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

OBJECTION TO 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

PETERSON, JOHNSON & MURRAY, S.C.

Michael P. Crooks
3 South Pinckney Street, #9
Madison, WI 53703
(608) 256-5220
mcrooks@pjmlaw.com

—and—

NORTON ROSE FULBRIGHT US LLP

Lawrence A. Larose
John F. Finnegan
Christy Rivera
Eric Daucher
1301 Avenue of the Americas
New York, NY 10019
(212) 408-5100
lawrence.larose@nortonrosefulbright.com

Attorneys for the General Account Stakeholders

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Cyrus Capital Partners, L.P., Polygon Global Partners LLP, and Taconic Capital Advisors, LP (collectively, the "General Account Stakeholders")[1] submit this Objection (the "Objection") to 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 (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").[2]

PRELIMINARY STATEMENT

The General Account Stakeholders object to the Exchange Transaction, and ask the Court to deny the Motion in its entirety, for three overarching reasons. First, as previously explained in the General Account Stakeholders' November 13, 2017 motion to adjourn [DEs 1386, 1387, 1388] (the "Motion to Adjourn"), it is premature to consider the Exchange Transaction. The financial projections and loss estimates contained in the Rehabilitator's and Ambac's supporting documentation were rendered stale and materially inaccurate when Hurricane Maria struck Puerto Rico. Ambac's exposure on Puerto Rico bonds exceeds $9 billion. The situation in Puerto Rico remains highly uncertain with mushrooming loss estimates and accelerating outmigration. Indeed, over half the island continues to live without electricity and Puerto Rico is in the process of making material negative revisions to its fiscal plans. Until the situation stabilizes and reliable information becomes available with which to establish Ambac's projected

[1] The General Account Stakeholders are comprised of three entities, which, through certain of their respective managed or affiliated funds, collectively hold approximately $1.2 billion in par value ($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.

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

losses on these bonds, it would be reckless for this Court to proceed with evaluating the Exchange Transaction. The only conclusion the Court could now reach is that the underlying facts are in flux, precluding any meaningful consideration of the Exchange Transaction. Indeed, as discussed in Section IV below, both the Rehabilitator and Ambac recognize that additional time is necessary to appropriately assess the magnitude of Puerto Rico creditor losses.

Second, the purposes of the Rehabilitation have not been met and the grounds for rehabilitation that existed in 2010 are present today. Now, as before, short-term claims threaten to deplete Ambac's assets to the disadvantage of long-term claimants and beneficiaries. The recent events in Puerto Rico underscore the fragility of Ambac's financial condition and, better than any words the General Account Stakeholders could have uttered, underscore why rehabilitation of the Segregated Account is essential to ensure the equitable treatment of long-term claimants and beneficiaries. Any doubt that the purposes of the Rehabilitation have not been met should be dispelled by two incontrovertible facts. The Office of the Commissioner of Insurance ("OCI") is insisting upon "enhanced" regulatory oversight as a precondition to approving the Exchange Transaction. The OCI is also permitting Ambac to use "prescribed accounting" measures post-Rehabilitation. Neither of these circumstances is consistent with the notion that Ambac (or its Segregated Account) have achieved financial stability. To the contrary, both belie that notion.

Third and, perhaps, most important, the Rehabilitator's position is not supported by ***any*** competent evidence. The Rehabilitator relies exclusively upon a so-called expert report prepared by the Gordian Group (the "Gordian Report").[3] But the Gordian Report is fundamentally flawed. It entirely ignores the overwhelming new losses facing Ambac as result of Hurricane Maria and

[3] The convention "Gordian Report" refers to the *Expert Report of Dennis M. McGettigan*, dated September 22, 2017 (DE 1375, Exhibit C).

fails to analyze reinvestment rate risk, instead merely assuming an unrealistically high rate of return—and is simply not credible.

STANDARD OF REVIEW AND BURDEN OF PROOF

Wisc. Stat § 645.35(2) controls the Court's analysis of the Rehabilitator's Motion, providing:

> **(2)** ORDER TO RETURN TO COMPANY. The rehabilitator may at any time petition the court for an order terminating rehabilitation of an insurer. ***If the court finds*** that [1] rehabilitation has been accomplished and that [2] grounds for rehabilitation under §645.31 no longer exist, it shall order that the insurer be restored to possession of its property and the control of its business. The court may also make that finding and issue that order at any time upon its own motion.

