STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10CV1576

BRIEF IN SUPPORT OF MOTION FOR TEMPORARY INJUNCTIVE RELIEF

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INTRODUCTION

This brief is submitted on behalf of the Wisconsin Commissioner of Insurance (the "Commissioner") in support of his motion for temporary injunctive relief in regard to rehabilitation of the segregated account (the "Segregated Account") of Ambac Assurance Corporation ("Ambac" or "the General Account"). The Segregated Account and the insurance policies allocated to it are more fully described in the accompanying Brief in Support of Rehabilitation and in the documents attached to the Commissioner's Verified Petition at Tab 1.

As shown below, the Commissioner has broad discretion to seek injunctive relief in furtherance of the purposes of rehabilitation proceedings, and it is well within the Court's authority to grant it. Injunctive relief is well-recognized by courts as an essential tool in furthering the purposes of insurer rehabilitation and other reorganization-type proceedings. The relief sought here by the Commissioner facilitates the orderly and equitable payment of claims and serves the remedial purposes underlying Chapter 645 by "protect[ing] the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogatives of proprietors." Wis. Stat. § 645.01(4).

The Commissioner requests that the Court grant temporary injunctive relief in the form specified in the accompanying proposed order to preserve the status quo. The requested relief is necessary to prevent catastrophic destruction of policyholder value and to provide the Commissioner adequate time to transition this troubled insurer to the stability of a court-approved rehabilitation plan. The Commissioner requests that the temporary injunctions be issued without bond consistent with Wis. Stat. § 645.08(1).

The injunctive relief specified in the order addresses the following four categories of potential harm faced by the Segregated Account at the outset of this rehabilitation proceeding:

1. Protection Against Inequitable *Ipso Facto* Provisions: The requested relief prevents the exercise of contractual *"ipso facto"* provisions in certain types of the policies allocated to the Segregated Account and underlying contracts of subsidiaries insured by those policies.[1] Those provisions otherwise might permit the parties to those policies and contracts (collectively, "counterparties") to point to the commencement of the rehabilitation proceeding as grounds for triggering early termination and resultant punitive "mark-to-market" damage claims, and for stripping the insurer of its normal "control rights." Maintaining those control rights is essential to ensure proper servicing of the contracts and underlying collateral and to prevent the counterparties from triggering inflated damage claims through premature liquidation of the underlying collateral securing the obligations guaranteed by the Segregated Account.

The details of the complicated injunctive provisions necessary to prevent punitive mark-to market damage claims and inequitable forfeiture of the Segregated Account's "control rights" are detailed in the proposed form of order. Absent the requested injunctive relief, the counterparties' potential exercise of the *ipso facto* provisions based on the filing for rehabilitation, with the resulting claims for mark-to-market damages and/or the seizure or premature sale of collateral, would result in enormous, inequitably inflated claims against the Segregated Account.

2. Moratorium on Claims Payments: The second component of the Commissioner's requested injunctive relief is to enjoin payment of claims or

[1] Unless otherwise stated, all references to the Segregated Account encompass the segregated account of Ambac and the Ambac subsidiaries that have been allocated to it; namely, Ambac Credit Products, LLC, Juneau Investments, LLC, and Aleutian Investments, LLC.

obligations of the Segregated Account without his consent or the consent of his authorized representatives. This injunction promotes an orderly claims payment process and, by authorizing the Commissioner to freeze claims payments until the finalization and approval of a rehabilitation plan, enables a systematic and equitable transition into rehabilitation and means of handling claim payments pursuant to a court-approved rehabilitation plan.

3. Maintain Payments Due the Insurer: The third component of requested relief is to require counterparties to continue to pay the premiums they owe on the policies allocated to the Segregated Account and to make the payments due on contracts insured by the policies in the Segregated Account.

4. Standard Chapter 645 Protections: The fourth and final component consists of standard first-day injunctive provisions found in all Wisconsin rehabilitation proceedings.

The order for temporary injunctive relief proposed by the Commissioner sets an orderly procedure for dealing with any objections to making the temporary injunctive relief permanent. Specifically, the order sets a deadline of 90 days (ending the first court business day at least 90 calendar days after entry of the order) by which any interested party may file a motion seeking to dissolve or modify the temporary injunctive relief. At the expiration of the 90-day period, if any such motions to dissolve or modify injunctive relief have been filed, the Court would set a responsive briefing schedule and a hearing date to argue the merits of any dispute pertaining to the nature, scope or duration of the injunctive relief. If no timely motions to modify or dissolve the injunctive relief are received, or if any such motions are received and denied by the Court,

the Commissioner will request that the Court make the temporary injunctive relief a permanent aspect of the final form of the Commissioner's plan for rehabilitation.

ARGUMENT

I. THE COMMISSIONER IS ENTITLED TO BROAD DEFERENCE IN REHABILITATION PROCEEDINGS.

In Wisconsin, as in other states, the law regarding insurance rehabilitation is one of flexibility and deference to the judgment of the Commissioner and, ultimately, the Court. The Commissioner has broad discretion to seek injunctive relief, the Court has broad authority to grant and enforce it, and the Rehabilitator has a broad legislative grant of authority to implement it to facilitate equitable and orderly rehabilitation proceedings.

