COURT OF APPEALS OF WISCONSIN
DISTRICT IV

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

Appeal No.
2011AP000561

TED NICKEL and OFFICE OF THE COMMISSIONER OF INSURANCE,

Petitioners-Respondents,

AMBAC ASSURANCE,

Interested Party-Respondent,

DEPFA BANK, PLC,

Interested Party-Appellant,

ACCESS TO LOANS FOR LEARNING STUDENT LOAN CORPORATION, AURELIUS CAPITAL MANAGEMENT LP, BANK OF AMERICA, N.A., CUSTOMER ASSET PROTECTION COMPANY ("CAPCO"), DEUTSCHE BANK NATIONAL TRUST COMPANY, DEUTSCHE BANK TRUST COMPANY AMERICAS, EATON VANCE, FEDERAL HOME LOAN MORTGAGE CORPORATION ("Freddie Mac"), FEDERAL NATIONAL MORTGAGE ASSOCIATION ("Fannie Mae"), FIR TREE INC., KING STREET CAPITAL MASTER FUND, LTD., KING STREET CAPITAL, L.P., LLOYDS TSB BANK PLC, MONARCH ALTERNATIVE CAPITAL LP, STONEHILL CAPITAL MANAGEMENT LLC, U.S. BANK NATIONAL ASSOCIATION, WELLS FARGO BANK, N.A. as Trustee for the LVM Bondholders, WILMINGTON

TRUST COMPANY, WILMINGTON
TRUST FSB,

Interested Parties-Co-Appellants,

ASSURED GUARANTY CORPORATION,
BANK OF NEW YORK MELLON,
COUNTRYWIDE HOME LOANS
SERVICING L.P., GOLDMAN SACHS &
CO., INC.,
HSBC BANK USA, NATIONAL
ASSOCIATION, KNOWLEDGEWORKS
FOUNDATION, ONE STATE STREET
LLC, NUVEEN ASSET MANAGEMENT,
PNC BANK, RESTORATION CAPITAL
MANAGEMENT LLC, STONE LION
CAPITAL PARTNERS LP, and
TREASURER OF THE STATE OF OHIO,
UNITED STATES OF AMERICA,

Interested Parties.

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

APPELLANTS DEUTSCHE BANK NATIONAL TRUST COMPANY AND DEUTSCHE BANK TRUST COMPANY AMERICAS' BRIEF

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Dated: July 1, 2011

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Deutsche Bank National Trust Company and Deutsche Bank Trust Company Americas, each acting solely in its capacity as trustee (collectively the "Trustees") for certain residential mortgage-backed securities, other asset-backed securities, collateralized loan obligation, or collateralized debt obligation trusts (collectively the "Trusts"), respectfully submit their opening brief pursuant to this Court's briefing order and Wisconsin Statutes section 809.19.[1]

ISSUES PRESENTED

1. Did the Circuit Court err in holding that the Office of the Commissioner of Insurance of the State of Wisconsin and its Commissioner ("OCI") lawfully created the Ambac Segregated Account and placed certain impaired policies issued by Ambac into that account, while preserving in Ambac other insurer-favored policies, and then ordering the statutory rehabilitation proceeding of only the Segregated Account?

The Circuit Court entered an order approving OCI's Plan purporting to rehabilitate the Segregated Account, even though the purported "rehabilitation" of the Segregated Account is in reality an impermissible liquidation of the Segregated Account to the detriment of the policyholders and to the benefit of the insolvent insurer.

This issue presents pure questions of law reviewed de novo, including the interpretation of statutes, *Pheasant Run Condominium Homes*

[1] The Trustees also join in the brief submitted by U.S. Bank National Association.

Association v. City of Brookfield, 2011 WI App 27, ¶ 5, 331 Wis. 2d 730, 795 N.W.2d 492 (Table); the application of a statute to a given set of facts, *Thorp v. Town of Lebanon*, 2000 WI 60, ¶ 18, 235 Wis. 2d 610, 612 N.W.2d 59; issues concerning OCI's statutory authority, *National Motorists Association v. Office of the Commissioner of Insurance*, 2002 WI App 308, ¶ 19, 259 Wis. 2d 240, 655 N.W.2d 179; and whether the government has effected a taking without just compensation, *E-L Enterprises, Inc. v. Milwaukee Metropolitan Sewage District*, 2010 WI 58, ¶ 20, 326 Wis. 2d 82, 785 N.W.2d 409.

Although findings of fact are generally reviewed for misuse of discretion, that standard does not apply here. This Court may therefore conduct its own examination of the record to determine whether the trial court actually exercised its discretion. *Hedtcke v. Sentry Ins. Co.*, 109 Wis. 2d 461, 471-72, 326 N.W.2d 727 (1982). Failing to exercise discretion is itself an abuse of discretion that should be reversed. *Id*. at 471.