Wisc. Stat § 645.35(2) (emphasis added). This statute vests this Court, and this Court alone, with the power to determine when, and under what circumstances, the Segregated Account may exit rehabilitation. The Rehabilitator does not have this authority. The Court therefore must conduct a plenary proceeding and may allow the Segregated Account to exit rehabilitation only if the Court is satisfied on the factual record developed before it that the purposes of the rehabilitation have been met and, in addition, that statutory grounds for rehabilitation no longer exist. *See* Wisc. Stat. § 645.35(2).[4]

Although not yet addressed by the courts in this State, courts in other jursdictions have rejected the notion that, when considering whether to terminate rehabilitation, the court must defer to the Commissioner's determination. *See Angoff v. Cas. Indem. Exchange*, 963 S.W.2d 258, 263 (Mo. Ct. App. 1997) (rejecting abuse of discretion standard for rehabilitator's determination that insurer in rehabilitation should be liquidated, stating the statute requiring court approval was not "a mandate for the court's being merely [a] 'rubber stamp.'"); *LaVecchia*

[4] Even the Rehabilitator, *albeit* unintentionally, acknowledges the Court's plenary authority, stating in Section XVIII of the 2017 Amended Disclosure Statement (at 61) that "the Court may determine that the Plan does not meet the legal requirements for the Proceedings to be concluded." (DE 1374.)

v. HIP of New Jersey, Inc., 324 N.J. Super. 85, 92 (Sup. Ct. N.J. 1999) (rejecting the Commissioner's argument that her determination that an insurer should be liquidated must be affirmed "absent a finding that her determination to seek liquidation is unreasonable or arbitrary")[5]; *cf. Florida Dep't of Ins. v. Cypress Ins. Co.*, 660 So.2d 1177, 1182-83 (Fla. 1st DCA 1995) (in the context of an insurer insolvency proceeding, the court concluded deference is not "applicable . . . [in] a judicial proceeding in which those functions [referring to fact finding and final decision making] are the responsibility of the circuit court.").

Grode v. Mutual Fire, Marine & Inland Insurance Co., 688 A.2d 233 (Commonwealth Ct. Pa. pub. Ordered Jan. 28, 1997)—one of the cases cited and relied upon by the Rehabilitator in its Motion papers—is also instructive. In that case, following a 10-year rehabilitation period, the court was asked to approve "a petition to terminate the Rehabilitation . . . and a request for discharge." *Id.* at 234. The court ultimately granted the petition but did so only after it was provided incontrovertible and uncontroverted competent evidence demonstrating that all claims, including creditor claims, could and would be paid in full. *Id.* at 236. The *Grode* court acknowledged that the rehabilitation process, which included conducting several plenary hearings, was time consuming, but concluded it was necessary to "ensure[] that policyholders and claimants received due consideration of their claims, an exceptionally important consideration in an insurance insolvency." *Id.*

In short, this Court must conduct an objective, dispassionate, and independent analysis to determine whether the Exchange Transaction is fair to all constituencies, including, in particular, long-term claimants whose interests were the *sine qua non* of this Rehabilitation at the outset and continuously thereafter until abandoned by Ambac in mid-2017.

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5 Notably, this case is relied upon by the Rehabilitator for his argument that an abuse of discretion standard of review applies—a standard the court in *LaVecchia* plainly did not apply.

The Rehabilitator, as the party seeking action by the Court, bears the burden of proof. *See Loeb v. Bd. of Regents*, 29 Wis. 2d 159, 164 (1965) (a party seeking judicial process to advance a position carries the burden of proof); *Ebert by Krueger v. Kettner*, 151 Wis. 2d 880, 883 (1989) (same); *see also Angoff*, 963 S.W.2d at 263 (Director of Department of Insurance bears burden of proof). Thus, this Court must determine whether the Rehabilitator carried his burden of showing through competent evidence that (1) "rehabilitation has been accomplished" and (2) "grounds for rehabilitation under § 645.31 no longer exist." Wisc. Stat. § 645.35(2). The sole evidence presented by the Rehabilitator in support of the Motion is the Gordian Report, which is outdated and not credible. In other words, the Rehabilitator failed to make the requisite showing and the Motion must be denied.

STANDING TO BE HEARD

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 Persons. Indeed, the Rehabilitation Plan (dated June 12, 2014), at Article 3.02, contemplates that "Interested Persons" will be involved in all proceedings involving the Rehabilitation. Moreover, the Rehabilitator effectively has conceded that the General Account Stakeholders are Interested Persons who have an unfettered right to make their concerns known to this Court. *See* Ex. 27[6] at 6 (SDC assured the General Account Stakeholders that they and all other "[i]nterested parties may appear at the [December 2017] Pretrial Conference by telephone"); Tr. of March 29, 2016 Hrg. (DE 1259) at 35 (Rehabilitator acknowledging that this Court has the discretion to allow the

[6] To avoid overburdening the Court with filings, Exhibits 1-31 referenced herein are the same Exhibits 1-31 attached to the November 13, 2017 Affidavit of John F. Finnegan filed in support of the General Account Stakeholders' Motion to Adjourn. Those Exhibits 1-31 are not submitted separately as attachments to this Objection. Exhibits 32-40 are attached to the November 22, 2017 Affidavit of John F. Finnegan filed in support of this Objection.

General Account Stakeholders, and others similarly situated to them, to participate in proceedings).

In the past, when challenging an entity's standing, the Rehabilitator has relied on two Wisconsin Court of Appeals cases, both of which are inapplicable here and do not support the Rehabilitator's position. In one of the decisions, *In re Ambac Assur. Corp.*, 351 Wis. 2d 539 (2013), the Wisconsin Court of Appeals actually concluded that the language of Wis. Stat. 645.33(5) "permits the circuit court to establish procedures that are tailored to the procedural necessities presented by the circumstances of each [individual] rehabilitation proceeding. That means that the rehabilitation court has the discretion to grant or deny a motion to intervene . . . ." *Id.* at 630. Plainly, the Court has authority to hear from the General Account Stakeholders.

