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

RESPONSE OF TRICADIA CAPITAL MANAGEMENT, LLC TO THE MOTION BY THE REHABILITATOR FOR AN ORDER DETERMINING AND DECLARING THE PROPER CONSTRUCTION OF AMBAC POLICY NOS. AB1003BE, AB1022BE, AB1049BE, AB1065BE, AND AB1088BE

PRELIMINARY STATEMENT

1. Tricadia Capital Management, LLC, on behalf of certain managed funds ("Respondent"), respectfully submits this response to the Rehabilitator's motion for an order determining and declaring the proper construction of Ambac Policy Nos. AB1003BE, AB1022BE, AB1049BE, AB1065BE and AB1088BE. (Bruce aff., Exhs. 1-5). The policies relate to certain classes of residential mortgage-backed certificates (the "Insured Certificates") issued as part of the following five transactions: Chevy Chase Funding LLC Series 2006-2, 2006-3, 2006-4, 2007-1 and 2007-2 (the "Transactions"). Funds managed by Respondent own approximately 16 percent of the Insured Certificates in the Transactions.

2. Respondent and the Rehabilitator agree: these policies and the governing documents appear to contain serious drafting errors which, if not reformed, would render the insurance illusory and ineffective and thus defeat the intent of the parties and the purpose of the policies. In addition, Respondent agrees that the policies and governing documents should be reformed. However, because the Rehabilitator's motion does not focus on the critical defect contained in the governing documents, the Rehabilitator's proposed solution fails to address adequately the underlying flaws in the documents.

3. In exchange for significant premium payments, Ambac guaranteed that the holders would receive payment in full of all interest due with respect to any Insured Certificates, as well as any losses suffered as a result of mortgage loan defaults on a monthly basis. However, as the Rehabilitator notes, the governing agreements contain nonsensical provisions which could be interpreted to require the Trustee to reimburse Ambac out of funds that would otherwise be distributed as principal to holders of the Insured Certificates. In fact, it is this interpretation of the reimbursement provision that is the cause of the "Write-down Amounts" on which the Rehabilitator now seeks clarity by the Motion.

4. This reimbursement arrangement is contrary to the practice in the industry and is not present in Ambac-insured transactions other than the Chevy Chase sponsored RMBS transactions. More importantly, this arrangement makes no economic sense, because under this mechanism Ambac would be reimbursed from funds that are supposed to go to the beneficiaries of its insurance policies. That is the exact opposite of insurance -- and violates bedrock insurance principles, including the made-whole doctrine requiring that the insured be made whole before the insurer may recover. In fact, if permitted this arrangement would convert Ambac from an insurer into a revolving lender that merely makes revolving loans to the policy beneficiaries, an outcome that the Rehabilitator himself says should be avoided as irrational and without any purpose.

5. As we show in greater detail below, the reimbursement arrangement on its face cannot be what any party intended. To address this flaw, the Court should reform the policies and governing documents as the Rehabilitator has proposed, as well as strike the provision in the governing documents that can be read to allow Ambac to reimburse itself from payments of mortgage principal, namely the second clause of the definition of Insurer Available

Reimbursement Amount in the Pooling and Servicing Agreements ("PSAs") (Bruce aff., Exhs. 6-10).

FACTUAL BACKGROUND

A. Ambac Agreed to Cover On a Current-Pay Basis All Realized Losses and Interest Shortfalls on the Insured Certificates

6. There are two basic types of cash flow structure for RMBS transactions: "shifting interest" and "overcollateralization." The Transactions at issue are shifting interest transactions. In a shifting interest transaction, the aggregate principal balance of the mortgage loans equals the aggregate principal balance of the certificates issued. This parity creates a "dollar for dollar" concept where all principal received on the mortgage loans will be required to be paid on the certificates. As addressed in further detail below, Realized Losses generated by mortgage loan defaults create a disparity that reduces the aggregate principal balance of the loans in the collateral pool. To maintain the equilibrium between the principal balance of the mortgage loans and the principal balance of the Certificates issued, the documents require a reduction in the principal balance of the certificates to maintain this "dollar for dollar" parity.