The law considers insurance to be a public asset. "[P]rotection of the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogatives of proprietors," Wis. Stat. § 645.01(4), is a shared public concern. *See, e.g., Cal. State Auto. Ass'n. Inter-Ins. Bureau v. Maloney*, 341 U.S. 105, 109 (1951) (holding that the rule that the police power "extends to all the great public needs" is "peculiarly apt when the business of insurance is involved—a business to which the government has long had a 'special relation'"); *Osborn v. Ozlin*, 310 U.S. 53, 65 (1940) ("Government has always had a special relation to insurance. The ways of safeguarding against the untoward manifestations of nature and other vicissitudes of life have long been withdrawn from the benefits and caprices of free competition."); *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 415 (1914) (noting that the insurance business is "of the greatest public concern"); *In the Matter of All-Star Ins. Corp.*, 484 F. Supp. 623, 626 (E.D. Wis. 1980) (noting the public concern embodied in Chapter 645).[2] To

[2] The United States Supreme Court aptly explained the public interest in insurance:

serve that public interest, Wisconsin established procedures for formal rehabilitation and authorized the Commissioner to take any of a number of actions "whenever he or she believes that the insurer may be successfully rehabilitated without substantial increase in the risk of loss to creditors of the insurer or to the public." Wis. Stat. § 645.31(1).

Wisconsin law encourages the Commissioner to utilize equitable remedies to serve the purposes of delinquency proceedings. The Commissioner "need not show irreparable harm or lack of an adequate remedy at law" to obtain an injunction under Chapter 645 of the Wisconsin Statutes, Wis. Stat. § 601.64(1), and Chapter 645 authorizes a wide spectrum of injunctive relief in rehabilitation actions. *See generally* Wis. Stat. § 645.05 (specifically authorizing injunctive relief to prevent the institution or further prosecution of any actions or proceedings against the insurer, "interference with the receiver or the proceedings," waste of the insurer's assets or dissipation of bank accounts, obtaining preferences, and levying of execution, among others). Most broadly, however, Chapter 645 expressly allows the Commissioner to seek injunctions against

> any other threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of the proceeding.

Wis. Stat. § 645.05(k).

> The effect of insurance—indeed, it has been said to be its fundamental object—is to distribute the loss over as wide an area as possible. In other words, the loss is spread over the country, the disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired . . . . [Insurers'] efficiency, therefore, and solvency are of great concern. The other objects, direct and indirect, of insurance we need not mention. Indeed, it may be enough to say, without stating other effects of insurance, that a large part of the country's wealth, subject to uncertainty of loss[,] ... is protected by insurance. This demonstrates the interest of the public in it . . . .

German Alliance Ins. Co., 233 U.S. at 412-13.

Because the Commissioner is required to act within the public interest, Wis. Stat. § 601.15,[3] his conclusion that certain injunctive relief is "necessary and proper" to prevent prejudice to "policyholders, creditors or shareholders, or the administration of the proceeding" warrants considerable deference. *Cf.* Wis. Stat. § 227.57(10) ("Upon such review of [agency decisions] due weight shall be accorded the experience, technical competence, and specialized knowledge of the agency involved, as well as discretionary authority conferred upon it."). As the Kentucky Supreme Court has noted,

> The [insurance rehabilitation and liquidation] statutes are designed to provide a comprehensive, efficient, and orderly procedure for liquidating insurance companies while protecting the rights of interested parties. Statutorily, the Commissioner is the appointed person in exclusive control over the proceedings, with guidance and approval provided by the court. . . . The Commissioner is best qualified to perform the rehabilitation/liquidation process as he has no special interest in the outcome except to administer the matter for the maximum benefit of all parties.

Minor v. Stephens, 898 S.W.2d 71, 76 (Ky. 1995). *See also Neblett v. Carpenter*, 305 U.S. 297, 302 (1938) (holding that the exercise of a rehabilitator's authority and discretion in formulating an aggressive plan to protect policyholders does not violate the Equal Protection or Due Process Clauses of the Constitution, and approval of such a plan is within the authority of the state court with jurisdiction over the delinquency proceeding); *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1092 (Pa. 1992) (noting that the Rehabilitator has the responsibility to determine facts, plans, and public policy, and his determinations cannot be disturbed "in the

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[3] *See also In the Matter of the Liquidation of Integrity Ins. Co.*, 754 A.2d 1177, 1186 (N.J. 2000) (insurance receiver had a "hybrid role," with fiduciary responsibility to the creditors of the insolvent insurer as opposed to the public at large, but at the same time acting in a public role); *PrimeHealth Corp. v. Ins. Comm'r*, 758 A.2d 539, 546 (Md. Ct. Spec. App. 2000) (as a public official, even when acting as a receiver, the Commissioner "is charged with a duty to act with a broad view toward minimizing financial harm to all policyholders, creditors, and the general public"); *El Paso Elec. Co. v. Tex. Dept. of Ins.*, 937 S.W.2d 432, 436 (Tex. 1996) (receiver for insolvent insurer performs a public, regulatory function and is a state officer, acting in behalf of the state and performing duties placed upon that office by state statutes); *Commercial Nat'l Bank v. Superior Ct.*, 17 Cal. Rptr. 2d 884, 886 (Cal. Ct. App. 1993) ("[I]n accordance with this public policy, the Commissioner has undertaken to rehabilitate the business of ELIC. The statutory authority he exercises in that effort is an aspect of the police power of the state.").

absence of bad faith, fraud, capricious action or abuse of power") (quotation omitted); *In the Matter of the Application of Van Schaick*, 239 A.D.490, 496, 268 N.Y.S. 88 (N.Y. App. Div. 1933) ("[I]t is well settled that the Legislature may enact a statute in broad outlines, leaving to the executive officials the duty of arranging the details.").

