STATE OF WISCONSIN : CIRCUIT COURT : DANE COUNTY

In the Matter of the Rehabilitation of:

SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

Case No. 10 CV 1576
Hon. Richard G. Niess

AMBAC ASSURANCE CORPORATION'S BRIEF IN RESPONSE TO OBJECTIONS TO THE REHABILITATOR'S MOTION TO FURTHER AMEND THE PLAN OF REHABILITATION

INTRODUCTION

Ambac Assurance Corporation ("AAC") respectfully submits this brief in response to objections to the Motion by the Commissioner of Insurance of the State of Wisconsin, as the Court Appointed Rehabilitator of the Segregated Account of Ambac Assurance Corporation ("Rehabilitator") to Further Amend the Plan of Rehabilitation filed on September 25, 2017 (the "Motion")[1].

ARGUMENT

I. AAC Supports the Rehabilitator's Motion to Further Amend the Plan of Rehabilitation

AAC supports the Rehabilitator's motion to further amend the Plan of Rehabilitation and hereby joins in (a) the brief filed by the Rehabilitator on December 11, 2017 in response to Objections to its Motion; (b) the brief filed by the Rehabilitator on December 11, 2017 in opposition to the COFINA Bondholder's Motion to Adjourn; and (c) the brief filed by the

[1] Capitalized terms not otherwise defined herein have the meaning ascribed to them in the Rehabilitator's Motion.

Rehabilitator on December 11, 2017 in opposition to the COFINA Bondholder's Letter Request for Discovery.

II. Adjourning Consideration of the Rehabilitator's Motion Would Likely Scuttle the Rehabilitator's Proposed Amendments to the Plan of Rehabilitation

The Motion concerns amendments to a Plan of Rehabilitation that the Rehabilitator has determined in his sound judgment is fair to holders of policies allocated to the Segregated Account and best serves the interests of policyholders, creditors and the public. The Rehabilitator has concluded that the Consensual Transaction, which provides "consideration of 93.5 cents per dollar in cash, Senior Secured Notes, and GA Surplus Notes exchanged today on outstanding obligations and payment in full on prospective claims – is superior to maintaining the status quo for perhaps as long as 37 years." Rehabilitator's 9/25/17 Br. at 3. The Second Amended Plan is based on the extensively negotiated Consensual Transaction between AAC, Ambac Financial Group, Inc. ("AFG") and a group of creditors with beneficial interests in a material percentage of Deferred Amounts and a majority of the General Account Surplus Notes (the "GA Surplus Notes"). The Consensual Transaction would "allow substantial payments to all creditors and facilitate an exit of the Segregated Account from rehabilitation." Rehabilitator's 9/25/17 Br. at 2.

As part of this Consensual Transaction, on July 19, 2017, AAC, AFG and the beneficiaries or holders (each, a "Holder") of a material portion of outstanding unpaid policy claims of the Segregated Account and a material portion of the outstanding GA Surplus Notes, executed the Rehabilitation Exit Support Agreement ("RESA"). Rehabilitator's 9/22/2017 Amended Disclosure Statement Accompanying the Second Amended Plan of Rehabilitation, Ex. C at 1. Section 7 of the RESA provides that the Holders of at least (i) 66 2/3% of the principal amount outstanding under the Senior Surplus Notes and (ii) 66 2/3% of the principal amount of

the Holder Deferred Amounts, may terminate the RESA upon the failure to meet certain milestones. *Id.* at Section 7. Furthermore, Section 7 of the RESA would allow any individual Holder to terminate the RESA with respect to itself upon the failure to close the Consensual Transaction by a date certain. *Id.* At least three of those milestones are threatened by the COFINA Bondholder's Motion to Adjourn. Failure to meet the required milestones likely would scuttle the Consensual Transaction and, in turn, the Second Amended Plan.

