STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10 CV 1576

THE ASSURED REINSURERS' BRIEF IN SUPPORT OF THEIR MOTION FOR A PARTIAL STAY PENDING APPEAL

SUMMARY OF ARGUMENT

Assured Guaranty Re Ltd. ("AG Re") and Assured Guaranty Corp. ("Assured Guaranty" and, together with AG Re, the "Assured Reinsurers") respectfully request a partial and conditional stay pending their appeal from the Court's June 14, 2011 Order Granting Rehabilitator's Motion to Enforce Injunction Against Assured Guaranty Corp. and Assured Guaranty Re Ltd. (the "Order"). The Assured Reinsurers seek to stay the Order only insofar as it requires the Assured Reinsurers to pay Ambac Assurance Corporation ("Ambac"), in cash, their proportionate share of the principal value of surplus notes delivered to the holders of policies allocated to the Segregated Account.

The Assured Reinsurers and the Rehabilitator have been in discussions concerning a stipulated stay of the Order while the Assured Reinsurers' appeal is pending. The parties have discussed stipulating to a stay, provided the Assured Reinsurers pay into an escrow account wherein the funds are invested in a conservative,

liquid account, such as a money market fund.[1] However, the parties reached an impasse when it came to the return that should accrue on the funds pending appeal. The Assured Reinsurers believe the return should be market-based, such that the prevailing party will keep whatever it is able to make during the dispute by investing the escrow payments in a money market fund. The Rehabilitator insists that if Ambac prevails on appeal, it be paid a guaranteed return of 5.1% per year, regardless of what the escrow account pays. The Assured Reinsurers believe its proposal is more reasonable and appropriate.

The Court has ample discretion and flexibility to impose a stay on terms it deems appropriate to the situation. In this instance, as discussed below, a stay is appropriate. Moreover, the Assured Reinsurers' market-based proposal fully serves the purpose underlying escrow interest, which is to compensate Ambac for the time-value of its money. Ambac will be compensated at the market rate for a low-risk investment under the Assured Reinsurers' proposal. In contrast, the Rehabilitator simply seeks a windfall. Neither Ambac nor any other investor can realistically achieve a 5.1% return under current market conditions in a newly opened, conservative and liquid account. Instead of paying Ambac for the time-value of its money, this guaranteed return would provide Ambac a generous rate of return associated with a higher risk and/or much longer term investment – but without any of the attendant risk or lack of liquidity.

[1] The Assured Reinsurers have also proposed that if Ambac wants to direct the funds into riskier investments, the Assured Reinsurers would be open to that as long as Ambac assumed the risk. The Rehabilitator, however, expressed preference for a safe, liquid account.

Since the parties are at an impasse, the Assured Reinsurers request that the Court enter a partial stay of the Order on the following basic conditions:

- The Assured Reinsurers will each open an interest-bearing escrow account in which to deposit the cash representing their proportionate share of surplus notes delivered to holders of policies allocated to the Segregated Account, as such amounts would be payable to Ambac under the Order.

- At the same time the Assured Reinsurers open the escrow account, Assured Guaranty will deposit $200,000 into the account, which represents Assured Guaranty's proportionate share of surplus notes delivered to the holder and beneficiaries of Segregated Account Policy number AB0632BE.

- While an appeal is pending, if the Segregated Account resolves other obligations with a payment of surplus notes, the Assured Reinsurers will deposit their proportionate share of the principal value of these notes into the escrow account as those amounts come due under the Order and the Assured Reinsurers' contracts with Ambac.

- The escrow agent will invest all escrowed funds in a money market fund (or funds), at the parties' direction.

- If the Assured Reinsurers ultimately do not prevail in their appeal, the escrow account will be paid to Ambac. In lieu of pre- or post-judgment interest, Ambac also will retain any interest or earnings on the escrow account's assets. If the Assured Reinsurers ultimately are successful on appeal, the escrow account (including any accrued interest or earnings) will revert to the Assured Reinsurers.

Such an escrow arrangement will ensure that Ambac receives all disputed payments, plus a return to compensate for the delay in receiving those payments, if the Assured Reinsurers' appeal is unsuccessful. Without the partial and conditional stay they request here, the Assured Reinsurers are likely to suffer substantial and irreparable harm if they prevail on appeal and then must try to recoup the amount of their past payments

from a financially troubled insurer. Finally, neither Ambac nor any interested parties or the public in general will be harmed by the limited relief the Assured Reinsurers seek.

FACTS

The Order awards two forms of relief against the Assured Reinsurers. First, it prohibits them from pursuing arbitration of their disputes with Ambac and requires them to withdraw a petition to compel arbitration that they filed in a New York state court. *See* Order ¶ 12 & p. 5 ¶ 1. Second, it requires the Assured Reinsurers to pay Ambac, in cash, their proportionate share of surplus notes delivered to holders of policies allocated to the Segregated Account. *See id.* ¶ 14 & pp. 5-6 ¶¶ 1, 3. The first of these cash payments is a $200,000 payment due, by stipulation of the parties, on August 5. *See* Aug. 1, 2011 Stipulation and Order. This motion concerns the second form of relief.