Consistent with these principles, this Court has broad discretion to grant and enforce the injunctions the Commissioner seeks. *See* Wis. Stat. § 645.05(1) (establishing that the Court may grant injunctions in Chapter 645 proceedings in accordance with the standards set forth in Chapter 813 of the Wisconsin Statutes); *Joint Sch. Dist. No. 1, City of Wis. Rapids v. Wis. Rapids Educ. Ass'n*, 70 Wis. 2d 292, 308, 234 N.W.2d 289, 299 (1975) (upholding the grant of an injunction under a statute authorizing injunctions pursuant to Chapter 813 in part because "[i]t is a basic rule that the granting or refusal of a temporary injunction is a matter lying within the discretion of the trial court"); *Mercury Records Prods., Inc. v. Econ. Consultants, Inc.*, 91 Wis. 2d 482, 499, 283 N.W.2d 613, 621 (Ct. App. 1979) (same).[4]

In the context of insurance rehabilitation, the Court's broad authority is even more well-recognized:

> To further the rehabilitation scheme, courts may impose injunctions prohibiting commencement or prosecution of litigation against an insolvent insurer while rehabilitation efforts are underway. Trial courts have considerable discretion concerning the scope of any such injunctions, including whether an injunction should be modified, and we will only disturb such a determination if the court abused its discretion.

[4] Further, this Court has the authority to enter temporary injunctions *ex parte*. *See, e.g.*, *Town of Union v. City of Eau Claire*, 2003 WI App ¶¶ 3, 12, 265 Wis. 2d 879, 667 N.W.2d 810 (affirming trial court's *ex parte* grant of preliminary injunction, which it later converted to a permanent injunction); *Fewell v. Pickens*, 39 S.W.3d 447, 455 (Ark. 2001) (affirming the *ex parte* grant of a permanent injunction in part because the enjoined parties had a later opportunity to be heard). Given the number of parties potentially interested in this proceeding who must receive notice and the urgent need for injunctive relief, it is impractical and would defeat the purposes of Chapter 645 to delay such relief until all parties can be identified, notified, and heard, or to grant such relief for a shorter time period.

In re Rehabilitation of Frontier Ins. Co., 870 N.Y.S.2d 144, 146 (N.Y. App. Div. 2008) (internal citations omitted). *See also In re Traders Compress Co.*, 381 F. Supp. 789, 795 (W.D. Okla. 1973) (holding that, in reorganization proceedings involving insurers, courts may use their power to delay or to deny enforcement of a contractual right to terminate a contract "in order to effect a reorganization of a company").

The Commissioner has deemed the injunctive relief specified in the proposed form of order as necessary and proper to serve the purposes of Chapter 645. As shown in the following sections, the Court acts well within its discretion and stands on firm precedential footing in granting that requested relief.

II. INJUNCTIVE RELIEF IS APPROPRIATE HERE.

As noted above, Chapter 645 establishes that the Commissioner "may at any time apply for and any court of general jurisdiction in this state may grant" such temporary injunctions "as are deemed necessary and proper to prevent . . . threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of the proceeding." Wis. Stat. § 645.05(1)(k). All of the proposed injunction provisions here readily meet those criteria.

A. The Proposed Injunctions are Necessary.

The injunctive relief sought by the Commissioner falls into four general categories: (1) an injunction against the counterparties' exercise of *ipso facto* clauses in many of their contracts, which, unless enjoined, would allow them to accelerate, terminate, seize collateral, change control of the servicing and administration of collateral, and/or seek rapid amortization under those contracts as a result of the filing of this proceeding; (2) an injunction against claims payments on account of policies and contracts allocated to the Segregated Account without the consent of the Commissioner; (3) an injunction requiring those parties who must make premium

or other contract payments when the insurer is not in rehabilitation to continue to make those payments during these proceedings or face cancellation of their policies or disallowance of future claims; and (4) other injunctions, all of which are routine and expressly authorized by Section 645.05. All of these injunctions are necessary to provide for the orderly and equitable treatment of policyholders and the ultimate rehabilitation of the Segregated Account.

First and foremost, an injunction against the exercise of *ipso facto* termination or loss-of-control rights[5] clauses is vital to an orderly, equitable, and ultimately successful rehabilitation proceeding. As noted above, many of the contracts at issue contain *ipso facto* termination clauses calling for mark-to-market damages upon termination, as measured by the market cost of replacement insurance. Given the subsequent exposure of many of the counterparties' insured investments as subprime, there is simply no insurance coverage presently available for such poor investments—at least not without the payment of exorbitant premiums. If the *ipso facto* and mark-to-market clauses were not enjoined, funds available to pay actual economic losses of the other policyholders could instead go toward large, non-pecuniary loss claims for a handful of policyholders, thus destroying Ambac's ability to successfully reorganize and have its Segregated Account emerge from rehabilitation. This is the very type of scenario the Legislature sought to avoid when it enacted Chapter 645. *See* Wis. Stat. § 645.01(4); Wis. Stat. Ann. introductory cmt. to ch. 645 (listing, among the goals the Legislature sought to achieve in Chapter 645, "[t]he provision of effective procedures for rehabilitation of companies seriously sick but still salvageable").