2. Was the Segregated Account lawfully created, with appropriate legal protections for policyholders and adequate capitalization, considering that (1) the transfer of policies into the Segregated Account amounts to an illegal novation of a contract with an insurer—Ambac—which is not itself in rehabilitation; (2) the Plan contains numerous provisions that exceed OCI's authority and are contrary to Wisconsin law; and (3) the Plan does not treat policyholders equitably?

The Circuit Court held that the Segregated Account was lawfully created with an adequate amount of capital and surplus and rejected the Trustee's other objections to the Plan, even though the Segregated Account has no capital or surplus, and even though the Plan deprives Segregated Account policyholders of the statutory and constitutional protections to which they are entitled under Wisconsin law and the U.S. Constitution.

This issue is subject to de novo review for the same reasons and under the same authorities as set forth for the first issue.

STATEMENT ON ORAL ARGUMENT AND PUBLICATION

The Trustees respectfully request oral argument. Given the procedural complexity of this case and the importance of the issues involved, the Trustees respectfully suggest that oral argument would be helpful to the Court in resolving those issues.

The Court's opinion in this case will meet the criteria for publication in Wisconsin Statutes section 809.23 because it will decide an issue of substantial and continuing public interest.

SUMMARY OF ARGUMENT

Wisconsin law permits insurers to create accounts segregated from the insurer's other insurance business lines so that insurers can guard against the possibility that future unanticipated misfortune in one business line could force policyholders "to subsidize other business in times of stress." *See* Comments, Wis. Stat. § 611.24(2). The statutory framework

provides for an insurer to establish a segregated account, if at all, *before* the insurer finds itself in dire financial straits—and *before* the policies at issue are written.

The reason is straightforward: The law permits segregated accounts to insulate lines of insurance business, and policyholders who purchase coverage from segregated accounts understand that they will have only the assets in the segregated account to support their coverage. The law does not permit the forced transfer of existing general account policies to a segregated account for the purpose of bailing out a failing insurer at the sole expense of the transferred policyholders. But the Plan approved by the Circuit Court, if permitted to stand, does just that.

Although OCI submitted (and the Circuit Court approved) a Plan that purports to be a rehabilitation of the Segregated Account, the Plan is no such thing. OCI's own statements demonstrate that it is, in reality, a liquidation of the policies in the Segregated Account in an attempt to bail out Ambac. That liquidation of the Segregated Account and de facto rehabilitation of the Ambac General Account are without any of the statutory and constitutional protections (not to mention compensation) for Ambac policyholders that would accompany its rehabilitation or liquidation under Wisconsin law and the U.S. Constitution.

In a statutory rehabilitation or liquidation of Ambac, all policyholders would have a ratable claim to all of Ambac's assets,

including any capital and surplus. The Plan strips the Segregated Account policyholders of that protection. The Plan also fails to provide Ambac policyholders who are forced to become Segregated Account policyholders at least the liquidation value of their claims, as controlling U.S. Supreme Court and Wisconsin precedents require.

Moreover, the Plan's de facto liquidation of the Segregated Account unlawfully disadvantages policyholders to impermissibly benefit the insolvent insurer—Ambac. That conclusion is confirmed by numerous provisions in the Plan that can only be explained by a desire to benefit Ambac—to the detriment of Segregated Account policyholders. Those provisions give the lie to OCI's assertion—accepted by the Circuit Court—that it is "rehabilitating" the Segregated Account, rather than impermissibly liquidating it.

Those provisions are also overbroad, exceed OCI's authority, and are contrary to Wisconsin law. The Circuit Court reversibly erred in approving a Plan containing such provisions because (1) the Plan's forced transfer of the policies from Ambac—which was neither rehabilitated nor liquidated—to the Segregated Account is an illegal novation because Ambac did not obtain the consent of the affected policyholders; (2) the Plan contains numerous provisions that exceed OCI's authority and violate Wisconsin law; (3) the Plan treats policyholders unfairly and inadequately; and (4) the Segregated Account was formed without adequate capitalization

and surplus—and fails to maintain adequate capitalization and surplus, as Wisconsin law requires.