The second decision, *Nickel v. FFI Fund Ltd.*, No. 2014AP2033, 2016 WL 8578206 (Wis. App. March 4, 2016),[7] is unpublished, but, in any event, also does not support the Rehabilitator's position on standing. In *Nickel*, the entities whose standing was at issue challenged the trial court's adoption of the Rehabilitator's "interpretation of a clause in a Pooling and Servicing Agreement" to which the appealing entities were not signatories. The trustee who was a signatory to the agreement, and who had been involved in the rehabilitation proceedings, chose not to challenge the court's ruling. The issue and facts here could not be more different from those in *Nickel*. The issues raised by the General Account Stakeholders do not hinge on the interpretation of a contract to which they are not parties. Rather, at issue here are (1) whether "rehabilitation has been accomplished" and (2) whether "grounds for rehabilitation under § 645.31 no longer exist." Wisc. Stat. § 645.35(2). In short, *Nickel* is inapposite and any

7 *See* Ex. 39.

reliance the Rehabilitator might place on it in an attempt to thwart the General Account Stakeholders' standing would be misplaced.

There is one additional reason why *Nickel* does not support the Rehabilitator's position that the General Account Stakeholders should not be heard in these proceedings. When preparing the Motion papers, the Rehabilitator had no obligation to include any material that he thought might undermine his effort to obtain this Court's approval of the Exchange Transaction. As such, absent the General Account Stakeholders, the Motion has only proponents, namely, the OCI, the Rehabilitator, Ambac, AFG, Segregated Account creditors and claimants, and General Account subordinate creditors who stand to reap a significant, immediate financial benefit—at the General Account claimants' and beneficiaries' expense—if the Motion is granted. Unlike these parties, the General Account Stakeholders are opponents of the Motion. The General Account Stakeholders' active participation in this proceeding will assist the Court in identifying and then sharpening the genuine issues and in better understanding the reams of financial data presented in the Motion. Absent an opponent of the Motion, this Court will have to devote substantial resources to assessing and vetting the assertions made in the Motion and to analyzing the opaque financial statements presented by Ambac and the Rehabilitator. [8]

[8] Ultimately, the Court is tasked with objectively evaluating the Exchange Transaction, and deciding whether it is an appropriate mechanism for concluding the Rehabilitation. S*ee* Wisc. Stat § 645.35(2). Without the input of the General Account Stakeholders to counterbalance the pro-Exchange Transaction advocacy of the Rehabilitator and the parties that stand to benefit financially from the transaction, the Court would need to look elsewhere for an objective evaluation of the transaction. In analogous situations, courts recognizing the need for avoiding a one-sided assessment of a major restructuring transaction have appointed independent experts. *See, e.g.*, Ex. 32 at 1 (*In re City of Detroit, Michigan*, No. 13-53846 (Bankr. E.D. Mich. Mar. 24, 2014) (DE 3170)) (recognizing that "[t]he Court has an independent duty to consider" a proposed restructuring plan and, in the absence of opponents of the transaction, issuing an order to show cause why an independent expert should not be appointed). The costs and delay associated with such independent analysis can and should be avoided here by allowing the General Account Stakeholders to participate fully in all court proceedings, including, in particular, the evidentiary hearing at which counsel for the General Account Stakeholders would cross-examine the Rehabilitator's witnesses.

MOTION TO ADJOURN

On November 13, 2017, the General Account Stakeholders filed a motion with this Court seeking to adjourn consideration of the Rehabilitator's Motion. That Motion to Adjourn remains pending before this Court. The General Account Stakeholders incorporate the Motion to Adjourn in its entirety into this Objection to the Rehabilitator's Motion.

OBJECTION

I. The Rehabilitation Plan is Specifically Designed to Protect Long-Tail Claimants from Short-Tail Claimants[9]

Ambac's primary business historically involved guarantying or otherwise providing credit support for bond obligations of municipalities and similar entities. But, in the mid-1990s, 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 (the "DS") (DE 462) at 3. Ambac's financial condition deteriorated significantly as a result of the 2008 financial crisis "arising from mortgage lending practices in the United States," and RMBS and other structured finance products to which Ambac had exposure suffered significant actual and projected future losses. *Id.*

OCI recognized that Ambac's structured finance liabilities posed a particularly acute risk to long-dated policies, 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

[9] The claims that necessitated the creation of the Segregated Account, and which gave rise to the GA SSNs and the DPOs, were short-tail in nature. Under the present Plan structure, of course, the GA SSNs and DPOs are subordinated obligations of effectively indefinite duration, as they are only payable so long as sufficient surplus exists. The Exchange Transaction would essentially accelerate and crystalize those payment obligations and reintroduce the risk of paying current creditors at the expense of long-tail policy beneficiaries.

claims while possibly leaving insufficient resources to pay in full the many policyholders with longer-dated claims." DS at 11. OCI decided that this risk could only be managed, and stakeholders would best be served, by the creation and rehabilitation of the Segregated Account, comprised primarily of Ambac's RMBS, structured finance and student loan liabilities. DS at 2, 7, 10-11. Indeed, ***"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 Plan of Rehabilitation (the "<u>Plan</u>") established General Account claimants—such as the General Account Stakeholders—as structurally senior to Segregated Account claimants and 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. *Id*.

