STATE OF WISCONSIN | CIRCUIT COURT BRANCH 9 | DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10 CV 1576

Rehabilitator's Opposition to the Motion of the CarVal Holders for an Order to Show Cause

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TABLE OF CONTENTS

INTRODUCTION 1

FACTUAL BACKGROUND 3

I. AMBAC'S PRE-REHABILITATION FINANCIAL DISTRESS 4

II. THE COMMENCEMENT OF THIS REHABILITATION PROCEEDING AND APPROVAL OF THE ORIGINAL PLAN OF REHABILITATION 6

III. THE REHABILITATOR'S BROAD DISCRETION AND THE INTERIM PAYMENT PERCENTAGE 9

IV. THE REHABILITATOR'S ONGOING MANAGEMENT OF THE SEGREGATED ACCOUNT AND MONITORING OF THE GENERAL ACCOUNT. 11

ARGUMENT 13

I. THE CARVAL HOLDERS DO NOT HAVE STANDING TO CHALLENGE THE REHABILITATOR'S DECISIONS. 13

II. WIS. STAT. § 645.72(1) DOES NOT APPLY TO REHABILITATION PROCEEDINGS. 15

III. THE CARVAL HOLDERS FAIL TO SHOW THAT THE REHABILITATOR HAS ABUSED THE BROAD DISCRETION GRANTED TO HIM BY BOTH THE LAW AND THE COURT-APPROVED PLAN OF REHABILITATION. 17

A. The Rehabilitator has Broad Discretion to Manage All Aspects of the Rehabilitation, Including Setting the Appropriate Interim Payment Percentage. 17

B. The CarVal Holders Misrepresent a Number of Important Facts. 18

1. The Carval Holders falsely suggest that the Rehabilitator has refused to make any cash distributions to policyholders for the past 18 months. 18

2. The CarVal Holders misrepresent the purpose of the $100 million minimum surplus requirement that the Commissioner imposed on Ambac's General Account. 19

3. The CarVal Holders misrepresent the Rehabilitator's financial projections. 20

4. The CarVal Holders misrepresent Ambac's purchases of Segregated Account-insured RMBS. 21

C. The CarVal Holders Rely on Revenue From RMBS-Related Litigation That Does Not Yet Exist. 22

IV. ANY DECISION ABOUT WHETHER TO RAISE THE IPP WILL BE BASED ON A NUMBER OF FACTORS, WITH THE PURPOSE BEING TO PROVIDE THE GREATEST OVERALL BENEFIT TO AMBAC POLICYHOLDERS AS A WHOLE 23

V. GRANTING THE CARVAL HOLDERS' MOTION WOULD RESULT IN A SIGNIFICANT DIVERSION OF THE REHABILITATOR'S RESOURCES AND SET A BAD PRECEDENT. 24

CONCLUSION 26

INTRODUCTION

The CarVal Holders' motion to show cause fails for three independent reasons. *First*, the CarVal Holders do not have standing to file motions in this proceeding or to otherwise challenge the Rehabilitator's decisions. The CarVal Holders are not parties to this proceeding. Nor are they policyholders of the Segregated Account of Ambac Assurance Corporation (the "Segregated Account"). The CarVal Holders are investment managers for a subset of downstream investors in certain obligations insured by Segregated Account policies. The holdings of this Court and the Court of Appeals in this case make clear that investors such as the CarVal Holders lack standing to challenge the Rehabilitator's decisions. *See Nickel v. FFI Fund Ltd.*, Appeal No. 2014AP2033 (March 4, 2016) (hereafter "*FFI Fund*").[1]

Second, the CarVal Holders' argument that the Commissioner of Insurance, as the court-appointed rehabilitator of the Segregated Account, is abusing his discretion is premised on a fundamental error of law. The CarVal Holders contend that the Rehabilitator is failing to adhere to the requirements of Wis. Stat. § 645.72(1) because, in their view, he is not paying claims "as promptly as possible." That statute applies only to insurer liquidation proceedings, not insurer rehabilitation proceedings. The rehabilitation statutes and the Court-approved Plan of Rehabilitation control these proceedings. Section § 645.72 does not. The controlling law grants the Rehabilitator broad discretion to make decisions relating to the rehabilitation, including whether and when to increase cash payments being made to Segregated Account policyholders.

[1] The decisions of this Court and the Court of Appeals cited in this brief are attached to the accompanying Affidavit of Jeffrey A. Simmons for the Court's convenience.

Third, even if they had standing and a legal basis on which to challenge the Rehabilitator's discretionary decisions, the CarVal Holders have failed to present evidence showing that the Rehabilitator has abused his broad discretion by maintaining the current 45% Interim Payment Percentage ("IPP"). Since the commencement of these proceedings in 2010, the Rehabilitator has worked to balance the competing interests of the holders of short-term Segregated Account policies, the holders of long-term Segregated Account policies, and the financial stability of Ambac Assurance Corporation's general account (the "General Account"). The General Account is not in rehabilitation, but remains under close oversight by the Office of the Commissioner of Insurance ("OCI") and provides the revenue necessary to pay Segregated Account policyholders. The Rehabilitator's overriding purpose has always been, and continues to be, to achieve outcomes that are the most favorable for policyholders as a whole, rather than cater to the narrower interests of particular groups of investors or Ambac's shareholders.

The CarVal Holders' motion, which argues for an immediate and dramatically large increase in the IPP, raises this same tension between the interests of various policyholders and investor groups that the Rehabilitator has confronted and successfully navigated throughout this rehabilitation. In fact, the week before the CarVal Holders filed their motion, the Rehabilitator received a letter from representatives of investors in long-dated securities insured by policies in the General Account, urging him not to increase the IPP due to concerns about Ambac's ability to pay potentially large future claims on policies insuring Puerto Rico government bonds.