ARGUMENT

I. OCI's Purported Rehabilitation Of The Segregated Account Is An Impermissible Liquidation Of The Segregated Account In An Effort To Bail Out Ambac

Included in the policies illegally transferred to the Segregated Account without consent or compensation were policies held by the Trustees (the "Trust Policies") for the benefit of holders of certain securities insured by Ambac or its affiliates (the "Insured Certificates"). The primary purpose of the Trust Policies is to ensure the timely payment of principal or interest on the Insured Certificates for the benefit of investors. In connection with the Trust Policies, the Trustees agreed to make substantial premium payments in exchange for Ambac's agreement to make claims payments to the Trusts if certain payment deficiencies arose with respect to the Insured Certificates.

Wisconsin law permits insurers to create segregated accounts that are "walled off" from the insurer's other insurance business lines so that insurers can guard against the possibility that unanticipated financial reversals in one business line will force policyholders "to subsidize other business in times of stress." *See* Comments, Wis. Stat. § 611.24(2). Insurers can establish segregated accounts to begin writing policies within a new line of business, if at all, *before* they find themselves in dire financial

straits. But they cannot do so to bail *themselves* out of financial troubles at the expense of certain General Account policyholders cherry-picked by the insurer.

Allowing Ambac to create a segregated account "after the house is already on fire" is anathema to Wisconsin's regulatory scheme. If permitted to stand, the Circuit Court's Order approving the Plan would permit any Wisconsin insurer to carve out any single insurance policy or group of policies that have generated claims—such as homeowner policies after a flood—unilaterally place them in a segregated account, and then treat them disadvantageously without affording policyholders the substantive and procedural protections afforded by Wisconsin law. That is not the law in Wisconsin.

A. The Plan Amounts To An Unlawful Liquidation Of The Segregated Account Without The Protections That Must Be Afforded Policyholders

The only possible explanation for the Plan is that it is not a rehabilitation of the Segregated Account at all. It is, instead, an unlawful de facto *liquidation* of the Segregated Account policies in an effort to bail out Ambac—without affording the Segregated Account policyholders the statutory and constitutional protections (and compensation) to which they are entitled.

1. The Plan Is An Unlawful Liquidation Of The Segregated Account

OCI has conceded that the Plan "provides for the orderly run-off . . . of the liabilities allocated to the Segregated Account." J.A.591. OCI has also admitted that the Plan's goal is to "run off the liabilities in the Segregated Account and terminate the Segregated Account thereafter." R.596:215. That is no "rehabilitation." It is a liquidation. *See generally* LEE R. RUSS, COUCH ON INSURANCE 5:24 (3d ed. 2010) ("In general, the rehabilitation statutes place upon the [rehabilitator] the responsibility of devising a plan . . . that will result in the successful continuation of the business of the insurer.").

Wisconsin law prohibits liquidation as a permissible purpose for rehabilitation. Indeed, the comments to Chapter 645 mandate that liquidation "*must* be used when the insurer's assets are to be distributed and the insurer dissolved." Introductory Comment to subch. III, Wis. Stat. ch. 645 (emphasis added). As the Legislature has explained, "[r]ehabilitation is not appropriate at a point where a company has been allowed to approach insolvency, unless substantial additional resources are poured into the enterprise *immediately* by contributors of capital funds." Comments, Wis. Stat. ch. 645 (emphasis in original).

There are no plans to infuse the Segregated Account with any cash at all—much less to do so "immediately." The inescapable conclusion is that

the Plan is a liquidation of the Segregated Account—not, as it purports to be, a rehabilitation of the Segregated Account.

2. The Plan Impermissibly Deprives Policyholders Of Statutory And Constitutional Rights

It is no mystery why OCI and Ambac disguise the Plan as a "rehabilitation" of the Segregated Account. In a statutory rehabilitation of *Ambac*, claimants with unpaid claims would have liens on the sole shareholder's interests in Ambac's assets. Wis. Stat. § 611.24(3)(e). By improperly liquidating Ambac's liabilities after cherry-picking Ambac policies for forced placement in the Segregated Account—and then mis-labeling it a rehabilitation of the Segregated Account—OCI has allowed Ambac's shareholder to preserve its interests in Ambac at the expense of policyholders.

In addition, OCI is attempting to use this artifice to skirt Wisconsin law. Because the Plan is in reality a liquidation of the Segregated Account and its policies (and a de facto rehabilitation of Ambac's General Account), Wisconsin law requires that a formal rehabilitation order be entered against Ambac and its General Account. *See id.* § 611.24(3)(e). Through its artifice, OCI has attempted to deprive the Segregated Account policyholders of their constitutional rights to opt out of the proposed Plan and to receive at least the liquidation value of their claims.

In a previous order, the Circuit Court correctly recognized that Wisconsin's "fair and equitable" standard requires "that policyholders must receive at least the liquidation value of their claims from a plan of rehabilitation." R.397:14. The Circuit Court reversed course in the Order when it rubberstamped OCI's own conclusion that "[t]here is no constitutional or statutory requirement that the Rehabilitator offer policyholders the right to opt out of the Plan of Rehabilitation in favor of taking a cash payment equaling the liquidation value of their permitted policy claim." J.A.157 (¶ 11). That is incorrect.

