

In the Matter of the Rehabilitation of:

Case No. 10 CV 1576

Segregated Account of Ambac Assurance Corporation

**NOTICE OF MOTION AND
MOTION TO APPROVE PURCHASE OF SURPLUS NOTES**

I. NOTICE OF MOTION

TO: All Parties-in-Interest

PLEASE TAKE NOTICE that the Commissioner of Insurance of the State of Wisconsin, as Rehabilitator of the Segregated Account of Ambac Assurance Corporation, has scheduled a hearing on Monday, June 4, 2012, at 2 p.m. before Judge William D. Johnston at the Lafayette County Courthouse, 626 Main Street, Darlington, Wisconsin, at which time the Rehabilitator will ask the Court to approve the exercise of certain call options for the purchase of surplus notes by Ambac Assurance Corporation, as detailed more fully in the motion below.

PLEASE TAKE FURTHER NOTICE that any interested parties may appear telephonically pursuant to the Court's standard tele-court procedure. Any parties interested in appearing telephonically should make the appropriate arrangements in advance of the hearing by calling 800-924-5680.

PLEASE ALSO TAKE FURTHER NOTICE that any objections to the relief requested in this Motion by the Rehabilitator should be in writing, and filed and served by no later than noon (Central Time) on Thursday, May 31, 2012.

II. MOTION TO APPROVE PURCHASE OF SURPLUS NOTES

The Commissioner of Insurance of the State of Wisconsin, as the court-appointed rehabilitator (the “Rehabilitator”) of the Segregated Account (“Segregated Account”) of Ambac Assurance Corporation (“Ambac”), hereby moves this Court to approve Ambac’s exercise of call options (the “Call Options”) to purchase approximately \$939 million in par amount of Ambac surplus notes (“Surplus Notes” or “Notes”) that were issued to three banks as part of a June 7, 2010 settlement agreement. The Call Options permit Ambac to repurchase those Surplus Notes for a total price of approximately \$278 million. The Rehabilitator believes that exercising the Call Options is in the best interest of Segregated Account policyholders because it is expected to result in a significant increase to the recoveries they will receive.

The grounds for this motion are as follows:

1. On June 7, 2010, Ambac and its wholly-owned subsidiary, Ambac Credit Products, LLC (“ACP”), entered into a settlement of certain credit default swap exposures and related financial guarantee exposures with a number of banks (the “Bank Group Settlement” or “Settlement”). The consideration for the Settlement varied for each bank, depending upon Ambac’s and ACP’s liabilities. As part of the Settlement, Ambac issued each of the banks varying amounts of surplus notes, based upon Ambac’s and ACP’s liability exposure to each of them. Ambac negotiated call option agreements with three of those banks, pursuant to which Ambac has the right to repurchase the Surplus Notes at specified prices. (*See* Seventh Affidavit of Roger A. Peterson (“Peterson Aff.”) ¶ 16.)

2. The letter agreements setting forth the Call Options with each of the three banks are attached as Exhibits A, B and C to the Peterson Affidavit, filed in support of this

motion. To address confidentiality provisions of the Bank Group Settlement, the Rehabilitator is not disclosing the names of the respective bank counterparties in this motion, and those names have been redacted from each Exhibit. (*Id.* ¶ 17.) The Rehabilitator believes the identity of the three banks is not relevant to this motion. If the Court disagrees, however, the Rehabilitator requests that it be permitted to disclose the names *in camera* for confidentiality reasons. For purposes of this motion, the Rehabilitator will refer to the banks as Bank A, Bank B, and Bank C.

3. Ambac's agreement with Bank A grants Ambac the right to purchase \$500 million in principal amount of Surplus Notes initially issued to Bank A. The total cash price for the Surplus Notes issued to Bank A is equal to \$.20 per dollar of principal amount, resulting in a total price of \$100 million. Ambac will remain obligated to pay all interest that has accrued on those Surplus Notes prior to the exercise of the Call Option, with the interest being payable when interest is paid on other surplus notes. (*See id.* ¶ 18 & Ex. A at 1.)