Many of the Segregated Account's policy obligations extend beyond 2030, and some as far as 2052. Given the length of those obligations and the amount of money at stake (literally billions of dollars), a decision regarding payments to policyholders is not one that should be made without considerable analysis and deliberation. Although the Rehabilitator is considering the feasibility of increasing the IPP, he has not made a decision on the issue.

Because the rehabilitation of an insurance company is primarily a complicated insurance management task rather than a legal task, the Rehabilitator is afforded great discretion when making decisions about such things as whether to increase the amount of interim cash payments to policyholders. *See Nickel v. Wells Fargo Bank*, 2013 WI App 129, ¶¶ 12, 18, 351 Wis. 2d 539, 841 N.W.2d 482 (hereafter "*Wells Fargo*"). The Rehabilitator should not be forced to adopt a particular decision making timeline to accommodate the short-term interests of a subset of investors. Nor should he be forced to divert his time and resources to prepare for and attend a lengthy evidentiary hearing to accommodate such interests. There are approximately 370 policies allocated to the Segregated Account and thousands of investors in the obligations those policies insure. Permitting subsets of those investors or policyholders to force an evidentiary hearing whenever they disagree with the Rehabilitator would make this proceeding unmanageable.

Accordingly, the Rehabilitator respectfully requests that the Court deny the CarVal Holders' motion for an order to show cause.

FACTUAL BACKGROUND

The rehabilitation of the Segregated Account is by far the largest and most complex insurer rehabilitation proceeding in Wisconsin history and among the largest in

U.S. history. At the start of these proceedings in 2010, there were approximately 1,000 insurance policies insuring $45 billion of policy obligations allocated to the Segregated Account. (*See* Affidavit of Daniel J. Schwartzer ("Schwartzer Aff.") ¶ 3.) The history of the events leading to this rehabilitation, the creation of the Segregated Account, and the Rehabilitator's formulation of his initial Plan of Rehabilitation (the "Plan") are described in detail in: 1) this Court's May 27, 2010 Findings of Fact and Conclusions of Law Regarding Motions of Certain RMBS Policyholders and Certain LVM Bondholders ("May 2010 Order"); 2) this Court's January 24, 2011 Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation ("Jan. 2011 Order"); and 3) the Wisconsin Court of Appeals' decision affirming the Court's approval of the Plan, *Wells Fargo*, 2013 WI App 129. That history is briefly restated here.

I. AMBAC'S PRE-REHABILITATION FINANCIAL DISTRESS

Ambac is a financial guaranty insurer, meaning it typically insures the timely payment of financial obligations such as bonds and other forms of debt securities. Originally, Ambac's core business was insuring municipal bonds. Over time, Ambac expanded into insuring a wider variety of financial obligations, including residential mortgage-backed securities ("RMBS"), bonds backed by pools of student loans, and more complex financial instruments such as credit default swaps and collateralized debt obligations. (*See* Jan. 2011 Order at 12 (¶ 30).)

Ambac's insurance policies are generally issued to trustees – typically large banks – that administer the funds associated with securities and other financial obligations insured by Ambac. (Schwartzer Aff. ¶ 4.) The trustees are contractually authorized to act on the behalf of underlying investors. (*Id.*) Despite the name they have given themselves, the CarVal "Holders" are investment funds (*see* Feb. 9, 2016 Daniel Kersten

Aff. ¶ 2), not Ambac policyholders. (*See* Jan. 2011 Order at 51 (¶ 146) (finding that certain investment funds are not policyholders and that "[t]heir description of themselves as 'policyholders' in this proceeding is misleading and inaccurate").) The trustees are the policyholders.

OCI began to increase its oversight of Ambac as the RMBS and other financial obligations Ambac insured began to suffer significant actual and projected losses. (*See* May 2010 Order at 2-3 (¶¶ 3-4.) Due to the complexity and financial magnitude of the transactions Ambac insures, OCI retained financial and legal advisors to assist it in monitoring and assessing Ambac's condition and formulating regulatory options to address OCI's concerns. (*Id.* at 3 (¶ 4).) By 2009, OCI and its advisors were working on Ambac-related matters on essentially a daily basis as Ambac's financial condition continued to deteriorate due in large part to rapidly growing claims on its relatively short-term RMBS policies. (*Id.*; Jan. 2011 Order at 12-16 (¶¶ 29-42).) In 2009 alone, Ambac made approximately $1.6 billion of gross claims payments, with the vast majority related to RMBS obligations. (May 2010 Order at 2-3 (¶ 3).) During the early months of 2010, Ambac was paying $130 million to $150 million per month on its RMBS policies alone. (Jan. 2011 Order at 16 (¶ 42).)

With Ambac's losses continuing to mount, OCI concluded that regulatory action was necessary to staunch the outflow of claims-paying resources to satisfy short-term policy claims, in order to protect the broader base of all Ambac policyholders, long-term as well as short-term. (*Id.* at 18 (¶ 49).) Absent such action, there was a significant and growing risk that Ambac would become insolvent before its existing claims obligations were satisfied. (May 2010 Order at 8 (¶ 19).)

OCI considered at least three regulatory options: placing Ambac in liquidation; placing all of Ambac in rehabilitation; or taking a more surgical approach that focused on those policies at the root of Ambac's financial distress. *See Wells Fargo*, 2013 WI App 129, ¶ 5; Jan. 2011 Order ¶¶ 60-61. OCI rejected liquidation and full rehabilitation because they carried a number of significant disadvantages. (*See generally* Jan. 2011 Order at 20-22 (¶¶ 56-60).) OCI chose the third option, which involved allowing Ambac to establish the Segregated Account, to which Ambac would allocate certain categories of troubled policies, and then placing the Segregated Account in statutory rehabilitation, to be managed directly by the Commissioner as Rehabilitator. (*Id.* at 22 (¶¶ 60-61).) The remaining, largely healthy, policies would be left in Ambac's "General Account," to be managed by Ambac under OCI oversight. (*Id.* at 27-29 (¶¶ 80-84).)