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[5] Under many of the counterparties' contracts, the Segregated Account currently holds "control rights" that give it the power to change mortgage servicers, to prevent counterparties and trustees from seizing and liquidating collateral, to control their rights and remedies (including suits against affiliated entities) and, in some cases, to prevent termination and its accompanying mark-to-market damages. The Rehabilitator's loss of those control rights—and their accompanying transfer to the counterparties through *ipso facto* provisions—would jeopardize the fair allocation of claims-paying resources to the greatest number of policyholders.

Because the Segregated Account and the General Account of Ambac may be able to continue any regular payments that are to be made under policies and contracts entered by them and their subsidiaries for actual losses, the protection offered by the proposed rehabilitation is at least equal to what it would have been prior to the occurrence of any events purportedly giving rise to termination rights. That being the case, it would subvert the remedial purpose of Chapter 645 to allow certain policyholders and counterparties to terminate and/or exercise control rights, thereby obtaining punitive mark-to-market or other non-pecuniary damages, causing inflated losses from premature liquidation of collateral, or otherwise interfering with equitable claims administration by the Rehabilitator.

Second, an injunction against claims payments by the Segregated Account (or on account of policies or contracts allocated to it) without the Rehabilitator's consent is necessary for several reasons. In the short term, it permits the Rehabilitator to temporarily freeze claims payments prior to the finalization and approval of a formal rehabilitation plan. This gives the Rehabilitator time to notify all policyholders of the commencement of these proceedings, provides an opportunity for the Rehabilitator to perform administrative tasks such as the ascertainment and marshalling of claims paying resources, and facilitates a measured transition into rehabilitation. In the long term, it serves to prevent a disorderly claims procedure and to assure that the Rehabilitator can sufficiently examine claims prior to committing claims-paying resources to them.

Third, the injunction is appropriate to avoid improper preferences among policyholders. Specifically, some policies and contracts allocated to the Segregated Account relieve counterparties and policyholders of the duty to pay premiums or make other payments upon the filing of a formal delinquency proceeding, but allow them to continue to retain coverage and

merely set off the amounts owed against future losses. In other words, while some policyholders must await actual losses before making claims for payment, these provisions would allow policyholders suffering no pecuniary loss to inequitably and impermissibly prioritize their claims by paying themselves *ahead* of any loss or deferred payment notes which would otherwise eventually be due them under the Commissioner's rehabilitation plan.

Fourth, standard first-day orders such as injunctions against waste, against lawsuits by Segregated Account policyholders outside this proceeding, against interference with the Rehabilitator, and others are routine and necessary to obtain some of the key benefits of rehabilitation proceedings: order, equity, and preservation of assets. They are all expressly authorized by Wis. Stat. § 645.05(1), and they are all especially necessary in a rehabilitation with such a high degree of complexity and high financial stakes for policyholders.

B. The Proposed Injunctions are Proper.

1. The *Ipso Facto* Termination and "Control Rights" Provisions in the Policies and Contracts Here are Unenforceable in the Context of Rehabilitation.

(a) Chapter 645 does not allow the types of mark-to-market damages at issue.

Wisconsin courts, like courts of equity elsewhere, may use the broad injunctive powers they possess to enjoin termination or "control rights" contractual provisions where the alternative threatens successful rehabilitation and thwarts recovery of actual losses on policies. Indeed, Wisconsin insurance law demands it in this case. Section 645.68 prioritizes claims for "losses incurred"; non-pecuniary claims are absent from the statute's order of distribution. Wis. Stat. § 645.68. In addition, Section 645.32(2) holds that "[e]ntry of an order of rehabilitation does not constitute an anticipatory breach of contract." While that provision arguably applies to circumstances other than here (because some of the contracts could be interpreted to mean that

the rehabilitation proceeding is a breach of contract in its own right), it is clear that the Legislature sought to prevent a rush of early terminations and immediate liability upon the initiation of a proceeding designed to rehabilitate an entity already in financial distress.

In a similar vein, Section 645.42(2) provides that the rights of creditors are "fixed" as of the date of filing of a liquidation petition. While this proceeding is a rehabilitation rather than a liquidation, the powers of the Court are similar and the overarching purpose the same in both proceedings: "the protection of the interests of insureds, creditors, and the public generally[.]" Wis. Stat. § 645.01(4). The Wisconsin Legislature's willingness to "fix" the rights of creditors such that the event of filing does not constitute a ground for termination damages in the liquidation context offers further support for the argument that similarly fixing counterparties' rights by barring future terminations (and their accompanying damages) is warranted in this rehabilitation. As the Minnesota Court of Appeals noted, "[t]he insolvency of the insurer should not give the insured rights it otherwise would not have had." *Minn. Mining & Mfg. Co. v. H&W Motor Express Co.*, 507 N.W.2d 622, 625 (Minn. Ct. App. 1993). The same principle holds when an insurer is in a financially hazardous state.

(b) Courts refuse to enforce contractual terms that would undermine delinquency proceedings.