The first milestone that would be placed in jeopardy by an indefinite adjournment requires that the Confirmation Hearing of the Rehabilitator's Motion commence within 180 days of July 19, 2017, i.e. by January 14, 2018. *Id.* at Section 7 (a). The second milestone that would be placed in jeopardy requires that the transactions underlying the Second Amended Plan, as detailed in the RESA, must be consummated within 270 days of July 19, 2017, i.e. by April 15, 2018. *Id.* Missing either of these deadlines is grounds for the Holders to terminate the RESA. The termination of the Consensual Transaction by the Holders would lead to the complete collapse of the Second Amended Plan and loss of significant value currently available to policy beneficiaries of the Segregated Account. The third milestone that would be placed in jeopardy requires that the transactions underlying the Second Amended Plan, as detailed in the RESA, must be consummated within 365 days of July 19, 2017, i.e., by July 19, 2018. Missing this deadline would allow any individual Holder to terminate the RESA with respect to itself. Since no Holder is obligated to assume the obligations of another Holder that terminates its participation in the Consensual Transaction, and the participation by all Holders is essential to the success of the Second Amended Plan, termination by any individual Holder may also prove fatal to the Second Amended Plan.

The COFINA Bondholders, who have no interest in the Segregated Account, in their November 13, 2017 submission ask this Court to adjourn the consideration of the Second Amended Plan in favor of indefinite maintenance of the status quo. General Account Stakeholder's 11/13/17 Br. at 35-36. The economic interests of these General Account policy beneficiaries, who have potential claims that do not ripen for many years, should not take precedence in this proceeding.

Granting the extension sought by the non-party COFINA Bondholders could result in the collapse of the RESA and the Consensual Transaction, to the detriment of the Segregated Account, AAC, its creditors and the general public. The COFINA Bondholders' request to adjourn should therefore be denied. Rehabilitator's 9/25/17 Br. at 3.

III. Article 6.13 is Both Necessary and Proper for the Success of the Second Amended Plan

The MHPI Objectors focus on Article 6.13 as it applies to policies in AAC's General Account.[2] By protecting contract rights as to policies in both the General and Segregated Account, which are to be merged, Article 6.13 enables AAC to support the Second Amended Plan to help facilitate a durable exit by the Segregated Account. Absent approval of Article 6.13, the defaults and alleged defaults that Article 6.13 addresses could otherwise prevent AAC from receiving reimbursements because AAC would not be able to remediate potential losses, and could trigger the loss of other of AAC's rights under transaction documents, including rights to direct a trustee with respect to, among other things, commencing or prosecuting a legal proceeding or liquidating underlying collateral, and rights to consent to transaction amendments,

[2] There has been no challenge to Article 6.13 as it applies to policies and contracts allocated to the Segregated Account.

which allows AAC to control transaction amendments that are potentially adverse to AAC. *See* Barranco Aff. ¶ 11.

By including Article 6.13, the Second Amended Plan prevents transaction parties, who purport to have the right to do so, from declaring contract defaults and/or exercising certain "control rights" that they might claim based on, among other grounds, the Rehabilitation Proceeding and the circumstances that led to the Rehabilitation Proceeding, including AAC's financial condition and noncompliance by AAC or the Segregated Account with any provision of any Policy or Transaction Document prior to the Effective Date of the Second Amended Plan. In the event that this case were to be misconstrued or misunderstood as a rehabilitation of AAC's General Account or as a receivership of AAC, the General Account or its assets, default declarations in violation of Article 6.13 could cause AAC to forfeit important control rights. Because AAC has specific expertise and skill in utilizing control rights to mitigate losses, which benefits both AAC and the bondholders, AAC is best situated to exercise control rights for the benefit of all policyholders. If confirmation of the Second Amended Plan were to jeopardize AAC's ability to utilize control rights, i.e., if Article 6.13 were not included, the effect would be detrimental to the amounts available to pay all policyholders, including those whose policies were allocated to the Segregated Account. It would also adversely affect the public at large. *See* Barranco Aff. ¶ 12.

Whereas the preservation of control rights was required at the time this case began in order to allow remediation efforts aimed at reducing potential strains on claims-paying resources, a durable rehabilitation exit is aided by preservation of all contract rights as provided by Article 6.13 and the Second Amended Plan as a whole. Just as retention of those contract rights during the rehabilitation case has enabled the Segregated Account and the General Account to mitigate

losses and maximize recoveries, thereby removing the original reasons for the creation of the Segregated Account and its rehabilitation, the loss of these contract rights (including control rights) that are protected by Article 6.13 would impede consummation of the Consensual Transaction (as defined by the Second Amended Plan) and the Second Amended Plan. *See* Barranco Aff. ¶ 13.

The protections afforded to the General Account by Article 6.13 continue to be necessary at the Segregated Account's exit. If the end result of the targeted proceeding is – as the MHPI Objectors would like to assert – that defaults are triggered as to General Account contracts, the entire purpose of the Segregated Account rehabilitation structure would be defeated. *See* Barranco Aff. ¶ 14.