II. THE COMMENCEMENT OF THIS REHABILITATION PROCEEDING AND APPROVAL OF THE ORIGINAL PLAN OF REHABILITATION

On March 24, 2010, OCI approved the creation of the Segregated Account and the Commissioner petitioned this Court to place the Segregated Account into Rehabilitation pursuant to the Insurers Rehabilitation and Liquidation Act, Wis. Stat. ch. 645. (May 2010 Order at 11, 13 (¶¶ 26, 32).) Approximately 1,000 Ambac policies, largely those insuring RMBS and student loan-backed securities, were allocated to the Segregated Account.[2] More than 14,000 other policies were left in Ambac's General Account. *See Wells Fargo*, 2013 WI App 129, ¶ 5; Jan. 2011 Order at 23-24 (¶¶ 64-69); May 2010 Order at 13 (¶ 31).

[2] Since that time, many of these policy obligations have ended, either through mutual agreement of the parties or the passage of time. As of December 31, 2015, there were approximately 370 policies remaining in the Segregated Account. (Schwartzer Aff. ¶ 6.)

Under this approach, the financial assets of the General Account were made available to pay the policy liabilities of the Segregated Account through a $2 billion secured note and a reinsurance agreement between the two entities. *Wells Fargo*, 2013 WI App 129, ¶ 8. The need to protect the claims-paying resources available to the Segregated Account also dictated that certain policies remain in the General Account. In particular, a significant number of policies were left in the General Account because they contained contractual rehabilitation/liquidation-proceeding "triggers" that would have caused Ambac to incur potentially large financial liability if they were allocated to the Segregated Account. Thus, it was in the interest of both Segregated Account and General Account policyholders to leave those policies outside of the rehabilitation. *See id.* ¶ 5; May 2010 Order at 9-13 (¶¶ 21-31); Jan. 2011 Order at 18-22 (¶¶ 51-63).

On October 8, 2010, the Rehabilitator filed his initial Plan of Rehabilitation with the Court. (Jan. 2011 Order at 3 (¶ 4).) The Plan called for the claims of Segregated Account policyholders to be paid 25% in cash and 75% in surplus notes (for tax reasons, the surplus notes were later eliminated and replaced with "Deferred Amounts" that "accrete" at the rate of 5.1%). (*See* June 1, 2015 Annual Report[3] ("2015 Annual Report") at 5-6.) The Court held five days of evidentiary hearings on the Rehabilitator's proposed Plan in November 2010. (Jan. 2011 Order at 4 (¶ 10).) Twenty-seven parties-in-interest, including some of the largest banks and investment funds in the world, filed written objections to confirmation of the Plan. (*Id.* at 7 (¶ 14).)

The diverging interests of short-term and long-term policyholders were a central issue at the hearings. The Rehabilitator set the initial cash payment percentage at a

[3] The Rehabilitator's June 1, 2015 Corrected Annual Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation is attached as Exhibit A to the Schwartzer Affidavit for the Court's convenience.

conservative 25% to ensure that there would be sufficient funds to pay claims that might not arise until many years in the future. (Jan. 2011 Order at 34 (¶ 103).) Holders of shorter term policy claims, however, urged the Rehabilitator and the Court to distribute more cash immediately. The Court addressed this dispute in its Order approving the Plan:

> The testimony at the hearing demonstrates that the Plan fairly balances and protects between the competing interests of policyholders with "long-tail" interests and those having "short-tail" interests. Certain of the objectors with "short-tail" interests argued that the Plan is too conservative regarding the percentage of cash being distributed in early years; conversely, objectors with "long-tail" interests argued that the Plan distributes cash too rapidly and should contain provisions for paying a certain percentage of each cash payment into a long-term "reserve." While neither extreme is satisfied by the immediate balance struck by the Rehabilitator pursuant to the Plan, the Court finds that the balance struck by the Rehabilitator is fair and reasonable under the circumstances.

(*Id.* at 51-52 (¶ 148).)

The Court approved the Plan on January 24, 2011. The Court's decision was affirmed in all respects by the Court of Appeals on October 24, 2013, *Wells Fargo*, 2013 WI App 129, ¶ 1, and the Wisconsin Supreme Court denied review. *See* 2014 WI 22 (Mar. 17, 2014). In its decision, the Court of Appeals expressly endorsed the Rehabilitator's approach of considering the interests of Ambac policyholders as a whole, not just those with policies allocated to the Segregated Account:

> [The appellants'] argument is too narrow in focus because it does not take into consideration the overall purpose of the rehabilitation, which, as we have discussed, is to reform and revitalize Ambac for the benefit of <u>all</u> policyholders, including the policyholders in the segregated account.

> Although the segregated account is a separate insurer for purposes of the rehabilitation, *see* Wis. Stat. § 611.24(3)(e), the segregated account is actually a part of Ambac and therefore what is in the best interests of Ambac as a whole is also in the best interests of the policyholders in the segregated account.

Wells Fargo, 2013 WI App 129, ¶ 73 (emphasis added).

III. THE REHABILITATOR'S BROAD DISCRETION AND THE INTERIM PAYMENT PERCENTAGE

Despite the courts' approvals, the Plan was later amended (the "Amended Plan") and did not formally go into effect until June 11, 2014, due to a dispute with the Internal Revenue Service regarding $700 million of tax refunds and other tax concerns. (*See* 2015 Annual Report at 3-6.) To provide relief to existing claim holders while those tax issues were being addressed, in 2012 the Rehabilitator recommended, and this Court approved, interim 25% cash payments to policyholders. (*See id.* at 8.) When the Amended Plan went into effect, the Rehabilitator increased the IPP to 45% and approved "catch up" payments to bring up to the 45% level those holders who had previously received 25% payments. (*See id.* at 7-8.)