The Assured Reinsurers have appealed from the Order, and the court of appeals has accepted the appeal. Notwithstanding their appeal, the Assured Reinsurers promptly complied with the portion of the Order requiring them to withdraw their petition to compel arbitration in New York state court, by filing a stipulation to discontinue the New York proceeding. But the Assured Reinsurers seek a stay of the Order during the pendency of their appeal insofar as the Order requires them to pay Ambac, in cash, their proportionate share of surplus notes delivered to holders of policies allocated to the Segregated Account. Ambac has already entered into one commutation agreement involving payment in non-cash surplus notes. *See* Order ¶ 6. Future agreements and any claims paid under the court-approved Plan of Rehabilitation, many of which may occur during the pendency of the Assured Reinsurers' appeal, also will involve payment in

surplus notes, and may involve significantly larger sums than the $200,000 already at issue. *See id.* ¶ 7.

Shortly after the Order was entered, the Assured Reinsurers and the Rehabilitator began discussing terms for relief pending appeal. *See* June 28, 2011 Stipulation ¶ 3; July 8, 2011 Stipulation ¶ 3; July 19, 2011 Stipulation ¶ 3. The discussion concerned a stay until the dispute between the parties is resolved, provided the Assured Reinsurers pay into escrow whatever amounts come due under the Order in the meantime. Aff. of Josephine Benkers dated Aug. 3, 2011 ("Benkers Aff.") ¶ 3. The Assured Reinsurers sent a draft agreement, to which the rehabilitator responded with a demand that the funds be guaranteed by the Assured Reinsurers to yield 5.1% APR, regardless of what the escrow account actually earned. Benkers Aff. ¶¶ 4-5 & Exhs. A-B.[2] The Assured Reinsurers believe the return should be market-based, such that if the Assured Reinsurers ultimately lose the dispute, Ambac will keep the accrued interest on the account earned during the dispute. The Rehabilitator insists that Ambac receive a guaranteed return of 5.1% per year, regardless of what the escrow account pays.

The Assured Reinsurers and their attorneys have researched the market rate of return currently paid by conservative money market funds. In this market, returns

[2] The Rehabilitator also responded by sending a standard template of terms from Bank of New York Mellon, which the Assured Reinsurers have reviewed. Benkers Aff. ¶ 6 & Exhs. C-D. While there are a few minor issues yet to be discussed at the time of this filing with respect to those terms to make sure they reflect the present situation and do not conflict with the draft terms the Assured Reinsurers proposed, the Assured Reinsurers agree to use Bank of New York Mellon and to have the agreement on its template. They do not anticipate any of these items to result in an impasse that would cause a need for further court involvement.

generally fall well below the 5.1% range. Benkers Aff. ¶ 7. In fact, the Assured Reinsurers were quoted rates less than 0.1%. *Id.*

ARGUMENT

As noted above, the parties are at an impasse over the terms of a stay, namely the interest that should accrue on the funds set aside in a escrow account. Nevertheless, the first inquiry the Court must undertake is whether a stay is appropriate at all, which is addressed in Section I, below. Section II demonstrates that the Court has and should use its discretion to enter an order setting the terms of the escrow agreements consistent with current market rates for a safe, money market account, rather than requiring the much higher rate requested by the Rehabilitator.

I. Staying Enforcement of the Order Is an Appropriate Exercise of This Court's Discretion.

The Court should grant the Assured Reinsurers request for a partial stay pending appeal. Wisconsin Stat. § 808.07(2) grants courts broad discretion to stay the enforcement of a judgment or order during the pendency of an appeal. Wis. Stat. §808.09(2)(a)(intro.)-(1). Depending on the character of the judgment or order appealed from, two different standards can apply to a motion under § 808.07(2). *See Scullion v. Wisconsin Power & Light Co.*, 2000 WI App 120, ¶¶ 1 & 17, 237 Wis. 2d 498, 613 N.W.2d 565.

To the extent the order or judgment functions as a money judgment, the court must consider (1) the likelihood of the appellant's success on appeal, (2) the appellant's ability to file an undertaking or otherwise to provide security sufficient to ensure full

payment if the appeal is unsuccessful, and (3) the risk that the appellant will be unable to recover from the appellee if it pays the judgment now and then wins on appeal. *See Scullion*, 237 Wis. 2d 498, ¶¶ 18-21. The court may also consider, when relevant, the potential harm that a delay in payment would cause to the appellee or the public interest. *Id.* ¶¶ 22-23.

To the extent a judgment or order is an injunction and not a judgment for money, a stay is appropriate where the appellant "(1) makes a strong showing that it is likely to succeed on the merits of the appeal; (2) shows that, unless a stay is granted, it will suffer irreparable injury; (3) shows that no substantial harm will come to interested parties; and (4) shows that a stay will do no harm to the public interest." *State v. Gudenschwager*, 191 Wis. 2d 432, 440, 529 N.W.2d 225 (1995).

Although the Order is framed as one enforcing an injunction, the Assured Reinsurers seek a stay of the Order only insofar as it enjoins them to pay money – that is, insofar as the Order functions as the equivalent of a money judgment. The Assured Reinsurers' motion for a stay therefore should be analyzed under the *Scullion* standard applying to motions to stay the enforcement of money judgments. However, even if the motion is analyzed under the *Gudenschwager* standard applicable to injunctions, the result is no different. The Assured Reinsurers easily meet both tests.

