COURT OF APPEALS OF WISCONSIN
DISTRICT IV

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

Ted Nickel and Office of the
Commissioner of Insurance,
Petitioners-Respondents,
Ambac Assurance,
Interested Party-Respondent,

Appeal No. 2014AP002033

v.

FFI Fund Ltd., FYI Ltd., Olifant
Fund, Ltd., Axonic Capital LLC,
Axonic Credit Opportunities Master
Fund LP and OC 523 Master Fund
LTD,
Interested Parties-Appellants.

On Appeal from the Order of the Dane County Circuit Court
Case No. 2010CV001576
The Honorable William D. Johnston Presiding

INTERESTED PARTIES-APPELLANTS' REPLY BRIEF

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INTRODUCTION

The Rehabilitator makes his intentions clear in his Response. He desires to: (i) protect the waterfall distribution scheme devised with Deutsche Bank, as Trustee, which gave the Rehabilitator priority in certain payments and (ii) tilt the playing field against Certificate holders so as to divest them of their procedural rights to challenge that arrangement. With that in mind, the Response reveals a series of contradictions:

- Although no dispute exists regarding the actual policy issued by Ambac—only an interpretation of the PSA—the Rehabilitator suggests that the Motion is core to the rehabilitation proceeding and its goals;
- Although the Rehabilitator has no dispute with the Trustee regarding the distribution scheme, he moves to "confirm" that arrangement and "declare" its correctness;
- Although the Trustee provided notice of the Motion to Senior Certificate Holders requiring them to respond independently, the Rehabilitator and the Trustee oppose their intervention and seek to deprive them of their procedural rights to challenge that distribution scheme;
- Although the Circuit Court expressly relied on certain extrinsic evidence not before it to support its decision, the Rehabilitator claims that no true dispute exists regarding the interpretation of the waterfall provisions of the PSA; and

- Although the Prospectus Supplement confirms the Senior Certificate Holders' interpretation of the PSA, the Rehabilitator suggests that this Court should disregard its existence as if it was not part of the transaction documents that the PSA parties themselves created, distributed and filed with the SEC.

In the end, the Circuit Court endorsed a process that materially prejudiced Senior Certificate Holders: the Rehabilitator brought a motion, not a lawsuit, supported by only one party he previously agreed to indemnify, in a process solely intended to bind third-party Certificate holders whose right to intervene and to conduct discovery he actively opposed. The Circuit Court did not consider the documents or the circumstances in their totality, but rather accepted the Rehabilitator's strained interpretation of the waterfall provisions out of context. It then availed itself of only certain extrinsic evidence while arbitrarily ignoring a document prepared by the parties that New York courts consider central to such transactions. As more fully explained below and in the Opening Brief, this Court should either reverse or vacate and remand the Circuit Court's decision.

ARGUMENT

I. The Circuit Court's Procedural and Contract Construction Errors Require Reversal.

The Rehabilitator's argument, reduced to its essence, is as follows: If our litigation position will augment the funds in the Segregated Account, we can forego fundamental procedural protections for third-parties and have the issues decided through an abbreviated, non-evidentiary motion procedure in the rehabilitation proceeding. This argument fails.

A. The Rehabilitator Ignores the Economic Reality of the Transaction and Wisconsin Law.

In the Rehabilitator's view, because he refused to name the Senior Certificate Holders in the injunction, they are only entitled to minimal procedural due process. Yet, the named entities (e.g., the Trustee and servicers) function only in a representative capacity while the Senior Certificate Holders are the true economic stakeholders competing with the Rehabilitator for the funds at issue. Moreover, while no bona-fide dispute existed between the Rehabilitator and the Trustee, the Circuit Court ordered the Trustee to pay the Senior Certificate Holders' funds to Ambac. The Senior Certificate Holders therefore have

every right to insist on proper procedures in a proceeding enjoining the Trustee in a matter that could permanently extinguish their rights. Thus, the Circuit Court should not have granted injunctive relief simply on motion and without the opportunity for the Senior Certificate Holders to fully participate in the litigation.