The Court-approved Amended Plan grants the Rehabilitator great discretion with respect to decisions about whether and when to increase the Interim Payment Percentage. For example, section 2.02 of the Amended Plan provides:

> The Rehabilitator *may*, in his *sole and absolute discretion*, make Deferred Payments in respect of each Deferred Amount and/or *increase the Interim Payment Percentage* from time to time in accordance with the Payment Guidelines.

(Amended Plan § 2.02 (emphasis added); *see also id.* § 1.304; Payment Guidelines §§ 2.3, 2.7.)[4]

Tension between the interests of Segregated Account short-term policyholders and investors, Segregated Account long-term policyholders and investors, and General Account policyholders and investors continues to this day. On February 3, 2015, for example, the Rehabilitator received a letter from counsel for several investment funds claiming to collectively hold "several billion dollars in par value of bonds that are insured by [the] General Account," including a large amount of bonds issued by the Puerto Rico Sales Tax Financing Corporation. (Schwartzer Aff. ¶ 10, Ex. B.) Those bonds are among the largest and longest-term obligations insured by the General Account. (*Id.* ¶ 10.) The funds' letter expressed concern that "increased payments to parties holding claims payable from the Segregated Account" "could severely prejudice General Account policyholders" who could be making large policy claims in the future due to the Puerto Rico government's financial crisis.[5] (*Id.*, Ex. B.) Ambac's chief executive officer received a similar letter from another group of investors in December 2015, expressing concern that adverse developments in Puerto Rico were placing those investors "at grave risk." (*Id.* ¶ 11, Ex. C.)

The Rehabilitator will give careful consideration to the arguments made in those letters, the arguments made by the CarVal Holders, and all other communications he receives from interested parties, in making any decisions about whether or not a change

[4] The Amended Plan, the Payment Guidelines, and other Plan-related documents are available on the Court-approved website, www.ambacpolicyholders.com, under the tab labeled "Plan of Rehabilitation Documents."

[5] On March 14, 2016, those same investment funds filed a letter with the Court expressing their concerns about a potential increase in the IPP and requesting to appear in these proceedings as interested parties.

in the IPP (or any other action that may affect policyholders and policy beneficiaries) is appropriate. (*Id.* ¶ 19.)

IV. THE REHABILITATOR'S ONGOING MANAGEMENT OF THE SEGREGATED ACCOUNT AND MONITORING OF THE GENERAL ACCOUNT.

The financial condition of the Segregated Account has generally improved under the Rehabilitator's management. (Schwartzer Aff. ¶ 6.) At the time of the Plan confirmation hearings in 2010, the Rehabilitator projected that the total cash recoveries of policyholders over time might range from 59% to 100%. (*Id.*) In his June 2015 Annual Report to the Court, the Rehabilitator increased those projected recoveries to between 83.6% and 100%. (*Id.*, Ex. A at 24-26.) More recently, on January 26, 2016, Ambac and the Segregated Account announced a settlement of RMBS litigation with J.P. Morgan that has paid Ambac $995 million. (Schwartzer Aff. ¶ 8.) As of December 31, 2015, the number of policies allocated to the Segregated Account had been reduced to approximately 370, insuring approximately $15.4 billion net par value of outstanding obligations. (*Id.* ¶ 6.)

At the same time, however, the Rehabilitator is monitoring certain General Account policies that have the potential for significant losses. (Schwartzer Aff. ¶ 9.) In particular, Ambac's General Account has policies insuring $2.2 billion of net par outstanding of securities issued by Puerto Rico government entities. (*Id.*) Shortly after the Rehabilitator filed his 2015 Annual Report, the Governor of Puerto Rico announced that Puerto Rico could not pay its debts and that they would need to be restructured. (*Id.*) Similarly, Ambac insures approximately $1.8 billion net par outstanding of securities issued by the City of Chicago and related entities which face significant financial challenges. (*Id.*) The Rehabilitator also continues to closely monitor Ambac policies

insuring obligations associated with certain California government entities and certain military housing projects. (*Id.*)

While the projected ultimate cash recovery percentages contained in the Rehabilitator's 2015 Annual Report exceed the current 45% IPP, the Rehabilitator has never indicated that those cash percentages, or anything remotely close to them, are available to be paid immediately. In fact, those ultimate cash recovery percentages are based on the assumption that the IPP does not increase until the last of the claims are paid many, many years from now. In his discussion of the ultimate cash recovery percentages in the June 2015 Annual Report, the Rehabilitator stated: "For purposes of this analysis only, the Rehabilitator has assumed that the Cash to Deferred Amount ratio remains unchanged at 45:55 for the duration of the projection period and that Deferred Amounts and Surplus Notes will remain outstanding until all Policy obligations are extinguished." (2015 Annual Report at 25 (emphasis added).) The "projection period" used in the Annual Report runs through 2052. (Schwartzer Aff. ¶ 7.)

The Rehabilitator continues to closely monitor and evaluate a wide variety of facts and issues that affect any decision regarding the IPP. (*Id.* ¶ 19.) The Rehabilitator is also permitting Ambac management to explore possible transactions that might allow the Segregated Account to exit these rehabilitation proceedings. (*Id.* ¶ 18.) Any decisions the Rehabilitator makes will be based on his determination of what is in the long-term best interests of Ambac policyholders as a whole. (*Id.* ¶¶ 18-19.)

