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
Hon. Richard G. Niess

BRIEF IN SUPPORT OF GENERAL ACCOUNT STAKEHOLDERS' MOTION TO ADJOURN PROCEEDINGS ON THE REHABILITATOR'S SEPTEMBER 25, 2017 MOTION TO FURTHER AMEND THE PLAN OF REHABILITATION CONFIRMED ON JANUARY 24, 2011 TO FACILITATE AN EXIT FROM REHABILITATION

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Cyrus Capital Partners, L.P., Polygon Global Partners LLP, and Taconic Capital Advisors, LP (collectively, the "General Account Stakeholders") respectfully submit this brief in support of their motion (the "Motion to Adjourn") for an order to defer consideration of the September 25, 2017 motion (D.E. 1371) (the "Motion") filed by the Commissioner of Insurance of the State of Wisconsin (the "Commissioner"), as court-appointed rehabilitator (the "Rehabilitator") of the Segregated Account (the "Segregated Account") of Ambac Assurance Corporation ("Ambac").

INTRODUCTION

Through its Motion, the Rehabilitator seeks approval of a proposed transaction and an amendment to the Plan of Rehabilitation (the "Exchange Transaction")[1] intended to facilitate the Segregated Account's exit from rehabilitation by, among other things, immediately drawing over $1.3 billion in cash from the General Account and imposing new burdens on the General Account for the benefit of Segregated Account stakeholders and Ambac's ultimate equity holders. The Motion is premised on the Rehabilitator's assertion that the exit from rehabilitation will be "durable," meaning that all policyholders—regardless of whether their policies are currently assigned to the Segregated Account or the General Account—would have their future policy claims paid in full.

An adjournment of the Court dates currently set for consideration of the Exchange Transaction is warranted because the sole evidentiary support for the Rehabilitator's conclusions regarding durability and Ambac's future ability to meet policyholder claims became outdated and unreliable shortly before the Motion was filed as a result of the tragic effects of Hurricane Maria in Puerto Rico.

[1] Unless otherwise indicated, capitalized terms used in this Motion to Adjourn shall have the meanings ascribed to them in the Plan of Rehabilitation, as amended.

As the Court is aware, Ambac is a financial guaranty insurance company, meaning that it is in the business of insuring payment as and when due on bonds and other financial products. Prior to the formation of the Segregated Account and the commencement of the rehabilitation, Ambac insured an enormous amount of bonds associated with Puerto Rico—***more than $9 billion in principal and interest***, including Ambac's longest-dated exposures. When Ambac was divided, these policies were assigned to the General Account. Under the Plan as currently formulated, payment on the policies assigned to the General Account is structurally senior to payment on policies assigned to the Segregated Account.

In recent years, Puerto Rico entered a period of severe financial distress, and is now subject to a unique bankruptcy-like process referred to as "PROMESA Title III," which was crafted by the federal government specifically to address Puerto Rico's needs. As a result of Puerto Rico's downward spiral, Ambac stands to suffer severe and highly unpredictable losses, making any near-term exit from rehabilitation for the Segregated Account a highly questionable proposition.

Nevertheless, on July 19, 2017, Ambac and the Rehabilitator unveiled the proposed Exchange Transaction, which would, among other things, immediately draw approximately $1.3 billion in cash out of the General Account for the benefit of Segregated Account stakeholders, generally accelerate the draw-down of General Account resources, impose substantial new liabilities on the General Account, and elevate both debt obligations and insurance policies that are currently assigned to the Segregated Account to structural parity with those assigned to the General Account.

As problematic as Puerto Rico was for Ambac at the time the Exchange Transaction was announced, everything became dramatically more uncertain—and unquestionably far worse for

Ambac—when Hurricane Maria struck Puerto Rico on September 20, 2017. The human and physical devastation inflicted by the storm was enormous, leaving essentially the entire island of Puerto Rico without power, running water, or telecommunications. For Ambac, the financial impact of the hurricane is presently unknowable, but is anticipated by the market to be catastrophically high.

Remarkably, just five days after the storm devastated Puerto Rico, the Rehabilitator filed the Motion. More remarkable still, the evidentiary support for the Motion is provided exclusively by a purported expert report signed just ***two days*** after the hurricane hit. That report makes no provision whatsoever for the catastrophic effects of Hurricane Maria. Instead, it contains the unfathomable statement that the purported expert "do[es] not believe that any changes, if necessary, to the Puerto Rico loss estimates used herein resulting from Hurricane Maria would materially change [his] conclusions." That statement—upon which the entire report, and thus the Motion, depends—is utterly bereft of support. It is not expert analysis. It is wishful thinking. And it is spectacularly incorrect.

In fact, since the issuance of that ill-conceived statement, Puerto Rico bond prices have collapsed, indicating ballooning expected losses for Ambac, even on a present value basis. Market-implied losses on Ambac-insured Puerto Rico bonds, which should roughly correspond with the Rehabilitator's post-Hurricane Maria "base case" expectations for those losses, now vastly exceed both the Rehabilitator's stress case projections and the so-called "margin of safety" relied upon by the Rehabilitator and his "expert." A true post-hurricane stress case designed to adequately protect policyholders would contemplate still greater losses.

Moreover, the bottom may not yet be in sight for Ambac's Puerto Rico losses. Both the Puerto Rico and federal governments contemplate actions that could further undercut bondholder recoveries, and correspondingly expand Ambac's liabilities. For example, just this week, Puerto Rico's governor suspended a significant portion of the Sales-and-Use Tax that is intended to secure and fund debt service for Ambac's most significant Puerto Rico bond exposure.

Ultimately, the Rehabilitator must acknowledge that, regardless of the merits of the Exchange Transaction prior to Hurricane Maria, Ambac's financial situation has now fundamentally changed for the worse. Reliable and credible information concerning Hurricane Maria's impact on Ambac's staggering Puerto Rico exposure, which exceeds Ambac's statutory surplus by a factor of seven, may not be available for months. This Court should not be asked to evaluate the Exchange Transaction meaningfully on the current record as the full effect of Hurricane Maria on Ambac's financial position—assets as well as liabilities—is currently unknown and unknowable.

The only sensible course of action at this juncture is to defer consideration of the Exchange Transaction and to await clarity regarding the losses that Ambac will suffer as a result of its Puerto Rico exposure. Ironically, halting litigation to prudently assess the impact of Hurricane Maria on bondholder losses is exactly the approach advocated by Claude LeBlanc, CEO of Ambac Financial Group, in his November 9, 2017 investor conference call, when he declared that "Ambac is calling for all concerned to pause litigation and refrain from weaponizing Hurricane Maria."[2] Only once that clarity is achieved can the Rehabilitator reassess whether an exit from rehabilitation can be structured and, if so, on what terms.

PARTIES AND JURISDICTION

The Movants. The General Account Stakeholders are comprised of three entities, which, through certain of their respective managed or affiliated funds, collectively hold approximately

[2] *See* Webcast of November 9, 2017 investor call, available at: http://ir.ambac.com/events.cfm.

$1.2 billion in par value (approximately $190 million in accreted value) of bonds that are insured by Ambac's General Account. Those bonds include Puerto Rico Sales Tax Financing Corporation ("COFINA") Sales Tax Revenue Bonds, Series 2007A maturing 2047 (CUSIP No. 74529JAN5) and 2054 (CUSIP No. 74529JAP0). The COFINA bonds are among the largest and longest-dated bonds insured by the General Account. The General Account Stakeholders are concerned that they would shoulder a significant (and disproportionate) burden if the Exchange Transaction were considered (and approved) prematurely. Some portion of the value that Ambac proposes to pay out immediately and in the future to complete the resolution of past claims against the Segregated Account might be needed years from now to ensure the equitable treatment of long-term policyholders whose policies remain in the General Account and whose losses now, more than ever before, appear to be virtually certain in amounts never before contemplated by Ambac or the Rehabilitator.[3]

Respondent. The General Account Stakeholders seek relief against the Commissioner, as respondent, in his official capacity as Rehabilitator of the Segregated Account. Prior to filing this Motion, the General Account Stakeholders asked the Rehabilitator to agree voluntarily to adjourn the Court's consideration of the Motion.[4]

[3] The General Account Stakeholders should be heard on this matter because, as the parties who stand to bear the burden of the Exchange Transaction, they are interested parties with an unfettered right to make their concerns known to the Court. Indeed, the Rehabilitator has previously acknowledged that this Court has the discretion to allow the General Account Stakeholders, and others similarly situated to them, to participate in these proceedings. *See* Tr. 3/29/16 Hrg (DE 1259) at 35. If the Rehabilitator intends to challenge their standing, the General Account Stakeholders are prepared to brief the issue in full for the Court on an expedited basis.

