COURT OF APPEALS OF WISCONSIN
DISTRICT IV

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

TED NICKEL and OFFICE OF THE COMMISSIONER OF INSURANCE,

Petitioners-Respondents,

AMBAC ASSURANCE,

Interested Party-Respondent,

v.

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, ONE STATE STREET LLC, STONEHILL CAPITAL

Appeal Nos. 2011-AP-561
and 2010-AP-2835

MANAGEMENT LLC, U. S. BANK NATIONAL ASSOCIATION, WELLS FARGO BANK, N.A., WELLS FARGO BANK, NATIONAL ASSOCIATION as Trustee for the LVM Bondholders, WILMINGTON TRUST COMPANY and WILMINGTON TRUST FSB,

Interested Parties-Co-Appellants

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

SUPPLEMENTAL OPENING BRIEF OF ACCESS TO LOANS FOR LEARNING STUDENT LOAN CORPORATION and LLOYDS TSB BANK PLC

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INTRODUCTION

Access to Loans for Learning Student Loan Corporation ("ALL") and Lloyds TSB Bank plc ("Lloyds Bank" or "Lloyds"") (together "ALL/Lloyds") are co-appellants in Appeal Nos. 2011-AP-561 and 2010-AP-2835, two of the consolidated appeals covered by this supplemental brief. ALL/Lloyds have joined in Appellants' Consolidated Opening Brief (the "Consolidated Brief" or "C.Br.") filed on June 17, 2011. They are filing this individual supplemental brief pursuant to the Court's May 3, 2011 Order.

TABLE OF AUTHORITIES

Cases

Statutes

STATEMENT OF SUPPLEMENTAL ISSUES

In addition to the six issues identified in the Consolidated Brief, ALL/Lloyds identify the following issues:

1. Regardless of the lawfulness of the Segregated Account, was there an insufficient basis for placing the ALL/Lloyd Ambac insurance policies into the Segregated Account? The circuit court concluded that the ALL/Lloyds' policies were properly placed into the Segregated Account. While sufficiency of the evidence generally is reviewed under a "clearly erroneous" standard (Wis. Stat. § 805.17(2)), for the reasons given in the Consolidated Brief, the Court should review this issue – and issues 2 and 3 below – *de novo*. (C.Br. at 2-3.)

2. Did the OCI fail to follow the requirements of Wis. Stat. §§ 611.13, 611.19, and 611.20 in forming the Segregated Account?

3. Was the OCI's evidence in support of its assertion that it complied with Wis. Stat. §§ 611.24(3)(a)'s requirement of "adequate capital and surplus" because "the Segregated Account has access to all of the assets of Ambac, in *pari passu* with General Account policyholders" illusory, wholly unsupported by the evidence and belied by the expert testimony?

STATEMENT OF ORAL ARGUMENT AND PUBLICATION

ALL/Lloyds agree with the Statement on page 7 of the Consolidated Brief.

SUPPLEMENTAL STATEMENT OF THE CASE

ALL/Lloyds file this separate brief because they assert that their insurance policies should not have been allocated into the Segregated Account. They also separately contend from the Consolidated Brief that OCI did not comply with Wisconsin statutes in the formation of the Segregated Account. Finally, they contend that the OCI's assertion that "the Segregated Account has access to *all of the assets of Ambac,* in *pari passu* with General Account policyholders" is unsupported by the evidence and belied by the expert testimony.

The Parties and the Policies

ALL is a California 501 (c)(3), nonprofit public benefit corporation which acts as a student lender dedicated to increasing access to education by offering innovative, affordable student loans to post-high school students. (R. 197: 1 (¶ 2.))[1] ALL issues bonds to finance its student loans. ALL obtained two Financial Guaranty Insurance Policies (the "Policies") from Ambac in order to provide credit enhancement for several hundred million dollars of asset-backed bonds, the proceeds of which were used to originate the federally guaranteed loans. The Policies insure payment of principal and interest on the bonds. (*Id.* at 1-2 (¶¶ 3-11.))