ARGUMENT

I. THE CARVAL HOLDERS DO NOT HAVE STANDING TO CHALLENGE THE REHABILITATOR'S DECISIONS.

The Affidavit of Daniel Kersten submitted in support of the CarVal Holders' motion contains a significant misstatement. Mr. Kersten states that "[t]he CarVal Holders hold 'Permitted Policy Claims'" and "have been issued 'Deferred Payment Obligations'" under the Rehabilitator's Amended Plan. (Feb. 9, 2016 Kersten Aff. ¶ 2.) That statement is false. Despite the name they have given themselves for purposes of their motion, the CarVal "Holders" are not Segregated Account policyholders and, as a result, do not hold "Permitted Policy Claims" or "Deferred Payment Obligations"[6] under the Amended Plan. (Schwartzer Aff. ¶ 12.) The CarVal Holders are a subset of investors in obligations insured by Segregated Account policies. (*Id.*) The relevant Segregated Account policyholders are the trustees for whatever obligations the CarVal Holders have invested in. (*Id.*) The CarVal Holders do not identify their investments or the relevant trustee-policyholders.

This Court and the Court of Appeals have repeatedly made clear that investors such as the CarVal Holders do not have standing to challenge decisions by the Rehabilitator. Just this month, in *FFI Fund Ltd.*, Appeal No. 2014AP2033 (March 4, 2016), the Court of Appeals rejected an appeal by another group of investors challenging the Rehabilitation Court's decision construing certain contracts. Those investors claimed that the decision affected the amount and timing of payments to them. The Court of Appeals explained at length why investors do not have standing in these proceedings:

[6] The term "Deferred Payment Obligations" does not exist under the Plan and Amended Plan. Mr. Kersten likely means "Deferred Amounts," which is a defined term under the Amended Plan.

[W]e acknowledge that the senior certificate holders have some personal interest in the rehabilitation court's order because it affects the timing and amount of the return on their Harborview investments. However, we note that the certificate holders are not actually parties to the Pooling and Servicing Agreement, and that the court's order is not directed at them. Rather the order is directed toward [the trustee] . . . .

[W]e are not persuaded that the senior certificate holders would be adversely impacted if they were barred from challenging the rehabilitation court's order. A rehabilitation proceeding is not an adversarial action, and the only formal parties to the current proceeding are the petitioning insurance commissioner and rehabilitator, Ted Nickel, and the subject insurer, Ambac. . . . To the extent that any other interested parties may have a right of limited participation in the rehabilitation proceeding, we note that [the trustee] was integrally involved in the initial litigation regarding approval of the rehabilitation plan. That prior involvement in this matter satisfies us that . . . [the trustee] is both able and willing to act to protect the interests of the senior certificate holders. The fact that the [trustee] is not pursuing an appeal here merely speaks to its evaluation that the senior certificate holder's position lacks merit.

Finally, and most importantly, the legal principles and judicial policies underlying a rehabilitation proceeding weigh heavily against allowing individual certificate or policy holders to have standing to challenge orders issued by the rehabilitation court following the adoption of a rehabilitation plan. A rehabilitation proceeding is to be treated as a management tool, rather than a legal task, and the rehabilitator should be granted broad authority and flexibility to act without cumbersome procedures. Introductory Comment to Wis. Stat. § 645.32, 1967 Wis. Laws. Ch. 89, § 17; *see also Wells Fargo*, 351 Wis. 2d 539, ¶¶ 12-14.

Id. at 3-4.

The holding of *FFI Fund* is consistent with prior rulings of this Court and the Court of Appeals. (*See* Jan. 2011 Order at 51 (¶¶ 146-147)) (rejecting challenges to Plan by investment funds who identified themselves as the "RMBS Policyholders" and stating: "Their description of themselves as 'policyholders' in this proceeding is misleading and inaccurate. . . . [T]hey have never offered or provided proof to the Rehabilitator or this Court as to their standing to assert legal positions in regard to any particular RMBS trust(s) . . . ."); *Nickel v. Aurelius Capital Mgmt. LP*, Appeal No. 2011AP2708 (March 1, 2013) at 6-7 (dismissing for lack of standing appeal by group of investors who challenged the Rehabilitator's decision to enter into an agreement they claimed affected their financial interests).

Those holdings preclude the CarVal Holders' challenge here. There is no legal basis for permitting the CarVal Holders to challenge the Rehabilitator's exercise of his broad discretion with respect to the administration of the Segregated Account.

II. WIS. STAT. § 645.72(1) DOES NOT APPLY TO REHABILITATION PROCEEDINGS.

Even if the CarVal Holders did have standing, their motion would fail as a matter of law, because it is based on a faulty legal premise. The CarVal Holders argue that the Rehabilitator has abused his discretion by not following the requirements of Wis. Stat. § 645.72(1). They contend that this statute requires the Rehabilitator to make claims payments to policyholders "as promptly as possible." (*See* CarVal Br. at 1, 5, 16-18.) Section 645.72(1), however, applies only to liquidation proceedings, not rehabilitation proceedings. The language of the statute makes this clear, stating:

> [T]he liquidator shall pay dividends as promptly as possible to security funds[7] under sub. (2) and to other creditors in a manner that will assure the proper recognition of priorities and a reasonable balance between the expeditious completion of the liquidation . . . .

Wis. Stat. § 645.72(1) (emphasis added). Section 645.72 contains a dozen references to "liquidator" and "liquidation" and never mentions "rehabilitation" or "rehabilitator." Rehabilitation proceedings are addressed in §§ 645.31-645.35.

The Court of Appeals in this proceeding rejected a similar argument that the priority provisions applicable to liquidations in § 645.68 should also apply to rehabilitations, stating:

> It is plain by the language of these statutes that they apply only to liquidation proceedings. There is no language in any of these statutes from which it can be reasonably inferred that these statutes apply to rehabilitation proceedings.