Due process requires that a rehabilitation plan must afford policyholders of an insurer the right to opt out of a proposed plan and receive at least the liquidation value of their claims. *Neblett v. Carpenter*, 305 U.S. 297, 305 (1938) (affirming plan because it satisfied those requirements). That is so even in the absence of statutory provisions specifically extending that right. *See, e.g.*, *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1093-94 (Pa. 1992) ("Under [*Carpenter*], creditors must fare at least as well under a rehabilitation plan as they would under a liquidation . . . ."). The *Carpenter* rule controls here, and requires reversal of the Circuit Court's Order confirming the Plan.

The Plan's failure to provide Segregated Account policyholders at least the liquidation value of their claims against Ambac not only violates due process, but also effects a taking without just compensation. Where, as

here, policyholders are deprived of their contractual property rights without receiving just compensation in the form of liquidation value, due process is violated. *Accord U.S. Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1, 19 n.16 (1977) ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid.").

The Circuit Court's confirmation of the Plan rests on a misreading of *Carpenter*. In the Circuit Court's view, even assuming a liquidation analysis were required, the one offered by OCI on the eve of the hearing was sufficient because OCI asserted there would have been collateral damage and other disadvantages if Ambac were liquidated (or rehabilitated). But under *Carpenter*, the question is not whether liquidation is preferable to rehabilitation. It is what policyholders would recover if a liquidation occurred. OCI did not even attempt to answer that question. As a result, the Circuit Court had no basis for concluding that the Plan meets the minimum constitutional and statutory threshold—and it does not.

B. The Plan's Own History And Provisions Confirm It Is An Impermissible Bail Out Of Ambac

The conclusion that OCI is impermissibly attempting to bail out Ambac (and not rehabilitate the Segregated Account) is confirmed by OCI's own actions and the Plan's provisions.

First, the history of OCI's interactions with Ambac underscores the real nature of the Plan. In 2008, OCI hired financial advisors, legal

counsel, and others to monitor and evaluate *Ambac's* financial condition—and met with them "extensively over many months . . . in regard to possible restructuring plans *for the company*." J.A.249 (¶¶ 7, 8) (emphasis added). OCI's own words confirm that long before Ambac created (and OCI approved) the Segregated Account, OCI and Ambac were attempting to restructure *Ambac* to address *Ambac's* financial difficulties.

Second, the Plan contains numerous provisions that can only be explained as benefiting Ambac—not rehabilitating the Segregated Account. *See*, *e.g.*, *infra* Part II.A (explaining that transfer of policies to Segregated Account and release of Ambac from any further liability under those policies is an unlawful novation); J.A.609-10 (§ 4.04(g)); J.A.386 (permitting Ambac to recoup the full amount of all recoveries, reimbursements, and other payments under the Trust Policies *in cash*, while requiring Ambac to pay only a fraction of each Segregated Account Policyholder claim in cash). Segregated Account policyholders could be required to reimburse Ambac more than they are actually paid under their policy claims—transforming Segregated Account policyholders from insurance policy beneficiaries into virtual reinsurers for Ambac's other policyholders.

If the Plan is permitted to stand, Ambac would benefit handsomely from it in numerous other ways. Ambac would be entitled to receive:

- All of its policy premiums;

- A waiver of certain litigation claims related to the Plan and rehabilitation;
- Mandatory venue in Wisconsin courts for all other litigation related to the Plan and rehabilitation notwithstanding bargained-for contract provisions in which Ambac consented to jurisdiction elsewhere;
- Waiver of setoff rights;
- The right to retain all of its directional and control rights; and
- A fee—in an undisclosed amount—that will be paid 100 percent in cash for serving as "Management Services Provider"—that is, for managing the Segregated Account with "the discretion to carry out and perform all other obligations or duties imposed on it by this Plan or by law in any manner it so chooses."

J.A.603 (§ 3.05), J.A.614-15 (§ 6.01), J.A.616-18 (§ 8.01), J.A.177 (¶ 4), J.A.178-79 (¶¶ 6, 7), J.A.182-85 (¶¶ 9.B, 9.C), J.A.369-70, J.A.386.