4. Ambac's agreement with Bank B grants Ambac the right to purchase \$150 million in principal amount of Surplus Notes initially issued to Bank B. The total cash price is determined by the following formula: \$.30 per dollar of principal amount of the Surplus Notes, plus an amount equal to the accrued unpaid interest on them. The total cash price that Ambac would pay for the Surplus Notes issued to Bank B is approximately \$60.7 million. (*See id.* ¶ 19 & Ex. B at 1.)

5. Ambac's agreement with Bank C grants Ambac the right to purchase approximately \$289 million in principal amount of Surplus Notes initially issued to Bank C. On its face, Ambac's agreement with Bank C specifies a total cash price equal to \$.20 per

dollar of principal amount of the Surplus Notes, plus an amount equal to the accrued unpaid interest on them. However, the agreement with Bank C also contains a “most favored nation” provision that requires the rate-per-dollar to be adjusted upward to equal the most favorable rate-per-dollar paid pursuant to a call option agreement with any other party to the Bank Group Settlement. As a result, the total cash price for the Surplus Notes issued to Bank C – like the Surplus Notes issued to Bank B – is \$.30 per dollar of principal amount of Surplus Notes, plus an amount equal to the accrued unpaid interest on them. That formula results in a total cash price of approximately \$117 million. (*See id.* ¶ 20 & Ex. C at 1.)

6. The Call Options with Bank A and Bank B must be exercised no later than June 7, 2012. (*See id.* ¶ 21 & Ex. A at 1, Ex. B at 1, 2.) In the case of Bank A, the June 7, 2012 deadline is expressly stated in the agreement. (*See id.* Ex. A at 1.) In the case of Bank B, the agreement sets a default deadline of November 30, 2012 (*see id.* Ex. B at 1), but the agreement requires that the deadline be adjusted to end on the date of the earliest Call Option deadline that Ambac negotiates with another bank (*see id.* at 2), which is the June 7, 2012 deadline with Bank A. With respect to Bank C, the deadline for exercising the call options is November 30, 2012. (*See id.*, Ex. C at 2.)

7. For all three transactions, Ambac’s right to exercise the Call Options and purchase the Surplus Notes is binding upon the banks’ transferees, assigns, and successors. A significant portion of the Surplus Notes are now held by parties other than the banks. Ambac believes that it knows the identity of those parties and is prepared to notify them of its decision to exercise the Call Options should the Court grant this Motion. (*Id.* ¶ 22.)

8. Because the Segregated Account, the Rehabilitator, and OCI are not parties to the Bank Group Settlement or the Call Option agreements, the Rehabilitator does not believe it is legally required to seek this Court's approval of Ambac's exercise of the Call Options. However, Ambac is required to obtain advance approval by OCI and the Rehabilitator before purchasing the Surplus Notes. Because exercising the Call Options involves the use of significant resources, and because the Bank Group Settlement has been the subject of disputes in the rehabilitation court proceedings, the Rehabilitator has exercised his discretion to make approval by this Court a condition for granting Ambac approval to proceed with the transactions.

9. Exercising all of the Call Options is in the best interest of Segregated Account policyholders because it is expected to significantly increase the claims-paying resources available to the Segregated Account and result in larger total cash payments to policyholders over the course of the Rehabilitation. (Peterson Aff. ¶ 30.)

10. In order to assess the merits of exercising the Call Options, Special Deputy Commissioner Roger Peterson, on behalf of the Rehabilitator, and the Rehabilitator's financial advisors, Jeffries & Co. and Gordian Group, LLC, compared the financial effects of purchasing and not purchasing the Surplus Notes. They analyzed four economic scenarios that represent a broad range of financial outcomes for Segregated Account policyholders. Each of the scenarios assumes that holders of Segregated Account policy claims will receive an initial distribution, in cash, equal to 25% of the amount of each policy claim. The unpaid balance of each policy claim is assumed to be satisfied either through the issuance of a surplus note or another type of deferred payment obligation. The portion of each policy claim that is not paid in cash in the initial distribution (the

“Non-Cash Consideration”) is assumed to be *pari passu* with surplus notes (including the Surplus Notes that are the subject of this motion), consistent with the stated positions of OCI and the Rehabilitator. (See Affidavit of Regina Frank (“Frank Aff.”) ¶ 8.)