[4] The General Account Stakeholders first asked the Rehabilitator to postpone judicial consideration of the Exchange Transaction by letter dated September 11, 2017. *See* Ex. 1. (All citations to "Ex. __" refer to the exhibits attached to the November 13, 2017 Affidavit of John F. Finnegan.) This request was made prior to Hurricane Maria making landfall on Puerto Rico. On November 6, 2017, the General Account Stakeholders sent a follow-up letter to the Rehabilitator explaining, in great detail, the devastating financial consequences of Hurricane Maria and reasserting the need for an adjournment of the Motion while those consequences are fully analyzed. *See* Ex. 2.

Continuing Jurisdiction. Pursuant to Article 6 of the Plan and Wis. Stat. §§ 645.33(2), 645.33(5), and 645.35, this Court has jurisdiction over the rehabilitation, implementation of the Plan, the parties, and the Motion.

BACKGROUND

I. Ambac's Initial Financial Challenges and the Formation and Rehabilitation of the Segregated Account

Ambac is a financial guaranty insurance company regulated by the Wisconsin Office of the Commissioner of Insurance ("OCI"). Historically, Ambac's primary business involved guarantying or otherwise providing credit support for bond obligations of municipalities and similar entities. In the mid-1990s, however, Ambac began to expand its business by providing financial guaranties for structured finance products, including residential mortgage-backed securities ("RMBS") and related products. *See* October 8, 2010 Disclosure Statement Accompanying Plan of Rehabilitation (DE 462) ("DS") at 3.

Ambac's financial condition deteriorated significantly as a result of the 2008 crisis "arising from mortgage lending practices in the United States." DS at 3. RMBS and other structured finance products to which Ambac had exposure suffered significant actual and projected future losses. *See id.* Ambac was unable to resolve its financial challenges, and OCI concluded that "absent regulatory action, there was a growing risk that [Ambac] could become insolvent before it satisfied all of its obligations under in-force policies." DS at 5. OCI determined that stakeholders would best be served by the creation and rehabilitation of the Segregated Account, comprised primarily of Ambac's RMBS and structured finance liabilities. *See* DS at 2, 7, 10-11. Accordingly, on March 24, 2010, the Segregated Account was formed and, upon the Commissioner's verified petition and with the consent of Ambac's board of directors, placed into rehabilitation. *See* DS at 9; Order for Rehabilitation (DE 11). Pursuant to the terms of the Order for Rehabilitation, the Commissioner was appointed as the Rehabilitator. The Court also appointed a "Special Deputy Commissioner," who, pursuant to Wis. Stat. § 645.33, was granted all powers of the Rehabilitator for purposes of carrying out the rehabilitation.[5]

Ambac's "General Account" retained all liabilities—primarily consisting of obligations under its insurance of debt issued by municipalities and similar entities (including Puerto Rico)—that were not specifically assigned to the Segregated Account, as well as all assets and claims-paying resources. *See* DS at 2, 52, 57-58.

Since the creation of the Segregated Account, and for several years beforehand, Ambac has not written any new policies.

II. Ambac Rehabilitator's Motivating Premise From 2010 to July 2017: Full Preservation of the General Account, Rehabilitation of the Segregated Account

In crafting a rehabilitation strategy, the Rehabilitator noted his "statutory directive to protect the interests of insureds, creditors and the public" and stated that "[f]irst and foremost . . . any regulatory action needed to be effective in curtailing claims payments on short-dated claims in order to avoid exhausting [Ambac]'s claims-paying resources before a fuller understanding of likely policy losses [short and long term] was achieved." DS at 5.

The Rehabilitator recognized that the liabilities of the Segregated Account posed a particularly acute risk to long-dated policies of the General Account, declaring that "[t]o continue to pay RMBS claims in full as they accrued would have treated certain policyholders inequitably by disproportionately reducing the amount of [Ambac]'s claims-paying resources in favor of certain RMBS policyholders with short-dated claims while possibly leaving insufficient resources to pay in full the many policyholders with longer-dated claims." DS at 11. Indeed, as

[5] The current Special Deputy Commissioner is Daniel J. Schwartzer.

has been previously recognized in these proceedings, "the primary reason [OCI] commenced rehabilitation proceedings was to prevent short-term policyholders 'from consuming a disproportionate share of Ambac's resources to the disadvantage of' long-term policyholders." *In re Ambac Assur. Corp.*, 351 Wis.2d 539, 613-14 (2013). The Rehabilitator therefore "concluded that any solution adopted would need to include a temporary claims payment moratorium followed by partial cash payments on claims" against the Segregated Account. DS at 5. The Rehabilitator further proposed and obtained approval of a Plan that established General Account policyholders—such as the General Account Stakeholders—as structurally senior to Segregated Account creditors.

At heart, the Plan is a straightforward "good bank/bad bank" plan. Under the current Plan, substantially all of Ambac's assets and claims-paying resources remain with Ambac's General Account (the "good bank"). The General Account, however, issued to the Segregated Account (the "bad bank") a $2 billion "Secured Note," as well as a "Reinsurance Agreement." *See* DS at 13-14. In essence, the Secured Note and the Reinsurance Agreement provide that claims-paying assets of the General Account will be made available *under certain circumstances* to pay claims against the Segregated Account. *See* DS at 13-14. Claims against the Segregated Account were originally paid an interim payment percentage ("<u>IPP</u>") fixed at 25 percent (Plan § 1.304), but the IPP was subsequently increased by the Rehabilitator to 45 percent. *See* IPP Notice, dated June 20, 2014 (DE 1122). The metric the Rehabilitator has always used and that it purports to continue to use when evaluating proposals is to "achieve outcomes that are the most favorable for policyholders as a whole, rather than cater to the narrower interests of particular groups." Rehabilitator's Opposition to CarVal Br. (DE 1241) at 2 & 12.

Through mid-2017, that strategy served Ambac well, allowing for Segregated Account policy beneficiaries to receive meaningful interim recoveries on their ill-fated structured finance products while positioning the General Account to survive the brewing downturn in its municipal portfolio.

III. The Proposed Exchange Transaction

On July 19, 2017, Ambac Financial Group, Inc. ("AFG"), of which Ambac is the principal operating subsidiary, announced that it had reached a restructuring support agreement with its creditors that would, through the Exchange Transaction, purportedly facilitate the Segregated Account's exit from rehabilitation. Ambac also indicated that OCI had confirmed "its support for the [Exchange] Transaction and its intention to move forward with an amendment to the Plan of Rehabilitation for the Segregated Account . . . to conclude the rehabilitation . . . ." Ex. 3 at 1.

From the General Account Stakeholders' perspective, the proposed Exchange Transaction can be basically summed up as follows:

- The Segregated Account will be folded back into the General Account and the rehabilitation terminated;
- Approximately $1.3 billion of cash will immediately flow out of the General Account to pay Segregated Account beneficiaries;
- "Known" new liabilities of approximately $900 million will flow into the General Account from the Segregated Account, and will be payable in full rather than at the current 45% IPP; and
- More than $1.5 billion of new notes will be issued and will be: (a) payable by the General Account; (b) secured by a lien on key litigation assets; and, (c) remarkably, given that Ambac has not written a new policy in more than 7 years, insured by Ambac's General Account (thus elevating a standard debt obligation to the level of a policy claim).