To ensure the parity of long-term and short-term claim payments, the Plan provided that claims against the Segregated Account would be satisfied with an interim payment percentage ("<u>IPP</u>") and a deferred payment obligation ("<u>DPO</u>") equal to the remainder of the claim. The cash payment for claims against the Segregated Account originally was at an IPP fixed at 25 percent (Plan § 1.304), but the Rehabilitator subsequently increased the IPP to 45 percent. *See* IPP Notice, dated June 20, 2014 (DE 1122).

The Rehabilitator continued to be guided by this fundamental (and statutorily dictated, by Wisc. Stat. § 645.01(4)(d)) principle of ensuring parity between short and long-term claimants, for the first seven plus years of these rehabilitation proceedings. Eighteen months ago, the Rehabilitator successfully fought off efforts by the CarVal Holders, beneficiaries of policies in the Segregated Account, to obtain a further increase to the IPP, arguing that the Rehabilitator could not "be focusing just on the short-term interests." Tr. of 3/29/16 Hrg. at 33:4-5 (DE 1259); *see also* Ex. 33 at 6 (stating "[a]ny change to the IPP [must be] sustainable and fair to ***all*** policyholders" (emphasis added)). And eleven months ago, the rehabilitator continued his focus on "***enhanc[ing] A[mbac]'s long-term claims-paying ability***." 12/16/16 Supp. to Annual Rpt. at 2 (DE 1324) (emphasis added). The Rehabilitator's 2017 Annual Report reflected no change in course and, indeed, indicated a significant deterioration in the Segregated Account's financial condition.[10]

In short, up until the middle of 2017, the Rehabilitator gave every indication that short and long-term claimants should and would be treated with parity. Through mid-2017, the Rehabilitator's cautious strategy served Ambac well, allowing for Segregated Account policy beneficiaries to receive meaningful interim recoveries while positioning the General Account to survive the brewing downturn in its municipal portfolio.

II. <u>The Exchange Transaction Clearly Favors Subordinated and Short-Tail Claimants</u>

On July 19, 2017, AFG announced that it had agreed upon the Exchange Transaction, with some of the DPO holders (creditors of the Segregated Account) and with some of the GA

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[10] Using Scenario Two to illustrate, whereas the 2016 Annual Report included projections by the Rehabilitator that holders of Surplus Notes and Recipients of Deferred Amounts would receive 100% of their outstanding claims, the 2017 Annual Report included a downward revision of 94.6% and changed the forecast concerning Junior Surplus Notes from a 17.4% recovery to "no recovery." *Compare* 2016 Rpt. (DE 1264) at 28 *with* 2017 Rpt. (DE 1350) at 30.

SSN holders (creditors of the General Account who are subordinated to General Account policy claims), which agreement purportedly would facilitate the Segregated Account's exit from rehabilitation. AFG indicated that OCI had confirmed "its support for the [Exchange] Transaction." Ex. 3 at 1.

From the General Account Stakeholders' perspective, the proposed Exchange Transaction can be summarized 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 and subordinated General Account claims;

- "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 immediately drain substantial resources from the General Account for the benefit of Segregated Account and subordinated General Account claimants (and AFG equity holders) and impose on the General Account additional exposure and debt, all while existing risks to the General Account are exploding. Accordingly, it is not at all evident where the funds will come from to pay 100% of claims going forward through 2054, particularly where the Rehabilitator recognizes that significant, unknowable risks remain: "***It is important to note that [Ambac]'s financial condition remains subject to many uncertainties that cannot be definitively incorporated in a projection model.***" Amended Disclosure Statement Accompanying the Second Amended Plan of Rehabilitation ("<u>2017 Amended DS</u>") at 33 (emphasis added) (DE 1374). The Rehabilitator is also acutely aware—having acknowledged so in writing—that even "relatively small changes in assumptions" could potentially have a material impact on outcomes. 2017 Annual Report at 29.

In an inexplicable turn of events, OCI decided to support the Exchange Transaction even though the transaction indisputably would place the interests of subordinated claimants that already have settled with or partially collected from Ambac, and other short-term claimants, well ahead of the interests of longer-term General Account policy claimants, such as the General Account Stakeholders.