If funds are insufficient to purchase the bonds, Lloyds Bank, as "Liquidity Provider," purchases such bonds as it is required to do and becomes owner of those bonds. (R. 327: 1 (¶ 3.)) As a result of the

[1] The citation format in this brief follows the Consolidated Brief (C.Br. at 8 n.1).

deterioration of Ambac's financial condition and the plummeting of its credit rating in 2008 (*see* JA. 357-58) the tendered bonds supported by Lloyds were not able to be remarketed and Lloyds, as Liquidity Provider, purchased those bonds. (R. 327: 1 (¶ 3.)) The interest rate payable on the bonds held by Lloyds increased with its purchase of the bonds in order to reflect the cost to Lloyds of funding the purchase; as a result, there was deterioration in the ALL Trust (created from payments of the underlying student loans). (*Id.* at 2 (¶ 9.)) Lloyds was entitled to periodic payments from available funds with the balance remaining outstanding being due five years from the purchase date, in this case, 2013. (R. 278: 3 (¶¶5-6.))

Unlike the other policies of insurance in the Segregated Account, the collateral that is pledged to the bonds is extremely strong. The student loans are guaranteed by several agencies and reinsured by the U.S. Department of Education for at least 97% of any defaulted principal and interest accrued under the loans. The claim trigger rate against those guarantors has been historically less than 10 per cent and there has never been a default by a guarantor in paying under its guarantee. (R. 197: 3(¶ 18.))

When the Policies were allocated to the Segregated Account by Ambac, the ALL bonds lost the full protection of the insurance which provided for payment of 100% of the potential claims, thus severely prejudicing the ALL bonds by making it much more difficult to remarket or refinance these bonds.

Moreover, the ripple effect of OCI's action will make it more difficult in general to find funding for ALL's student loan program. (*Id.* (¶ 19.))

Placement of the Policies into the Segregated Account

As addressed in detail in the Consolidated Brief, on March 24, 2010, Ambac, with the approval of OCI, created the Segregated Account; on the same day, OCI filed this rehabilitation proceeding for the Segregated Account. Ambac and OCI determined that approximately 14,000 policies would remain in Ambac's General Account because: (a) they lacked "material projected impairments," (b) the collateral damage of a rehabilitation proceeding as to those policies could outweigh the benefits of that allocation, and/or (c) certain policyholders who did have material impairment (namely the Bank Group) agreed to forbear the trigger on the default of the loan and eventually settled the liability with OCI. (R. 74: 9-10 (¶¶ 11-12.))

Ambac and OCI decided the ALL/Lloyds policies should go into the Segregated Account "because they [were] expected to incur substantial losses due to the structure of the transaction." Those "expected" losses were based on Lloyds' contractual right to payment in full in 2013, actual deterioration of the ALL Trust due to the higher interest rates paid to Lloyds and another ALL bondholder, Depfa Bank plc, and the possibility (without an injunction) that Lloyds would further increase the interest rate to a default interest rate. (*Id.* (¶ 6.))

OCI failed, however, to specify how the expected losses from the Policies compared to any of the expected losses of similarly situated policies in the General Account. For example, with respect to Lloyds' 2013 balloon payment, the record does not include any estimate of those likely losses. Yet, the existence of a balloon payment in advance of maturity of the collateral does not indicate the likelihood of losses, unless there is a significant difference between the amount of the balloon payments and the expected value of the underlying collateral. No such expected values of the student loan collateral were provided to the Court.

Further, with respect to the current and expected continuation of losses resulting from the higher interest rates Lloyds was entitled to, those rates were variable rather than fixed, but neither Ambac nor OCI provided the parties or the circuit court with estimates of expected rates or of expected losses due to interest rates. As to OCI's concern that Lloyds might invoke a default interest rate based on the occurrence of a "trigger," Lloyds did not invoke the trigger before the March 24, 2010 injunction, nor was it given the opportunity to agree to forbear exercising the default trigger as other policy or bondholders were given in order to remain in the General Account. (*See* R. 197: 2 (¶ 14.))