The terms of the counterparties' contracts and policies cannot trump the above-cited statutes barring recovery of the type of damages at issue here within the rehabilitation context, including statutes that give the Court the right to enjoin any "threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders, creditors or shareholders, or the administration of the proceeding." Wis. Stat. § 645.05(1)(k). Insurance delinquency proceedings, from their inception, have elevated the public interest over

private contracts. As the California Supreme Court noted in one of the leading insurance rehabilitation decisions:

> Neither the company nor a policyholder has the inviolate rights that characterize private contracts. The contract of the policyholder is subject to the reasonable exercise of the state's police power. The only restriction on the exercise of this power is that the state's action shall be reasonably related to the public interest and shall not be arbitrary or improperly discriminatory.

Carpenter v. Pac. Mut. Life Ins. Co., 74 P.2d 761, 774-75 (Cal. 1937), *aff'd*, *Neblett v. Carpenter*, 305 U.S. 297 (1938). *Accord Minor*, 898 S.W.2d at 80 ("Neither the insurance company nor policyholders have inviolate rights that characterize ordinary private contracts. The policyholders' contracts as well as others with interest in the company, are subject to a reasonable exercise of state police power."); *Foster*, 614 A.2d at 1095 (confirming a plan that altered contractual rights because it "foster[ed] the legitimate public purpose of safeguarding the public interest from the potentially innumerable consequences of [the insurer's] insolvency"); *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990) ("[C]ontractual terms are not sacrosanct when an insurance company is insolvent."), *aff'd in all relevant respects*, 614 A.2d 1086 (Pa. 1992).

This principle is consistent with the state of federal bankruptcy law when Chapter 645 was enacted. *See, e.g.*, *Weaver v. Hutson*, 459 F.2d 741, 744 (4th Cir. 1972) (refusing to enforce a forfeiture provision because it would result in "the complete emasculation of the reorganization"); *In re Fleetwood Motel Corp.*, 335 F.2d 857, 862 (3d Cir. 1964); *In re Traders Compress Co.*, 381 F. Supp. at 794 ("[S]hould the contract be literally enforced, the debtors' ability to reorganize would be obstructed. Under these circumstances, the courts have uniformly enjoined the cancellation of such contracts."); *cf. Cont'l Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island & Pac. R.R. Co.*, 294 U.S. 648, 675 (1935) (holding, thirty-two years prior to the

passage of Chapter 645, that a court could enjoin counterparties from their contractual right to sell collateral upon appointment of a receiver because to do otherwise would "so hinder, obstruct, and delay the preparation and consummation of a plan of reorganization as probably to prevent it").

Subsequent to those cases, Congress added "safe harbor" provisions exempting credit derivatives from automatic stay provisions and other restrictions upon bankruptcy creditors. 11 U.S.C. § 546(e), (g). Several states followed suit in similar reorganization contexts, but Wisconsin bucked this trend and chose not to amend Chapter 645 to exempt derivatives. Rules of statutory construction hold that the state legislature acts or abstains from acting with knowledge of legal developments. *See, e.g.*, *Town of Vernon v. Waukesha County*, 99 Wis. 2d 472, 479-80, 299 N.W.2d 593, 598 (Ct. App. 1980) (presuming legislative awareness of and acquiescence in an agency interpretation of a statute when the legislature failed to amend the statute in a manner that would change that interpretation), *aff'd*, 102 Wis. 2d 686, 307 N.W.2d 227 (1981). Under these principles, the state legislature's knowledge of—and refusal to act in spite of—federal law indicates its own intent to break with the federal doctrine on this point.

(c) The counterparties' contracts are executory and therefore cannot be terminated due to commencement of a reorganization proceeding.

In addition, because the CDS policies and agreements entered by Ambac and/or its subsidiaries are payable in periodic installments rather than up-front, both Ambac and the counterparties presently have continuing obligations to each other. As a result, absent the credit derivative exemption under federal law that Wisconsin has declined to enact for state insurance proceedings, a Chapter 11 bankruptcy court would characterize these agreements as executory contracts—contracts "under which debtor and nondebtor each have unperformed obligations" on the date of the petition. *Black's Law Dictionary* 369 (9th ed. 2009); *see In re Lehman Bros.*

Holdings Inc., 422 B.R. 407, 415-16, 420-21 (Bankr. S.D.N.Y. 2010) (refusing to enforce an *ipso facto* provision of a swap contract governed by the same generic master agreement as the CDS agreements here because "[t]he language and structure of the ISDA Master Agreement that forms a central part of the Swap Agreement demonstrate that these contracts are executory").

Under the Bankruptcy Code, executory contracts cannot "be terminated or modified . . . at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned upon" the debtor's insolvency or the commencement of the bankruptcy proceeding itself. 11 U.S.C. § 365(e)(1). This rule "invalidates *ipso facto[]* or bankruptcy clauses" that "permit the other contracting party to terminate the contract or leave, in the event of bankruptcy" because such rights to terminate "frequently hamper[] rehabilitation efforts." 1 *Collier Pamphlet Edition Bankruptcy Code* 365 (2009) (describing congressional purposes for enacting § 11 U.S.C. 365(e)).