More significantly, the Circuit Court ordered final declaratory relief directly against Senior Certificate Holders contrary to Wis. Stat. § 806.04(11), which requires that interested persons be made parties when declaratory relief is sought. The Rehabilitator does not deny that Senior Certificate Holders are interested parties. He instead overreaches in claiming that Wis. Stat. § 645.33(5) gives the Circuit Court the right to disregard other requirements of Wisconsin law. (Respondent's Br. ("R.Br.") at 19-20.) Section 645.33(5) only speaks of the confirmation of a rehabilitation plan. It does not purport to eliminate the

Declaratory Judgment Act, interpleader rules, and the Wisconsin Rules of Civil Procedure.[1]

B. The Trustee's Collaboration with the Rehabilitator Underscores Procedural Deficiencies of the Motion and the Circuit Court's Decision.

The Rehabilitator argues that the Trustee was the only necessary party and erroneously cites three New York cases concerning bond trustees litigating on behalf of bondholders. (R.Br. at 18.) None of those cases concerned competing interests in a trust, and in *every one*, the parties' rights were determined through properly commenced civil actions rather than abbreviated motion practice. Indeed, the *Equitable Trust* decision expressly recognized that bondholders have a right to intervene when a trustee is the named party:

> The bondholders are in such case *quasi* parties to the suit, and have the right at any time to intervene and become actual parties. They may come in under the decree and take the benefit of it, or, so long as the proceedings are not definitely closed, they may obtain a hearing, and show the proceedings to be erroneous.

Equitable Trust Co. of N.Y. v. Vanderbilt Realty Improvement

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1 In their Opening Brief, the Senior Certificate Holders explained the limits of *One West* and *Assured* decisions and the importance of the procedural rules. (Appellants' Opening Brief ("Opening Brief" or "App.Br.") at 23-26.)

Co., 140 N.Y.S. 1008, 1010 (App. Div. 1913) (quoting Jones on Corporate Bonds and Mortgages, § 294 (3d Ed.)) (emphasis added).

In determining whether the Trustee is even capable of adequately representing interested non-parties, the Wisconsin Supreme Court has explained that "we look to see if there is a showing of collusion between the representative and the opposing party . . . or if the representative's interest is adverse to that of the proposed intervenor." *Helgeland v. Wis. Municipalities*, 2008 WI 9, ¶ 87, 307 Wis. 2d 1, 745 N.W.2d 1. Here, the Trustee is highly conflicted and adverse to Senior Certificate Holders. Indeed, upon receiving notice that it was incorrectly disbursing funds under the PSA, the Trustee faced potential liability to the entire Senior Uninsured Class and thus sought legal cover from the Rehabilitator. The Rehabilitator had previously agreed to indemnify the Trustee and filed the Motion to insulate the Trustee from adverse claims. (*See* R. 890:34,A-App.340-342 (Plan of Rehabilitation, As Amended, Section 8.02) (Trustee will be indemnified for claims arising out of its compliance with Plan so

long as Trustee tries to have action brought before Rehabilitation Court); *see also* R.Br. at 12.)

The Trustee in fact acknowledged that its ability to even request an interpretation of the PSA that might be adverse to the Rehabilitator is circumscribed under the Plan. (R.933:63-64,A-App.097-098 (counsel for Trustee explaining belief that, under injunctions incorporated by Plan, the Trustee cannot even bring interpleader action to determine correct interpretation of the PSA).) Thus, the Trustee has simply "doubled down" on its erroneous interpretation of the PSA in order to shift its economic exposure to the Segregated Account.

C. The Circuit Court's Procedural and Construction Errors Substantially Prejudiced the Senior Certificate Holders.

According to the Rehabilitator, the Motion did not prejudice the Senior Certificate Holders because it "presented a pure matter of contract interpretation." He further asserts that counsel for the Senior Certificate Holders stated that no discovery would be necessary because the terms of the transaction documents were unambiguous. (R.Br. at 23.) Thus, the Rehabilitator suggests that "[b]oth sides agreed that the PSA

is unambiguous" such that there could be no prejudice occasioned by the lack of discovery. (*Id.*)

The Rehabilitator ignores the fact that each side argued that the PSA was unambiguous in opposite directions. Indeed, counsel for the Senior Certificate Holders explained to the Circuit Court that their position on discovery depended on how the Circuit Court addressed these interpretive issues, and thus, discovery may in fact be required:

> [B]ecause the contract is unambiguous . . . no discovery would be needed.
>
> However, what we are saying is that the procedure that should get us there starts with a standard procedure of the court hearing that question of whether or not these are unambiguous and integrated contracts and making those rulings and then there can be decisions on whether or not there should be discovery regarding the intent of the parties and the interpretation of the contracts.