Moreover, the bulk of the other policies that were allocated to the Segregated Account were then incurring losses because of the deterioration of their own collateral, and it was the pressure of those claims on Ambac which

precipitated OCI to take over and form the Segregated Account. Conversely, the ALL/Lloyds policies were allocated to the Segregated Account *not* because of the deterioration of their collateral, but because of the deterioration of *Ambac*. (R. 327: 2 (¶ 9.))

ARGUMENT

ALL/Lloyds fully adopts the Consolidated Brief as well as the applicable portions of the RMBS Brief in Appeal No. 2010-AP-1291 regarding intervention and the formation of the Segregated Account. The principal focus of this supplemental argument is on the allocation of the Policies to the Segregated Account. In addition, the argument will briefly supplement the prior appellate briefs on the proper statutory standard for adequate capitalization under Wis. Stat. § 611.24(3)(a).

I. IN THE UNLIKELY EVENT THAT THE SEGREGATED ACCOUNT WAS LAWFULLY ESTABLISHED, THE COURT SHOULD DIRECT THE CIRCUIT COURT ON REMAND TO RETURN THE ALL/LLOYDS POLICIES TO THE GENERAL ACCOUNT.

OCI did not present admissible evidence that supported a reasonable or rational basis for allocating the Policies to the Segregated Account as compared to the policies that remained in the General Account. (*E.g.,* R. 562:158-162; R. 564: 9-11.)) The Policies are wholly distinguishable from what Ambac and the Commissioner refer to as the "toxic" bonds in the

Segregated Account where the underlying collateral was a major concern with the Ambac insurance policies (R. 197:3 (¶ 18); R. 196: 3 (¶ 16.))

The Policies are unlike the other policies that were allocated to the Segregated Account. Unlike the mortgage-backed securities and credit-default swap guaranty insurance losses, ALL and Lloyds are wholly innocent with respect to their potential, future losses, as the only reason that there is any potential for losses against the Lloyds Policy is the financial downfall of Ambac. (R. 196: 2 (¶ 9.)) A policyholder should not be punished because its insurer caused the potential losses to occur. Moreover, unlike the "toxic" policies generally allocated to the Segregated Account, the underlying assets backing the ALL bonds are strong and, insured by the federal government, will continue to be strong.

Given the strength of the collateral supporting the Policies compared to other policies in the Segregated Account, Ambac's and OCI's general assertions about their standards for allocations to the Segregated Account are insufficient to explain why the Policies are in the Segregated Account. The little data provided about aggregate losses in the Segregated Account compared to the General Account say nothing about actual or likely losses from the Policies.

The principal criterion for allocation of policies to the Segregated Account was "material projected losses." OCI's evidence of such losses from the Policies was pure speculation. The OCI's witnesses at the confirmation

hearing on the Plan were unable to provide evidence of "the material projected losses" on the Lloyds Policy at the June 2013 maturity date when ALL/Lloyds could first make a claim. (R. 562: 156-160; R. 564: 9-11).) ALL/Lloyds agreed to waive any confidentiality to the disclosure of the loss data, thus obviating one of the reasons the OCI did not want to disclose the loss data. (R. 562: 161.) Moreover, ALL/Lloyds never increased the interest rate to the "default rates" because of Ambac's below-investment-grade ratings (even though it had the option). Unlike other policyholders in the General Account, ALL/Lloyds was also not afforded the opportunity to continue to "forbear" the right to increase to a "default rate" that would have been the "trigger" to increase any potential claim under the Lloyds Policy.