The importance of control rights to AAC has also been judicially recognized, when the *Nickel* court concluded that "Although the trustee banks argue that their exercise of control rights might not have a financial impact on [AAC], they provide no evidence to counter the circuit court's findings based on Mr. Peterson's affidavit that allowing the trustee banks to exercise control rights would likely be damaging to the policyholders and the public in general." 2013 WI App 129, ¶ 143. The *Nickel* court reached this conclusion by relying on the Circuit Court's findings and the prior record, including the Fourth Affidavit of Roger Peterson,[3] in its decision affirming confirmation of the Initial Plan. *See id.* at ¶¶ 142-44.

[3] Roger Peterson, acting as Special Deputy Commissioner, filed his Fourth Affidavit on August 10, 2010, in response to pleadings filed by certain interested parties in June of 2010, seeking to intervene and obtain relief from the Rehabilitation Court's initial temporary injunction. There, Mr. Peterson, though speaking about policies allocated to the Segregated Account, explained the importance of preserving "control rights", which he described as "the insurer's contractual rights under various transactional documents that enable the insurer to exercise a greater level of control and access to information than parties on the creditor side (commonly called 'control rights')", the importance of which applies equally to policies that had been in either account going forward. Peterson Fourth Aff. ¶11.

The reason Article 6.13 must be extended to apply to all AAC contracts is because if the Rehabilitation were to cause or be viewed as having caused defaults under all AAC agreements, including those in the General Account, section 611.24 of the Wisconsin Statutes - which expressly permits the targeted rehabilitation of a segregated account - would be rendered ineffective and the successful conclusion of this rehabilitation case would be jeopardized. Article 6.13 thus effects a central tenet of this case: protecting AAC from contract defaults that would have been triggered if the General Account or its assets were subject to rehabilitation. Those protections have been in place since the Rehabilitation Proceeding began. *See, e.g.,* Order for Temporary Injunctive Relief 10/24/10, ¶¶ 5-10 ("Temporary Injunction); testimony of Wisconsin Commissioner of Insurance, Sean Dilweg, Confirmation Hearing In the Matter of the Rehabilitation of Segregated Account of Ambac Assurance Corp. (Nov. 15, 2010) [AMBAC 00053341] at 137:15-19 and 151:16-12 ("We wanted a more surgical approach because of the thousands of policyholders where we would have triggered their covenants if we had moved forward with the full rehabilitation or liquidation." "[A] full liquidation or rehabilitation would have thrown the policyholders into turmoil, and [I] felt that some form of the Segregated Account or multiple Segregated Accounts were contemplated at one time would be the best result"); testimony of Wisconsin Commissioner of Insurance Director of Bureau of Financial Analysis and Examinations, Roger Peterson, Tr. 11/16/10, 167:21-168:5 ("Reasons why we rejected the full Rehabilitation had to do with the failure to preserve durable coverage, loss of control rights, ah, undue financial hardship on certain AAC policyholders").[4] The record

[4] The affidavit of May 20, 2010 filed by Cathleen Matanle, then a Managing Director of AAC, which this Court can consider as a part of the record of the Rehabilitation explained the damage that could occur were the General Account to have been subjected to rehabilitation in 2010:

> 27. [AAC's] decision-making process in establishing the Segregated Account, as compared to the alternative of a full rehabilitation, reflects

establishes that the purpose of leaving certain liabilities in the General Account was to assure that no defaults would occur with respect to those policies.

This was further documented in the Rehabilitation Court's decision to confirm the Initial Plan, where it relied on testimony, as well as the Disclosure Statement Accompanying Plan of Rehabilitation,[5] to find that "a general or full rehabilitation of AAC could have triggered costly defaults across many of those contracts and crystallized substantial losses from a variety of different contractual obligations which was sometimes referred to in the testimony as "collateral damage." *Decision and Order Confirming the Rehabilitator's Plan of Rehabilitation, With Findings of Fact and Conclusions of Law*, ¶ 51 (Jan. 24, 2011), citing Peterson Tr. 11/16/10, 152:2-12. The Rehabilitation Court elaborated that, although OCI had considered a full rehabilitation of AAC, OCI "much preferred the latter, more surgical option. OCI was concerned regarding the potential adverse effects of a full rehabilitation, including the pulling of default triggers . . . ." *Id.* at ¶55, citing Peterson Tr. 11/16/10, 161:2-17. Throughout the course of the Rehabilitation, the Segregated Account and the General Account have utilized their control rights for the benefit of policyholders. They have used, and continue to use, such control rights

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> the desire to avoid unnecessarily subjecting the vast majority of [AAC's] policies to the uncertainty, ambiguity, and financial consequences of rehabilitation.