In other words, the Exchange Transaction would, in order to end the rehabilitation, immediately drain substantial resources from the General Account for the benefit of Segregated Account stakeholders (and AFG equity holders) while risks to the General Account are exploding.

The Motion seeking approval of the Exchange Transaction was filed with the Court on September 25, 2017. The sole evidentiary support for the Motion is provided by the accompanying purported *Expert Report of Dennis M. McGettigan Regarding Ambac Assurance Corporation and the Segregated Account of Ambac Assurance Corp.* (the "Gordian Report"), which is dated September 22, 2017 (DE 1375, Exhibit C).

In the Gordian Report, Mr. McGettigan opines that the Exchange Transaction will result in a "durable exit" from rehabilitation for the Segregated Account. McGettigan describes a "durable exit" as one in which Ambac "is able to pay all prospective policy claims in full and in cash under all four [financial projection] Scenarios, while also maintaining a sufficient buffer, or margin of safety, so that [Ambac] will be able to maintain payment in full even if adverse developments occur over the course of the Projection Period," which runs through the end of 2054. Gordian Report at 19.

In conducting his analysis, McGettigan asserts that he considered four different financial projection scenarios developed by the Rehabilitator, with Scenario One being the most optimistic and Scenario Four being the most conservative. Gordian Report at 4. Using these four scenarios, McGettigan concluded that "[t]he minimum margin of safety, in present value terms, ranges from $637 million, in Scenario Four, to $1.3 billion, in Scenario One, with a four Scenario average margin of safety of $946 million." Gordian Report at 24. None of the Scenarios make any adjustments whatsoever for the catastrophic effects of Hurricane Maria.

IV. The Elephant in the Room: Ambac's Massive Exposure to Puerto Rico

Ambac has insured an enormous amount of debt—more than $2.6 billion in current accreted value and over $9 billion in principal and interest—across Puerto Rico's capital structure. The entirety of that exposure resides in the General Account, which now faces the prospect of extraordinarily high losses. The table below summarizes Ambac's current exposure to Puerto Rico-related issuances, and the market-implied losses that should currently be anticipated with respect to each of those issuances:[6]

General Obligation Bonds	Net Accreted (in millions)	Current Trading Price	Implied Loss (in millions)
General Obligation Bonds	$56	27%	$41
PR Public Building Authority Revenue - GO Guaranty	$112	23%	$86
Total General Obligation Exposure	$168		$127
Revenue Bonds			
COFINA Senior Bonds	$1,336	40%	$803
PRIFA Bonds	$532	5%	$507
PRHTA '68	$27	57%	$12
PRHTA '98	$431	12%	$379
Convention Center Bonds	$125	5%	$119
Total Revenue Bond Exposure	$2,450		$1,820
Grand Total Puerto Rico Exposure:	**$2,618**		**$1,947**

In order for the Court to truly understand the depth and breadth of the challenges facing Ambac and the General Account from events in Puerto Rico, and the reasons to adjourn the Motion at this time, we present a detailed analysis of Ambac's exposures below.

A. The Reality in Puerto Rico Prior to Hurricane Maria

i. *Prolonged Fiscal Distress Becomes Acute and Revenues Pledged for Bond Payments are "Clawed-Back"*

Puerto Rico has struggled financially for a number of years, facing the combined headwinds of expiring federal subsidies, more than a decade of nearly continuous recession, and

[6] All trading price data contained in this brief is provided by Bloomberg, and is as of close of trading on November 9, 2017.

an ongoing steady decline in population. However, since approval of the Plan and the most recent increase in the IPP, Puerto Rico has suffered an acute financial crisis. In particular, on June 28, 2015, then-Governor of Puerto Rico Alejandro Garcia Padilla publicly declared that Puerto Rico's broad debt stack "is not payable." Ex. 4.

Critically, Puerto Rico's general obligation bonds enjoy what has been described by some as a constitutional first priority on all "available resources" of Puerto Rico when there are otherwise inadequate amounts available for debt service. On November 30, 2015, then-Governor Alejandro Garcia Padilla issued an executive order invoking that right for the first time in Puerto Rico's history and implementing a "clawback" of revenues with respect to a number of Puerto Rico's instrumentalities, including the Puerto Rico Infrastructure Financing Authority ("PRIFA"), the Puerto Rico Highways and Transportation Authority ("PRHTA"), and the Puerto Rico Convention Center District Authority ("PRCCDA"). This clawback took the form of the complete redirection of ***all*** revenues that would otherwise have been available for debt service of these entities into the Commonwealth's Treasury. Since that time, each of the affected entities has been in complete payment default. Notably, Ambac's General Account insures more than $1.1 billion of debt (in current accreted terms) issued by entities subject to the clawback. As a result, Ambac has already been required to make substantial payments to bondholders. *See* Ex. 5 at 78.

On February 1, 2016, Puerto Rico released a proposal for a general restructuring of its finances through an enormous distressed debt exchange. Ex. 6. Creditors rejected the proposal.

ii. *PROMESA and Puerto Rico's Fiscal Plan*

On June 30, 2016, the U.S. federal government enacted the Puerto Rico Oversight, Management, and Economic Stability Act, 48 U.S.C. §§ 2101, *et seq.* ("PROMESA"). PROMESA is intended to "address[] Puerto Rico's debt by establishing an oversight board, a process for restructuring debt, and expedited procedures for approving critical infrastructure projects." Ex. 7. Among other things, PROMESA established an "Oversight Board" tasked with steering Puerto Rico and its instrumentalities back to fiscal health and created two new specialized procedures for restructuring Puerto Rico's debt. The first of these procedures, referred to as Title III, is a full bankruptcy-like court proceeding—essentially a cross between a corporate Chapter 11 case and a municipal Chapter 9 case—guided by the Oversight Board.

On May 9, 2017, the Oversight Board filed petitions placing the Commonwealth of Puerto Rico and COFINA into PROMESA Title III proceedings. *See generally In re The Financial Oversight and Management Board for Puerto Rico*, Case Nos. 17-bk-3283-LTS, 17-bk-3284-LTS (D. P.R.). The Oversight Board has since done the same with respect to various other Puerto Rico instrumentalities, including PRHTA, the Puerto Rico Employees Retirement System ("ERS"), and the Puerto Rico Electric Power Authority ("PREPA").

PROMESA required the formulation of a "Fiscal Plan," which provides the roadmap—as approved by Puerto Rico's Oversight Board—for Puerto Rico's ultimate restructuring as it was envisioned at the time of the plan's approval (which substantially predated Hurricane Maria). Ex. 8. As such, the Fiscal Plan provides a useful level-setting tool with respect to expected creditor losses ***prior to*** Hurricane Maria. Even then, the outlook for creditors was grim.

Notably, the original Fiscal Plan projected that, over the next 10 years, there would be an average of $787 million available annually for debt service with respect to, among other things: (a) Puerto Rico General Obligation bonds, including bonds issued by the Puerto Rico Public Buildings Authority (the "PBA") that have the benefit of a general obligation-level guarantee; (b) COFINA, (c) PRHTA, (d) PRIFA, and (e) PRCCDA. Over the same ten-year span, these entities would average an aggregate of $3.3 billion in required annual debt service, implying aggregate creditor recoveries of only 24%—pre-Hurricane Maria. As reflected in the chart above, and as addressed in greater detail below, Ambac's General Account has substantial (and with respect to COFINA, enormous) exposure to each of these impaired credits. Moreover, the Fiscal Plan appears to lock in the revenue clawback described above. In plain terms, even before Hurricane Maria struck, Puerto Rico's Fiscal Plan demonstrated that Ambac would suffer enormous losses.