III. The Purposes of the Rehabilitation Have Not Been Met and Grounds for Rehabilitation Continue

A. Wis. Stat. § 645.01(4)(d) Mandates Equitable Treatment of Short-Term and Long-Term Claimants

The purpose of the Wisconsin Insurer Rehabilitation and Liquidation Act "is the protection of the interests of insureds, creditors, and the public generally . . . ***through (d) [e]quitable apportionment of any unavoidable loss***." Wis. Stat. § 645.01(4) (emphasis added). Equitable apportionment is "a pervasive goal" of the Insurers Rehabilitation and Liquidation Act. *Id.* at cmt. In accordance with this articulated purpose, the Rehabilitator has stated 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 . . . [and] to take into account other stakeholders affected by this Rehabilitation." Ex. 27 at 3; *see also* Rehabilitator's 9/25/17 Br. (DE 1372) at 22 (summarily referencing fairness "to all constituents" (emphasis added)). And, for more than seven years, the Rehabilitator acted accordingly, working to ensure the parity of loss payments to short and long-term claimants.

In the Motion, however, the Rehabilitator now asks the Court to ignore the statutory directive, as well as the fundamental structure of the Plan, which require that the liabilities of the

Segregated Account, and the payment thereof, be prudently and cautiously managed to avoid impairing future claims against the General Account. Instead, the Rehabilitator now promotes a plan that immediately siphons billions of dollars from—and heaps liabilities upon—the General Account in order to make immediate payments to subordinated and short-tail claimants despite the increasingly uncertain risks facing Ambac. This plan shifts ***all of the risk*** of Ambac's (in)ability to pay claims in full through 2054 to long-tail claimants from the General Account. The Rehabilitator has provided no explanation or, indeed, justification for his change in policy and departure from the statutory directive of equitable treatment. Absent legitimate justification for such a change in course, the Rehabilitator's Motion must be denied.

The Motion must also be denied because the Exchange Transaction does not comply with Wis. Stat. § 645.35(2). The OCI does not undertake to "restore…control" over Ambac to Ambac's management. To the contrary, the OCI intends to laden Ambac with additional regulatory handcuffs, establishing (*albeit* unwittingly) that the goals of the Rehabilitation have not yet been fully met. *Compare* Wis. Stat. § 645.35(2) (upon requisite finding the "insurer [is to] be restored to possession of its property and the control of its business") *with* Rehabilitator's 9/25/17 Brief (DE 1372) at 41 (Ambac "will receive enhanced regulatory scrutiny for a period of time to be determined by the Commissioner") and Gordian Report at 25 (Ambac is to be subject to "administrative constraints" to ensure "liquidity to pay policy claims").

B. The Rehabilitator and the Gordian Report Ignore the Elephant in the Room: Puerto Rico Losses and Hurricane Maria

The General Account's exposure to the Puerto Rico bonds is a critical factor in this Court's consideration of the Motion. As discussed at length in the General Account Stakeholders' Motion to Adjourn, Ambac's guaranties of Puerto Rico bonds constitute a significant portion of the General Account's exposure.

Ambac has insured an enormous amount of debt—more than $2.6 billion in current accreted value and over $9 billion in total principal and interest—across Puerto Rico's capital structure. The entirety of that exposure resides in the General Account, which now faces the certainty of extraordinarily high losses.

As challenging and uncertain as Puerto Rico was for Ambac at the time the Rehabilitator's team unveiled the Exchange Transaction, Hurricane Maria "***fundamentally changed Puerto Rico's reality***," Ex. 15 at 1 (emphasis added), and plunged Puerto Rico into "one of its worst crises in modern history," Ex. 16 at ¶ 4. Yet, just two days after Hurricane Maria struck Puerto Rico, the Rehabilitator filed the Motion and the supporting Gordian Report without any analysis of the effects of Hurricane Maria on the proposed Exchange Transaction. Instead, in the Gordian Report, Mr. McGettigan incredibly asserted: "***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).

Mr. McGettigan's purported belief—asserted while telecommunications with Puerto Rico still were almost entirely offline and before any damage assessment had been performed—that the effects of Hurricane Maria would not materially change his conclusions simply ignores the "elephant in the room" and is not expert advice on which the Rehabilitator (or this Court) can reasonably rely.[11] *See* Wisc. Stat. § 645.33(3). It is not supported by even one shred of analysis or evidence. To the contrary, it is rank speculation, made in willful ignorance of conditions in Puerto Rico. Further, Mr. McGettigan's purported belief is not consistent with the

[11] The fact that Puerto Rico bonds insured by Ambac trade well-below par indicates the market's belief that there is a substantial risk—even in the absence of the Exchange Transaction—that Ambac will default on its General Account policy obligations. Indeed, Ambac's General Account Puerto Rico bonds trade at prices that are substantially below the amounts that Ambac is offering to pay to the theoretically structurally subordinate Segregated Account claimants in connection with the Exchange Transaction.

Rehabilitator's 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. 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.

For a comprehensive discussion of the particulars of Ambac's Puerto Rico bond exposures and the effects of Hurricane Maria on those exposures, the General Account Stakeholders again respectfully refer the Court to their Motion to Adjourn.