(Matanle Aff. ¶ 27) (emphasis added). Ms. Matanle affirmed, by way of further examples, that the targeted rehabilitation of the Segregated Account was designed specifically to avoid triggering events of default. *Id.* at ¶30. ("Triggering events of default in transactions can have far-reaching consequences, not only for [AAC] and its policyholders, but for the issuers of these securities and their affiliates, and for the millions of men and women who depend on these issuers and their affiliates for their livelihood.").

[5] Disclosure Statement Accompanying Plan of Rehabilitation, 6 (Oct. 8, 2010) ("'trigger provisions' [in AAC-insured financings] that give rise to losses or cause losses to increase or to become accelerated ... as well as the potential for impairment of AAC's transactional control rights, made it more likely that policy claims would arise and/or reduce or eliminate AAC's ability to recover all or a portion of amounts paid in claims, all of which would harm AAC's policyholders").

to mitigate their liability exposures, reduce volatility in their insured book and maximize recoveries, all of which inures to the benefit of policyholders. AAC's continued ability to exercise such control rights is essential in facilitating AAC's ability to proceed as a durable insurer after termination of the Rehabilitation and merger of the Segregated Account back into the General Account. The Second Amended Plan, including Article 6.13, is designed in a manner that both is consistent with the rehabilitation process to date and allows AAC to continue to exercise its control rights for the benefit of its policyholders. But, if the General Account were not to be protected by Article 6.13, defaults could exist, or be asserted to exist, with respect to both General Account and Segregated Account contracts, resulting in many circumstances of control rights vesting in third parties, which is value destructive and contrary to the Rehabilitator's durability assumptions. *See* Barranco Aff. ¶ 9.

Now that the Segregated Account is poised to exit rehabilitation, Article 6.13 is required to prevent any such further efforts by the MHPI Objectors or any other AAC contract-counterparties, and thereby achieves a central goal of this case by "avoid[ing] unnecessarily subjecting the vast majority of [AAC's] policies to the uncertainty, ambiguity, and financial consequences of rehabilitation." Barranco Aff. Ex. A, Matanle Aff. ¶ 27.

IV. Other State Rehabilitation Courts Have Approved Similar Provisions to Article 6.13

There is precedent outside of Wisconsin that supports the adoption of Article 6.13 in connection with the Second Amended Plan. In the rehabilitation case of Financial Guaranty Insurance Corp. ("FGIC"), which is in the same business as AAC, the New York Supreme Court approved Section 3.5 of the FGIC plan of rehabilitation, which provides, similar to the provisions at issue in the Second Amended Plan, that:

> (a) Subject to Section 3.7 of the Plan [specific settled resolution for the exercise of certain RMBS Control Rights], and except as part of a transaction subject to Section 4.8 hereof [Alternative Resolution of Claims] or as may be ordered or approved by the Court, from and after the date of the Order of Rehabilitation, any default, event of default or other event or circumstance relating to [FGIC] then existing (or that would exist with the passing of time or the giving of notice or both) under any FGIC Contract or Transaction Document, as a result of (whether directly or indirectly) the Rehabilitation or the Rehabilitation Circumstances shall be deemed to be cured and not to have occurred (including, for the avoidance of doubt, any default, event of default or other event or circumstance that has arisen (or that may otherwise arise with the passing of time or the giving of notice or both) due to a lack of payment or performance of or by the FGIC Parties under any FGIC Contract or Transaction Document).
>
> (d) If based on or in connection with the occurrence or existence of any of the Rehabilitation Circumstances or of a lack of payment or performance of or by the FGIC Parties under any FGIC Contract or Transaction Document, FGIC would be precluded from exercising any FGIC Right under the express terms and conditions of such FGIC Contract or Transaction Document to direct or instruct the Trustee to take or refrain from taking any actions as specified therein (other than with respect to matters addressed in Section 3.7 below which shall be governed by that Section), then FGIC may nonetheless exercise such FGIC Right to direct or instruct the Trustee . . . .
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> (e) For the avoidance of doubt, nothing in this Plan is intended to modify, amend, supplement or waive the terms and conditions of any Transaction Documents, but rather is intended to clarify, in the context of and giving effect to all the provisions of the Plan, the relative rights of FGIC, the holders(s) of the insured Instruments, and the Trustees in respect of the exercise of their rights and remedies set forth in the Transaction Documents.

