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

OBJECTION TO MOTION TO CONFIRM PROCEDURES FOR RESOLVING CLAIMS THROUGH ALTERNATIVE RESOLUTIONS INCLUDING SYNTHETIC COMMUTATIONS

Aurelius Capital Management, LP, in its capacity as owner of or manager of funds that own residential mortgage-backed securities insured by Ambac Assurance Corporation ("AAC"), by its attorneys, hereby objects to the Rehabilitator's Motion to Confirm Procedures for Resolving Claims Through Alternative Resolutions Including Synthetic Commutations (the "Motion"). For the reasons set forth below, the Court should deny the Motion.

OBJECTION

Despite the fact that the Rehabilitator has announced concerns with the feasibility of the Rehabilitation Plan, he now asks the Court to approve procedures to resolve claims of Segregated Account claimants. At this point in time, no one, including the Rehabilitator, AAC, or the Court, can assess whether settlements, in the form of commutations or otherwise, are equitable to the interests of Segregated Account claimants – a requirement for any possible settlement. Although the Rehabilitator's confirmed Rehabilitation Plan contemplates a 25/75 payment of cash and surplus notes, that Plan has sat dormant for over seven months and the Rehabilitator is contemplating amendments to the Plan that might reduce recoveries for claimants. (*See* Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation ("June 1 Report"), at 6 (June 1, 2011).)

Any settlements entered into could be more favorable than what the Plan ultimately provides to claimants, which would make the settlements inequitable in violation of Wisconsin law. For example, if the Rehabilitator agrees to pay a claimant 25% of its claim in cash and 25% of its claim in surplus notes, such a settlement would be inequitable, unjust, and unlawful if the Rehabilitation Plan is amended to eliminate the issuance of surplus notes – something the Rehabilitator is already contemplating. (*See* June 1 Report, at 6 ("Such amendments to the Plan could include the elimination of the issuance of surplus notes by the Segregated Account . . . .") Similarly, a commutation in which a claimant receives 50% of its claim in cash would be inequitable, unjust, and unlawful if the Plan is amended to reduce the 25% cash component and eliminate the payment of surplus notes.

Any settlements independent of the confirmed Rehabilitation Plan, and at a time when the Rehabilitator has not communicated any clear expectations for a rehabilitation plan to the Court or claimants, should be rejected. The Court should deny the Motion because: (1) the Rehabilitator may not pursue any commutations when the Plan of Rehabilitation is not yet effective and is likely subject to revision; and (2) the scheme for secret commutations permits the Rehabilitator to continue his disturbing trend of carrying out this rehabilitation in secrecy, in violation of Wisconsin law and the public statements of the Rehabilitator.

I. Commutations Are Inappropriate When The Future of the Plan, and the Rehabilitation Itself, Are In Serious Doubt.

Wisconsin law provides that the Office of the Commissioner of Insurance ("OCI"), acting here through the Rehabilitator, must treat policyholders "fairly and equitably" and manage insurer rehabilitations so as to ensure the "equitable apportionment of any unavoidable loss." Wis. Stat. §§ 601.01(2), 645.01(4)(d). At this time, pursuing a strategy of selective commutations would violate these statutory requirements.

A. There is uncertainty as to the future of the Rehabilitation.

Although the Rehabilitator's confirmed Rehabilitation Plan contemplates payment of allowed claims with 25% cash and 75% surplus notes, that Plan has sat dormant for over seven months.[1] In the Motion, the Rehabilitator notes that he "has not designated an effective date for the Plan, as the Rehabilitator is not satisfied that all of the conditions precedent to effectiveness of the Plan set forth in Section 5.01 of the Plan have been satisfied." (Motion, at 3.) The Rehabilitator has not indicated which of the conditions necessary for consummation listed in Article 5.01 of the Plan are unsatisfied, when the situation may be resolved, and when the Rehabilitator expects the Plan to go into effect.

Indeed, at the present time, it appears that the Rehabilitation itself is in suspense. Pursuant to this Court's Orders, Policyholders in the Segregated Account are required to continue paying premiums on their policies, and recoveries on the insured instruments are being used by AAC for the benefit of the General Account. Yet 18 months into the rehabilitation, the policyholders in the Segregated Account have received nothing on their valid claims. Their assets are being used to fund AAC and the General Account, with no prospect of even the meager return offered by the Plan.