The Disclosure Statement provides that "[t]he payment of principal and interest on the Surplus Notes will be expressly subordinate in right of payment to the prior payment in full of all . . . Policy Claims." J.A.394-95; *see also* J.A.704-07 (¶ 10). If Ambac were to go into a delinquency proceeding, policyholders holding surplus notes in satisfaction of their claims could be subordinated to policyholders whose claims arose later in time and had not yet been converted to surplus notes. OCI has indicated that notwithstanding the creation of the Segregated Account, the financial condition of the remainder of Ambac remains precarious. R.613:12-13

("Ambac was financially hazardous back in March of this year when this proceeding was commenced and it remains so today.").[2]

Under the Plan, Ambac's General Account policyholders may actually derive *greater* benefits from the Plan than they would in the absence of the purported rehabilitation, while the Segregated Account policyholders may derive fewer benefits than if they had no insurance at all. That other Ambac policyholders—and Ambac itself—may benefit from the Plan while only Segregated Account policyholders are disadvantaged confirms that the Plan is not a rehabilitation of the Segregated Account, but an impermissible liquidation for the benefit of Ambac.

II. The Plan Is Unlawful

Even if OCI's Plan to "rehabilitate" the Segregated Account were not an impermissible attempt to bail out Ambac without affording policyholders the compensation and protections to which they are entitled, the Circuit Court's Order still should be reversed because the Plan is itself unlawful in several respects.

[2] Since the Circuit Court rendered its decision in this case, Ambac has already defaulted on the first payment on surplus notes. *See* Ambac Form 8-K (filed June 7, 2011), *available at* http://sec.gov/Archives/edgar/data/874501/000119312511160045/d8k.htm (last visited June 27, 2011). This Court may take judicial notice of that fact, which appears in Ambac's 8-K filing. Wis. Stat. § 902.01(2), (2)(b); *Perkins v. State*, 61 Wis. 2d 341, 346, 212 N.W.2d 141 (1973) (courts may take judicial notice of documents outside the trial court record that are "immediately accessible").

A. The Transfer Of The Trust Policies To The Segregated Account Is An Illegal Novation

A novation is (i) the assignment by one party to another of obligations and liability under a contract; (ii) the assumption by the assignee of those obligations and liabilities; and (iii) the agreement by the counterparty to the contract to accept the assignee's performance for that of the assignor, and to release the assignor from any further liability on the assigned obligations. *See Siva Truck Leasing, Inc. v. Kurman Distribs.*, 166 Wis. 2d 58, 67, 479 N.W.2d 542 (Ct. App. 1991). A novation does not release the assignor unless the counterparty consents to the transaction with the understanding that the assignor will be released and that the counterparty's sole recourse will be against the assignee. *Id.*

That rule is frequently applied to transfers of insurance policies by assignment from one insurer to another. *See, e.g.*, *State Dep't of Pub. Welfare v. Cent. Standard Life Ins. Co.*, 19 Wis. 2d 426, 435, 120 N.W.2d 687 (1963). Such transfers cannot release the original insurer (assignor) from liability under the assigned policy unless the policyholder consents to the release. *Id.*; *see also* RESTATEMENT OF CONTRACTS (Second) § 280, cmt. d (1979)).

Without policyholder consent, there can be no release of the original insurer—not even where, as here, the insurance regulator has approved the transfer. *See, e.g.*, *Baer v. Associated Life Ins. Co.*, 248 Cal. Rptr. 236, 239

(Ct. App. 1988). The rationale for that rule is straightforward. A policyholder decides to purchase insurance coverage based on many factors—including the size, quality, and creditworthiness of the insurer. The insurer therefore has no right to unilaterally transfer its policy obligations to another—thereby forcing its insured not only to accept substitute coverage with a stranger, but also to surrender the insured's rights and recourse against its original insurer.

The keystone of OCI's plan to bail out Ambac was the creation of the Segregated Account and the transfer by Ambac of some of its insurance policies to the Segregated Account—with Ambac thereby released from any further liability on those policies. Under the authorities discussed above, there is no question that the forced transfer of Ambac polices to the Segregated Account was, in both form and substance, an illegal novation.

First, a segregated account is by statute deemed to exist and operate as a separate insurer within an insurer, and it is required to have its own assets and liabilities which are not chargeable with or against the insurer's general account and other segregated accounts. Wis. Stat. § 611.24(3)(c) & comments thereto. Second, although Ambac policyholders are entitled to a ratable claim against all of Ambac's assets—and to have their claims paid on time, in full, and in cash—the Trustees were stripped of those (and many other) rights when their policies were forcibly transferred to a Segregated Account which has no assets and no surplus, and which will pay claims, if

at all, only through a combination of cash and surplus notes of dubious value.