7. There are two kinds of certificate guaranty insurance: (i) "current-pay," in which the insurer covers shortfalls in the payment of interest on the related certificates and covers realized losses allocated to such certificates, in each case, on a monthly basis, and (ii) "ultimate-pay," in which the insurer covers the shortfalls of interest on a monthly basis and shortfalls of principal only at the final distribution date of the certificates. Current pay policies are typically used in first lien residential mortgage-backed securities transactions such as the Transactions at issue here. Ultimate pay policies are typically used in second lien residential mortgage-backed securities transactions.

8. In current-pay insurance policies, the insurer commonly receives only a limited right to recover certain of the insurance payments made. This reimbursement is typically made only from the interest portion of payments made by mortgage loan borrowers, and only after such interest payments have been used to pay interest on senior classes of certificates, including insured certificates, the premium to the insurer and certain fees to the trustee.

9. In current pay policies, the insurers generally are not permitted to be reimbursed out of the mortgagors' payments of principal. The reason for this rule is clear. As described above, in these types of transactions the aggregate principal balance of the mortgage loans equals the aggregate principal balance of the certificates issued. If an insurer could use mortgagors' principal payments to reimburse itself for previously made insurance payments, it would be taking principal from the certificate-holders, disrupting the parity structure utilized in these transactions and creating another separate insurance obligation for the insurer.

10. Ambac's insurance was a crucial part of the "credit enhancement" offered to potential investors to induce them to buy the insured Certificates. The Private Placement Memoranda for the Transactions (Bruce aff., Exhs. 11-15) represented that Ambac "unconditionally and irrevocably guarantees" on each Distribution Date, the payment of interest and "Realized Losses" allocable to the insured Certificates. (*Id.* at 81). As discussed above, Realized Losses are the result of individual borrowers defaulting on their mortgage loans and recoveries that are less than the outstanding loan amount. Under the PSAs, Realized Losses, as the term implies, are defined as "the excess of the Principal Balance" owed by the borrower on an individual mortgage loan "over proceeds, if any, received" from that mortgage loan when liquidated. (Bruce aff., Exhs. 6-10 at 39). In sum, the intent of the insurance was to protect the holders of the Insured Certificates from borrower defaults on a current basis.

11. Ambac also agreed under the PSAs to make its payments of insurance on a current-pay basis, as soon as insured losses were incurred. Payments of interest and principal are due to be made to the insured Certificate-Holders on "Distribution Dates" defined to be the "25th day of each calendar month" (Bruce aff., Exhs. 6-10, Article I at 23), and Ambac committed in the policies to "pay any Insured Amount payable" in connection with each such Distribution Date. (Bruce aff., Exhs. 1-5).

B. The Reimbursement Provision in the Ambac Policies Defeats the Insurance Feature

12. Arguably, the PSAs allow Ambac to be reimbursed for the insurance payments Ambac previously made. Section 4.02 of the PSAs sets forth the "waterfall" by which distributions of interest and principal will be made. Within that waterfall, Ambac is permitted to receive on each Distribution Date -- if sufficient funds are available to make the payment -- "the amount of any Insured Payments made on any previous Distribution Date, to the extent not previously reimbursed, with interest thereon at the Late Payment Rate." (Bruce aff., Exhs. 6-10, § 4.02 at 83).