Post-hurricane, however, the Oversight Board—against the wishes of bondholders (including Ambac)—is pushing forward with the formulation of new fiscal plans while the Commonwealth is in the depths of societal and financial distress. The Oversight Board's proposed schedule is as follows:

Schedule for engagement and certification

Date	Topic	Details
Nov 16	Listening Session: Macro effects on revenue/expenses	Attendees: All stakeholders Location: San Juan, Puerto Rico Topics: Population, GNP, fiscal multiplier effects
Nov 28	Listening Session: Fiscal measures	Attendees: All stakeholders Location: San Juan, Puerto Rico Topics: Magnitude, structure and timing of fiscal changes
Dec 4	Listening Session: Economic development	Attendees: All stakeholders Location: New York City Topics: Capital investment, labor reform, recovery funding
Dec 22	CW/PREPA/PRASA submit draft FP to FOMB	Timeline allows for subsequent review/revision in conjunction with FOMB
Jan 12	FOMB replies to CW/PREPA/ PRASA draft FP	FOMB will either certify or recommend revisions
Feb 9	UPR/HTA/GDB/COSSEC submit draft FPs	Timeline allows for subsequent review/revision in conjunction with FOMB
Feb 23	FOMB replies to UPR/HTA/ GCB/COSSEC's draft FP	FOMB will either certify or recommend revisions

Under that schedule, the Commonwealth's new fiscal plan will be formulated before electrical power is even restored across the island, and in the shadow of the exodus of approximately 90 thousand people from Puerto Rico in the six weeks since the hurricane. There can be no doubt that any new fiscal plans developed and certified by the Oversight Board so soon after Hurricane Maria will show dramatically decreased revenue and other projections and, therefore, dramatically increased potential losses for bondholders. Indeed, the Oversight Board's representatives suggested during the Oversight Board's last public meeting that the revised fiscal plans would likely contemplate an approximately 15% decline in Puerto Rico's population.[7] Moreover, the Oversight Board has indicated that its revised fiscal plan for the Commonwealth of Puerto Rico will shift from a ten-year time horizon (potentially capturing Puerto Rico's recovery in the later years) to a five-year time horizon (which would focus more heavily on Puerto Rico's period of deep distress). In Ambac's third quarter earnings call, held on November 9, 2017, Claude LeBlanc, chief executive officer of AFG, stated his belief that the accelerated schedule and compressed time horizons for revised fiscal plans is "deliberately designed" to depress bondholder recoveries. *See* FN 2.

iii. *The Commonwealth-COFINA Dispute*

A third gating issue with respect to Puerto Rico's overall reorganization is the resolution of the so-called "Commonwealth-COFINA Dispute." At issue in the Commonwealth-COFINA Dispute is whether the Puerto Rico sales tax revenues that have been pledged for COFINA debt service, after consideration of all procedural and substantive defenses and counterclaims, including certain constitutional issues, are property of the Commonwealth or property of COFINA.

[7] A publicly available video recording of the Oversight Board's most recent public meeting remains forthcoming, but is expected to be available in the near future at https://juntasupervision.pr.gov/index.php/en/videos-of-meetings/.

The Official Committee of Unsecured Creditors appointed in Puerto Rico's Title III case contends that the funds should be deemed property of the Commonwealth and diverted for payment of general obligation debt, retiree obligations, other unsecured creditors, and "essential services" of Puerto Rico. *See* Ex. 9 at 41-43. COFINA stakeholders, including Ambac, are opposing those efforts, arguing that the pledged revenues are property of COFINA. *See* Ex. 10 at Counterclaims. As a result, the Commonwealth-COFINA Dispute presents a sharp, binary outcome. If the Official Committee and the general obligation bondholders are successful, then COFINA bondholders will most likely suffer 100% losses on their bonds as they will be deprived of the sole source of payment for the bonds. Ambac has insured approximately $7.3 billion of COFINA bonds that are at risk of being completely wiped out. If discounted at the "risk-free" rate implied by a 30-year U.S. Treasury bond, such losses would amount to ***$2.9 billion today*** in present value terms. If the COFINA bondholders are successful, they may enjoy substantial recoveries (subject to the other risks facing COFINA, discussed below).

Through a unique protocol entered in the Title III cases, these issues are to be joined and decided on an expedited basis. *See* Ex. 11. Pursuant to the most recent scheduling order entered in the Commonwealth-COFINA Dispute, all summary judgment motions are required to be filed on or before January 31, 2018. Briefing will be completed 28 days later. Trial is expected to be held in early March 2018. *See* Ex. 12 at 4. Thus, in the relatively near future, all stakeholders will have substantially better information concerning Ambac's ultimate viability.

B. <u>Puerto Rico was Utterly Devastated by Hurricane Maria</u>

In early September 2017, Puerto Rico received a glancing blow from Hurricane Irma. Just two weeks later, on September 20, Puerto Rico received a direct hit from Hurricane Maria. Hurricane Maria traversed the entire length of the island, leaving complete devastation in its wake.

The effects of Hurricane Maria, in particular, have had severe consequences for every aspect of life in Puerto Rico. Judge Swain, who is overseeing Puerto Rico's Title III cases, described the effect of the storms in stark terms:

> Millions of American citizens whose U.S. home is Puerto Rico are without light, water, food, fuel and even basic sewer services. Hospitals are struggling without fuel and supplies; considerable areas of the island are isolated due to inaccessibility and one area is threatened by the imminent collapse of a decades-old dam that was heavily weakened by María and could possibly trigger a life-threatening flood. These Americans, who were in the process of restructuring billions in debt through these PROMESA Title III proceedings in the hope of emerging from an economic crisis of unprecedented proportions, now face an even graver humanitarian crisis, one also that threatens their already challenging path back to economic stability.

Ex. 13 at 2.[8] In seeking hurricane-relief aid from the federal government, the Oversight Board explained in no uncertain terms that:

> ***Hurricanes Maria and Irma have fundamentally changed Puerto Rico's reality.***
>
> . . .
>
> . . . ***the damage that Puerto Rico has suffered is catastrophic and island-wide.*** It is far more significant and extensive than what other hurricanes have inflicted on Puerto Rico in recent memory. While it remains too early for us to provide a damage assessment, a preliminary report from Moody's Analytics suggested it could be approximately $95 billion, which is ***roughly 150% of Puerto Rico's annual GNP.*** Moreover, the FOMB believes that Hurricanes Irma and Maria will cause Puerto Rico's central government and some of its instrumentalities to face ***severe cash shortfalls from lower revenues, higher costs, and delayed or reduced cost-saving measures*** that had been required by the [Oversight Board]'s plans.

Ex. 15 at 1-2 (emphasis added). The Puerto Rico Fiscal Agency and Financial Advisory Authority has confirmed that assessment, declaring that "[a]s a result of these devastating storms, Puerto Rico is currently facing one of its worst crises in modern history." Ex. 16 at ¶ 4.

[8] Similarly, on September 29, 2017, the Clerk of the United States District Court for the District of Puerto Rico issued Notice 17-12, stating that "[t]he passage of Hurricane Maria has created a state of emergency, which encompasses the unavailability of power, destruction of communication towers, the limited access to food, fuel, and water." Ex. 14 at 1.

In short, Hurricane Maria proved to be a humanitarian and societal disaster for Puerto Rico on a scale never before seen in the United States.

Just two days after the hurricane struck, the Gordian Report was executed.

C. Puerto Rico Suffers Financial Collapse, Resulting in Massive New Losses for Ambac

The physical and human toll wrought by Hurricane Maria resulted in an immediate collapse of Puerto Rico's already embattled finances. In the course of issuing sweeping downgrades for Puerto Rico-related bonds, Moody's Investors Service explained:

> The lower ratings are aligned with our estimates of Puerto Rico's reduced debt servicing capacity given extensive damage from Hurricane Maria. Puerto Rico faces almost total economic and revenue disruption in the near term and diminished output and revenue probably through the end of the current fiscal year and maybe well into the next. ***The weaker trajectory will undercut the government's ability to repay its debt, a matter now being weighed in a bankruptcy-like proceeding authorized by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)*** . . . .

Ex. 17 at 1. Underscoring this point, the Puerto Rico Fiscal Agency and Financial Advisory Authority has confirmed that Puerto Rico's disaster relief efforts will result in "net cash outflow of $3.2" billion in November and December of 2017 alone.[9]

Puerto Rico's reduced capacity to repay creditors has dire implications for Ambac. While the details of Ambac's various Puerto Rico exposures threaten to overwhelm, they are critical to the Court's understanding the depths of Ambac's current financial peril and are presented below.