Under Wisconsin law, the transfer of the policies could be legally effective only with policyholder consent. OCI never attempted to secure the necessary consent because it knew it could never be obtained. OCI instead chose to force the novation—notwithstanding the lack of consent or any statutory authority (given that Ambac is not, and never was, the subject of a formal rehabilitation or liquidation proceeding).

OCI cannot have it both ways. If Ambac is not the subject of a rehabilitation or liquidation, then Ambac remains fully liable on the Segregated Account policies in the absence of policyholder consent to the novation. OCI has no statutory authority to release Ambac from its full liability on the transferred policies so long as Ambac is not itself the subject of a formal liquidation or rehabilitation proceeding.

B. The Plan Contains Numerous Provisions That Exceed OCI's Authority And Are Contrary To Wisconsin Law

The Plan confirmed by the Circuit Court contains numerous provisions designed specifically to benefit Ambac, to the detriment of Ambac policyholders whose policies were forcibly transferred to the Segregated Account. Those provisions are overbroad, exceed OCI's authority, and are contrary to Wisconsin law.

1. The Plan's Release, Immunity, And Indemnification Provisions Are Overbroad And Impermissible

It is only common sense that the provisions of a rehabilitation plan must bear a relationship to the rehabilitation itself—and it necessarily follows that such provisions cannot be overbroad. *See, e.g.*, *Koken v. Fid. Mut. Life Ins. Co.*, 803 A.2d 807, 814, 817 (Pa. Commw. Ct. 2002) (provisions must be "necessary and proper"). The release, indemnification, and immunity provisions of the Plan fail that test, because they exist primarily to benefit Ambac, not to rehabilitate the Segregated Account. By design, neither Ambac nor the General Account is before the Court. Provisions that benefit Ambac and General Account policyholders at the expense of Segregated Account policyholders are thus necessarily overbroad (and unlawful).

Specifically, the release provisions in Section 8.01 of the Plan protect the General Account, Ambac, and virtually everyone else associated with Ambac—from affiliates to shareholders and even to former employees—from any liability whatsoever. Similarly, the indemnification provisions in Sections 9.01 and 9.02 of the Plan immunize and indemnify not only OCI, but also Ambac, the General Account, and "each of their respective current and former members, shareholders, affiliates, officers, directors, employees and agents" with respect not only to any action taken

regarding the Segregated Account, but also to any action related to the Plan in any way. J.A.621-22.

Those overbroad provisions exceed the OCI's mandate in purporting to rehabilitate the Segregated Account alone. There is no legitimate reason why entities not in rehabilitation should benefit from such broad releases. Even worse, despite the Plan's broad liability waivers for anyone even remotely related to Ambac, the Plan provides no immunity and only marginal indemnities to protect the Trustees—who are forced to implement the various Plan provisions—from liability arising out of the Plan.

The breadth of the release, indemnification, and immunity provisions runs afoul of Wisconsin law. *See* Comments, Wis. Stat. § 645.34 ("The rehabilitator should not be permitted to escape actions and proceedings against the insurer—if he needs to do that the insurer should be liquidated, not rehabilitated. . . ."); Wis. Stat. § 645.08(2) (permitting immunity only for the state, commissioner, special deputy commissioner, rehabilitator, insurance security fund, and their employees or agents only for acts or omissions conducted pursuant to certain designated provisions of the rehabilitation chapter). Yet the Plan's release provisions purport to release claims against all Ambac-related entities for essentially any action whatsoever, other than claims of intentional fraud or willful misconduct.

The Plan confirmed by the Circuit Court thus strips rights from Segregated Account policyholders even as it provides rights to Ambac and

others. In so doing, the Plan impermissibly decreases the assets available to the entity in rehabilitation only to strengthen the financial position of entities not in rehabilitation.

2. The Plan's Reallocation Of Rights And Liabilities Exceeds OCI's Authority

Under the Plan, Segregated Account policyholders are prohibited from exercising basic rights afforded to them by their policies. Those prohibitions find no justification in the law. They can only be explained as impermissible attempts to insulate Ambac from liabilities arising from the Segregated Account. For example, the Plan:

- Prohibits Segregated Account policyholders from asserting any right of "subrogation or recoupment of any kind, directly or indirectly" against Ambac or the General Account;
- Prohibits Segregated Account policyholders from asserting their rights of setoff against Ambac or the General Account; *but*
- Expressly retains Ambac's rights of setoff against the Segregated Account policyholders.

J.A.617-18 (§ 8.01(iv)), J.A.612 (§ 4.07). Segregated Account policyholder claims are subject to Ambac's unconstrained setoff power even after a claim is deemed "permitted" under the Plan. Such an absolute right—which purportedly trumps all other laws and rules of court—would prevent any claim from ever becoming final, and should be prohibited for that reason alone.

