situation here. The Segregated Account carries extensive liabilities and the General Account has *not* assumed any of them. (*See* RMBS Br. 33-34.) OCI and AAC stripped the Segregated Account of assets tied to its policies, such as premiums and remediation recoveries, and left them in the General Account. (R. 1-18–1-19.) Separating the premiums from the insurance policies allocated to the Segregated Account violates Wis. Stat. §611.24(3)(b) because the income and assets attributable to the Segregated Account must remain identifiable with the particular account, and gains from assets attributable to the Segregated Account must be credited to that account.

More importantly, Wis. Stat. §611.24, which governs the creation of segregated accounts, requires that "[t]he commissioner shall require the corporation to have and maintain an adequate amount of capital and surplus in the segregated account." Wis. Stat. §611.24(3)(a). The comments to Wis. Stat. §611.24 make clear that a segregated account must contain adequate capital to enable the segregated account to "function and survive

like a separate corporation," and to make the segregated account "independently viable." Wis. Stat. Ann. §611.24, comments. Wisconsin does not grant the commissioner the authority to permit *no* capital and *no* surplus, as it did here.

2. The Transfer Of The RMBS Policies To The Segregated Account Was A Novation.

The RMBS Policyholders demonstrated that the transfer of the RMBS Policies to the Segregated Account was an ineffective novation. (RMBS Br. 34-37.) OCI argues that novation cannot apply to acts of a regulator. (OCI Br. 70.) OCI ignores precedent finding a regulator's actions pursuant to a rehabilitation plan can be a novation. *Carpenter v. Pac. Mut. Life Ins. Co. of Cal.*, 74 P.2d 761, 777 (Cal. 1938) ("Every policyholder who consents to the [rehabilitation] plan clearly enters into a novation with the new company."), *aff'd sub nom Neblett v. Carpenter*, 305 U.S. 297 (1938).

OCI claims the RMBS Policyholders' view of novation could be used to challenge "*any* statute or official act that might alter contractual obligations." (OCI Br. 70.) OCI's action was a novation because OCI did not act under the aegis of the insurance statutes – it acted in contravention

of the statutes by transferring the RMBS policies to an inadequately capitalized Segregated Account. (RMBS Br. 36.)

By placing the policies in the Segregated Account, OCI and AAC severed AAC's obligation to the RMBS Policyholders and replaced it with an obligation of the Segregated Account. They also altered that obligation so that claims will be paid partly in cash and partly in surplus notes. Moreover, unlike the rehabilitation at issue in *Carpenter*, OCI did not permit policyholders to opt out and receive liquidation value. *Carpenter*, 305 U.S. at 304-05. Because the RMBS Policyholders did not consent and OCI and AAC did not provide *any* consideration, the novation was ineffective. (RMBS Br. 34-37.)

3. The Transfer Of The RMBS Policies To The Segregated Account Was An Unconstitutional Taking And Violated Due Process.

The RMBS Policyholders established in their initial brief that they had a property interest in their insurance policies, OCI's actions substantially impaired their rights under the policies, and that the transfer of the policies to the Segregated Account without any compensation was a taking. (RMBS Br. 38-41.) OCI and AAC respond that the RMBS Policyholders' "contractual rights vis-à-vis Ambac remain intact" and that "the policy terms remained the same." (AAC Br. 49; OCI Br. 75.)

Those contentions are incorrect. Under their policies, the RMBS Policyholders had a contractual right to receive full cash payments as claims accrued. (RMBS Br. 35, 40.) OCI and AAC substituted a new contract requiring the RMBS Policyholders to make claims only against the inadequately capitalized Segregated Account, which OCI admits will not make full payments to the RMBS Policyholders. (*See* R. 73-17–73-18.)

AAC suggests that this is not a taking because insurance is "so highly regulated" that interference from the state could be reasonably anticipated. (AAC Br. 50.) AAC's argument is unprecedented. The taking in this case was not the transfer of the policies to the Segregated Account alone, rather it was the transfer of only some AAC policies to an *inadequately* funded Segregated Account for the purpose of running off the liabilities. No policyholder in a Wisconsin-domiciled insurer could have foreseen this abuse of OCI's authority and the Circuit Court's refusal to review it. At most, the parties anticipated that the regulator would create an *adequately* capitalized Segregated Account that would not have the effect of impairing some, but not all, of the policies. Permitting OCI to transfer policies to an inadequately capitalized Segregated Account would render the takings clause meaningless. Indeed, at a minimum, it is a fundamental constitutional principle that, under a rehabilitation plan, policyholders must

receive at least what they would if the company were liquidated. *Carpenter*, 305 U.S. at 304-05.

OCI further argues that the RMBS Policyholders were not entitled to due process before their policies were transferred to the Segregated Account and that notice and a pre-deprivation hearing was "administratively impossible." (OCI Br. 75.) Essentially, OCI argues that it may disregard policyholders' due process rights because it would be inconvenient to honor them. This is not the law. *See Zinermon v. Burch*, 494 U.S. 113 (1990) ("the Court usually has held that the Constitution requires some kind of a hearing *before* the State deprives a person of liberty or property.").