9 *See, e.g., Liquidity Update to the Financial Oversight and Management Board for Puerto Rico (FOMB), 10th Public Meeting, San Juan, Puerto Rico, October 31, 2017* at 3, available at: https://juntasupervision.pr.gov/wp-content/uploads/wpfd/50/59f882282f987.pdf.

i. *Ambac's Exposure to Puerto Rico General Obligation Debt*

Ambac's General Account has insured approximately $168 million of current accreted value of Puerto Rico's general obligation debt. This exposure takes the form of approximately $56 million of pure general obligation bonds and $112 million of PBA bonds that are supported by a general obligation-level guaranty from the government of Puerto Rico. Pure general obligation bonds currently trade at 27%, implying losses for Ambac of $41 million on a present accreted basis. The PBA bonds currently trade at 23%, implying losses for Ambac of $86 million on a present accreted basis. In total, Ambac can expect—as a market-informed base case—$127 million of losses on its Puerto Rico general obligation bond exposure. A stress case should contemplate substantially greater losses.

The ultimate fate of Puerto Rico's general obligation bonds will depend in part on the outcome of the Commonwealth-COFINA Dispute. In the event that the General Obligation bondholders prevail in that dispute, there may be some modest upside for Ambac on its General Obligation bond exposure relative to current trading prices. However, the Commonwealth's representatives have intimated that they may use any newly freed COFINA revenues to pay "essential services" rather than to fund general obligation debt service, indicating that general obligation bondholder upside from the Commonwealth-COFINA Dispute may be limited.

The Gordian Report states that Ambac's "various Puerto Rico exposures, and the potential losses associated with such exposures, may be interdependent to some degree, such that a worse-than-expected outcome for one issuer to which AAC has exposure could result in reduced losses in respect of other AAC-insured obligations." *See* Gordian Report at 22. However, given that Ambac's exposure is heavily skewed towards COFINA, any upside would be overwhelmed—many times over—by increased losses on the COFINA side of the ledger. Additionally, for the reasons detailed in our description of each issue, particularly the absolute size of Ambac's exposure to long-tail COFINA bonds and to bonds subject to revenue clawback by the Commonwealth, the Gordian Report's analysis is fundamentally misleading.

ii. *Ambac's Exposure to COFINA Debt*

Whether Ambac's General Account thrives or fails is likely to turn on the ultimate recoveries for COFINA bondholders. In total, Ambac has insured approximately $7.3 ***billion*** par value of COFINA bonds, the great majority of which are zero-coupon capital appreciation bonds that do not mature until 2054. The General Account Stakeholders are substantial holders of those bonds. The current accreted value of Ambac's COFINA exposure is approximately $1.366 billion.[10]

By way of background, COFINA is essentially a super-priority securitization structure. Bonds are secured by a portion of the proceeds generated by Puerto Rico's Sales-and-Use Tax, which in theory is channeled into COFINA before becoming "available resources" of the Commonwealth or otherwise subject to claims by the government of Puerto Rico. It is this structure that is at issue in the Commonwealth-COFINA Dispute described above. Historically, the Sales-and-Use Tax proceeds supporting COFINA were sufficient to meet COFINA's debt service requirements.

Now, however, COFINA faces a confluence of problems. First, Hurricane Maria has negatively affected the COFINA revenue stream in a variety of ways. In the short term, the formal economy—on which the Sales-and-Use Tax depends—is enormously impaired. But even as the formal economy begins to reemerge, the infrastructure for collecting the Sales-and-Use Tax is and will remain heavily impaired. As discussed during the Oversight Board's October 31

[10] We understand that Ambac has purchased a substantial portion of its insured COFINA debt in the open market over the past year or more. *See* Ex. 5 at 62. This does not materially change the analysis because the debt is now held as an investment and will result in an investment loss rather than a policy claim.

open meeting, the collection of the Sales-and-Use Tax depends upon a "fiscal terminal network." Hurricane Maria completely knocked out that network, at least temporarily reducing the collection rate to zero. Even now, Puerto Rico's Treasury Department has only a fraction of its collection offices open, and those offices are having little success in collecting the taxes. Ex. 18 at 3-4. In total, the government of Puerto Rico and the Oversight Board have forecast a 53% decline in Sales-and-Use Tax collections as a result of the hurricane.

In the longer term, empirical data shows that major hurricanes have significant, and long-term, negative effects on population levels in the impacted area. For example, the population of New Orleans dropped precipitously after Hurricane Katrina in 2005, and is still—12 years later—approximately 14% below its pre-hurricane levels. *See* Ex. 19. For a region such as Puerto Rico that was already suffering from long-term population decline, these negative effects are likely to be substantial. Significantly fewer people living and working in Puerto Rico will mean significantly lower Sales-and-Use Tax revenues, even if the mechanisms for collecting that tax were functioning. Indeed, Moody's Investors Service cited this very concern in issuing its most recent credit downgrade for COFINA. *See* Ex. 17 at 1.

Second, the Commonwealth's legislative and executive response to the hurricanes threaten further harm to COFINA. In particular, the government has threatened for some time "to take emergency tax measures ***including eliminating or reducing the sales and use tax***," thereby eliminating COFINA's sole source of debt service revenue. Ex. 20 at 1. On November 8, 2017, Governor Rosselló began to carry out this threat, issuing an executive order that suspended the Sales-and-Use Tax for all small- and medium-sized businesses in Puerto Rico. *See* Ex. 21. In announcing that measure, the Governor also confirmed that the government is considering legislation to fully eliminate and replace the Sales-and-Use Tax.

Third, the Commonwealth-COFINA Dispute continues to loom over COFINA and creates a very real risk that COFINA bondholders may recover nothing from COFINA on their bonds and will instead seek payment in full from Ambac.

The combination of these risks has, unsurprisingly, sharply depressed COFINA bond trading prices, suggesting a sharply increased risk of loss to Ambac. Comparable uninsured COFINA bonds currently trade at only 40%, down from 60% pre-hurricane. These trading prices imply expected losses for Ambac of 60%, or approximately $803 million on an accreted basis. In nominal terms, long term, those losses would be more than $4 billion.

Post-Hurricane Maria, losses of that magnitude with respect to COFINA should be OCI's market-informed ***base case***, not stress case. Yet it appears that OCI's base case (which OCI has refused to disclose in detail) reflects projected losses with respect to COFINA of only 33%. *See* Gordian Report at Exhibit 14. Indeed, it appears that even OCI's stress case contemplates losses with respect to COFINA of only 45%. *See id.* Thus, the market's ***actual*** post-hurricane ***base case*** is already 15% below OCI's ***stress case***, and a whopping 27% below OCI's base case. Given the enormous size of Ambac's COFINA exposure, this difference amounts to losses exceeding OCI's projections by hundreds of millions of dollars in accreted terms, and billions of dollars in ultimate nominal terms. A true post-hurricane stress case must contemplate still greater losses.

iii. *Ambac's Exposure to PRIFA Debt*

Ambac's General Account has also insured approximately $532 million by present accreted value of PRIFA bonds. PRIFA bonds are generally referred to as "rum bonds" because they are secured by certain proceeds of an excise tax on rum shipped to the mainland United States. The United States federal government (through the IRS) collects this tax, and then remits the proceeds of the tax to the government of Puerto Rico. However, the funds theoretically securing the payment of rum bonds are subject to the constitutional clawback discussed above. As a result, 100% of those funds are being diverted to the Commonwealth Treasury rather than being deposited in the sinking fund. Consequently, PRIFA bonds have been in complete payment default since January 1, 2016.