Yet the Plan does more than disadvantage Segregated Account policyholders while insulting Ambac from their claims. It reallocates certain rights to Ambac. It requires that Segregated Account policyholders transfer all of their interests—including related claims against third parties—to Ambac. J.A.610 (§ 4.04(h)). That forced transfer of third-party contractual rights to an entity not in rehabilitation exceeds OCI's authority—and demonstrates that OCI's Plan to "rehabilitate" the Segregated Account is an impermissible attempt to benefit Ambac.

3. The Plan Shifts Duties And Obligations Onto The Trustees Without Sufficient Compensation Or Protection

The Plan confirmed by the Circuit Court also attempts to shift additional costs and obligations onto the Trusts and Trustees without providing sufficient compensation or protection.

The primary purpose of the Trust Policies is ensuring the timely payment of principal and interest payments on the Insured Certificates. The Trust Policies therefore require Ambac to pay claims within two to three business days after receiving a claim notice, and before the Trustee must distribute funds to the underlying Insured Certificates (the "Distribution Date"). Under the Plan, however, Ambac would have an indefinite period of time in which to evaluate each Segregated Account claim, and it could delay claims payments at least until after the Distribution Date. J.A.607-09 (§ 4.04(b), (c), (d)). Moreover, the Plan calls for payment of Segregated

Account claims in only 25 percent cash and 75 percent surplus notes. The Trust Policies, however, state that all payments are to be made in *cash*.

If Ambac delays payment until after the Distribution Date, as the Plan permits it to do, the delay will impose substantial operational burdens upon the Trustees. For example, if an Insured Certificate is transferred to a new certificate holder after the claim has been filed, but before Ambac pays the claim, and the Trustees deliver the late payment to the new certificate holder, under the plan the Trustees are required to set the record date to determine which certificate holder—when the claim was submitted, or when the payment is received—is entitled to the payment. The Trustees will bear the risk that the former certificate holder will argue that the payment should have been delivered to it when it still held the certificate.

The Plan may also force the Trustees to administer a solution to Plan-created problems that is foreign to the standard industry payment mechanisms—thereby forcing the Trustees to deal with a costly, unworkable system. Further, the Plan could be construed as requiring the Trustees to operate in a manner that violates the terms and conditions of the governing Trusts documents. The Plan thus imposes substantial burdens and risks on the Trustees without commensurate protections or compensation.

C. The Plan Treats Segregated Account Policyholders Unfairly

A central objective of the Wisconsin Insurance Code is to ensure that policyholders are treated "fairly and equitably." Wis. Stat. § 601.01(2). When an insurance company's precarious financial situation may result in loss to claimants or shareholders, Wisconsin's regulatory scheme aims to achieve the "equitable apportionment of [that] unavoidable loss." Wis. Stat. § 645.01(4)(d) & Comments. For that reason, Wisconsin law requires that "[n]o subclasses shall be established within any class." *Id.* § 645.68; *see also id.* § 611.24(2) (segregated account may not be "contrary to the law or to the interests of any class of insureds"). The Plan confirmed by the Circuit Court fails to satisfy the general requirement of fair and equitable treatment, and violates the specific prohibition against the establishment of subclasses.

OCI concedes that the Ambac policies allocated to the Segregated Account are in the same class, or business line, as the Ambac policies that remain in the General Account. *See* R.596:191-92 (all policies are part of Ambac's financial guaranty line of business). But the Plan does not treat the Trustees and other Segregated Account policyholders equitably in relation to Ambac General Account policyholders. Instead, the Plan relegates Segregated Account policyholders to de facto subclass status.

As demonstrated in greater detail above, Segregated Account policyholders will bear the loss of Ambac's business model disproportionately, while other Ambac policyholders in the same class will benefit—as will Ambac's general creditors and sole shareholder. Meanwhile, General Account policyholder claims are being paid in full, in cash, and on time, while Segregated Account policyholders are being (and will continue to be) denied the full benefits of their coverage precisely because the risk they purchased insurance to avoid has come to pass.

Under the Plan, the Segregated Account policyholders retain all of their obligations—such as paying their premiums in full—while being stripped of many of their contractual rights without compensation, such as their rights:

- To be paid entirely in cash (instead of percent in surplus notes that in three out of four scenarios by OCI will not be paid in full by 2050) for claims;
- To reacquire control rights after an insurer event of default;
- To enforce the statutory and common law right of setoff;
- To retain certain claims against the Segregated Account or Ambac;
- To "enforc[e], attach[], collect[], or recover[] in any manner any judgment, award, decree, or order against the Segregated Account, the General Account or [Ambac] or any of the property to be distributed under the terms of this Plan, other than as permitted under subparagraph (i) above;"

- To bring an action in any other court or jurisdiction, notwithstanding express provisions of Ambac policies to the contrary; and
- To recover punitive, consequential, special or exemplary damages.