It appears that this situation may continue for the foreseeable future. The Rehabilitator has reported that this entire Plan process might be derailed because tax considerations that the Rehabilitator did not originally contemplate may prevent implementation of the Plan's key provisions. In his June 1, 2011 status report, the Rehabilitator said he is considering certain undisclosed modifications to the Plan based on potential adverse consequences of certain tax issues:

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[1] Parties have appealed the Court's January 24 Order approving the Plan, but the Court's Order has not been stayed. The Rehabilitator remains able to implement the Plan.

> The issuance of surplus notes by AAC and the issuance of surplus notes by the Segregated Account as contemplated by the Plan, together with continued deterioration of AAC's financial strength, could subject AAC to the risk of deconsolidation from the AFGI consolidated tax group for U.S. federal income tax purposes, which may require AAC to recognize significant cancellation of indebtedness income ("CODI") and limit AAC's ability to deduct surplus note interest. The recognition of substantial CODI and limitation of the surplus note interest deduction may have a material adverse effect on the financial condition of AAC and the Segregated Account, and reduce recoveries to Segregated Account policyholders. The Rehabilitator is continuing to evaluate these tax considerations and whether amendments to the Plan and/or the initiation of rehabilitation proceedings with respect to AAC would eliminate or mitigate such adverse potential tax consequences for the benefit of policyholders. Such amendments to the Plan could include the elimination of the issuance of surplus notes by the Segregated Account and/or the imposition of transfer restrictions on any surplus notes issued by the Segregated Account.
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> The Rehabilitator currently has no specific timeline or deadline for determining whether to seek amendments to or modifications of the Plan. When such decisions are finalized, the Rehabilitator will promptly advise parties-in-interest on the court-approved website, ambacpolicyholders.com.

(*See* June 1 Report, at 6.)

Further, at a hearing on July 8, 2011, the Rehabilitator's counsel noted that growing concerns about claim impairments, increasingly contentious litigation with the IRS, tax issues, and pending appeals have delayed the Plan and may lead to Plan amendments. (July 8, 2011 Hrg. Tr. at 25.) However, neither the Rehabilitator nor his counsel has explained the economic impact of those issues to Segregated Account policyholders and their anticipated recoveries under the Plan, including (1) the impact of changes to the Rehabilitator's loss assumptions; (2) the effect of a large claim by the IRS against AAC; and (3) the economic consequences of any tax issues.

As a result, the Rehabilitator's limited statements on the status of the rehabilitation demonstrate that there are serious questions about the feasibility of the Rehabilitation Plan, and the Rehabilitator is considering amending that Plan. The 25/75 cash/note split could be altered

significantly as a result of those amendments, making it impossible to determine at this time what Segregated Account claimants will receive.

B. In light of the current uncertainty, selective commutations would be unjust.

In the Motion the Rehabilitator asks the Court to approve procedures to permit it to resolve claims of Segregated Account claimants. The Rehabilitator seeks the authority to commute policies of a certain amount, in whole or in part, without further disclosure or judicial review. Given the uncertainty surrounding the Plan and the Segregated Account, and the Rehabilitator's secrecy concerning its actions, permitting commutations would be unjust.

A prerequisite for a commutation is a determination that the settlement is equitable to the interests of Segregated Account claimants. Wis. Stat. §§ 601.01(2), 645.01(4)(d), 645.68; *cf. In re AWECO, Inc.*, 725 F.2d 293, 298-99 (5th Cir. 1984) (settlement in bankruptcy proceedings must be fair and equitable to non-settling claimants based on greater evidence than "unsubstantiated, gratuitous declarations regarding . . . estate's worth").

At this point in time, no one, including the Rehabilitator, AAC, or the Court, can assess whether the proposed settlements, in the form of commutations or otherwise, are equitable and lawful. Any settlements entered into could be more favorable to the settling policyholder than what the rehabilitation plan (if one is ever implemented) ultimately provides to claimants, which would make the settlements inequitable in violation of Wisconsin law. Alternatively, allowing commutations now would permit the Rehabilitator to resolve claims in an environment of fear and uncertainty that would lead policyholders to settle at too low a consideration. While OCI may consider that to be a good deal, it is not in the collective interests of policyholders, whose interests OCI is bound to protect. Wis. Stat. § 645.01(4). Moreover, should the Segregated Account ever be liquidated, commutations may also constitute impermissible preferences.