Nor is there any indication that this situation will ***ever*** change: even the pre-hurricane Fiscal Plan indicated that no revenues would be made available for PRIFA debt service. As a result, uninsured PRIFA bonds are trading at a mere 5%. This implies losses for Ambac of $507 million on a present accreted basis. However, the 5% trading price simply represents "option" upside—the hope that something might change that would result in value flowing to PRIFA bondholders. As noted, even pre-hurricane status quo recoveries were 0%, which should be Ambac's base case with respect to PRIFA. That would imply losses for Ambac of $532 million on a present accreted basis.

iv. *PRHTA (Highway Revenue)*

Ambac has a relatively small exposure of $27 million to PRHTA (Highway Revenue) bonds (also referred to as PRHTA '68 bonds). Highway Revenue bonds are payable from several sources, including: (a) Puerto Rico gasoline and other fuel taxes, (b) highway tolls, and (c) certain license fees. *See* Ex. 22. However, the pledged tax revenues are subject to the clawback and, as a result, are presently not being made available for highway revenue bond debt service. The pledged toll revenues are somewhat differently situated, but are nevertheless presently being withheld. Ambac itself has highlighted the dire status of its PRHTA collateral, stating in a recent brief filed with the District Court in Puerto Rico that the pre-hurricane Fiscal Plan, "apparent[ly] dictate[s] that ***no money*** will be available to pay HTA's bonds." Ex. 23 at 3. Indeed, the pre-hurricane Fiscal Plan for PRHTA indicated that PRHTA would have had ***negative*** $487.3 million of available free cash flow available for debt service over the next 10 years, indicating that PRHTA would have required substantial cash infusions from the Commonwealth Treasury simply to continue operating, even without making any payments to bondholders. Moreover, in response to a motion for a preliminary injunction brought by a holder of uninsured PRHTA bonds in the PRHTA Title III case, the District Court recently held that the bondholder failed to a show "a likelihood of success" on its claim that the PRHTA bonds are secured by a statutory lien on toll revenues, or indeed any lien at all. *See* Ex. 24 at 13-14. This ominous development portends ultimate losses of 100% on PRHTA bonds.

PRHTA (Highway Revenue) bonds trade relatively lightly, but presently stand at 57%. This would imply losses for Ambac of $12 million on a present accreted basis. That may be a reasonable (if optimistic) base case, but, as Ambac itself noted, even the existing fiscal plan allocates ***no*** revenue for payment of PRHTA bonds. A stress case would therefore assume 100% losses on Ambac PRHTA (Highway Revenue) bonds (i.e., $27 million on a present, accreted basis).

v. *PRHTA (Transportation Revenue)*

Ambac has a much more substantial exposure of $431 million to PRHTA (Transportation Revenue) bonds. PRHTA (Transportation Revenue) bonds are payable from: (a) excess proceeds ***after*** payment of PRHTA (Highway Revenue) bonds; (b) certain excise tax proceeds on petroleum products; and (c) certain toll revenues on facilities not financed by PRHTA (Highway Revenue) bonds. *See* Ex. 22. PRHTA (Transportation Revenue) bonds suffer from all of the same collateral risks as the PRHTA (Highway Revenue) bonds, but magnified due to their generally inferior collateral position. Comparable uninsured PRHTA (Transportation Revenue) bonds currently trade at 12%, which implies losses for Ambac of $379 million on a present accreted basis. However, as with the PRHTA (Highway Revenue) bonds, the Fiscal Plan (even pre-hurricane) provided ***no*** revenue for payment of PRHTA (Transportation Revenue) bonds. A proper stress case would therefore assume 100% losses (i.e., $431 million on an accreted basis).

vi. *PRCCDA (Hotel Revenue)*

Finally, Ambac's General Account has insured $125 million of PRCCDA (Hotel Revenue) bonds. These bonds are payable primarily from pledged hotel occupancy tax revenues collected by the Puerto Rico Tourism Company. The PRCCDA revenues are expressly subject to the clawback and are therefore not being deposited for the benefit of PRCCDA bondholders. Moreover, even if the revenue was not subject to clawback, the underlying revenue stream has been severely harmed by the collapse of Puerto Rico's tourism industry post-hurricane (although that could conceivably rebound over the medium or long term, depending on other factors). Reference bonds that are similarly situated to the PRCCDA bonds insured by Ambac currently trade at 5%, implying losses for Ambac of $119 million on a present accreted basis. However, even pre-hurricane status quo recoveries were 0%, which should be Ambac's base case with respect to PRCCDA. That would imply losses for Ambac of $125 million on a present accreted basis.

In total, current market prices imply that Ambac will suffer losses of ***$1.947 billion*** in present accreted value terms as a result of the Puerto Rico-related bonds that it has insured. To be clear, this is not a "conservative," "downside," or "stress-case" estimate—it is the market's collective best guess of the ***average*** losses that can be expected. A true stress case would contemplate significantly higher losses. Indeed, as noted above, in a true stress case for Ambac—which would include an absolute litigation loss for COFINA in the Commonwealth-

COFINA Dispute—Ambac stands to lose approximately ***$2.9 billion***, in risk-free present value terms, ***on COFINA debt alone***.[11]

For comparison's sake, the Rehabilitator's "stress case" contemplates ***total*** General Account losses of only $1.8 billion in purported present value terms (using a flatteringly high discount rate). *See* September 22, 2017 *Amended Disclosure Statement Accompanying The Second Amended Plan of Rehabilitation* (D.E. 1374) ("Amended DS") at 32.

ARGUMENT

At this time, it is simply not possible to predict with any degree of confidence the requirements of Puerto Rico's forthcoming revised Fiscal Plan or estimate the revenue that Puerto Rico will have available for debt service. Consequently, it is impossible to confidently quantify the losses that Ambac will suffer. What is known to a virtual certainty is that those losses will be massive and substantially greater than were contemplated at the time the Rehabilitator submitted the Motion and the supporting Gordian Report. By seeking to go forward with consideration of the Exchange Transaction at this time, the Rehabilitator is asking the Court to render a decision of profound importance based on financial assumptions that are self-evidently stale and materially inaccurate. The Court should decline to proceed on that basis and should instead direct the Rehabilitator to recalibrate its analysis of Ambac's Puerto Rico

[11] In addition to the risks discussed above, all of Puerto Rico's existing bond issuances may potentially be subjected to further losses (meaning still more losses for Ambac) as a result of "priming" by disaster-relief loans from the federal government. The court overseeing Puerto Rico's Title III cases has already entered an order confirming that the proceeds of the first $4.5 billion tranche of disaster-relief loans being provided to Puerto Rico by the federal government "shall not be subject to any liens, encumbrances, priorities, or other claims by pre-existing creditors in any form whatsoever." Ex. 25 at ¶ 2. Moreover, in crafting that loan package, Congress took the unusual step of setting aside the rules normally applicable to Community Disaster Loans, which generally permit such loans to be forgiven without the intervention of any senior government officials, and instead requiring the express approval of the Secretary of Homeland Security, in consultation with the Secretary of the Treasury, for any forgiveness of the loan. *See* Ex. 26 at 2-3.

exposures and thereafter reconsider whether an exit from rehabilitation in the near future and on the terms contemplated by the Exchange Transaction is truly in the best interest of ***all*** of Ambac's policyholders.[12]

A. The Court's Decision, as Well as the Rehabilitator's Actions, Must be Based on Accurate, Reliable, Up-to-Date Information

Ultimately, the authority and responsibility for modifying a plan of rehabilitation—as is contemplated by the Exchange Transaction—lies with this Court. *See* Wisc. Stat. § 645.33(5) ("the court may either approve or disapprove the plan proposed, or may modify it and approve it as modified."). The decision to end a rehabilitation—as is also contemplated by the Exchange Transaction—similarly lies with this Court.[13] The Court should only authorize termination of a rehabilitation upon a showing, *inter alia*, "that rehabilitation has been accomplished and that grounds for rehabilitation under § 645.31 no longer exist . . . ." Wisc. Stat. § 645.35(2).