A. A Stay is Appropriate Under the *Scullion* Test.

1. There is more than a "mere possibility" the Assured Reinsurers will succeed on appeal.

To satisfy *Scullion*'s first factor, relating to the likelihood of success on appeal, an appellant of course need not persuade the trial court that "there is a high probability that it has just erred." *Scullion*, 237 Wis. 2d 498, ¶ 18. If the appellant could meet that burden, it should be filing a motion for reconsideration rather than a motion for a stay. Instead, the appellant must only establish "more than a 'mere possibility'" that the appeal will be successful. *Id.* (quoting *Gudenschwager*, 191 Wis. 2d at 441).

The standard of appellate review, the existence of clear and binding precedent on point, and the complexity of the issues on appeal are relevant to whether the appellant has more than a "mere possibility" of success on appeal. When "the de novo standard of review for legal issues [applies], if there is not clear and binding precedent on point, and if the circuit court concludes the issue is a close one or a complex one, the likelihood of success on appeal will generally be greater." *Id.* ¶ 19. The Assured Reinsurers can demonstrate more than a mere possibility of success on appeal under this standard.

First, the principal issues the Assured Reinsurers may raise on appeal are subject to the court of appeals' *de novo* review:

(1) **Issue #1:** Does this Court have personal jurisdiction over AG Re? **Standard:** Personal jurisdiction is a question of law that the court of appeals reviews *de novo*. *Capitol Fixture v. Woodma Distributors*, 147 Wis. 2d 157, 160, 432 N.W.2d 647 (Ct. App. 1988).

(2) **Issue #2:** Does the Court's March 24, 2010 Order for Temporary Injunctive Relief (the "Injunction") enjoin the Assured Reinsurers from arbitrating a dispute about their contracts with Ambac (the "Reinsurance

Agreements")? **Standard:** The meaning of a court order is a question of law that the court of appeals reviews *de novo*. *Park v. Health*, 2007 WI App 176, ¶ 13, 304 Wis. 2d 512, 737 N.W.2d 88.

(3) **Issue #3:** Is the Rehabilitator equitably estopped from arguing that the Injunction enjoins the Assured Reinsurers from arbitrating a dispute about the Reinsurance Agreements? **Standard:** "When the facts and reasonable inferences therefrom are not disputed, it is a question of law whether equitable estoppel has been established." *Milas v. Labor Ass'n of Wisconsin, Inc.*, 214 Wis. 2d 1, 8, 571 N.W.2d 656. The appellate courts review this question *de novo*. *Id.*

(4) **Issue #4:** Under the McCarran-Ferguson Act, are the Assured Reinsurers' rights under the Federal Arbitration Act reverse preempted? **Standard:** The interpretation of a statute and its application to a given set of facts is a question of law that the court of appeals reviews *de novo*. *Klemm v. American Transmission Co.*, 2011 WI 37, ¶ 17, __ Wis. 2d __, __ N.W.2d __.

(5) **Issue #5:** Does the Injunction require the Assured Reinsurers to pay, in cash, a proportionate share of payments made in non-cash surplus notes? **Standard:** The meaning of a court order is a question of law that the court of appeals reviews *de novo*. *Park*, 304 Wis. 2d 512, ¶ 13.

(6) **Issue #6:** Was the contract dispute between the Assured Reinsurers and Ambac properly raised by motion and adjudicated in the rehabilitation proceeding? **Standard:** The court of appeals must interpret provisions of Chapter 645 and must consider the Assured Reinsurers' constitutional due process rights when determining whether it was appropriate to adjudicate the contract dispute between Ambac and the Assured Reinsurers upon a motion in the rehabilitation proceeding. The interpretation of a statute and its application to a given set of facts is a question of law that the court of appeals reviews *de novo*. *Klemm v. American Transmission Co.*, 2011 WI 37, ¶ 17, __ Wis. 2d __, __ N.W.2d __. So is the question whether the Assured Reinsurers were afforded due process. *Xerox Corp. v. Wis. Dep't of Revenue*, 2009 WI App 113, ¶ 12, 321 Wis. 2d 181, 772 N.W.2d 677.

(7) **Issue #7:** Do the Reinsurance Agreements permit the Assured Reinsurers to demand arbitration of their contract dispute with Ambac? **Standard:** Contract interpretation presents a question of law that the court of appeals reviews *de novo*. *Johnson v. Heritage Mut. Ins. Co.*, 188 Wis. 2d 261, 265, 525 N.W.2d 85 (Ct. App. 1994).

> **Issue #8:** Do the Reinsurance Agreements require the Assured Reinsurers to pay, in cash, a proportionate share of payments made in non-cash surplus notes? **Standard:** Contract interpretation presents a question of law that the court of appeals reviews *de novo*. *Johnson v. Heritage Mut. Ins. Co.*, 188 Wis. 2d 261, 265, 525 N.W.2d 85 (Ct. App. 1994).

Second, no precedential case has dealt with the precise situation here. No Wisconsin appellate decision concerns a Chapter 645 rehabilitator's attempt to enforce a rehabilitation court's injunction against a reinsurer that is party to a reinsurance contract allocated to the general account of an insurer whose segregated account is in rehabilitation. There are also no Wisconsin appellate decisions concerning a reinsurer's obligation to pay, in cash, its proportionate share of non-cash surplus notes delivered by the insurer to commute policies or settle claims. Nor do any Wisconsin appellate decisions decide whether a rehabilitation court has personal jurisdiction over a reinsurer that has not been served under § 801.11 and has done business with a Wisconsin-domiciled insurer based out of state, or whether a rehabilitator is subject to equitable estoppel under facts approximating those of the present case. The Assured Reinsurers' appeal therefore will involve questions that cannot be decided through rote application of precedent.