The OCI witnesses also admitted that without access to the policy and loss data related to the other policies in the General Account, there was no method by which ALL and Lloyds could determine if the alleged material projected impairment on the Policies was comparable to the other policies in the General Account. (R. 600: 15-16.) Ambac could have supplied ALL/Lloyds with "redacted" versions of the list of policies left in the General Account from which ALL/Lloyds could determine if its policy's impairment was any worse than others left in the General Account. (Id. at 16-17.) However, no such data was provided to ALL/Lloyds, even though Ambac did possess the policy-by-policy loss data for the General Account. As discussed in the Consolidated Brief, the interested parties in the rehabilitation proceeding, including

ALL/Lloyds, made repeated information and discovery requests for information to test the validity of placement of particular policies in the Segregated Account. Those requests were repeatedly denied.

II. OCI FAILED TO FOLLOW THE REQUIREMENTS OF WIS. STAT. §§ 611.24(3)(a), 611.13, 611.19, AND 611.20 IN FORMING THE SEGREGATED ACCOUNT.

The Consolidated Brief establishes that the Segregated Account was not formed with "adequate capital and surplus" as required under the second sentence of Wis. Stat. 611.24(3)(a). (C.Br. at 38-46.) The circuit court also erred in relying in part on a "minimum capital and surplus" standard to conclude that the Commissioner had properly formed the Segregated Account (JA 233-234) because the first sentence of that same statute requires that the Commissioner have issued a "certificate of authority of [the] newly organized corporation." The record reflects that no such certificate of authority has ever been issued. (*See also* Wis. Stat. §§ 611.13, 611.19, and 611.20.) OCI witness Roger Peterson could not even recall if an "organizational permit" (required for a certificate of authority) was even issued. (R. 562: 164-169) Therefore, OCI formed the Segregated Account without the requisite certificate of authority and it should be declared void.

III. THE OCI'S EVIDENCE IN SUPPORT OF ITS ASSERTION THAT IT COMPLIED WITH WIS. STAT. §§ 611.24(3)(a) WAS ILLUSORY, WHOLLY UNSUPPORTED BY THE EVIDENCE AND BELIED BY THE EXPERT TESTIMONY.

OCI relied entirely on two documents, the Secured Note and the Reinsurance Agreement, as its support for its statement that the "the Segregated Account has access to all of the assets of Ambac, in *pari passu* with General Account policyholders." However, each of these documents has provisions that make payment to the Segregated Account's claimants contingent or conditional on various events that are unrelated to the policies that were originally issued by Ambac. Experts in the insurance and reinsurance industry opined that the key document upon which OCI relied, the Reinsurance agreement, could not have such contingencies and still be valid and enforceable. (R. 329: 5-7 (¶¶ 12-16); R. 330: (¶¶ 17-25.)) Without an effective reinsurance agreement, and as explained in detail in the Consolidated Brief, the Segregated Account did not have adequate capital or surplus. As the New York Court of Appeals decided just a few days ago, despite a state insurance regulator's approval an insurer's division of assets and liabilities into two insurers without providing fair consideration supports various claims, including the prohibition of fraudulent conveyances. *ABN Amro Bank, N.V. v. MBIA, Inc.*, 2011 N.Y. Slip. Op. 05542, 2011 WL 2534059, * 9 (N.Y. Court of Appeals June 28, 2011). More importantly, in this case the creation of the Segregated Account violated Wis. Stat. § 611.24(3)(a).

CONCLUSION

For all of these reasons, in the unlikely event that the Segregated Account is upheld, the ALL/Lloyds Policies should be allocated back to the General Account.

Dated: July 5, 2011

By /s/
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FORM AND LENGTH CERTIFICATION

I certify that this brief conforms to the rules contained in Wis. Stat. § 809.19(8)(b) and (c) and the Court's May 3, 2011 Order for a brief produced with a proportional serif font. The length of this brief is 2,154 words.

/s/

Lawrence Bensky

July 5, 2011

CERTIFICATION
(Wis. Stat. § 809.19(12))

I certify that the text of the electronic copy of this reply brief is identical to the paper copy of the brief.

/s/
_____
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July 5, 2011

CERTIFICATE OF SERVICE

I certify that on July 5, 2011, I caused three copies of this supplemental brief to be served by mail on the following:

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