13. Ambac's reimbursement payments are to be drawn from an "Insurer Available Reimbursement Amount," which establishes the form and amount of the reimbursements that Ambac may receive. The definition of this term states, "[w]ith respect to any Distribution Date," that Ambac's reimbursement may include interest that has accumulated in the trust for the insured Certificates and "the portion of the Senior Principal Distribution Amount which would otherwise be distributed to the holders of" the insured Certificates. (Bruce aff., Exhs. 6-10, Article I at 27). Under the literal reading of this provision, in any given month Ambac may be compelled to insure Certificateholders for the full principal portion of all Realized Losses, but in the immediately following month Ambac will be permitted to divert from

the Certificateholders as much of the then-current principal payments received from mortgagors as Ambac needs to reimburse itself for the amount of the insurance payments it had made in the prior month. The PSAs contain no limitation on the amount of principal that Ambac may divert from Certificateholders and use to reimburse itself. Nor do the PSAs explain how the Certificateholders will be made whole for the diverted principal – the very point raised by the Rehabilitator.[1]

ARGUMENT

I. BECAUSE THE REIMBURSEMENT MECHANISM PRODUCES ABSURD AND UNINTENDED RESULTS AND IS CONTRARY TO LAW, IT SHOULD BE REFORMED

14. The Rehabilitator correctly notes that under New York law, insurance policies like any contracts may be reformed if there is clear and convincing evidence of a mutual mistake by the parties. Motion at ¶ 27. *See Callen v. Hartford Ins. Co.*, 15 A.D.3d 973, 974 (4th Dep't 2005) (reformation of insurance policy requires "'clear, positive and convincing evidence' of a mutual mistake") (citation omitted); *EGW Temporaries, Inc. v. RLI Ins. Co.*, 83 A.D.3d 1481, 1482 (4th Dep't 2011) (reforming payment bond issued by insurance company; "plaintiff established by the requisite clear and convincing evidence" that the carrier and insured had made a mutual mistake). While the Rehabilitator has correctly noted that the policies should be reformed to cover Write Down Amounts, the Rehabilitator's motion does not go far enough. The same reasons cited by the Rehabilitator in support of the motion likewise mandate reformation of the reimbursement provisions under the relevant documents. The wording of the reimbursement provision could only have been the result of a mutual mistake, since the

[1] Under paragraphs 126 and 127 of the Court's January 24, 2011 decision approving the Rehabilitation Plan, non-cash consideration paid on account of the Policies shall not be entitled to reimbursement. Respondent reserves the right to challenge reimbursement on any other basis.

mechanism as drafted is illogical, serves no legitimate purpose, and turns bedrock insurance principles upside down.

A. The Reimbursement Mechanism is Illogical, Flawed and Serves No Purpose

15. Holders of insured RMBS certificates are commonly covered on a current-pay basis for Realized Losses that their Certificates may incur from month to month. However, it would never be rational to allow an insurer to be able to reimburse itself by diverting payments of principal away from their beneficiaries the month after it pays on a Realized Loss. Doing so will cause the certificates to be undercollateralized, and will require that further insurance payments be made in the future.

16. Yet that is exactly what Ambac purports to be allowed to do with the Chevy Chase Certificates. This scenario is the result of the erroneous definition of "Insurer Reimbursement Available Amount" in the PSAs, which allows principal from mortgage loans to be paid to Ambac. The Rehabilitator urges that the relevant documents should not be construed in a way that would allow Ambac's insurance policy to be turned "into something akin to a revolving loan, with Ambac paying claims for losses each month, taking back that money each succeeding month." (Motion ¶ 17). While the Motion makes that point with respect to the Write Down Amounts that the Rehabilitator wants to insure, the Rehabilitator ignores that it is actually the reimbursement provision that is causing the write-down amount, thereby converting Ambac's insurance into a revolving loan.

17. Ignoring the error created by the reimbursement provision, the Rehabilitator focuses instead on the secondary issue of insurance coverage for Write Down Amounts at the Final Scheduled Distribution Date. There is no doubt that losses in respect of Mortgage Loans were intended to be covered, for the parties intended that Realized Losses would be covered on a

current basis. In fact, if Realized Losses are paid on a current basis and current principal proceeds are permitted, as is standard, to pay down only the outstanding principal balance of the Certificates, there should be no Write Down Amounts. Write Down Amounts and Realized Losses are just different ways of describing the same concept – namely that when borrowers on the underlying mortgage loans fail to make their full required payments of mortgage principal, then the holders of the Certificates also incur losses on the principal of their Certificates.