Third, the Assured Reinsurers' appeal involves complex issues for which the Assured Reinsurers uniformly have strong supporting arguments. The Court's decision granting the Rehabilitator's motion against the Assured Reinsurers does not preclude a finding that more than a mere possibility exists that the Assured Reinsurers' arguments will prevail on appeal. Briefly summarized, the Assured Reinsurers intend to make the following arguments to the court of appeals:

1. **This Court lacks jurisdiction over AG Re.** The Assured Reinsurers argued to this Court that the Rehabilitator failed to serve Ag Re pursuant to Wis. § 801.11, that no substantive grounds for jurisdiction exist under any long-arm statute, and that the Due Process Clause precludes jurisdiction in any event. *See* May 9, 2011 Br. of Assured Guaranty Re Ltd. and Assured Guaranty Corp. in Opp'n to Rehabilitator's Motion to Enforce Inj. ("Assured Reinsurers' Br. in Opp'n") at 14-18. The Rehabilitator asserted that the Court has jurisdiction under Wis. Stat. § 645.04(5), which expressly relates to jurisdiction over certain persons "served pursuant to s. 801.11," yet still denied that he had any obligation to serve AG Re pursuant to § 801.11. *See* May 16, 2011 Rehabilitator's Reply in Supp. of Mot. to Enforce Inj. Against Assured Guaranty Corp. and Assured Guaranty Re Ltd. ("Rehabilitator's Reply Br.") at 16, 19-21.

2. **The Injunction does not enjoin the Assured Reinsurers from arbitrating their contract dispute with Ambac**. When initiating the rehabilitation proceeding, the Rehabilitator defined the limit of the relief he sought: "there is a bright-line separation between what we're asking [the Court] to do as part of the rehabilitation proceeding as to the [S]egregated [A]ccount, not you know, tainting or affecting or spilling over into the affairs of the general account." Mar. 24, 2010 Hr'g Tr. at 9:15-19. Accordingly, the Injunction explicitly states that it "*does not apply* to policies or other contracts which remain in the Ambac General Account." Injunction at 1 (emphasis added). It is undisputed that the Assured Reinsurers' contracts with Ambac remain in the Ambac General Account and that the parties' dispute concerns the Assured Reinsurers' rights and duties under these General Account contracts. The Order is incorrect in

concluding that this dispute is one "in respect of the Segregated Account or policies (including financial guarantee insurance policies and surety bonds), contracts or liabilities allocated to the Segregated Account." Order ¶ 11 (quoting Injunction ¶ 1).

The Order also expands the Injunction's scope beyond its stated intent. The Wisconsin courts long have held that "an injunction order must be construed strictly in favor of the person charged with violating it." *Wisconsin Central Railroad Co. v. Smith*, 52 Wis. 140, 8 N.W. 613, 614 (1881). In seeking the Injunction, the Rehabilitator explained that the Injunction was needed to prevent *Segregated Account policyholders and contract counterparties* from terminating their policies or contracts, seeking immediate payment of their claims against the Segregated Account, ceasing payments of premiums or other amounts they owed on Segregated Account policies, or initiating lawsuits concerning their Segregated Account policies. *See* Mar. 24, 2010 Br. in Supp. of Mot. for Temp. Inj. Relief ("Injunction Br.") at 2-3, 9-11. The Assured Reinsurers, which are neither Segregated Account policyholders nor contract counterparties, lie outside the Injunction's intended scope.

Further, the Rehabilitator's counsel himself confirmed the Injunction's scope in emails to the Assured Reinsurers. In June 2010, counsel for the Rehabilitator told the Assured Reinsurers that the Injunction "does not apply to enjoin any actions that Assured Guaranty or its affiliates may take under the insurance agreements (including . . . demanding arbitration in accordance with the terms of the agreement)." Aff. of Alexander R. Cochran filed May 9, 2011 ("Cochran Aff.") ¶ 9 & Ex. B. Later, he represented a second time that, with an exception not applicable here, disagreements

about the Reinsurance Agreements would "remain subject to arbitration (consistent with the contract)." *Id.* ¶ 15 & Ex. D. Before changing his mind a few months ago, even the Rehabilitator understood that the Injunction does not enjoin actions taken under the Reinsurance Agreements.

3. **The Rehabilitator is equitably estopped from arguing that the Injunction enjoins the Assured Reinsurers from arbitrating their contract dispute with Ambac**. The representations by counsel for the Rehabilitator also equitably estop the Rehabilitator from taking a contradictory position now. The Assured Reinsurers provided ample evidence that they relied on the Rehabilitator's representations when deciding not to object to the Injunction or to the Rehabilitator's Plan of Rehabilitation. *See* Assured Reinsurers' Br. in Opp'n at 27-29; *see also* Aff. of James M. Michener filed May 9, 2011 ("Michener Aff.") ¶¶ 6, 16; Supplemental Aff. of James M. Michener filed June 7, 2011, ¶¶ 3 & 10-11; Aff. of Michael E. Wiles filed June 7, 2011, ¶ 15; Aff. of Wolcott B. Dunham, Jr. filed June 7, 2011, ¶ 14.