The purpose of rehabilitation of an insurance company is to protect "insureds, creditors, and the public generally." Wisc. Stat. § 645.01(4). In this case, the Rehabilitator has acknowledged that he is required to protect the interests of not only the Segregated Account beneficiaries, but General Account beneficiaries as well, stating that "it is the responsibility of the Rehabilitator and the Office of the Commissioner of Insurance (OCI) to protect the interests of policy beneficiaries in both the Segregated Account, as well as the General Account of AAC . . . [and] to take into account other stakeholders affected by this Rehabilitation." Ex. 27 at 3.

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12 Incredibly, in the Motion, the Rehabilitator mentions the interests of short-term policyholders multiple times, but never once addresses the impact of the Exchange Transaction on, or the fairness of the Exchange Transaction to, long-term policyholders.

13 *See also* Amended Plan of Rehabilitation dated June 12, 2014 at Art. 6.01(e), (h) (Court retained "exclusive jurisdiction," inter alia, "to consider any amendment or modification of this Plan or any documents related to this Plan" and to "enter an order closing the Proceeding"). Further, pursuant to Art. 3.06(b) of the Plan, any resolution of claims (such as the Exchange Transaction) involving a payment by the Segregated Account in excess of $50 million is subject to the Court's approval.

This Court has similarly emphasized the need for the Rehabilitator to protect stakeholders in "the general account because, of course, that's where the funds for the payment of these obligations in the segregated fund are either secured or actually forthcoming." Tr. 3/29/16 Hrg. (D.E. 1259) at 62:7-13 (emphasis added).

In its brief in support of the Motion, the Rehabilitator argues that it has met this requirement, asserting that the Exchange Transaction "is fair and equitable to ***all*** constituents as compared to continuation of Rehabilitation." *See* Rehabilitator's 9/25/17 Br. (D.E. 1372) at 22. The Rehabilitator has also requested that the Court make the following specific findings:

- "The Rehabilitator provided sufficient information to the Court in connection with the approval of the Plan Amendment to determine the value of the claims or interests to be treated pursuant to the Plan Amendment" (emphasis added);
- "The Plan Amendment is consistent with the priority structure of Wis. Stat § 645.68 in furtherance of the equitable apportionment of unavoidable losses," both near term and long term; and
- "[The purpose of] the rehabilitation has been accomplished and the grounds for rehabilitation no longer exist."

See Ex. C to Amended Disclosure Statement at Ex. A thereto at 11.

In support of these proposed findings, the Rehabilitator now takes the position that a conclusion to the rehabilitation is permissible because, among other things, "the Rehabilitator's advisors have increased stress case scenario loss estimates, which have correspondingly increased claims paying resources needed to meet the baseline for the required margin of safety in the Second Amended Plan." Rehabilitator's 9/25/17 Br. (D.E. 1372) at 26.

While the Rehabilitator may be entitled to some deference, that deference is limited. Of particular relevance here, and as the Rehabilitator has acknowledged, the Rehabilitator must base his decisions and actions on accurate, reliable, and up-to-date factual information. *See* Tr. of 3/29/16 Hrg. (D.E. 1259) at 29:21-23 (Rehabilitator's counsel stating that "if the Rehabilitator is acting on incorrect factual information, then maybe that might be a basis for some finding of abuse of discretion.").

Here, there can be no question that the Gordian Report—the sole evidentiary support for the Rehabilitator's Motion and its conclusion that the Exchange Transaction would adequately address the risks posed by Puerto Rico—is outdated and fundamentally flawed. The Gordian Report admittedly fails to address the sea-change in Ambac's expected losses attributable to Hurricane Maria and is inconsistent with Ambac's own public announcements outside of this Court.

i. *The Gordian Report is Outdated and Not Reliable*

As challenging and uncertain as Puerto Rico was for Ambac at the time the Rehabilitator's team unveiled the Exchange Transaction, Hurricane Maria completely shifted the paradigm. Yet just two days after Hurricane Maria struck Puerto Rico, the Gordian Report, which, again, is the ***sole evidentiary*** basis for the Motion, was finalized. The Gordian Report contained a truly remarkable statement:

> The loss projections contemplated herein, including those for Puerto Rico, incorporate allowances for unknown catastrophic developments, such as hurricanes. Although limited visibility exists with respect to the ultimate economic effects of Hurricane Maria on Puerto Rico and [Ambac's] Puerto Rico exposures, ***at this time I do not believe that any changes, if necessary, to the Puerto Rico loss estimates used herein resulting from Hurricane Maria would materially change my conclusions.***

Gordian Report at 22 (emphasis added).

It is unfathomable that such a statement could have found its way into a purportedly objective expert report within two days of perhaps the most devastating natural disaster ever to strike the United States—while telecommunications with Puerto Rico were still almost entirely offline and before any damage assessment could be performed.

Mr. McGettigan's purported belief that the effects of Hurricane Maria would not materially change his conclusions (i.e., to simply ignore the "elephant in the room") is not expert advice on which the Rehabilitator can reasonably rely. *See* Wisc. Stat. § 645.33(3) ("The rehabilitator may consult with and obtain formal or informal advice and aid of insurance experts."). It is supported by not one shred of analysis or evidence. To the contrary, it is rank speculation, made in apparent ignorance of the fact that Puerto Rico has just suffered one of the most devastating natural disasters ever to befall any portion of the United States.

Nor is Mr. McGettigan's purported belief consistent with the Rehabilitator's own assertion that his support for the Exchange Transaction was premised upon "considerable analysis and ***months*** of consultations with experts . . . ." Rehabilitator's 9/25/17 Br. (D.E. 1372) at 17 (emphasis added). Mr. McGettigan could not have analyzed the effects of Hurricane Maria in the near-complete absence of communications with Puerto Rico. Nor could the Rehabilitator have communicated with experts in any meaningful way during the few days between Hurricane Maria's landfall on Puerto Rico and the filing of the Motion.

In any event, it is incontrovertible that Mr. McGettigan's statement has proven false, unless he simply believes that collapsing market prices for Puerto Rico bonds have no relevance for the losses Ambac should be projecting with respect to Puerto Rico bonds that it has insured. To illustrate the folly of Mr. McGettigan's statement, we have prepared and attached hereto a series of charts reflecting the market trading prices of uninsured Puerto Rico bonds with characteristics similar to the bonds insured by Ambac. For the Court's convenience, we have also included a line on each chart indicating the date (September 22, 2017) on which Mr. McGettigan declared that he believed there would be no material changes to his conclusions as a result of Hurricane Maria. The pattern is remarkably clear: in every case, the reference bond prices collapsed almost immediately after Hurricane Maria and Mr. McGettigan's ill-informed statement regarding the hurricane's effect. *See* Ex. 28.

Ambac's current predicament can be summarized in the following chart:[14]

			(in millions)
Grand Total Market-Implied Puerto Rico Losses			$1,947
Additional RMBS Losses			$600
Other Segregated Account Loses			$300
Total "Known Losses"			**$2,847**

Present value losses of this magnitude would eliminate any so-called "margin of safety" articulated and relied upon by the Gordian Report. If the Exchange Transaction is implemented, Ambac will be left with purported assets of only $2.958 billion and purported surplus of only $1.619 billion. Thus, if the Exchange Transaction were to go forward, based on what we know today, and even assuming that a true downside case in Puerto Rico does not occur, Ambac's "known losses" would amount to 96.2% of Ambac's post-transaction assets, and a staggering 175.8% of its total surplus. Thus, in light of current information, it appears that the Exchange Transaction would overwhelm any perceived margin of safety and leave Ambac insolvent, based solely on its Puerto Rico and Segregated Account exposures.[15]

Ambac Credit Statistics Following Exchange Transaction			(in millions)
Total Ambac Assets			$2,958
Puerto Rico Losses / Ambac Assets			***65.8%***
"Known Losses" / Ambac Assets			***96.2%***
Total Ambac Surplus			$1,619
Puerto Rico Losses / Ambac Surplus			***120.3%***
"Known Losses" / Ambac Surplus			***175.8%***

14 "Additional RMBS Losses" and "Other Segregated Account Losses" per the Rehabilitator's Segregated Account "stress-case" loss estimates. *See* 2017 Annual Report (DE 1350) at 26.