Moreover, even if a post-deprivation hearing were sufficient, the Circuit Court did not provide a meaningful one. OCI failed to produce evidence demonstrating adequate capitalization, the Circuit Court refused to order discovery, and the RMBS Policyholders and others were not allowed to intervene. The post-deprivation hearing does not mitigate the harm the policyholders have suffered.

AAC's last argument is that the RMBS Policyholders were not irreparably harmed by the transfer of their policies to the Segregated Account because receiving less than full payment is not irreparable injury.

(AAC Br. 53.) Again, AAC ignores the law. Irreparable harm is not an element of a takings or due process claim. *See, e.g.*, *Wis. Med. Soc'y, Inc. v. Morgan*, 2010 WI 94, ¶ 38, 328 Wis. 2d 469, 787 N.W.2d 22**;** *Mathews v. Eldridge*, 424 U.S. 319, 332-33 (1976).

III. The Circuit Court Erred In Failing To Review the CDS Settlement.

The RMBS Policyholders demonstrated that the Circuit Court erred in declining to review the CDS Settlement. (RMBS Br. 44-52.) The Circuit Court announced it lacked authority to review the CDS Settlement and refused discovery to allow the parties to explore these issues and present their arguments to the Circuit Court.[2] (R. 151-14, 151-125–151-126, App. 32, 42-43.) Now, OCI and AAC attempt further to insulate the CDS Settlement from review. Their arguments are incorrect.

A. The Circuit Court Erred In Stating It Lacked Authority To Review The CDS Settlement.

The Circuit Court stated on May 25 that it lacked authority to review the transaction because it involved the General Account, which was not in rehabilitation. (R. 151-125–151-126, App. 42-43.) Ignoring what the

[2] Contrary to AAC's argument, the RMBS Policyholders do not concede that CDS is insurance. (AAC Br. 27 n.15.) OCI did not provide the discovery necessary for the policyholders, or the Court, to determine whether CDS constitutes insurance under Wisconsin law. (RMBS Br. 51.)

Court said, and instead relying on the written findings that were drafted by OCI and signed without revision by the Court, OCI and AAC argue the Circuit Court reviewed the CDS Settlement. (AAC Br. 24; OCI Br. 40-42.) AAC creates a *per se* rule of interpretation – without any citation to authority – that "[w]henever there is a conflict between a final written order and prior oral statements on the record, the final order controls." (AAC Br. 24.) AAC ignores the rule that an unambiguous oral pronouncement is binding when the oral order and the written judgment conflict. *State v. Perry*, 136 Wis. 2d 92, 113-15, 401 N.W.2d 748, 758 (1987); *Musick v. State Farm Bank*, No. 2008AP2386, 2009 WL 3209227, 2009 WI App 174, ¶ 15, 322 Wis. 2d 573, 776 N.W.2d 288, (Reply-App. 44-48).

The Circuit Court's oral ruling that it did not have the authority to review the CDS Settlement was unambiguous. The Court held that it was not empowered to "dip into the activities and try to overview the activities" of OCI when acting as regulator. (R. 151-126, App. 43; *see also* R. 151-130, App. 47 ("I think this is a decision by OCI on the general account under their broad authority and they have the right to go forward on that because this court is basically taking the position that I don't have control of that, it's their call.").) The Circuit Court gave no indication that the written findings of facts and conclusions of law supplanted its oral ruling.

To the contrary, the Circuit Court's oral statements demonstrate its clear intention to hold that it did not have authority to review the CDS Settlement.

Even assuming that the Circuit Court's May 27 Order somehow demonstrates that the Circuit Court changed its mind and reviewed the CDS Settlement, that order contains no independent review or consideration. (*See* RMBS Br. 45-46.) The factual record was so sparse that the Circuit Court would have had no basis to approve the CDS Settlement. (RMBS Br. 45-46, 51.)

B. The Circuit Court Should Have Reviewed The CDS Settlement.

The consummation of the CDS Settlement required court review. (RMBS Br. 44-52.) OCI argues that the Circuit Court could not review the CDS Settlement because OCI was "acting *in its role as regulator of Ambac*" and that the CDS Settlement "relates to the policies that are in Ambac's General Account, *not* in the Segregated Account." (OCI. Br. 50-51.) OCI and AAC ignore the fact that the Cooperation Agreement requires the Segregated Account's written consent to consummate any transaction by AAC that involves consideration in excess of $5,000,000. (*See* R. 1-33.) Thus, the CDS Settlement – even if it was a General

Account transaction – was also a transaction of the Segregated Account that was subject to judicial review.