Similarly, even though a bankruptcy filing may constitute a default under the language of a nondebtor's contract with the debtor, and even though trustees must normally cure such defaults prior to assuming executory contracts, 11 U.S.C. § 365(b)(1), an exception to this duty to cure exists when the event of default is the mere filing for bankruptcy or the insolvency of the debtor. Obviously, when the "triggering event" of the default in the case is the filing of a bankruptcy petition itself, the trustee cannot literally "cure" the triggering event. In such circumstances, and in light of the *ipso facto* rule described above, the cure "requirements do not apply to a default that is a breach of a provision relating to insolvency or the financial condition of the debtor, the commencement of the case, or the appointment of a trustee or custodian." 3 Alan N. Resnick & Henry J. Sommer, *Collier on Bankruptcy* § 365.05, at 365-53 (15th ed. rev. 2009). The rationale for this rule is straightforward:

> This exception to the general rule requiring cure of defaults furthers the bankruptcy policy of preventing the enforcement of *ipso facto* or optional bankruptcy termination clauses. In the context of the cure requirement, the exception is particularly important because the trustee cannot possibly cure a default flowing, for example, from the debtor's commencement of a case. If a provision stating that the contract was in default upon the filing of a bankruptcy petition could be enforced, parties could write contracts that could never be assumed by a trustee or debtor in possession.

Id. § 365.05[4], at 365-59.

Nor can the failure to pay liquidated damages under those executory contracts constitute a failure to cure. Indeed, it would make little sense for the Bankruptcy Code to specifically excuse trustees from the general need to cure a contractual default based on the mere filing of the petition, but then hold that the trustee must satisfy the contractual damages provision for that same default in order to assume the contract. It would potentially create a situation in which a trustee seeking to assume the contract would not only owe the other party the debtor's remaining obligations under the contract, but also damages that would have been owed had the contract been terminated by the bankruptcy filing—a windfall for the nondebtor contractual parties.

The law avoids this absurd outcome. Under the Bankruptcy Code, the trustee may assume an executory contract without making "satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract[.]" 11 U.S.C. § 365(b)(2)(D). Even if the liquidated damages clauses are not "penalty rates" or "penalty provisions," at least two courts of appeals have concluded that the assumption of an executory contract with an acceleration provision only requires resolution of the triggering event of default, not its contractual consequences. *See Di Pierro v. Taddeo* (*In re Taddeo*), 685 F.2d 24, 27 (2d Cir. 1982) ("Under § 365(b), the trustee may assume executory contracts and unexpired leases only if he cures defaults—but the cure

need address only the individual event of default, thereby repealing the contractual consequences.") (citing cases). *See also In re LHD Realty Corp.*, 726 F.2d 327, 332 (7th Cir. 1984) (holding that § 1124 of the Code recognizes that a debtor may reverse the acceleration of an obligation caused by its default). As noted above, the Bankruptcy Code itself nullifies the "triggering event" through its *ipso facto* rules, thus reversing any acceleration that would have otherwise arisen out of that event should the trustee opt to assume the contract.

The Wisconsin insurance insolvency statutes lack any direct reference to executory contracts, but Section 645.46(11) of the Wisconsin Statutes gives the liquidator power to "enter into such contracts as are necessary to carry out the order to liquidate, and affirm or disavow any contract to which the insurer is a party." This tracks the language of Section 365 of the Bankruptcy Code, which grants the trustee the power to accept or reject obligations under executory contracts. 11 U.S.C. § 365(a). However, because the reach of Wis. Stat. § 645.46 is not limited to executory contracts, it is reasonable to conclude that the Wisconsin provision grants the state rehabilitator *more* authority.

In short, the Rehabilitator has the power to assume those obligations of Ambac and its subsidiaries that have been allocated to the Segregated Account, thereby reversing acceleration and reinstating the maturity of the claims as they existed before this filing. A proceeding in a Wisconsin receivership court is "a special proceeding through which the Debtor is entitled to rehabilitate itself," and as such, the court will have equitable powers of the type described above. *In re Traders Compress Co.*, 381 F. Supp. at 793. This Court may exercise such powers to enjoin a counterparty's exercise of any contractual right to terminate a contract with an insurer that is subject to rehabilitation.

2. The Court Has The Authority To Require the Commissioner's Consent Before Making Claims Payments.

The broad scope of the Court's equitable power in rehabilitation proceedings includes the power to enjoin claims payments made without the Rehabilitator's consent, and specifically to allow the Rehabilitator to impose a temporary freeze on claims payments prior to the finalization and approval of a plan for rehabilitation. The Rehabilitator has the statutory authority to "take the action he or she deems necessary or expedient to reform and revitalize the insurer," Wis. Stat. § 645.33, and a suspension of claims payments is necessary and accepted method to ensure an orderly transition into rehabilitation. *See Ins. Comm'n of S.C. v. New S. Life Ins. Co.*, 248 S.E.2d 591, 594 (S.C. 1978) (approving a moratorium on policy payments by an insurer in rehabilitation to certain policyholders "for such period and to such extent as may be necessary" pursuant to the "broad authority" of the rehabilitator). Further, Chapter 645 strives for "[e]quitable apportionment of any unavoidable loss." Wis. Stat. § 645.01(4)(d). As noted in the Petition, the Commissioner has concluded that this purpose is best served through a cash-note claims payment process—a process that cannot begin before determining the most appropriate cash-note ratio, and obtaining SEC approval to issue the notes.