By way of update, since the General Account Stakeholders filed the Motion to Adjourn, on November 15, 2015, counsel for the PROMESA Oversight Board announced in a hearing before Judge Swain that, as a result of the devastation wrought by Hurricane Maria, "***[t]he bottom line is we know now that the money available for debt service over the next five years is almost non-existent***." Ex. 34 (emphasis added).[12] Reflecting this new reality, the forthcoming five-year fiscal plan for Puerto Rico will include ***no debt service***. *Id.* Yet, during those next five years, from 2018 to 2022, Ambac-insured Puerto Rico bond principal and interest obligations will come due totaling $446.3 million, Ex. 35 at 5; if Puerto Rico is not paying those amounts, Ambac will be. Additionally, Puerto Rico bond prices have suffered a downward spiral, with market-implied losses for Ambac now standing at $1.933 billion as of November 17, 2017. Notably, these losses are calculated relative to the current accreted values of the securities. In

[12] Ambac's 10-Q for the period ending September 30, 2017 states that "loss and loss expense for the three and nine months ended September 30, 2017 were driven by…[h]igher projected losses in domestic public finance largely driven by negative development on insured Puerto Rico bonds for the three and nine months ended September 30, 2017, in addition to negative developments in the Military Housing sector." Ex. 5 at 73.

nominal dollar terms, with losses compounding for literally decades, the payments will of course be much higher.

The table below summarizes Ambac's current accreted exposure to Puerto Rico bond issuances, and the market-implied losses that should currently be anticipated with respect to each of the issuances.[13]

General Obligation Bonds	**Net Accreted (in millions)**	**Current Trading Price**	**Implied Loss (in millions)**
General Obligation Bonds	$56	24%	$42
PR Public Building Authority Revenue - GO Guaranty	$112	22%	$88
Total General Obligation Exposure	$168		$130
Revenue Bonds			
COFINA Senior Bonds	$1,336	42%	$779
PRIFA Bonds	$532	5%	$506
PRHTA '68	$27	59%	$11
PRHTA '98	$431	10%	$388
Convention Center Bonds	$125	5%	$119
Total Revenue Bond Exposure	$2,450		$1,803
Grand Total Puerto Rico Exposure:	**$2,618**		**$1,933**

If the Exchange Transaction were to be approved and closed, Ambac would be expected to bear the following overall losses:[14]

			(in millions)
Grand Total Market-Implied Puerto Rico Losses			$1,933
Additional RMBS Losses			$600
Other Segregated Account Loses			$300
Total "Known Losses"			**$2,833**

Present value losses of this magnitude would eliminate any so-called "margin of safety" articulated in, and relied upon by, the Gordian Report. If the Exchange Transaction is implemented, Ambac will be left with purported assets of only $2.95 billion and purported

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13 All trading price data contained in this Objection is provided by Bloomberg, and is as of close of trading on November 17, 2017.

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.

policyholder surplus of only $1.62 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 95.8% of Ambac's post-transaction assets, and a staggering 175% 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			
Total Ambac Assets			$2,958
Puerto Rico Losses / Ambac Assets			***65.3%***
"Known Losses" / Ambac Assets			***95.8%***
Total Ambac Surplus			1,619
Puerto Rico Losses / Ambac Surplus			***119.4%***
"Known Losses" / Ambac Surplus			***175.0%***

To be clear, the charts above do not reflect a "conservative," "downside," or "stress-case" estimate—instead, they reflect 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 in the Motion to Adjourn, 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 ***$3 billion***, in risk-free present value terms, ***on COFINA debt alone***. 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* 2017 Amended DS at 32.

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.

C. The Gordian Report's Assumed Rate of Return is Unsupported, Unrealistic and Could be Catastrophic

Even if the Gordian Report's loss assumptions were realistic (which they plainly are 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. The Gordian Report provides no support for its use of the 5.1% figure. Mr. McGettigan's only defense for this obvious lapse in the analysis is his summary assertion that he "believe[s] that [5.1%] is a reasonable estimate for [Ambac]'s long-term reinvestment rate." *See* Gordian Report at 20.

The potential effects of the use of this unsupported reinvestment rate could be catastrophic. Given the very long duration of Ambac's insured book, which runs through 2054 (including enormous COFINA tail obligations in 2052 through 2054), even small shortfalls in that assumed rate of return would be sufficient to entirely erode Ambac's purported margin of safety. An estimate of the appropriate discount rate can be made 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%. *See* Ex. 36 at 13. Given the decreased liquidity of the remaining portfolio, *see* 2017 Amended DS at 22, it may be necessary to shift to a more conservative investment strategy, which would further reduce the average yield.

The Gordian Report, incredibly, does not include any sensitivity analysis for projected rates of investment portfolio return over the nearly 40 year duration of Ambac's insured book. 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 2.79% (based on the current 30-year U.S. Treasury bond) Ambac's ending investment balance would fall more than ***$10 billion*** below the ending balance arrived 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, even under Mr. McGettigan's most optimistic loss scenarios, would be eliminated.