(R.933:37,A-App.071.) Thus, the very best the Rehabilitator can argue is that the PSA is ambiguous—not that it is unambiguous in the contrary direction. Because the Circuit Court rejected Senior Certificate Holders' argument regarding the PSA's unambiguous meaning, Senior Certificate Holders were significantly prejudiced by the inability to conduct discovery as to the parties' intent.

Although the Circuit Court ruled that the Rehabilitator's interpretation of the PSA's plain meaning was correct, it ignored the Prospectus Supplement and relied—paradoxically—on extrinsic information not in evidence to reach that conclusion: "[Y]ou start with the fact that the parties to the agreement, the four parties, are all in agreement. They do not find any ambiguity or other difficulty in interpreting their agreement. *And that is the way it comes to the court.* " (R.933:72,A-App.106 (emphasis added).)

The Rehabilitator does not dispute that the Circuit Court relied on this and other extrinsic evidence in reaching its decision. Nevertheless, he contends that any such error was harmless because the Circuit Court concluded the PSA's terms were clear. (R.Br. at 26 n.5.) This argument fails because the improper consideration of extrinsic information was the *very basis* for that conclusion. Thus, Senior Certificate Holders' inability to conduct discovery and present evidence of the parties' intent unduly prejudiced them. Moreover, the Circuit Court's consideration of only certain extrinsic evidence (particularly purported facts not even in the record) despite finding no

ambiguity, constituted reversible error by itself. (App.Br. at 39-43.) The Response fails to advance any credible arguments to refute this conclusion.

II. Rehabilitator's Interpretation of PSA Section 5.01(a)(i)(C) Ignores the Distinctions Between Principal Payments and Interest Payments.

According to the Rehabilitator: (i) Section 5.01(a)(i)(C) permits Ambac to obtain reimbursement for principal payments and (ii) the Circuit Court correctly disregarded language in the Prospectus Supplement contradicting this interpretation. (R.Br. at 26-49.) The Rehabilitator is wrong on both fronts.

A. The Terms of the PSA Alone Refute the Rehabilitator's Arguments.

Simply stated, Section 5.01(a)(i)(C) governs distribution of the "Interest Remittance Amount" and expressly omits the defined term covering principal reimbursement (*i.e.*, the "Certificate Insurer Reimbursement Amount"). (*See* App.Br. at 45-47 & n.13.) Moreover, allowing reimbursement for principal would violate PSA Section 5.03(b)'s allocation of principal losses to Certificates in the Junior Insured Class before Certificates in the Senior Uninsured Class. (*Id.* at 49.) Furthermore,

permitting reimbursement for principal would inappropriately elevate Ambac's rights of subrogation.[2] (*Id.* at 53-55.) The Prospectus Supplement corroborates this interpretation. (R.904:101,A-App.592 (Second Fraser Aff., Ex. A, p. S-96) (explaining Ambac is only entitled to reimbursement under Section 5.01(a)(i)(C) "with respect to draws made under the Policy with respect to interest").)

In attempting to avoid the PSA's plain meaning, the Rehabilitator relies on PSA Section 5.08(b), which provides:

> To the extent that the Certificate Insurer has made a payment in respect of Realized Losses [*i.e.*, unpaid principal] and such amount has not previously been reimbursed pursuant to Section 5.01(a)(i)(C) [*i.e.*, the interest waterfall], 5.01(a)(ii)(B) [*i.e.*, a principal waterfall], 5.01(a)(iii)(B) [*i.e.*, another principal waterfall], ***or*** 5.01(a)(iv)(D) [*i.e.*, the "Excess Cashflow" waterfall], the Certificate Insurer will be entitled to be subrogated to the rights of the Holders of the Insured Certificates . . . .

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2 The Rehabilitator argues that Ambac's rights go beyond subrogation because unlike holders of Insured Certificates, Ambac can obtain payment from the proceeds of "both Loan Groups" in the Trust rather than from the "related Loan Group." (R.Br. at 37-38.) This observation does not aid the Rehabilitator's argument because it does not give Ambac any greater rights to repayment than the holders of Insured Certificates. Under no circumstances can Ambac get reimbursed unless the holders of Insured Certificates have already been paid. Thus, obtaining reimbursement from "both Loan Groups" does not enhance Ambac's rights over those of the Insured Certificate holders. Even assuming that Ambac's reimbursement rights are somehow distinct from subrogation, such a distinction would not demonstrate that Ambac can be reimbursed for principal losses from the "Interest Remittance Amount" under PSA Section 5.01(a)(i)(C).