3. Chapter 645 Authorizes Injunctions to Modify Contractual Terms to Require Payments Due the Insurer to Avoid Preferences.

Some of the policies and contracts at issue include clauses that could allow a counterparty, upon the commencement of this proceeding, to retain policy coverage or contractual rights while withholding premiums or other payments as they come due as a setoff against future claims. If valid, counterparties withholding payments under such clauses could cease contributing to Ambac's liquid claims paying resources without consequence, then, should losses occur, receive compensation in the form of a cash-note split for one portion of their losses while receiving cash (plus the time value of money) in the form of withheld payments for the

other portion. Meanwhile, counterparties who lack that option and continue to make payments would receive only a cash-note split for the entirety of their losses, without the "free rider" benefits enjoyed by counterparties who withhold their contractual payments.

Wisconsin law does not permit this inequitable result. Under Wis. Stat. § 645.56(2)(d), "[n]o setoff or counterclaim may be allowed in favor of any person where . . . [t]he obligation of the person is to pay premiums, whether earned or unearned, to the insurer." Further, Chapter 645 authorizes injunctions against "[a]ny threatened or contemplated action that might lessen the value of the insurer's assets or prejudice the rights of policyholders [or] creditors." Wis. Stat. § 645.05(k). For the reasons expressed in the prior paragraph, allowing counterparties to withhold payments would cause both of the harms § 645.05(k) seeks to prevent.

III. THE REHABILITATOR MAY EXERCISE AUTHORITY OVER THE SUBJECT INSURER'S SUBSIDIARIES.

The Commissioner anticipates that some of the counterparties who are parties to contracts with Ambac subsidiaries that have been allocated to the Segregated Account may contend that the Court lacks authority to enter injunctive relief in regard to such contracts because they are not insurance policies from Ambac directly; they are instead contracts originally made between Ambac subsidiaries and supported by guaranty policies issued by Ambac. Such a position would be unsupported by either the implications of Wisconsin law or precedent from other jurisdictions. Issuing injunctive relief in regard to these contracts is practical and necessary to effectuate the rehabilitation of the Segregated Account, and the fact that some of the entities at issue are not formally regulated insurance companies should not deter the Court from granting the injunctive relief in regard to those contracts in order to protect the interests of the Segregated Account.

A. Wisconsin Statutory Law

Insurance regulation in this state is not confined by formal corporate barriers. Chapter 617 of the Wisconsin Statutes provides ample support for the authority of a rehabilitator to exercise the insurer's authority over contracts entered by affiliates. The chapter's stated purpose "is to protect the interests of insureds, stockholders and the public against intercorporate transactions among affiliates that may affect the solidity of insurers authorized to do business in [Wisconsin] or otherwise be detrimental to protected interests." Wis. Stat. § 617.01(2). The Legislature specified that Chapter 617 "shall be liberally construed to achieve the above purpose." Wis. Stat. § 617.01(1). Section 617.21 offers a plethora of provisions that govern a Wisconsin insurer's transaction with affiliates, and gives the Commissioner the authority in subsection (3) to "disapprove any transaction [between the insurer and affiliate requiring disclosure] if the Commissioner finds that it would violate the law or would be contrary to the interests of insureds, stockholders or the public." Thus, regulation of transactions by Ambac's various subsidiaries, all of which entered contracts that were guaranteed by Ambac itself, is hardly unauthorized.

Nor is it unprecedented. Under Wis. Stat. § 645.32, the Court overseeing rehabilitation must appoint the Commissioner as rehabilitator and direct the rehabilitator to "take possession of the assets of the insurer and to administer them under the orders of this court." As described below, at least two states have used this "take possession of assets" language in their respective statutes to enjoin claims against, and control the property of, insurance company subsidiaries even when those subsidiaries were not registered or domiciled within the state of the rehabilitation proceeding.

B. *In re Mutual Benefit Life Insurance Company*

In *In re Mutual Benefit Life Ins. Co.*, 609 A.2d 768 (N.J. Super. Ct. App. Div. 1992), the New Jersey Appellate Division upheld a similar order enjoining foreclosure actions on various subsidiary properties. Over the 1980s, Mutual Benefit Life ("MBL") invested $5 billion in real estate projects through at least 33 limited partnerships in which it held either a 50% or 100% interest. *Id.* at 771. Various local housing authorities made loans to the partnerships, which they funded with bonds and then secured with mortgages and guarantees from MBL. *Id.* The appellants in *Mutual Benefit* were indenture trustees for the housing authority bonds who were enjoined from foreclosing on the mortgaged properties. *Id.*

The rehabilitation order authorized the commissioner to (1) take possession of MBL's real and personal property "of any nature"; (2) conduct its business; and (3) remove the causes and conditions which had made rehabilitation necessary. *Id.* at 770. The order also restrained "all . . . persons or entities of any nature" from, among other things: (1) bringing or maintaining any action against MBL; (2) making or executing any levy upon MBL's property; (3) selling, transferring, wasting or otherwise disbursing or disposing of or encumbering the assets and property of any nature of MBL except as directed by the Rehabilitator or ordered by the court; and (4) interfering in any way with the Commissioner's discharge. *Id.* The court enjoined all indenture trustees from "commencing or continuing foreclosure actions or other litigation against, or interfering with the property of: (i) real estate partnerships owned in whole or in part by the Mutual Benefit Life Insurance Company in Rehabilitation, or by its wholly owned subsidiary, Muben Realty Company, and (ii) real estate partnerships for which Mutual Benefit Life Insurance Company is a guarantor of partnership indebtedness." *Id.* at 771.