In re Rehab. of Fin. Guaranty Ins. Co., Plan Approval Order, Index No. 401265/2012 (Sup. Ct. N.Y. County June 11, 2013), Exhibit 1 at 3-5, available at http://www.fgic.com/policyholderinfocenter/planapprovalorder.pdf. Section 3.5 of the FGIC plan imposed even more significant burdens on contract counterparties, because in that case, FGIC and its affiliate, FGIC Credit Products, had defaulted in the payment of policy obligations before the rehabilitation case began. Thus the "cure" of defaults retroactively prevented both FGIC's and its affiliate's counterparties that had not received payment of losses from exercising contract rights. Here, in contrast, AAC has paid claims in full on all General Account policies

since the commencement of the rehabilitation and will continue do so. The New York and Wisconsin insurance laws both provide broad power to the rehabilitator to remedy the causes of the rehabilitation. *Compare* N.Y. Ins. Law § 7403(a) (McKinney) ("An order to rehabilitate a domestic insurer shall direct the superintendent and his successors in office, as rehabilitator, forthwith to . . . take such steps toward the removal of the causes and conditions which have made such proceeding necessary as the court shall direct."), *with* Wis. Stat. § 645.33(2) ("Subject to court approval, the rehabilitator may take the action he or she deems necessary or expedient to reform and revitalize the insurer . . . ."). As in FGIC, the Wisconsin Rehabilitation Court can certainly deem cured "defaults" based on the Rehabilitation.

Guidance is also available from decisions that recognize rehabilitation courts' authority to protect a rehabilitation insurer by enjoining third-party actions against the insurers' affiliates. *See, e.g., Garamendi v. Exec. Life Ins. Co*., 17 Cal. App. 4th 504 (Ca. Ct. App. 2d Dist. 1993) (trial court overseeing Executive Life rehabilitation validly exercised in rem jurisdiction to enjoin proceedings against assets of partnerships in which Executive Life had ownership interest, because entities shared an "identity of interest" and partnerships' assets were reasonably necessary to promote the insolvent company's rehabilitation); *In re Mutual Benefit Life Ins. Co.*, 258 N.J.Super. 356, 609 A.2d 768 (A.D.1992) (state rehabilitation court has authority to enjoin bond trustees from foreclosing on real estate projects in which insurer owned partnership interests); *Green v. Champion Ins. Co.*, 577 So.2d 249, 259–60 (La. App. 1st Cir.1991) (state rehabilitation court may assert jurisdiction over assets of affiliated entities where insurer and the entities constitute a "single business enterprise"). *See also Morgan Stanley Mortg. Cap., Inc. v. Ins. Comm'r. State of California*, 18 F.3d 790 (9th Cir. 1994) (because California court's in rem jurisdiction over rehabilitation case of Executive Life Insurance Company was asserted first and

extended to assets of affiliates in which insurer had ownership interest, full faith and credit was due to state court's injunction). These decisions support the conclusion that protection of AAC as a whole, including the General Account, is well-within the Rehabilitation Court's authority.

While they are separate entities for purpose of rehabilitation under Wisconsin law, the Segregated and General Accounts were once a single economic unit and will be again when merged. The Segregated Account also is capitalized through the Secured Note and reinsurance agreement issued by the General Account. Whereas the *Executive Life* and *Mutual Benefit* cases, cited above, involved injunctions issued to protect downstream affiliates of rehabilitating insurers, the relationship between the Segregated Account and General Account is even closer. If the *Mutual Benefit* and *Executive Life* courts could enter injunctions protecting downstream affiliates, *a fortiori* the Rehabilitation Court can enter injunctions protecting the General Account.

CONCLUSION

For the reasons above, this Court should grant the Rehabilitator's Motion in its entirety, deny the Objections and approve the Second Amended Plan of Rehabilitation.

Dated: December 11, 2017

Respectfully submitted,

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