OCI has acknowledged now is not a time to go forward with the settlements it has reached so far. Apparently recognizing the problems that may arise from commutations given the uncertainty surrounding the rehabilitation, the Rehabilitator announced on June 2, 2011 that he was not approving the payment of interest on surplus notes issued pursuant to a 2010 commutation with certain credit default swap counterparties. OCI should not be considering further commutation agreements when it has determined that payments under the ones it rashly entered in the past are inappropriate.

In sum, the Rehabilitator cannot ensure that commutations will be on terms that are fair and equitable to Segregated Account claimants when it is uncertain what those claimants will receive under the Plan. This Court should not delegate to the Rehabilitator the ability to enter into settlements that may disadvantage the estate, if the Rehabilitator guesses wrong, or the Policyholders OCI is charged with protecting, if things improve. Commutations of any sort are therefore impermissible at this time. Instead, the Rehabilitator should fulfill its statutory duty and adopt a fair plan that treats all AAC policyholders in a fair and equitable manner.

II. The Rehabilitator Should Not Be Permitted To Carry Out The Rehabilitation In Secret.

In addition, the commutation procedures the Rehabilitator seeks to implement would further the disturbing trend of secrecy that has characterized these rehabilitation proceedings by permitting the Rehabilitator to settle claims without disclosure to or involvement of this Court and interested parties.

This Court has oversight responsibility for the Rehabilitator's actions in these proceedings. Wis. Stat. § 645.33(2). Although the Wisconsin Legislature intended rehabilitation proceedings to be flexible and informal in operation, it also required rehabilitators to "act under the supervision of the court." Wis. Stat. § 645.32, cmts. Moreover, this formal rehabilitation

proceeding under Chapter 645 of the Wisconsin Code is unlike summary proceedings provided for elsewhere in the same chapter.[2] Unlike court hearings in summary proceedings under Section 645.24 which may be confidential, formal rehabilitation proceedings are to be open:

> [I]f a formal proceeding is needed and is commenced, it is neither possible nor desirable for it to be anything other than completely public. No proceeding so far-reaching and with so much latent capacity for harm to the public should be tolerated without the public having full access to information about it.

(Wis. Stat. § 645.24 cmt.) The Rehabilitator has agreed that transparency is important, as he testified during the confirmation hearings that insureds "need to have an avenue to understand what's happening to them." (S. Dilweg, Nov. 15, 2010 Hrg. Tr., at 165.)

Commutations on unknown terms that are reached behind closed doors are antithetical to the transparency that Wisconsin law requires and the Rehabilitator has acknowledged is important. This Court and interested parties must be informed of commutations that would deplete assets to pay other Segregated Account claimants, including the magnitude and structure of those commutations. Though the amount of information made available to this Court and interested parties is inadequate as a matter of law (as Aurelius and others have argued to this Court and now on appeal), commutations handled behind closed doors will further interfere with the ability of this Court to make meaningful decisions about what is best for Segregated Account policyholders.

Moreover, the Rehabilitator's failure to make the Plan effective and to begin distributions forces insureds to languish indefinitely with no certainty about when they can expect to receive any payments on their loss claims under AAC policies. The Rehabilitator should not now be permitted to pursue settlements with select claimants while forcing others to wait in the dark, wondering whether assets will be available to provide them equitable treatment in the future.

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[2] *Compare* Wis. Stats. §§ 645.31-.77 (Subchapter III - Formal Proceedings) *with* Wis. Stats. §§ 645.21-.24 (Subchapter II - Summary Proceedings).

Such a result would further exacerbate the discriminatory treatment among insureds that the Rehabilitator has already permitted. If the Rehabilitator wishes to enter into settlements with claimants, the Court should require him to do so after the Rehabilitation Plan has become effective. The Court should not permit the Rehabilitator to say that he does not know the status of his Rehabilitation Plan, while at the same time saying that he knows what settlements are fair and equitable. If the Rehabilitator does not think the conditions to Plan effectiveness have been satisfied, then settlements pursuant to the alternative resolution provisions in Section 3.06 of the Plan should not be permitted.

CONCLUSION

For all of these reasons, the Motion should be denied.

Dated this 26th day of August, 2011.

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