Wells Fargo, 2013 WI App 129, ¶ 53; *see also id.* ¶¶ 52-58. It is these same "priorities" that are referenced in § 645.72(1) (see underlining above), further confirming that this statute does not apply to rehabilitation proceedings.

The emphasis on quickly getting cash out the door to policyholders in liquidation proceedings makes sense, because in a liquidation proceeding all policies are cancelled and the insurer's liabilities are generally fixed as of the date of the filing of the petition for liquidation. *See* Wis. Stat. §§ 645.42(2), 645.43(1). Thus, there is less concern about what policy liabilities might arise years later. In a rehabilitation proceeding, by contrast,

[7] In addition, as shown by the language of the statute, the "as promptly as possible" requirement applies only to dividends paid to security funds, not claims payments to policyholders. *See also* § 645.72(3) ("The court may order the liquidator to pay dividends to security funds under sub. (2) more expeditiously . . . ."). Thus, even if § 645.72(1) applied to rehabilitation proceedings, it would not support the CarVal Holders' argument.

the policies remain in force and the insurer's policy liabilities may vary over time as the insurer remains in business – which is precisely the case with the Segregated Account and its many policies covering widely varying periods of time.

III. THE CARVAL HOLDERS FAIL TO SHOW THAT THE REHABILITATOR HAS ABUSED THE BROAD DISCRETION GRANTED TO HIM BY BOTH THE LAW AND THE COURT-APPROVED PLAN OF REHABILITATION.

Even if the CarVal Holders had standing to bring their motion, and even if the statute under which they bring their challenge applied to rehabilitation proceedings, the CarVal Holders' motion must still be denied because they are challenging a decision that falls squarely within the Rehabilitator's broad discretion and they have failed to show that the Rehabilitator has abused that discretion.

A. The Rehabilitator has Broad Discretion to Manage All Aspects of the Rehabilitation, Including Setting the Appropriate Interim Payment Percentage.

The Court of Appeals has repeatedly made it clear in these proceedings that the Rehabilitator has great discretion with respect to his management of an insurer in rehabilitation. In its decision affirming this Court's approval of the Rehabilitator's original Plan of Rehabilitation, the Court of Appeals explained:

> The legislature designed the insurance rehabilitation statutory scheme to be flexible and informal and conferred substantial power to the rehabilitator to effectuate rehabilitation . . . . He [or she] must act under the supervision of the court, of course, but the court's control should be liberal, not strict, and should be provided without cumbersome procedures.

Wells Fargo, 2013 WI App 129, ¶ 12 (quoting Introductory Comment to Wis. Stat. § 645.32, 1967 Wis. Laws, ch. 89, § 17); *see also id.* ¶ 14 ("Although the rehabilitator operates under the supervision of the court, the rehabilitator has broad powers."); *FFI*

Fund at 4 ("A rehabilitation proceeding is to be treated as a management tool, rather than a legal task, and the rehabilitator should be granted broad authority and flexibility to act without cumbersome procedures.").

The Circuit Court must "uphold the determinations made by the rehabilitator unless the rehabilitator abused his or her discretion." *Wells Fargo*, 2013 WI App 129, ¶ 18. *See also id.* ("[I]t is not the function of the courts to reassess the determinations of fact and public policy made by the Rehabilitator. Rather, the involvement of the judicial process is limited to safeguarding of the plan from any potential abuses of the Rehabilitator's discretion.") (quoting *Foster v. Mutual Fire, Marine and Inland Ins. Co.*, 531 Pa. 598, 609, 614 A.2d 1096 (1992)). In addition, with respect to increases in the IPP, such as those demanded by the CarVal Holders, the Amended Plan of Rehabilitation approved by the Court expressly provides that the IPP shall be determined by the Rehabilitator "in his sole and absolute discretion." (*See* Amended Plan §§ 1.304, 2.02.)

The CarVal Holders' motion seeks to eliminate the Rehabilitator's discretion and interfere with his management of the Segregated Account by demanding an immediate and dramatic increase—from 45% to at least 83.6%—in the IPP on a timetable that is most beneficial to the CarVal Holders, rather than to policyholders and policy beneficiaries as a whole. (*See* CarVal Br. at 12, 19.) Moreover, the CarVal Holders distort the facts as they strain to make their argument.

B. The CarVal Holders Misrepresent a Number of Important Facts.

1. The Carval Holders falsely state that the Rehabilitator has refused to make any cash distributions to policyholders for the past 18 months.

Attempting to exaggerate the financial magnitude of this dispute, the CarVal Holders repeatedly state that the Segregated Account stopped making any cash payments

to policyholders after the Rehabilitator increased the IPP to 45% in June 2014. In their brief, the CarVal Holders state: "For the balance of 2014 and the *entirety* of 2015, . . . no further distributions were made, nor any explanations given justifying the absence of distributions" and "the Rehabilitation process required by Wisconsin law ground to a second halt." (CarVal Br. at 7 (emphasis by CarVal Holders).) The CarVal Holders' reiterate that misrepresentation in their February 24, 2016 Amended Notice of Motion and Motion, stating: "For more than 18 months, the Rehabilitator has not approved *any* distributions of *any* kind." (Am. Mot. at 2 (emphasis by CarVal Holders).) In reality, the Segregated Account has made 45% cash distributions to holders of valid policy claims *every month* since the 45% IPP took effect. (Schwartzer Aff. ¶ 13; *see also* 2015 Annual Report at 7.)

2. The CarVal Holders misrepresent the purpose of the $100 million minimum surplus requirement that the Commissioner imposed on Ambac's General Account.