D. The Rehabilitator has Presented No Evidence that the Exchange Transaction is in the Best Interests of General Account Claimants and their Beneficiaries

The focus of the Rehabilitator's brief and accompanying papers is on the benefit of the Exchange Transaction to DPO holders and GA SSN holders. In his 2017 Amended Disclosure Statement, the Rehabilitator states he "believes the Second Amended Plan is fair and equitable to holders of Deferred Amounts," 2017 Amended DS at 2, and that "it is in the best interests of the Segregated Account and its creditors to now effect the Second Amended Plan and related Rehabilitation Exit Transactions . . . including the termination of the Proceeding and consummation of the Merger contemplated thereby." 2017 Amended DS at 9. The Rehabilitator similarly states the "purpose of the DPO Exchange Offer is to effect the same economics for holders of Deferred Amounts, including [Ambac], and holders of GA SSNs." *Id.* at 44; *see also* Rehabilitator's 9/25/17 Br. at 18 (purpose of rehabilitation would be "fulfilled by first satisfying existing obligations to Deferred Amounts beneficiaries of the Segregated Account and GA Surplus Note holders").

Despite touting the importance of the interests of long-term General Account claimants for more than seven years, neither the Rehabilitator nor the Gordian Report now gives even lip service to those interests, which include the interests of the General Account Stakeholders. Indeed, Ambac's General Account has $49.24 billion net par outstanding exposure, comprised of

$40.59 billion exposure on U.S. Public Finance guaranties, $5.18 billion exposure on "other structured finance" guaranties, $9 million CLOs and other CDOs, and $3.46 billion in international guaranties. Amended DS at 26. The General Account exposure is increasingly more severely adversely classified. *See id.* If the Exchange Transaction is permitted to proceed, it is increasingly likely that Ambac's assets will have dissipated by the time the General Account Stakeholders seek to recover on Ambac's guaranty.

E. There is No "Margin of Safety" to Protect the General Account

In the Gordian Report, Mr. 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, Mr. 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. This so-called "margin" is completely illusory—actual market-projected losses for Ambac are vastly greater than the supposedly hyper-conservative "Scenario 4." Taking into account the billions of dollars of losses that Ambac stands to suffer in connection with Puerto Rico, and the other "known losses" of Ambac as shown above (*see* Section III.B), Ambac has no margin of safety at all.

The Rehabilitator's (and the Gordian Report's) margin of safety analysis is flawed in several additional respects. First, the analysis fails to acknowledge that under 3 of 4 Scenarios, Ambac is unable to meet its financial obligations. *See* 2017 Amended DS at 34-35. Moreover, under the fourth scenario, Ambac just barely meets its obligations and does so only if Ambac receives more than $1 billion in "fee and miscellaneous income" between 2036, when Ambac is projected to obtain $402 million, and 2047, when Ambac is projected to obtain more than $600 million. *See* Ex. D to 2017 Amended DS at 7. The source of this mystery income remains wholly unexplained.[16]

Second, the Rehabilitator and Ambac recognize that litigation is "inherently unpredictable." 2017 Amended DS at 65-66. Yet, the projected RMBS (Representations & Warranty, or "R&W") Litigation recoveries are, under the Gordian Report and Rehabilitator's analysis, key to the durability of the rehabilitation.[17]

Third, with respect to the RMBS Litigation recoveries, Mr. McGettigan had to put his thumb on the scale to justify the Exchange Transaction. Although Mr. McGettigan assumes that "the RMBS [R&W] Litigation proceeds will be sufficient to pay the Senior Notes in full," the RMBS Litigation proceeds secure the Senior Secured Notes only up to the amount of $1.4 billion. 2017 Amended DS at 38-39. Any shortfalls in RMBS litigation proceeds would be payable by Ambac on parity with General Account policy claims through the new financial guaranty insurance policy to be issued in the Exchange Transaction (which is somehow being authorized for the benefit of subordinated claimants despite the fact that Ambac has not

[16] Also without explanation, that same Exhibit D to the 2017 Amended DS sets out precipitous declines in the contingency reserve in 2025 (a reduction of $265 million) and in 2032 (a reduction of $343 million), and reflects a negative $1.359 billion loss and loss adjustment expense reserve post transaction. DE 1374, Ex. D at 1-2. There is, as yet, no explanation for this negative reserve. Additionally, although the Rehabilitator suggests in his papers that the Exchange Transaction might enable Ambac to once again write new policies and thereby generate revenues in the form of policy premiums, the Rehabilitator's expert apparently does not foresee Ambac being in a financial condition to issue new policies until at least 2054. See Gordian Report at 10.

[17] Notably, in one of the RMBS Litigations identified by the Rehabilitator, *Ambac Assur. Corp. v. Countrywide Home Loans, Inc.*, on May 16, 2017, the New York intermediate appellate court rejected Ambac's argument that a New York insurance statute "dispense[d] with the common-law requirement of proving justifiable reliance and loss causation" to establish fraud, and further concluded that the possible damages recoverable by Ambac are more restricted than what Ambac sought. *Ambac Assur. Corp. v. Countrywide Home Loans, Inc.*, 151 A.D.3d 83, 86, 88-89 (N.Y. App. Div. 1st Dep't 2017). *See* Ex. 40.

otherwise been able to write business for nearly a decade). Mr. McGettigan wishes this potential exposure away in his "analysis."[18]

Fourth, there is, as the Rehabilitator notes, no assurance that "the sale of the RMBS securities collateral will produce proceeds in an amount sufficient to pay any or all amounts due on the Senior Secured Notes or that holders will be successful in any litigation seeking payments pursuant to the Secured Notes Policy." Further, there has been "no appraisal of the value of the RMBS securities" that are utilized in the margin of safety analysis. 2017 Amended DS at 66-67.