4. **The Assured Reinsurers' rights under the Federal Arbitration Act are not reverse preempted**. The Order concludes that under the McCarran-Ferguson Act, "[t]he Injunction preempts and renders inapplicable any . . . conflicting federal statutes," including "[t]he Federal Arbitration Act." Order ¶ 10. But the McCarran-Ferguson Act "bars application of the [Federal Arbitration Act] to insurance contracts only in the context of a *state statute* evincing the same . . . ." *American Heritage Life Ins. Co. v. Orr*, 294 F.3d 702, 708 (5th Cir. 2002) (emphasis in original); *see also* 15 U.S.C § 1012 ("No Act of Congress shall be construed to . . . supersede *any law enacted by any state*

for the purpose of regulating the business of insurance." (emphasis added)). Unlike a statute, a court order is not "enacted by [a] state" and thus cannot trigger reverse preemption.

5. **The Injunction does not require the Assured Reinsurers to pay, in cash, a proportionate share of payments made in non-cash surplus notes.** As explained above, the Injunction expressly has no application to contracts that, like the Reinsurance Agreements, remain in the Ambac General Account. The Assured Reinsurers therefore did not violate the Injunction's prohibition against withholding payments "to . . . the Ambac General Account *under or in connection with policies or contracts allocated to the Segregated Account*." Order ¶ 13 (quoting Injunction ¶ 7) (emphasis added). The Rehabilitator sought this paragraph of the Injunction so that policyholders or contract counterparties would "continue to pay the premiums they owe on *the policies allocated to the Segregated Account* and to make payments due on *contracts insured by the policies in the Segregated Account*." Injunction Br. at 3 (emphasis added). This paragraph of the Injunction has nothing to with the Reinsurance Agreements, which are neither policies allocated to the Segregated Account nor contracts insured by policies in the Segregated Account.

The Assured Reinsurers also do not "owe" the disputed payments to Ambac in the first place. *See* Order ¶ 14. Whether the Assured Reinsurers owe these payments depends on how the Reinsurance Agreements are construed. As explained in connection with issues #6-8 below, this question of contract interpretation was not properly before the Court, and the Order in any event misconstrues the Reinsurance Agreements.

6. **The contract dispute between the Assured Reinsurers and Ambac was not properly raised or adjudicated in the rehabilitation proceeding.** The Rehabilitator's motion against the Assured Reinsurers purported to seek only enforcement of the Injunction – not an order declaring and enforcing the parties' rights under the Reinsurance Agreements. *See* Apr. 15, 2011 Notice of Mot. and Mot. to Enforce Inj. Against Assured Guaranty Corp. and Assured Guaranty Re Ltd. at 1 (moving the Court "to enforce its March 24, 2010 injunction against parties-in-interest Assured Guaranty Corp. and Assured Guaranty Re Ltd."). Nevertheless, two of the Order's paragraphs adjudicate the Assured Reinsurers' contract rights and obligations. *See* Order ¶ 15 (construing the Reinsurance Agreements' arbitration and insolvency clauses); *id.* ¶ 16 (construing an unspecified clause in the Reinsurance Agreements).

Even if the Rehabilitator's motion had sought such relief, Chapter 645 did not authorize the Court to adjudicate a contract dispute involving Ambac – but not the Segregated Account, which is the delinquent insurer – as a party. Section 645.34 simply requires other Wisconsin courts to stay actions against an insurer in rehabilitation "for such time as is necessary for the rehabilitator to obtain proper representation and prepare for further proceedings." Wis. Stat. § 645.34(1). No provision in Chapter 645 states that litigation involving the insurer in rehabilitation – much less related litigation to which that insurer is not even a party – should be adjudicated by the rehabilitation court.

The absence of such authorization makes sense, because "[a] rehabilitation proceeding is *not an adversarial litigation* designed to adjudicate the diverse and divergent interests of each policyholder." July 16, 2010 Order Denying Mots. of Wells

Fargo Bank and Certain LVM Bondholders and Emergency Mots. to Postpone the July 9, 2010 Hr'g on the Mots. of Wells Fargo Bank and Certain LVM Bondholders at 7 (emphasis added; quoting a brief by Ambac). Even in a liquidation proceeding, the liquidator is empowered to initiate litigation *but not as a mere subcomponent of the liquidation proceeding*. *See* Wis. Stat. 645.46(12) (liquidator authorized to "institute in the name of the insurer or in his or her own name any suits and other legal proceedings, *in this state or elsewhere* . . . ." (emphasis added)). A rehabilitation proceeding should not encompass a discrete dispute that would not have been appropriate even in a liquidation.

Finally, even if the rehabilitation proceeding were an appropriate place for adversarial litigation, the Assured Reinsurers were denied the procedures that ordinarily attend litigation, such as pleadings, discovery, dispositive motion practice, and trial. The Court resolved this dispute based solely on the Rehabilitator's motion, a set of briefs and affidavits in support or opposition, and a single hearing, without testimony. Unlike past receivers, the Rehabilitator did not try to initiate a discrete action against the Assured Reinsurers that might have afforded due process. *Contrast All-Star Insurance Corp.*, 110 Wis. 2d 72, 74, 327 N.W.2d 648 (1983) (liquidator commenced discrete actions against defendants to recover money due under contracts); App. to Appellant's Br. [in *All-Star Ins. Corp.*] at 1-4 and App. of Def.App. Lee M. Scarborough & Co. [in *All-Star Ins. Corp.*] at i & 101-13, found in 4127 *Appendices and Briefs*, 110 Wis. 2d 58-118, at tab 2 (Wis. State Law Library) (appending copies of the summonses and complaints served on the *All-Star Ins. Corp.* defendants).