18. In assessing whether the policies should be reformed as the Rehabilitator proposes, the Court may look by analogy to the standard applied when an insurance rehabilitator seeks in a proposed rehabilitation plan to alter contractual policy provisions. In that context, the Rehabilitator must show that the proposed contractual change is reasonable and necessary to effectuate an important public purpose. *See Foster v. Mut. Fire Ins. Co.*, 614 A.2d 1086, 1094 n.4. (Pa. 1992); *Consedine v. Penn Treaty Network Am. Ins. Co.*, 2012 Pa Commw. LEXIS 341, at *222 (Pa. Commn. May 3, 2012). As set forth above, the reimbursement mechanism serves no legitimate purpose, and by the Rehabilitator's own logic is unfair and economically irrational. On this basis alone, the Court should reform the documents to eliminate the anomalous outcome they create.[2]

[2] It is worth noting that the central theme of the Rehabilitator's Motion is to give meaning to clause (ii) of the definition of the term Deficiency Amount. As quoted in the Motion, the policies define "Deficiency Amount" as "the sum of (i) **as of any Distribution Date**, the sum of (a) [insured interest shortfalls] and (b) **the amount of the principal portion of any Realized Losses allocable to the Class A-1I Certificate and the Class A-NA Certificates on such Distribution Date** and (ii) on the applicable Scheduled Final Distribution Date, the Certificate Balance of the Class A-1I Certificate and the Class A-NA Certificates to the extent unpaid on such Scheduled Final Distribution Date." (Bruce Aff., Exs. 1-5, definition of "Deficiency Amount" (emphasis added)). The Rehabilitator argues that absent proper construction or reformation, the intent of the parties would be frustrated and that the insurance provided by Ambac would be illusory. Similarly, Respondent seeks to give meaning to the other clause in the definition of the term Deficiency Amount, specifically where Ambac is required to pay the amount of Realized Losses on a current basis to policyholders. As the Rehabilitator did with respect to clause (ii), Respondent contends that absent proper construction or reformation of certain provisions related to reimbursement, the intent of the parties would be frustrated and the insurance provided by Ambac would be illusory.

B. The Reimbursement Mechanism Violates the Made-Whole Doctrine

19. The reimbursement mechanism should be reformed for a second, independent reason: the mechanism violates the well-settled New York law principle known as the "made-whole" doctrine that an insurer may not recover until the insured is fully compensated for its insured loss.

20. The PSAs are explicit in stating that Ambac must insure the principal portion of Realized Losses on a current-pay basis. If Ambac does so, then the insured Certificateholders will be made whole on any losses of principal, and there will be no Write Down Amounts. But if Ambac is permitted under the guise of reimbursement continually to divert current payments of principal to itself, then Ambac can keep the insured Certificateholders from being made whole.

21. Citing well-settled case law, the Rehabilitator urges that the governing documents should not be read in a way that would cause Ambac's insurance to be "illusory." (Motion at ¶¶ 14, 18). *See, e.g.*, *Thomas J. Lipton v. Liberty Mutual Ins. Co.*, 34 N.Y.2d 356, 361 (1974). Respondents agrees. Yet that is exactly the effect of the reimbursement provision. Under this provision, Ambac pays the insured certificate-holders for their losses, but then compels the Holders to repay Ambac as soon as the very next month. As a result, the Certificateholders are never made whole on a current basis, and they are forced to face at best the speculative possibility of receiving some payment at the Final Scheduled Distribution Date.