In addition, OCI was not acting only in its role as regulator when it approved the CDS Settlement. The General Account is inextricably intertwined with the rehabilitation of the Segregated Account, over which the Court has authority. Wis. Stat. §645.33(2). The Secured Note and Reinsurance Agreement that have recourse to the General Account, are the sole sources of funding for the rehabilitation. If AAC's statutory surplus falls below $100 million, or such higher amount as OCI determines, the General Account – through the Secured Note and the Reinsurance Agreement – will no longer be obligated to contribute to the rehabilitation. (R. 1-64; R. 1-79.) The Segregated Account is completely dependent on the General Account, and if the General Account fails, the Segregated Account's funding will disappear. (RMBS Br. 47-48.)

C. The Challenge To The Circuit Court's Failure To Review The CDS Settlement Is Not Moot.

OCI and AAC argue that the RMBS Policyholders' appeal is moot. (OCI Br. 61-63; AAC Br. 34-35.) OCI and AAC are incorrect for the following reasons.

First, this Court already considered and rejected OCI and AAC's mootness argument. The Court stated: "We conclude that even though the settlement agreement has been consummated, this court may still review whether the circuit court erred when it denied the injunction." (6/18/2010 Order 5.) Nothing has changed since the Court's Order.

Second, AAC asserts that the RMBS Policyholders cannot challenge the CDS Settlement because they have not asserted a claim for money damages or sued the Bank Group. (AAC Br. 35.) AAC ignores that the Circuit Court's *ex parte* injunction specifically precludes the RMBS Policyholders from challenging the CDS Settlement outside of the rehabilitation proceeding, the same proceeding AAC and OCI claim the RMBS Policyholders should not be allowed to participate in as parties.

Third, the RMBS Policyholders *have* demanded damages. The RMBS Policyholders requested that the CDS Settlement be undone and the money returned to the General Account. (RMBS Policyholders' Combined Response 7-8; *see also* RMBS Br. 52.) Moreover, as OCI and AAC are aware, on August 30, 2010, the RMBS Policyholders sought leave from the Circuit Court to modify the injunction order so they could file a fraudulent conveyance action. This request is still pending, so the RMBS Policyholders continue to be precluded from taking any action outside the

rehabilitation proceedings. Indeed, as this Court recognized, if the CDS Settlement is found to be improper, the RMBS Policyholders may seek to recover the disbursed funds. (6/2/2010 Order 6.)

D. No Bond Was Required To Stay The CDS Settlement.

The RMBS Policyholders were not required to post a bond to modify the Injunction Order. Wis. Stat. §813.06 is inapplicable because the RMBS Policyholders are not "seeking an injunction," rather, they are seeking to *modify* OCI's injunction.

In any event, a bond was unnecessary. The RMBS Policyholders proposed an arrangement whereby the consideration could be held in escrow, which OCI rejected. (RMBS Policyholders' Memo. in Support of Renewed Emer. Mot. for Inj. Pending Appeal 24-25.)

CONCLUSION

For the foregoing reasons and those set forth in the RMBS Policyholders' opening brief, the RMBS Policyholders respectfully request that this Court reverse the Circuit Court's order denying the RMBS Policyholders' motion to intervene and motion to modify the temporary injunctive order.

Dated this 6th day of January, 2011.

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COURT OF APPEALS OF WISCONSIN
DISTRICT IV

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

Appeal No. 2010-AP-1291,
2010-AP-2022

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Plaintiffs-Respondents,

AMBAC ASSURANCE,

Interested Party-Respondent,

v.

WELLS FARGO BANK/Trustee of Bondholders, BANK OF NEW YORK MELLON and DEUTSCHE BANK NATIONAL TRUST COMPANY,

Defendants,

FEDERAL HOME LOAN MORTGAGE CORPORATION,

Defendant-Petitioner-Co-Appellant,

AURELIUS CAPITAL MANAGEMENT LP, FIR TREE, INC., KING STREET CAPITAL MASTER FUND, LTD., KING STREET CAPITAL, L.P., MONARCH ALTERNATIVE CAPITAL, LP and STONEHILL CAPITAL MANAGEMENT LLC,

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CAPITAL PARTNERS, LP,

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APPEAL FROM THE ORDER OF THE CIRCUIT COURT OF DANE COUNTY CASE NO. 10 CV 1576 THE HONORABLE WILLIAM D. JOHNSTON PRESIDING

FORM AND LENGTH CERTIFICATION

I certify that this brief meets the form and length requirements of Wis. Stat. § 809.19(8)(b) and (c), by virtue of the Court of Appeals' Order dated December 30, 2010, for a brief and appendix produced with proportional serif font. The length of the brief is 5,835 words.

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CERTIFICATION OF COMPLIANCE WITH WIS. STAT. § 809.19(12)

I hereby certify that:

I have submitted an electronic copy of this reply brief, which complies with the requirements of Wis. Stat. § 809.19(12). I further certify that:

This electronic brief is identical in content and format to the printed form of the brief filed as of this date.

A copy of this certificate has been served with the paper copies of this brief filed with the Court and served on all opposing parties.

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