11. The primary variables in each of the four scenarios are: 1) the amount of estimated losses for both the General Account and the Segregated Account, and 2) the amount of estimated recoveries to be received from remediation efforts for residential mortgage-backed securities (“RMBS”) policies allocated to the Segregated Account. Projected losses were estimated under “base case” and “stress case” scenarios using a 5.1% discount rate. The base case losses (including accrued but unpaid claims) for the General Account and the Segregated Account are estimated to be, respectively, \$570 million and \$7.4 billion. The stress case losses (including accrued but unpaid claims) for the General Account and the Segregated Account are estimated to be, respectively, \$1.0 billion and \$9.0 billion. RMBS remediation recoveries are assumed to be either 100% or 50% of Ambac’s projections, which were estimated to be \$2.4 billion as of the end of the third quarter of 2011, using a 5.1% discount rate. All of the estimates are based on financial data for the fiscal quarter ending September 30, 2011. (Peterson Aff. ¶ 10.)

12. The four economic scenarios used for purposes of assessing the merits of exercising the Call Options are as follows:

- (a) **Scenario One:** Assumes base case losses for both the General Account and the Segregated Account, and 100% realization of projected RMBS remediation recoveries.

(b) **Scenario Two:** Assumes base case losses for both the General Account and the Segregated Account, and 50% realization of projected RMBS remediation recoveries.

(c) **Scenario Three:** Assumes stress case losses for both the General Account and the Segregated Account, and 100% realization of projected RMBS remediation recoveries.

(d) **Scenario Four:** Assumes stress case losses for both the General Account and the Segregated Account, and 50% realization of projected RMBS remediation recoveries. (*Id.* ¶ 12.)

13. The Rehabilitator's analysis shows that under each of the four scenarios, the ratio of the present value of claims-paying resources to the present value of total expected policy claims is greater with the proposed purchase of the Surplus Notes than without that purchase. As a result, under each of the four scenarios, purchasing the Surplus Notes results in a significant increase in the total projected claim recoveries for Segregated Account policyholders. (Peterson Aff. ¶ 23.) The chart below sets forth the present value of, and percentage increases to, in total claim recoveries under each scenario. Cash amounts have been discounted using a discount rate of 5.1%. (*See id.*)

	Scenario One	Scenario Two	Scenario Three	Scenario Four	Four Scenario Average
Present Value of Increase in Total Claim Recoveries (in millions)	\$496	\$369	\$348	\$197	\$353
Increase in Percentage of Total Claim Recoveries	5.7%	4.3 %	3.4%	1.9%	3.9%

14. The total cost of purchasing all of the Surplus Notes as of June 7, 2012 will be approximately \$278 million. The total principal amount of the Surplus Notes and accrued interest payable to third parties that will be reduced as a result of the purchase will be approximately \$985 million. Thus, the total purchase price represents approximately \$0.28 per dollar. (*Id.* ¶ 24.)

15. The proposed purchase of the Surplus Notes will result in a reduction in the statutory surplus of Ambac's General Account equal to the amount paid to purchase the Surplus Notes. The Rehabilitator anticipates that the reduction in Ambac's statutory surplus due to the purchase of the Surplus Notes, together with an increase in reserves on both Segregated Account and General Account obligations will, as of the second quarter of 2012, cause the General Account to report statutory surplus of exactly \$100 million, and cause the Segregated Account to report negative statutory surplus. (*Id.* ¶ 25.)

16. The anticipated negative statutory surplus does not affect the Rehabilitator's conclusion that the proposed purchase of the Surplus Notes pursuant to the Call Options is in the best interest of the Segregated Account. Statutory surplus does not provide an appropriate measure for evaluating the effect of various transactions and developments on Segregated Account policyholders, because it is calculated with respect

to Ambac's (i) statutory reserves, which do not reflect a complete picture of Ambac's total liabilities, and (ii) admitted assets, which do not reflect a complete picture of Ambac's claims-paying resources over time. In particular, although Ambac is contractually liable to pay principal and interest on the Surplus Notes, statutory accounting principles direct Ambac not to include this liability in its statutory reserves. Yet statutory accounting principles also dictate that the purchase price of the Surplus Notes be deducted from Ambac's admitted assets. Thus, no matter how much the purchase of Surplus Notes may increase the ultimate cash recovery of Segregated Account policyholders, the purchase will always reduce Ambac's statutory surplus, because Ambac's admitted assets will be reduced by the purchase price without a corresponding reduction in its statutory reserves. (*Id.* ¶ 26.)