15 Of course, Ambac's anticipated losses extend beyond Puerto Rico and the Segregated Account. Excluding Puerto Rico issuances, Ambac has approximately $3.335 billion of "stressed" public finance exposure: $1.588 billion of public finance exposures rated BBB- and $1.747 billion of below-investment-grade public finance exposures. *See* Ex. 29.

Finally, even if the Gordian Report's loss assumptions were realistic (which they are certainly not, particularly in light of Hurricane Maria), its conclusions depend on the unrealistic assumption that Ambac's investments will earn 5.1% annually, compounded indefinitely. Yet the Gordian Report provides literally no support for its use of the 5.1% figure. Mr. McGettigan's only defense for this obvious lapse in the analysis is that he "believe[s] that [the 5.1% assumed discount rate] is a reasonable estimate for AAC's long-term reinvestment rate." *See* Gordian Report at 20.

The potential effects of this unsupported belief are potentially catastrophic. Given the very long duration of Ambac's insured book, which runs through 2054 (including enormous tail obligations in 2052 through 2054), even small shortfalls in that assumed rate of return would be sufficient to entirely erode Ambac's surplus purported margin of safety.

A crude check regarding an appropriate discount rate can be performed using Ambac's actual third quarter 2017 operating results, as reflected in the company's most recent Operating Supplement, which provides the investment portfolio composition and associated yields. After backing out returns attributable to Ambac-insured RMBS (which are intended to be retired in connection with the proposed Exchange Transaction), Ambac's portfolio yield falls to approximately 3.7%.[16] Given the decreased liquidity of the remaining portfolio, it may be necessary to shift to a more conservative investment strategy that would further reduce the average yield.

Incredibly, the Gordian Report does not include any sensitivity analysis for projected rates of investment portfolio return over the nearly 40 year duration of Ambac's insured book.

[16] *See Ambac Quarterly Operating Supplement 3Q2017*, at 13, available at: http://ir.ambac.com/common/download/download.cfm?companyid=AMDA-1TKRMB&fileid=963458&filekey=E96C5005-0B45-48FC-B1B9-A66A4552FD00&filename=07-014_3Q17_Operating_Supplement_2017-11-08_FINAL2.pdf.

In a simplistic model, intended solely for illustrative purposes, in which Ambac emerges from the Exchange Transaction with approximately $3 billion of assets (as is contemplated), but earns a realistic risk-free 2.93% (based on the 30-year U.S. Treasury bond) Ambac's ending investment balance would fall approximately ***$10 billion*** below the ending balance arriving at using the aspirational 5.1% projected by the Gordian Group. *See* Ex. 30. While the General Account Stakeholders have not been given access to Mr. McGettigan's model, they are confident that if this more realistic investment rate is utilized, Ambac's entire surplus and margin of safety under even Mr. McGettigan's most optimistic loss scenarios would be eliminated.

In short, the Gordian Report is outdated and gravely flawed at a fundamental level and, at a minimum, is inconsistent with the state of Ambac's likely losses post-Hurricane Maria. As a result, the Rehabilitator has erred to the extent he has relied upon the Gordian Report in seeking to go forward with a hearing on the Exchange Transaction at this time.

ii. *Ambac Admits that it Cannot Currently Assess the Losses that it is Likely to Suffer as a Result of its Puerto Rico Exposures*

Contemporaneously with the Rehabilitator's assertion to this Court that Ambac's Puerto Rico-related risks are knowable and manageable, Ambac is making clear in other forums that it ***cannot*** anticipate the course of Puerto Rico's restructuring (and, by extension, its effect on Ambac). On November 9, 2017, Ambac held its third quarter earnings call with investors. During that call, Claude LeBlanc, chief executive officer of AFG, lambasted the Oversight Board's decision to press ahead with the formulation of new fiscal plans before the effects of Hurricane Maria are fully understood, declaring "[t]his makes no sense. ***No responsible body should recommend the development of a fiscal plan prior to seeing and considering the results of recovery and stabilization efforts."*** *See* FN 2 (emphasis added).

In a similar vein, Ambac continues to press for discovery from the Oversight Board, the Commonwealth of Puerto Rico, and AAFAF, arguing that "Ambac and other creditors need to understand the models and methodologies used by the Commonwealth in formulating a fiscal plan." *See* Ex. 31 at ¶ 7. In justifying that demand, Ambac explained—just days ago—that "[w]ithout this information, ***Ambac cannot accurately evaluate and react to any restructuring proposals*** made by the Debtor, including in connection with any proposed plan of adjustment." *Id.* at ¶ 5 (emphasis added). Underscoring that point, Ambac asserts that "In Light of Hurricanes Maria and Irma, Ambac Requires This Information More than Ever." *Id.* at ¶ B.

If Ambac itself cannot "accurately evaluate" the risks posed by Puerto Rico without additional information, and if "no responsible body" would propose a restructuring "prior to seeing and considering the results of recovery and stabilization efforts" in Puerto Rico, the Rehabilitator cannot possibly possess sufficient information to gauge those risks and propose a Puerto Rico-dependent restructuring for Ambac.

B. The Interests of All Policyholders Would be Best Served by Adjourning the Rehabilitator's Motion and Ordering the Rehabilitator to Submit Periodic Reports Concerning the Status of Ambac's Exposure to Puerto Rico

The Rehabilitator's Motion for approval of the Exchange Transaction asks the Court to ignore the fundamental structure of the Plan and of the rehabilitation as a whole, which requires that the liabilities of the Segregated Account, and the payment thereof, be prudently and cautiously managed to avoid impairing claims against the General Account.

On the basis of the information before the Court at present, it is simply not possible to realistically estimate Puerto Rico's revenue streams available for debt service, making it impossible to know whether the Exchange Transaction can proceed without impairing the General Account. This is exactly the position advocated by the Rehabilitator's team in this very Court 18 months ago, well before Hurricane Maria devastated Puerto Rico, when the

Rehabilitator successfully opposed a motion to compel an increase in the IPP to Segregated Account beneficiaries. Hurricane Maria has made the situation dramatically worse and more confused, not better or clearer. As demonstrated above, the effects of the storm will most likely result in truly massive new losses for Ambac that are unaccounted for in the analysis supporting the Exchange Transaction. In light of these new facts, the Gordian Report is utterly stale and its assertion that losses as a result of Hurricane Maria would not materially change its conclusions is unsupportable.

Indeed, moving forward with the Exchange Transaction at this juncture could bring about exactly the risk that the OCI feared when it ordered rehabilitation for the Segregated Account—exhaustion of claims-paying assets for the benefit of short-dated liabilities, to the detriment of holders of long-dated policies, such as the General Account Stakeholders. *See* DS at 11; *see also* Rehabilitator's 3/23/16 Opposition to the Motion of the CarVal Holders for an Order to Show Cause (D.E. 1241) at 24 ("because increasing the [payments to beneficiaries in the Segregated Account] has irreversible financial consequences, it should not be done prematurely."). The only reasonable approach at this juncture is therefore to adjourn the Motion while the situation in Puerto Rico further develops. Ironically, such a "pause" to prudently assess the impact of Hurricane Maria on bondholder losses and litigation is exactly the approach that Ambac's chief executive office has demanded the Oversight Board adopt with respect to Puerto Rico's restructuring as a whole. *See* FN 2. The General Account Stakeholders endorse that approach here.

CONCLUSION

For the foregoing reasons, the General Account Stakeholders respectfully request that the Court adjourn consideration of the Rehabilitator's Motion and require that, until further notice, the Rehabilitator provide written status updates to the Court, during the first week of each month, addressing the impact of the situation in Puerto Rico, and of the General Account's Puerto Rico bond exposures, on these proceedings. Alternatively, the General Account Stakeholders request that the Court adjourn consideration of the Rehabilitator's Motion until after the United States District Court for the District of Puerto Rico renders its decision in the Commonwealth-COFINA Dispute, thereby crystalizing a substantial portion of Ambac's potential liabilities with respect to Puerto Rico.

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Respectfully submitted,

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