In their effort to create the impression that the Rehabilitator is needlessly sitting on a mountain of excess cash, the CarVal Holders repeatedly use the $100 million minimum surplus that the Commissioner has imposed on Ambac's General Account as a point of reference. (*See* CarVal Br. at 1-2, 14.) According to the CarVal Holders, the amount of capital currently available for distribution to policy holders is "almost *40 times* the amount of necessary surplus established by the Rehabilitator in the Amended Plan." (*Id.* at 1-2 (emphasis by CarVal Holders).) That minimum surplus requirement was never intended to be a benchmark for determining how much cash is immediately available for distribution to Segregated Account policyholders. Instead, and as explained in this Court's January 2011 Order, the $100 million surplus requirement was necessary so that

Ambac could maintain its insurance licenses in other states. (*See* Jan. 2011 Order at 49 (¶ 141); Schwartzer Aff. ¶ 14.)

3. The CarVal Holders misrepresent the Rehabilitator's financial projections.

The CarVal Holders' repeatedly reference what they misleadingly describe as the Rehabilitator's "worst-case" projections of policyholder recoveries. (*See* CarVal Br. at 1, 9, 11, 12; CarVal Am. Mot. at 2.) Those projections are actually the Rehabilitator's "stress case" projections, identified as "Scenario Four" in his 2015 Annual Report. The "stress case" projections assume stress-case loss estimates for both the General Account and the Segregated Account, and assume that Ambac achieves only 75% of the expected recoveries in RMBS-related litigations. (*See* 2015 Annual Report at 25-26.) While Scenario Four represents an adverse set of financial circumstances, the Rehabilitator has never described that scenario as the "worst case." In fact, the Rehabilitator specifically warned in the Annual Report that "[a]ctual losses attributable to General Account and/or Segregated Account policies may exceed these base case and stress case loss estimates, perhaps materially, and such estimates do not represent a cap on prospective losses." (*Id.* at 23.) There is always a chance that unanticipated events, such as larger than expected losses on General Account policies or an unexpected loss in a major RMBS-related litigation, could materially alter the Rehabilitator's projections.

Moreover, the CarVal Holders ignore the basic assumptions underlying the recovery projections contained in the Rehabilitator's Annual Report. The CarVal Holders suggest that by projecting an 83.6% total recovery to policyholders under Scenario Four, the Rehabilitator has stated that there is sufficient cash available to increase the IPP to 83.6% now. The CarVal Holders boldly argue: "it follows that an

increase of the IPP to *at least* 83.6% would be even more conservative." (CarVal Br. at 12 (emphasis by CarVal Holders).) That assertion is simply irresponsible.

The Annual Report states: "The Rehabilitator's Financial Projections are not intended to project the timing of any (i) future adjustment of the Interim Payment Percentage (currently, 45% of Permitted Claims) . . . ." (2015 Annual Report at 24.) More important, the projections of total cash recovery percentages set forth in the Annual Report are based on the assumption that the IPP does not increase until the last of the claims are paid in 2052. Again, the Annual Report plainly states:

> For purposes of this analysis only, the Rehabilitator has assumed that the Cash to Deferred Amount ratio remains unchanged at 45:55 for the duration of the projection period and that Deferred Amounts and Surplus Notes will remain outstanding until all Policy obligations are extinguished. At that time, all residual claims-paying resources are assumed to be distributed to Deferred Amount and Surplus Note holders up to the then-outstanding amount of such obligations.

(2015 Annual Report at 25 (emphasis added).) In other words, those projections are only valid if the Rehabilitator does not increase the IPP. The projections are conducted with those assumptions to account for the interests of holders of long-term policy obligations (Schwartzer Aff. ¶ 7), which the CarVal Holders ignore.[8]

4. The CarVal Holders misrepresent the nature of both Ambac's asset management practices and its purchases of Segregated Account-insured RMBS.

In the Second Affidavit of Daniel Kersten filed by the CarVal Holders on February 25, 2016, Mr. Kersten argues that the Rehabilitator is colluding with Ambac

[8] The CarVal Holders also argue that not increasing the IPP "markedly impairs the financial condition of Ambac" because Deferred Amounts accrete at an annual rate of 5.1%. (CarVal Br. at 14-15.) The Rehabilitator's projections, however, account for that accretion. (Schwartzer Aff. ¶ 17.)

management to turn the company into a "hedge fund" at the expense of Segregated Account policyholders. (Feb. 25, 2016 Kersten Aff. ¶ 7.) The CarVal Holders appear to base this curious argument on two pieces of evidence. The first is a recent statement by Ambac's CEO that "given the long duration tail of our liability book, *asset management is and will remain a core focus of Ambac* if we are to meet our obligations to our long duration policyholders . . . ." (*Id.* ¶ 9 (emphasis by CarVal Holders).) According to Mr. Kersten, "'[a]sset management' is a euphemism for running a hedge fund." (*Id.* ¶ 10.) That statement is difficult to understand. Prudent asset management is an essential task of an insurance company.

The second piece of "evidence" the CarVal Holders cite is Ambac's recent acquisitions of residential mortgage-backed securities that are covered by Segregated Account insurance policies. Those acquisitions, however, are nothing new. The acquisitions are part of a long-standing investment policy approved by the Rehabilitator and OCI and are subject to certain monetary limits that have not yet been reached. Ambac's purchases of these "Ambac-wrapped" RMBS have been described in the Rehabilitator's Annual Reports to this Court since 2014. (*See* May 2, 2014 Annual Report at 13.)