7. **The Reinsurance Agreements permit the Assured Reinsurers to demand arbitration of their contract dispute with Ambac.** The Reinsurance Agreements both state, in relevant part, that disputes arising out of those contracts must be arbitrated unless "the Company is subject to Proceedings [under Chapter 645 of the Wisconsin Statutes]." Order ¶ 5; Michener Aff. Ex. A, art. 15; *id.* Ex. B, art. 16. The Order concludes that "the Company is subject to [Chapter 645] Proceedings" within the meaning of these contract provisions. Order ¶ 15. But "the Company" is not subject to Chapter 645 proceedings, because "the Company" is defined as Ambac in one contract and as Ambac plus Ambac Assurance UK Limited ("Ambac U.K.") in the other. *See* Michener Aff. Ex. A at 1; *id.* Ex. B at 1. Neither Ambac nor Ambac U.K. is subject to a Chapter 645 proceeding. The only insurer being rehabilitated is the Segregated Account. *See* Oct. 8, 2010 Disclosure Statement Accompany Plan of Rehabilitation ("Discl. St.") at 1 ("NEITHER [AMBAC] NOR ITS GENERAL ACCOUNT, NOR ANY OF THE POLICIES, CONTRACTS, ASSETS, EQUITY OWNERSHIP INTERESTS AND RIGHTS OR LIABILITIES IN THE GENERAL ACCOUNT, IS IN REHABILITATION AS PART OF THE PROCEEDING OR OTHERWISE.").

The Rehabilitator, in fact, has repeatedly stressed that the Chapter 645 proceeding against the Segregated Account is *not* a proceeding against Ambac. In opposing an emergency motion for injunctive relief, the Rehabilitator presented an affidavit stating that "OCI's statutorily mandated interest in protecting the best interests of policyholders generally, and the public, would be disserved by needlessly subjecting the vast majority of Ambac's sound policies to rehabilitation." Aff. of Roger A. Peterson filed May 20,

2010, ¶ 9(a)(v). In a letter to the Securities and Exchange Commission on behalf of the Segregated Account, the Rehabilitator's counsel also represented that "[t]he Rehabilitation does not include Ambac Assurance, its general account or [Ambac Financial Group, Inc.]." Letter from Steven R. Barth (Nov. 11, 2010) at 1, Tab 6 of the May 9, 2011 App. of Assured Guaranty Re Ltd. and Assured Guaranty Corp. in Opp'n to Rehabilitator's Mot. to Enforce Inj. *See also, e.g.*, June 10, 2010 Br. in Opp'n to Wells Fargo's Mot. to Modify Temp. Inj. Order and to Intervene at 4 ("OCI determined that placing Ambac as a whole into a rehabilitation proceeding would trigger material damages to the detriment of all policyholders."); June 30, 2010 Br. in Opp'n to the LVM Movants' Various Mots. Pertaining to Inclusion of the LVM Bond Policy in the Segregated Account at 12 (potential adverse consequences "clearly presented a rational basis for choosing to establish and rehabilitate the Segregated Account in lieu of commencing the rehabilitation of Ambac as a whole"); Aug. 17, 2010 Rehabilitator's Consol. Br. in Opp'n to All Mots. Scheduled for Hr'g on Sept. 9, 2010 at 5 ("Blindly swinging the sledgehammer of a full-blown rehabilitation or liquidation of Ambac, as Movants implicitly suggest as their preferred alternative, would not better serve the purpose of '[e]quitable apportionment of any unavoidable loss.'").

8. **The Reinsurance Agreements do not require the Assured Reinsurers to pay, in cash, a proportionate share of payments made in non-cash surplus notes.** In concluding that the Reinsurance Agreements require the Assured Reinsurers to make the disputed payments, in cash, the Order relies on the Reinsurance Agreements' insolvency clauses, which apply when "Proceedings . . . against the Company pursuant to

Chapter 645 of the Wisconsin Insurance Code" have been initiated. Order ¶¶ 4, 15. But for the reasons given above, these provisions do not apply. The Rehabilitator has not initiated rehabilitation proceedings against "the Company," which the Reinsurance Agreements define to mean Ambac or Ambac plus Ambac U.K.

The Order also is contrary to the Reinsurance Agreements' provision stating that that the Assured Reinsurers' interest and liability will "follow the fortunes" of Ambac. Michener Aff. Ex. A, art. 5; *see also id.* Ex. B, art. 6 (reinsurers' liability "shall follow that of [Ambac]"). In the settlement context, this language requires application of the "follow-the-settlements doctrine," a fundamental tenet of reinsurance law that generally obligates a reinsurer to pay its proportionate share of a settlement entered into by the entity it is reinsuring, whether that settlement is beneficial or burdensome. *See generally N. River Ins. Co. v. ACE Am. Reins. Co.*, 361 F.3d 134, 139-40 (2d Cir. 2004).

The Order deviates from the follow-the-settlements doctrine here, because it requires the Assured Reinsurers to pay a share of the surplus notes' principal value in cash even though the Commissioner has absolute discretion over when – and whether – to pay the surplus notes, and even though the Rehabilitator and Ambac did not even attempt to prove that the surplus notes have a value equal to or approximating their principal amounts. The cash payments required of the Assured Reinsurers do not follow the payments made in non-cash surplus notes. They instead provide a potential windfall to Ambac, allowing it to count surplus notes that may never actually be paid as the equivalent of an immediate cash loss entitling them to an immediate infusion of cash from the Assured Reinsurers.