(R.Br. at 33-34 (citing PSA § 5.08(b)) (emphasis added).) The Rehabilitator suggests that this language expressly contemplates that Ambac will be reimbursed for principal payments under the interest waterfall of PSA Section 5.01(i)(C). The Rehabilitator is mistaken.

Section 5.08(b) is simply a "belt and suspenders" provision that incorporates every waterfall provision entitling Ambac to reimbursement with respect to the mortgage loans in the Trust Fund.[3] Thus, if Ambac has not been reimbursed with respect to Realized Losses under any of the provisions entitling it to reimbursement, Ambac can invoke this "catch-all" provision to recover those amounts. This provision does not provide, however, that Ambac "will be" reimbursed for principal payments under the interest waterfall.

Tellingly, the Rehabilitator did not invoke Section 5.08 in the proceedings before the Circuit Court.

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3 Although PSA Section 5.01(g) also provides Ambac with reimbursement rights, those rights concern the "Final Maturity Reserve Trust," which is "a separate trust" under the PSA governed by separate distribution procedures. (R.886:305-306,A-App.257-258 (Eleventh Peterson Aff., Ex. D, pp. 101-102) (PSA § 5.09).)

Furthermore, the Rehabilitator's interpretation of Section 5.08 would directly conflict with other provisions of the PSA. For example, permitting Ambac to receive reimbursement under Section 5.03(a)(i)(C) on account of principal losses incurred by the Junior Insured Class before more senior Certificates have been repaid would violate Section 5.03(b)'s express priority provisions. (App.Br. at 49-50.) *See also Wells Fargo Bank, N.A. v. ESM Fund I, LP*, 785 F. Supp. 2d 188, 196 (S.D.N.Y. 2011) (explaining reimbursing junior certificate insurer before senior certificates are repaid would directly conflict with PSA's establishment of unsubordinated class of senior certificates). Thus, the PSA is, at best, ambiguous. *Hudson v. Allstate Ins. Co.*, 809 N.Y.S.2d 124, 126 (App. Div. 2006) (contract ambiguity created by conflicting provisions). As such, the Rehabilitator's claim that the PSA unambiguously permits principal reimbursement under Section 5.01(a)(i)(C) is untenable.

B. The Rehabilitator Fails to Distinguish Recent New York Decisions Requiring Consideration of the Prospectus Supplement in Securitization Litigation.

As explained in the Opening Brief, when interpreting a pooling and servicing agreement for a mortgage securitization,

New York law requires the consideration of a prospectus supplement—which is not considered parol evidence—even where the PSA is unambiguous.[4] (App.Br. at 29-39.) *In re Trusteeship Created by Am. Home Mortg. Inv. Trust 2005–2*, No. 14 Civ. 2494, 2014 WL 3858506, at *21 (S.D.N.Y. July 24, 2014) ("[I]n construing the [PSA], I am required to read it alongside the Prospectus [Supplement] ... .").

The Rehabilitator attempts to disparage the several recent holdings of courts addressing the role of the Prospectus Supplement under New York law—including the highest federal court sitting in New York—by incorrectly referring to them as "dicta" or "contrary to" New York law. (R.Br. at 39.) The cited cases demonstrate that courts do consider a prospectus supplement when interpreting the terms of a pooling and servicing agreement for a mortgage securitization. (App.Br. at 35-36, 38 (citing cases).)

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4 Although the Circuit Court failed to consider the Prospectus Supplement, it failed to identify any reason for this refusal. Indeed, the Circuit Court did not make any determination as to contractual integration. Accordingly, the Circuit Court's ruling should, at a minimum, be reversed and remanded for such a determination.