C. The CarVal Holders Rely on Revenue From RMBS-Related Litigation That Does Not Yet Exist.

The CarVal Holders also suggest that the Rehabilitator should increase the IPP based upon future damage awards or settlement proceeds from pending litigation. One of the most significant potential sources of revenue for the Segregated Account is potential recoveries from lawsuits that Ambac and the Segregated Account have filed against the issuers of Ambac-insured RMBS. As mentioned above, on January 26, 2016, Ambac and

the Segregated Account settled cases against J.P. Morgan for $995 million. While that settlement was a positive financial development, Ambac and the Segregated Account still have a number of significant RMBS litigation claims pending. In particular, Ambac and the Segregated Account have several lawsuits pending against Bank of America and Countrywide Home Loans-related entities with large damages claims that are material to the finances of the General Account and the rehabilitation of the Segregated Account. The CarVal Holders appear to take the favorable settlement of these claims as a given, stating that Bank of America "has a track record of settling claims with financial guarantors favorably." (CarVal Br. at 9.) But the fact is that the cases against Bank of America and Countrywide are ongoing, and while Ambac and the Segregated Account believe that favorable outcomes are likely, it would be irresponsible for the Rehabilitator to assume there is no risk of unfavorable outcomes in those complex cases.

IV. ANY DECISION ABOUT WHETHER TO INCREASE THE IPP WILL BE BASED ON A NUMBER OF FACTORS, WITH THE PURPOSE BEING TO PROVIDE THE GREATEST OVERALL BENEFIT TO AMBAC POLICYHOLDERS AS A WHOLE.

The CarVal Holders suggest that the Rehabilitator is refusing to increase the IPP to somehow benefit Ambac's management and shareholders. That is not true. (Schwartzer Aff. ¶ 18.) The Rehabilitator has permitted Ambac management to explore potential transactions that might enable the company to exit rehabilitation and will continue to do so. (*Id.*) If Ambac were to succeed in putting together such a transaction, and the transaction appeared to benefit policyholders as a whole, that might be one factor affecting a decision about whether to increase the IPP. (*Id.*) However, the possibility of such a transaction has not, and will not, dictate the Rehabilitator's decision. (*Id.*)

A decision about whether to increase the IPP will be based upon a number of factors including, among other things, favorable financial developments such as the settlement of the J.P. Morgan litigation, and negative developments such as concerns about the ability of Puerto Rico and Chicago government entities to repay the debts insured by Ambac's General Account. (*Id.* ¶ 19.) The Rehabilitator's overall goal will be to provide the greatest benefit to Ambac policyholders as a whole, not just those policyholders or investors who claim to have the most pressing short-term needs. (*Id.*) That approach is consistent with the Rehabilitator's duties under the law. *See Wells Fargo*, 2013 WI App 129, ¶ 76 ("[T]he exigencies attendant to a major commercial insolvency and the goals of rehabilitation necessitate the reality that 'individual interests may need to be compromised in order to avoid greater harm to the broader spectrum of policy holders and the public.'") (quoting *Foster*, 614 A.2d at 1094). But because increasing the IPP has irreversible financial consequences, it should not be done prematurely.

V. GRANTING THE CARVAL HOLDERS' MOTION WOULD RESULT IN A SIGNIFICANT DIVERSION OF THE REHABILITATOR'S RESOURCES AND SET A BAD PRECEDENT.

Managing the Segregated Account and monitoring Ambac's General Account are complicated, time-consuming tasks that involve a large number of outside financial and legal advisors and OCI staff. (Schwartzer Aff. ¶ 20.) Preparing for and participating in what might be a multi-day hearing regarding whether the Rehabilitator should increase the IPP would require a significant diversion of the Rehabilitator's time and resources. (*Id.*) It is not something that should be imposed upon the Rehabilitator to satisfy the self-interested demands of a subset of investors or without a clear showing that the Rehabilitator is abusing his broad discretion. Again, the Court of Appeals stated:

> The legislature designed the insurance rehabilitation statutory scheme to be flexible and informal and conferred substantial power to the rehabilitator to effectuate rehabilitation . . . . He [or she] must act under the supervision of the court, of course, but the court's control should be liberal, not strict, and should be provided without cumbersome procedures.

Wells Fargo, 2013 WI App 129, ¶ 12 (quoting Introductory comment to Wis. Stat. § 645.32, 1967 Wis. Laws, ch. 89, § 17).

Even if the CarVal Holders had standing and § 645.72(1) applied to rehabilitation proceedings, the CarVal Holders have failed to make the considerable showing necessary to justify an evidentiary hearing. The fact that the Rehabilitator is now projecting possible long-term policyholder recoveries of between 83.6% and 100% is evidence of how *well* the Rehabilitator has performed his functions thus far. The fact that the Rehabilitator has been cautious about increasing the IPP is evidence of his prudence in light of the fact that many Segregated Account policies insure obligations extending as far as 2052. The CarVal Holders' desire to be paid more quickly is not a basis for interfering with what thus far have been the Rehabilitator's successful efforts to protect the interests of policyholders and beneficiaries as a whole.

Granting such a motion would set a bad precedent for these proceedings. There are thousands of investors in, and numerous trustees for, the hundreds of obligations insured by policies allocated to the Segregated Account. There are at least 49 interested parties who have made appearances in these proceedings. Twenty-seven parties-in-interest, including some of the largest banks and investment funds in the world, filed written objections to confirmation of the Plan. (Jan. 2011 Order at 7 (¶ 14).) Permitting these interested parties to demand that the Rehabilitator appear at evidentiary hearings

whenever his decisions do not favor their short-term financial interests would make these proceedings unmanageable and significantly disrupt the Rehabilitator's work.

CONCLUSION

As shown above, the CarVal Holders' motion fails for three independent reasons: 1) the CarVal Holders do not have standing to challenge the Rehabilitator's decisions; 2) the statute that forms the basis of their argument that the Rehabilitator abused his discretion, Wis. Stat. § 645.72(1), does not apply to rehabilitation proceedings; and 3) the CarVal Holders have not shown any other basis for concluding that the Rehabilitator has abused his discretion. Accordingly, the Rehabilitator respectfully requests that the Court deny the CarVal Holders' Motion for an Order to Show Cause.

Dated this 23rd day of March, 2016 FOLEY & LARDNER LLP

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