The New Jersey Appellate Division upheld the court order enjoining the trustees from foreclosing on the properties. The court had little trouble finding that New Jersey's UILA gave

the Commissioner and the trial court the right to affect property held by MBL indirectly through its subsidiaries. *Id.* at 778-80. To add support to what it deemed authority obviously granted by the state statute's plain language, the court looked to federal bankruptcy law. The court noted that while the automatic stay provisions of the Bankruptcy Code ordinarily apply only to the debtor and its property, an exception exists for "unusual circumstances." *Id.* at 779 (citing, *inter alia*, *A.H. Robins Inc. v. Piccinin*, 788 F.2d 994, 999 (4th Cir. 1986)). These circumstances exist when "the debtor may be said to be the real party defendant and the judgment against the third-party defendant will in effect be a judgment or finding against the debtor. An illustration of such a situation would be a suit against a third party who is entitled to absolute indemnity by the debtor[.]" *Id.* at 779 (quoting *A.H. Robins*, 788 F.2d at 999). The New Jersey court found such circumstances because MBL, like Ambac, was guarantor of the liabilities of its affiliated entities and thus foreclosure actions against those entities would severely hamper MBL's rehabilitation. *Id.*

C. *Garamendi v. Executive Life Insurance Company*

Similarly, in *Garamendi v. Executive Life Ins. Co.*, 21 Cal. Rptr. 2d 578 (Ct. App. 1993), a California appellate court broadly read the California Insurance Code to uphold an order preventing seizure of mortgage notes held as collateral in a subsidiary transaction. Executive Life Insurance Company (ELIC), as part of its investment strategy, formed and participated in numerous limited partnerships, joint ventures, and other enterprises. *Id.* at 580-81. Two of the partnerships entered into a transaction with Morgan Stanley whereby they sold mortgage notes for cash and the right to repurchase the notes later for an agreed sum. *Id.* at 581-82. In substance the transaction was a secured loan because the notes were placed with Security Pacific National Bank for the duration of the agreement. *Id.* at 582. After ELIC went into rehabilitation, Morgan Stanley sued in federal court to obtain custody of the notes. *Id.* The Commissioner

intervened, the District Court dismissed Morgan Stanley's claim, and Morgan Stanley was limited to arguing in state court that the rehabilitation court's injunction order was inapplicable to its claims. *Id.*

The injunction order at issue "enjoined the transfer, hypothecation, or other dissipation of ELIC's assets, and enjoined the initiation, prosecution, or continuation of all proceedings against ELIC in any other forum." *Id.* at 580. Morgan Stanley argued that: (1) California law prohibited the trial court from exercising *in rem* jurisdiction over the property of a partnership that was an entity legally separate from ELIC, and (2) federal law prohibited applying state insolvency laws to the partnership because the partnerships were not in the "business of insurance." *Id.* at 586-89.

The California Court of Appeals rejected both arguments. It cited numerous state and federal authorities for the proposition that rehabilitation warrants such broad authority. *Id.* As the court noted, such procedures exist "to protect the debtor from an uncontrollable scramble for its assets in a number of uncoordinated proceedings in different courts." *Id.* at 584. "This being the case, the jurisdiction of a state court overseeing an insurance insolvency cannot, in reason, be any less comprehensive than that of a bankruptcy court in similar circumstances." *Id.* at 587.

If policyholders and counterparties to CDS contracts purport to terminate or exercise other remedies based upon the filing of this petition for rehabilitation of the Segregated Account, then Ambac and its policyholders would be collectively worse off. If not enjoined, the terminations and other actions would bring about the "uncontrollable scramble for assets" the *Garamendi* court describes, without any way to coordinate their orderly and equitable distribution. All of Ambac's policyholders would suffer the fallout.

CONCLUSION

As shown in the accompanying brief supporting the Commissioner's Verified Petition for Rehabilitation, Ambac's mounting liabilities, the mismatch between its short-term and long-term liabilities and assets, the shrinking value of its claims-paying resources and its inability to generate new business and profits make clear the need for rehabilitation. At the same time, however, it maintains the assets to continue paying claims in full as they arise, though on a cash-note split basis to ensure that it will not need to liquidate long-term assets prematurely. The Legislature enacted the rehabilitation provisions of Chapter 645 precisely for insurers in Ambac's presently precarious situation, through the "provision of effective procedures for rehabilitation of companies seriously sick but still salvageable." Wis. Stat. Ann. introductory cmt. to ch. 645.

But the initiation of this rehabilitation proceeding for the Segregated Account would cause innumerable problems and solve few should CDS and other counterparties whose contracts include harsh *ipso facto* clauses succeed in obtaining windfall sums for liquidated damages and causing massive a loss of value to the Segregated Account by stripping it of its control rights over the collateral underlying insured obligations. Without immediate entry of the injunctive relief provisions in the proposed order, this filing holds the potential to harm policyholders and the public by decimating an insurer, rather than rehabilitating it.

For the foregoing reasons, the Commissioner respectfully requests that this Court enter the attached Order for Temporary Injunctive Relief.

Dated this 24th day of March, 2010.

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