Fifth, the 2017 Amended Disclosure Statement acknowledges that "[t]he Senior Secured Notes will bear interest at variable rates. As a result, increases in interest rates will increase the cost of servicing the Senior Secured Notes and could adversely affect [Ambac's] profitability and cash flows." *Id.* at 69-70. But, again, the Rehabilitator's durability analysis does not account for fluctuations in interest rates.

Sixth, the Rehabilitator assumes a 5.1% reinvestment rate indefinitely. As discussed above in Section III.C., that figure is not supported anywhere in the Rehabilitator's papers, is exceedingly unrealistic, and, if only marginally overstated, would be catastrophic to the margin of safety.

F. <u>Other Irregularities Confirm that the Exchange Transaction Cannot be Approved</u>

In his 2017 Amended Disclosure Statement, the Rehabilitator expressly acknowledges that his projections are not in compliance with "published guidelines of the SEC, the American

[18] Moreover, historically, and as recently as June 5, 2017, the Rehabilitator's stress case assumption for RMBS Litigation proceeds assumed realization of "75% of the GAAP amounts." *See, e.g.*, 2017 Annual Report at 30. Mr. McGettigan, however, "increased the stress case recoveries for RMBS Litigations used in the Projections" to 84%. He purportedly did so based on his perception of "market validation for potential RMBS Litigation recoveries provided by [market interest in] the Tier 2 Notes." Gordian Report at 9. But the correlation between the two is tenuous at best, and completely unexplained.

Institute of Certified Public Accountants, Accounting Principles Generally Accepted in the United States of America ("GAAP") or in accordance with U.S. statutory accounting principles ("SAP") prescribed or permitted by the State of Wisconsin Office of the Commissioner of Insurance ("OCI")." 2017 Amended DS at 3. Indeed, nowhere does the Rehabilitator provide post-Exchange Transaction financial projections in compliance with GAAP or SAP. Further, only 46% of Ambac's investment portfolio carrying value consists of investment grade obligations, "versus 49% three months prior and 69% as of December 2013." 2017 Amended DS at 21. But there is no indication in the Rehabilitator's analysis that the non-investment grade obligations have been discounted in any way as required by GAAP and SAP. If the rehabilitation truly has "been accomplished" as the Rehabilitator asserts, it seems that the Rehabilitator readily should have provided an analysis utilizing both GAAP and SAP. The absence of that analysis here speaks volumes.

IV. Ambac and the Rehabilitator Admit that they Cannot Currently Assess the Extent of Losses in the General Account

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, sharply criticized 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* Ex. 37 at 3 (emphasis added).

In a similar vein, Ambac pressed 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 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 asserted that "In Light of Hurricanes Maria and Irma, Ambac Requires This Information More than Ever." *Id.* at ¶ B. That effort was rejected by the PROMESA court, leaving Ambac, by its own admission, without the information that it needs to evaluate Puerto Rico's restructuring.

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. Moreover, in his November 14, 2017 letter to this Court seeking cancellation of the November 17, 2017 Court conference, the Rehabilitator admitted that conditions in Puerto Rico require additional due diligence on his part, stating:

> The Special Deputy Commissioner overseeing the Rehabilitation, and its financial advisors from the Gordian Group and Jefferies, are currently in San Juan, Puerto Rico meeting with officials there as part of his due diligence to evaluate the economic status of the island and continue the ongoing assessment of durability.

DE 1394 at 1. This is an admission that such "due diligence" was ***not*** conducted before the ill-informed statements in the Gordian Report were presented as evidence to this Court, and is just another reason why reliance on the Gordian Report is unsupportable.

The General Account Stakeholders reserve their rights to request additional time and to submit a supplemental objection if and when the Rehabilitator files any supplemental papers in support of the Motion.

CONCLUSION

For the foregoing reasons, and for the reasons set out in the Motion to Adjourn, the General Account Stakeholders respectfully request that the Court deny the Rehabilitator's Motion.

Dated: Madison, Wisconsin
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Respectfully submitted,

PETERSON, JOHNSON
& MURRAY, S.C.
By *Electronically signed by Michael P. Crooks*
Michael P. Crooks
3 South Pinckney Street, # 9,
Madison, WI 53703
(608) 256-5220
mcrooks@pjmlaw.com

—and—

NORTON ROSE FULBRIGHT US LLP
Lawrence A. Larose
John F. Finnegan
Christy Rivera
Eric Daucher
1301 Avenue of the Americas
New York, NY 10019
(212) 408-5100
lawrence.larose@nortonrosefulbright.com

Attorneys for the General Account Stakeholders