J.A.607-09 (§ 4.04(d)), J.A.614-15 (§ 6), J.A.617-18 (§ 8.01(ii), (iv)), J.A.178-79 (¶ 6), J.A.182-85 (¶¶ 9.B, 9.C). The Plan severely curtails the rights of the Segregated Account policyholders, while preserving all the rights of Ambac's other policyholders under virtually identical policies. That inequitable and unfair treatment of policyholders under the Plan violates Wisconsin law.

D. The Segregated Account Is Undercapitalized

Wisconsin law could not be clearer: "[T]he commissioner shall require [an insurer] to have and maintain an adequate amount of capital and surplus in the segregated account." Wis. Stat. § 611.24(3)(a). OCI violated its statutory duty by approving a segregated account that by any legitimate measure was inadequately capitalized (and which, in fact, has no capital or surplus). OCI admits the Plan may be doomed to fail because the Segregated Account continues to lack adequate capitalization. The Circuit Court should never have approved such a Plan.

Contrary to the clear statutory command, the Segregated Account was not established with either adequate capital or surplus. *See* R.38:24-25. As OCI's own witnesses have candidly admitted, the Segregated Account

"has no assets" but "only liabilities," while the assets "all reside in the General Account." R.596:215, 218; R.597:32-33. Nor are there any plans to infuse capital into the Segregated Account. *See* J.A.596:215. OCI's acknowledgement that the rehabilitation was designed to run off the Segregated Account's liabilities, and that the Segregated Account will be terminated thereafter, is a candid admission that the Segregated Account was inadequately capitalized. *See* J.A.591; R.596:215.

The Segregated Account holds only a non-marketable note and reinsurance agreement issued by Ambac. They provide no sufficient assurance of adequate capitalization because, under their plain terms, Ambac has no obligation to make any payments to the Segregated Account if Ambac's statutory surplus falls below $100 million, or such other amount as determined by OCI. J.A.263-64, 309. Moreover, OCI intends the Segregated Account to pay claims only 25 percent in cash and 75 percent in surplus notes of highly dubious value. *See supra* note 2 & Part II.B.3. The surplus notes that would be used to pay claims are worth only pennies on the dollar, and it is unlikely those claims would ever be paid. R.597:61.

OCI's acknowledgement that the purported "rehabilitation" of the Segregated Account was designed to run off liabilities, and that the Segregated Account will be terminated thereafter, is a candid admission that the Segregated Account was inadequately capitalized. *See* J.A.591; R.596:215. Nonetheless, even after hearing uncontested evidence of the

Segregated Account's inadequate capitalization, the Circuit Court simply accepted OCI's say-so that despite all evidence to the contrary, the Segregated Account is adequately capitalized. That unfounded conclusion is erroneous.

The lack of adequate capitalization has serious implications for affected Ambac policyholders. If Ambac were to enter into insolvency proceedings down the road, Ambac might argue that the Segregated Account's claims would be subordinate to those of Ambac's General Account policyholders. In a statutory rehabilitation or liquidation of Ambac, however, the Segregated Account policyholders would have a ratable claim to whatever capital and surplus exists at Ambac. By approving the Plan, the Circuit Court stripped Segregated Account policyholders of that protection.

Avoiding such unfair and inequitable results is the reason Wisconsin law prohibits insurers like Ambac, which have insufficient capital, from creating segregated accounts. Such insurers lack the claims-paying resources to prevent the prejudice to policyholders that inevitably results. The Segregated Account is unlawful for that reason, too.

CONCLUSION

For the foregoing reasons, the Circuit Court's Order should be reversed.

Dated this 1st day of July, 2011.

Respectfully submitted,

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DISTRICT IV

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

Appeal No. 2011AP000561

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Petitioners-Respondents,

AMBAC ASSURANCE,

Interested Party-Respondent,

DEPFA BANK, PLC,

Interested Party-Appellant,

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Interested Parties.

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 hereby certify that this brief conforms to the rules contained in § 809.19(8)(b) and (c) of the Wisconsin Statutes for a brief produced with a proportional serif font. The length of this brief is 5,340 words.

Dated this 1st day of July, 2011.

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CERTIFICATION OF COMPLIANCE WITH RULE 809.19(12)

I hereby certify that:

I have submitted an electronic copy of this brief, excluding appendix, if any, which complies with the requirements of section 809.19(12). I further certify that:

This electronic brief is identical in content and format to 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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