In advancing his argument, the Rehabilitator relies on cases dealing with New York's parol evidence rule in different contexts, namely, cases addressing fully self-contained agreements distinct from pooling and servicing agreements for a mortgage securitization. (R.Br. at 39-41 (citing *Hassett v. S.F. Iszard Co.*, 61 N.Y.S.2d 451 (N.Y. Sup. Ct. 1945); *Bank of N.Y. v. BearingPoint, Inc.*, No. 600169106, 2006 WL 2670143 (N.Y. Sup. Ct. Sept. 18, 2006); *M & T Bank Corp. v. LaSalle Bank N.A.*, 852 F. Supp. 2d 324 (W.D.N.Y. 2012); *Wayland Inv. Fund, LLC v. Millenium Seacarriers, Inc.*, 111 F. Supp. 2d 450, 455 (S.D.N.Y. 2000)).) The material factual distinctions as well as the fact that these cases are all lower trial court decisions make these cases inapposite, non-binding and unpersuasive.

Finally, the Rehabilitator relies on language from the Prospectus Supplement providing that the description of the Certificates "is subject to, and is qualified in its entirety by reference to, the actual provisions of the [PSA]." (R.Br. at 44-45.) According to the Rehabilitator, the PSA trumps the Prospectus Supplement in the event of a conflict, but there is no conflict here. At best, there is ambiguity in the PSA that the Prospectus

Supplement effectively resolves in favor of the Senior Certificate Holders.[5]

CONCLUSION

For the reasons stated in the Opening Brief and herein, the Circuit Court's decision should be reversed on the merits for its erroneous interpretation of the PSA. At a minimum, the Circuit Court's ruling should be vacated and remanded because of procedural and construction errors to facilitate a new decision on an adequate record.

Dated this 23rd day of December, 2014.

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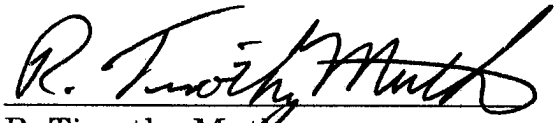
5 As the Rehabilitator recognizes, extrinsic evidence is properly considered where the underlying contract is ambiguous. *See, e.g., M & T Bank*, 852 F. Supp. 2d at 333. As explained above, the PSA is, at best, ambiguous because the Rehabilitator's interpretation of Section 5.01(a)(i)(C) directly conflicts with Section 5.03(b)'s priority provisions. Thus, even if PSA Section 5.01(a)(i)(C) did not unequivocally prohibit the reimbursement of principal and even if the Prospectus Supplement constituted extrinsic evidence, the Circuit Court still committed reversible error in (i) refusing to consider the Prospectus Supplement (along with the other extrinsic information it improperly considered in isolation) and (ii) adopting the Rehabilitator's erroneous interpretation of the PSA.

Respectfully submitted,



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FORM AND LENGTH CERTIFICATION

I hereby certify that this brief conforms to the rules contained in Wis. Stat. § 809.19(8)(b) and (c) for a brief produced with a proportional font. The length of this brief is 2,952 words.

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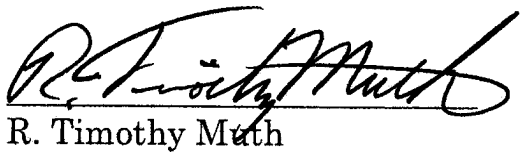

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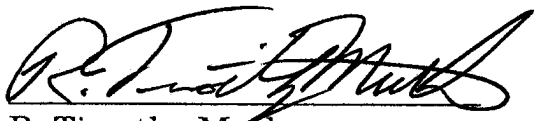
CERTIFICATION REGARDING ELECTRONIC BRIEF PURSUANT TO WIS. STAT. §809.19(12)(f)

I hereby certify that I have submitted an electronic copy of this brief, excluding the appendix, if any, which complies with the requirements of Wis. Stat. § 809.19(12).

I further certify that this electronic brief is identical in content and format to the printed form of the brief filed as of this date.

A copy of this certification has been served with the paper copies of this brief filed with the Court and served on all opposing parties.

Dated this 23rd day of December, 2014.



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CERTIFICATION AS TO DELIVERY OF INTERESTED PARTIES-APPELLANTS' REPLY BRIEF

I hereby certify that pursuant to Wis. Stat. § 809.80(3)(b)2., on December 23, 2014, the Interested Parties-Appellants' Reply Brief was delivered to Federal Express for delivery to the Clerk of the Wisconsin Court of Appeals within three calendar days.

Dated this 23rd day of December, 2014.

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