17. The more appropriate measure for evaluating the benefits of this transaction involves comparing the present value of total claims-paying resources with the present value of total expected policy-level claims with the proposed transaction, and without the proposed transaction. Using such a measure, the Rehabilitator's financial analysis projects that in each scenario, the ratio of the present value of claims-paying resources to the present value of total expected policy-level claims is greater with the proposed purchase of the Surplus Notes than without such purchase. As set forth above, the Rehabilitator projects that the purchase of the Surplus Notes will result in Segregated Account policyholders recovering 1.9 to 5.7 percentage points more on their claims than would be the case if the Surplus Notes are not purchased. (*Id.* ¶ 27.)

18. The anticipated statutory surplus of exactly \$100 million in the General Account will not affect the ability of the Segregated Account to pay policy claims, and the

assets of the General Account will continue to be available to pay Segregated Account policy claims through the Secured Note and Aggregate Excess of Loss Reinsurance Agreement (the “Reinsurance Agreement”). There are provisions in both the Secured Note (Section 1(c)) and Reinsurance Agreement (Section 1.04) which state that the General Account will not have any liability to make any payment to the Segregated Account under the Secured Note or Reinsurance Agreement, as applicable, to the extent that such payment would cause the statutory surplus of the General Account to fall below \$100 million. Those provisions are implemented by reducing the liability that the Segregated Account cedes to the General Account, such that the General Account’s statutory surplus stops decreasing when it reaches \$100 million and any further decreases in statutory surplus (*e.g.*, due to an increase in reserves or a decrease in assets without a corresponding decrease in reserves) will be reflected in the statutory surplus of the Segregated Account – not the General Account. (*Id.* ¶¶ 28-29.)

19. As shown above, the purchase of the Surplus Notes is in the best interest of the Segregated Account because it resolves Ambac’s liability under the Surplus Notes for substantially less than Ambac would ultimately pay if it did not purchase the Surplus Notes. As a result, the purchase will increase the projected total claim recoveries for Segregated Account policyholders under all reasonable economic scenarios projected by the Rehabilitator.

20. Time is of the essence for obtaining approval of this transaction. As described above, pursuant to the terms of the Call Option agreements with Banks A and B, Ambac must notify the current holders of the Surplus Notes of its exercise of the Call Options no later than June 7, 2012. Because many of the Surplus Notes are now held by a

number of parties, at least one of which is overseas, Ambac needs as much extra time as possible under the circumstances to ensure that notices are properly effected before the deadline. (*Id.* ¶ 31.)

III. CONCLUSION

For all of the reasons stated above, the Rehabilitator respectfully requests that the Court grant this Motion and approve Ambac's purchase of the Surplus Notes.

Dated this 16th day of May, 2012.

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Segregated Account of Ambac Assurance
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In the Matter of the Rehabilitation of:

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Segregated Account of Ambac Assurance Corporation

**ORDER GRANTING REHABILITATOR'S MOTION TO
APPROVE PURCHASE OF SURPLUS NOTES**

This matter came before the Court for a hearing on the Rehabilitator's Motion to Approve Purchase of Surplus Notes (the "Motion"). The Motion came before the Court on proper advance written notice for hearing in open court. Appearances were noted on the record. All interested parties were afforded the opportunity to appear and be heard on the Motion.

The Court having considered the Rehabilitator's Motion and the information provided at the hearing, it is hereby **ORDERED** that the Rehabilitator's Motion is **GRANTED**.

Dated this ____ day of _____, 2012.

BY THE COURT:

Honorable William D. Johnston
Lafayette County Circuit Court Judge
Presiding by Judicial Appointment