2. The escrow arrangement proposed by the Assured Reinsurers will ensure that Ambac receives all disputed payments, plus interest or earnings to compensate for the delay in receiving those payments, if the Assured Reinsurers' appeal is unsuccessful.

If the Assured Reinsurers are unsuccessful in their appeal, Ambac will receive from escrow all payments that have come due under the Order plus the entire return that Ambac has been able to earn in the market by investing the escrow payments in a money market fund. As explained in Section II below, this arrangement would adequately compensate for the delay in Ambac's receipt of payments under the Order.

3. There is a substantial risk the Assured Reinsurers will be unable to recover from Ambac if they make the disputed cash payments now and then prevail on appeal.

"[T]he right to appeal a money judgment is not a meaningful one if the money must be paid pending appeal and cannot later be recovered." *Scullion*, 237 Wis. 2d 498, ¶ 21. Yet if the Assured Reinsurers pay Ambac now, in cash, for their share of the principal amounts of surplus notes delivered to holders of policies allocated to the Segregated Account, they will risk losing that cash if the court of appeals determines that the Assured Reinsurers should not have been compelled to pay it. The possibility that Ambac will be unable to repay the Assured Reinsurers down the road is very real. Ambac's financial condition indisputably is poor, which is why the Rehabilitator created the Segregated Account and initiated this rehabilitation proceeding. *See* Mar. 24, 2010 V. Pet. for Order of Rehabilitation ¶¶ 5-8.

4. Ambac will not be harmed by any delay in payment of the Assured Reinsurers' share of settlement payments made in surplus notes.

The lack of harm to Ambac is first established because, as explained in Section II below, the escrow arrangement proposed by the Assured Reinsurers will ensure that Ambac receives all disputed payments, plus interest or earnings to compensate for the delay in receiving those payments, if the Assured Reinsurers' appeal is unsuccessful. "In most cases the undertaking, other security or demonstrated proof of financial ability to ultimately pay the judgment plus interest for the delay in paying the judgment, will make the ultimately successful respondent whole." *Scullion*, 237 Wis. 2d 498, ¶ 22.

Nor can the Rehabilitator or Ambac claim that Ambac needs the cash now, because the point of the surplus notes is to relieve Ambac of the need to pay cash to policyholders at this time. In fact, because the Rehabilitator, in his capacity as the Commissioner of Insurance, has "absolute discretion in determining whether to allow payments to be made on the Surplus Notes," Discl. St. at 39, Ambac need not pay down the surplus notes at any specific time.

5. The public interest will not be harmed by any delay in payment of the Assured Reinsurers' share of settlement payments made in surplus notes.

"[I]n the usual money judgment appeal," the public interest "is not a relevant consideration and will not weigh either in favor of or against a stay." *Scullion*, 237 Wis. 2d 498, ¶ 23. This is no less true in this case than in others. The partial, conditional stay sought by the Assured Reinsurers will have no effect on the public.

B. In the Alternative, a Stay Is Appropriate Under the *Gudenschwager* Test.

1. The Assured Reinsurers have made a strong showing that they are likely to succeed on the merits of their appeal.

Like the *Scullion* test, the *Gudenschwager* test does not require an appellant to persuade the trial court that there is "a high probability of success on the merits." *Gudenschwager*, 191 Wis. 2d at 441. The appellant instead must demonstrate "more than the mere 'possibility' of success on the merits." *Id.* "[T]he probability of success that must be demonstrated" also is "inversely proportional to the amount of irreparable injury the [appellant] will suffer absent the stay." *Id.*

For the reasons given above, the Assured Reinsurers have considerably more than a mere possibility of success on the merits of their appeal. First, the principal issues the Assured Reinsurers will raise on appeal are subject to the court of appeals' *de novo* review. Second, no precedential case has dealt with the precise situation presented here. Third, the Assured Reinsurers' appeal involves complex issues for which the Assured Reinsurers have strong supporting arguments.

2. The Assured Reinsurers will suffer irreparable injury unless a stay is granted.

For this factor of the *Gudenschwager* analysis, "[t]he harm alleged must be evaluated in terms of its substantiality, the likelihood of its occurrence, and the proof provided by the movant." *Id.* at 441-42. Here, the Assured Reinsurers would face a high likelihood of substantial harm without a stay.

The likelihood of harm absent a stay would be high because, as explained above, if the Assured Reinsurers pay Ambac with cash now for their share of payments Ambac has made in surplus notes, they will risk losing that cash, if the court of appeals determines that the Assured Reinsurers should not have been compelled to pay it, because Ambac may be unable to repay the Assured Reinsurers given its indisputably troubled financial condition.

The injury the Assured Reinsurers would suffer without repayment also would be substantial. Under the Order, the Assured Reinsurers are liable to pay 6.6667 percent of $3 million in surplus notes delivered in connection with just one commutation. Order ¶ 6. As the Court has recognized, future settlements also will involve surplus notes, likely resulting in additional liability for the Assured Reinsurers. *See* Order ¶ 7.