22. This approach turns bedrock insurance principles upside down. New York law, which governs the Ambac policies, provides that "[u]nder the common law of subrogation, an insurer has the right to 'stand in the shoes' of the insured and seek recompense from the third-party tortfeasor for the amount paid to the insured, *provided that the insured has been made whole*." *USF&G v. Maggiore*, 299 A.D.2d 341, 344 (2d Dep't 2002) (citation omitted; emphasis

in original). That is because when an insurer has provided coverage, "the burden of loss should rest on the party paid to assume the risk, and not on an inadequately compensated insured, who is the least able to shoulder the loss." *Id.* To hold otherwise would be "contrary to the principal purpose of an insurance contract: to protect an insured from loss, thereby placing the risk of loss on the insurer, and the insurer has accepted payments from the insured to assume this risk of loss." *Id*. (quoting 16 Couch, Insurance 3d § 223:136).

23. This principle is black-letter law in New York and elsewhere. *See, e.g.*, *Fasso v. Doerr*, 12 N.Y.3d 80, 87 (2009) ("If the sources of recovery ultimately available are inadequate to fully compensate the insured for its losses, then the insurer—who has been paid by the insured to assume the risk of loss—has no right to share in the proceeds of the insured's recovery from the tortfeasor") (citation omitted); *Niemann v. Luca*, 168 Misc. 2d 1023, 1026 (Suffolk Cnty. 1996) ("[The made-whole rule] is based upon the nature of the relationship between the insurer and the insured: if the loss of one of the two must go unsatisfied, it should be the insurer who bears such loss since it is has been paid to assume the risk of such loss."); *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 246 S.W.3d 653, 673 (Tex. 2008) ("Insurance is an agreement by which one party assumes a risk faced by another in return for a premium payment. This risk-shifting is the purpose of insurance.") (citation omitted); *McShane v. N.J. Mfrs. Ins. Co.*, 867 A.2d 1207, 1213 (N.J. App. Div. 2005) (citing *Wine v. Globe Am. Cas. Co.*, 917 S.W.2d 558, 562 (Ky. 1996), for proposition that placing burden of loss on the claimant instead of the insurer that was paid to bear risk would defeat the "age old" principles of subrogation).

24. Far from honoring the made-whole doctrine, the reimbursement mechanism would in effect grant Ambac a right of subrogation enforceable even though its insureds will not

be paid in full on their insured loss. Allowing Ambac to recover any amounts before the certificateholders are paid in full would turn the made whole doctrine on its head.

25. It is no response to this problem for the Rehabilitator to say that under the reformation he seeks, the Write Down Amounts will be insured and the certificate holders will recover at the end of the life of the policies. As noted above, the Realized Losses are supposed to be insured on a current-pay basis, in cash, and not on an ultimate-pay basis 35 years from now, which is when the Rehabilitator's proposal would have them be insured. These policies bear all the indicia of current-pay policies. There is no evidence that Ambac or anyone intended that the policies create an illusory payment of Realized Losses on a current basis only to convert them a month later into obligations that can be paid in 35 years later.

26. Nor can the Rehabilitator rely on those authorities permitting parties by contract to modify the made-whole doctrine. The Rehabilitator himself acknowledges that the policies require reformation. Reforming those policies in a way that continues to frustrate basic insurance law could not be more unreasonable, illogical and unfair.

CONCLUSION

27. The parties clearly intended to create a current-pay insurance policy paying for Realized Losses on a current basis. If their policies are allowed to work as intended, there should be no Write-Down Amounts at the end of the transaction. Instead, what the parties have been given is a reimbursement mechanism that is not standard and produces absurd results. As far as Respondent is aware, this reimbursement provision is not found in any other insured transactions. Moreover, the provision creates a nonsensical revolving loan transaction, causes the transaction to be under-collateralized, and runs counter to what clearly was intended to be a current pay structure.

28. For these reasons, the Court should (i) reform the policies as requested by the Rehabilitator and, in addition, (ii) reform the definition of Insurer Available Reimbursement Amount in the PSAs to strike the second clause of the definition, the provision allowing principal proceeds to be used to reimburse the insurer.

29. Should the Court require a formal motion to reform the documents as set forth above, Respondent is prepared to file that motion promptly.

Dated: February 27, 2013

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