3. A stay will cause no harm to interested parties.

A stay would cause harm to interested parties only if it harmed Ambac's ability to make cash payments that come due during the pendency of the appeal, or after the appeal assuming the Assured Reinsurers do not prevail. Such harm will not be realized after the appeal, because the escrow arrangement proposed by the Assured Reinsurers will ensure that Ambac receives all disputed payments, plus interest or earnings to compensate for the delay in receiving those payments, if the Assured Reinsurers' appeal is unsuccessful. Nor will such harm come about while the appeal is pending. Ambac is not required to pay the surplus notes at any specific time; instead, the Rehabilitator already has, in his capacity as Commissioner of Insurance, "absolute discretion in determining whether to allow payments to be made on the Surplus Notes." Discl. St. at 39.

4. A stay will not harm to the public interest.

The public interest is also a factor in the *Scullion* analysis and is discussed above. For the reasons given there, the public interest will not be harmed if the Court grants the stay requested by the Assured Reinsurers.

II. A Market-Based Return Will Serve the Purpose of Escrow Interest by Compensating Ambac for the Time-Value of Its Money.

This Court should condition a stay using an escrow arrangement proposed by the Assured Reinsurers, whereby the funds simply accrue the interest that a safe money market account generates.

Wisconsin Stat. § 808.07(2) grants courts broad discretion to stay the enforcement of a judgment or order during the pendency of an appeal, and to fashion the terms of such a stay to be appropriate to the situation at hand. When money due under a judgment or order is to be paid into escrow during an appeal, the matter of interest is put to the circuit court's discretion. The court has discretion not to require payment of any interest at all. *See Estate of Matteson v. Matteson*, 2008 WI 48, ¶ 79, 309 Wis. 2d 311, 356, 749 N.W.2d 557 ("[I]n some cases, executions may be stayed, *tolling interest* . . . ." (emphasis added)); *see also Downey, Inc. v. Bradley Center Corp.*, 188 Wis. 2d 435, 449, 524 N.W.2d 915 (Ct. App. 1994) (post-judgment interest stops accruing once judgment payor has "surrendered the funds and no longer has use of the money"; interest accrues only until judgment is paid, not "until the judgment *is paid to the prevailing party*" (emphasis in original)). It is well within a trial court's discretion to reqire that interest accrue at a market-based rate. *Management Computer Services, Inc. v. Hawkins, Ash,*

Baptie & Co., 224 Wis. 2d 312, 317, 331-32, 592 N.W.2d 279 (Ct. App. 1998) (affirming circuit court's decision to require payment of a "market rate of interest," accomplished by distributing escrow proceedings "to several banks in order that the deposits would earn interest").

Sound policy underpins the rule that post-judgment interest is not required when a judgment has been paid into escrow. Escrow payments eliminate a chief concern that post-judgment interest is meant to address: the "incentive for judgment debtors to timely pay amounts determined due." *Id.* at 332. To the extent a court requires any interest to accrue on funds held in escrow, it may impose this requirement only to compensate the prevailing party for "the time-value of [its] money." *Id.* at 331. The losing party's incentives are simply not at issue.

The Assured Reinsurers' escrow proposal would adequately compensate Ambac for the time-value of its money. Ambac would be compensated at the rate determined by the market for low-risk money market investments. The Assured Reinsurers' proposal thus is substantially similar to the one approved in *Management Computer Services*, where the circuit court ordered escrow funds to be distributed to banks to earn a market rate of interest. *See Management Computer Services, Inc. v. Hawkins, Ash, Baptie & Co.*, 224 Wis. 2d at 317 & 331-32.

The Rehabilitator, in contrast, demands a windfall. A 5.1% return on a low-risk, newly opened, investment is not possible in the current market. If it were, the Rehabilitator would not need to ask the Assured Reinsurers to guarantee that return. The Rehabilitator essentially asks to enjoy the safety of a liquid, low-risk investment while

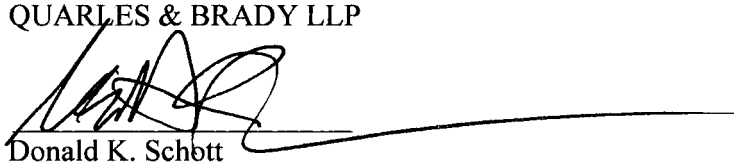
simultaneously reaping a return that, in the market, would be available only to investors willing to incur a much higher level of risk. Ambac could not use the funds due under the Order to earn the guaranteed 5.1% annual return it seeks from the Assured Reinsurers. Under the terms the Rehabilitator insists upon, a stay pending appeal would not preserve the status quo – it would be a mechanism for the Rehabilitator to make unusual profits at the Assured Reinsurers' expense were it to prevail on appeal. The Court should adopt the Assured Reinsurers' proposal, granting a stay conditioned on the payment of the funds at issue into interest bearing escrow accounts, without further guarantee of any higher rate of return than that earned in the accounts.

CONCLUSION

For the reasons set forth, the Assured Reinsurers respectfully request that the Court grant their motion for a partial stay pending appeal and stay its June 14, 2011 Order, on the conditions described above, insofar the Order requires the Assured Reinsurers to pay Ambac in cash for their proportionate share of the principal value of surplus notes delivered to holders of policies allocated to the Segregated Account.

Dated this 3rd day of August, 2011.

QUARLES & BRADY LLP

By: 

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Note: Assured Guaranty Re Ltd. appears without waiving its objection to personal jurisdiction.