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May 24, 2010

HAND DELIVERED

Mr. Carlo Esqueda
Dane County Circuit Court
215 S. Hamilton Street
Madison, WI 53703

Dear Mr. Esqueda:

Re: *In the Matter of the Rehabilitation of: Segregated Account of Ambac Assurance Corporation*
Case No. 10-CV-1576

Enclosed for filing please find the original and one copy of the following documents:

- The Reply of RMBS Policyholders;
- RMBS Policyholders' Notice of Motion and Motion *Instanter* to Exceed Page Limit;
- Certificate of Service regarding the above-referenced documents.

Please file the originals, file-stamp the copies and return the copies to our awaiting messenger. Thank you for your attention to this matter.

Sincerely,

Bryan K. Nowicki

REINHART\3646918BN:SMF

Encs.

cc The Honorable William D. Johnston *(w/encs. via hand delivery)*
Counsel of Record *(See enclosed Certificate of Service)*

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

REPLY OF RMBS POLICYHOLDERS

Aurelius Capital Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC and their respective managed fund entities (collectively, the "RMBS Policyholders") submit this reply in further support of the RMBS Policyholders' Emergency Motion to Modify Order for Temporary Injunctive Relief and Motion Seeking Expedited Relief (the "Motion").[1]

INTRODUCTION

Despite OCI's efforts to craft a solution to the financial troubles plaguing AAC, OCI has embarked upon a course of action that contravenes the Wisconsin statutes governing these proceedings. OCI has announced its intention to consent to a $4.6 billion settlement with CDS Counterparties (the "CDS Settlement") (i) without first seeking this Court's approval that is required by applicable Wisconsin law,[2] and (ii) in disregard of the structure of priority of claims expressly prescribed by Wisconsin statute. If the CDS Settlement is consummated without a full

[1] Except as otherwise defined herein, capitalized terms shall have the meaning ascribed to them in the RMBS Policyholders' Brief in Support of the Motion, and "OCI" shall refer to the Wisconsin Office of the Commissioner of Insurance. In addition, in connection with this reply, the RMBS Policyholders adopt and incorporate by reference the Emergency Motion to Enjoin Consummation of the Proposed Settlement Between Ambac and Certain CDS Counterparties (the "LVM Motion") and brief in support thereof (the "LVM Brief") that were filed by the LVM Bondholders in this proceeding on May 5, 2010.

[2] On March 25, 2010, in a television interview, the Commissioner stated that the CDS Settlement "would also have to be approved by us [OCI] and in Court." *See Wisconsin's Dilweg Interview About Ambac Contracts*, Mar. 25, 2010, available at http://www.bloomberg.com/apps/news?pid=20601110&sid=aUQr94wN4dqg (last visited May 23, 2010). However, OCI has not taken this position elsewhere. *See, e.g.,* Aff. of Roger A. Peterson (the "Peterson Aff."), ¶ 44 (Section 1.02 of the Cooperation Agreement "does not specify that Court approval is needed.").

hearing by this Court, the rights of all holders of insurance policies issued by Ambac – both in the Segregated Account and in the General Account – will be critically impaired. Consequently, the RMBS Policyholders join the indenture trustees and other holders of Ambac insurance policies – holding policies in face amounts totaling in excess of $10 billion and comprised of policies in the General Account as well as in the Segregated Account – in respectfully requesting that this Court enter an order (or, in the alternative, modify the Injunction Order) so as to preclude the execution and consummation of the CDS Settlement without this Court's prior approval after sufficient notice and an opportunity for the RMBS Policyholders (and the other interested parties) to be heard and present evidence obtained through very targeted discovery.[3]

ARGUMENT

I. THE WISCONSIN STATUTE REQUIRES THAT THIS COURT REVIEW THE CDS SETTLEMENT AS PART OF THE REHABILITATION PROCEEDING.

The requirement of the Wisconsin statute is plain: in rehabilitation proceedings, "*[s]ubject to court approval*, the rehabilitator may take the action he or she deems necessary or expedient to reform or revitalize the insurer." Wis. Stat. § 645.33(2) (emphasis added). OCI seeks an end run around this express requirement of the Wisconsin statute: it asserts that it is authorized to approve the CDS Settlement pursuant to its authority under state insurance laws other than Chapter 645 of the Wisconsin statutes. *See* Brief in Opposition to RMBS Policyholders' and LVM Bondholders' Emergency Motions for Injunctive and Other Relief (the "OCI Opp. Br."), at 15-17. This argument is flawed in at least two respects.

[3] As to the other issues identified in the RMBS Policyholders' Motion, including the challenges to the formation of the Segregated Account, the RMBS Policyholders agree with AAC that these issues should not be addressed at the May 25 hearing but rather should be presented pursuant to the schedule established by the Court for the motion filed by Wells Fargo Bank, N.A., with a hearing on July 9. *See* AAC Brief in Opposition to the Motion and LVM Motion (the "AAC Opp. Br."), at 4-5.

First, this argument flies in the face of a key provision that OCI and AAC included in a foundational document establishing the Segregated Account that was approved by this Court. *See* Order for Rehabilitation, ¶ 6. The Cooperation Agreement between AAC and the Segregated Account requires the Segregated Account's written consent to consummate any transaction by AAC that involves consideration or other proceeds in excess of $5,000,000. *See* Cooperation Agreement, § 1.02. The $4.6 billion CDS Settlement would, of course, exceed that threshold many times over. The Segregated Account's consent for such transactions is understandable because the Segregated Account's principal source of funding, and its lifeblood for its reformation or revitalization, is AAC. Given the magnitude of the CDS Settlement, however, the Commissioner, acting on behalf of the Segregated Account as rehabilitator, cannot give his consent without this Court's approval. *See* Wis. Stat. § 645.33(2).

Second, OCI's attempt to wall off the affairs of the General Account (over which it asserts unfettered discretion) from the Segregated Account (as to which it concedes the application of Wis. Stat. § 645.33(2)) fails because of the very structure OCI itself constructed in establishing the Segregated Account. The CDS Settlement is, of necessity, a settlement to which Ambac Credit Products, LLC ("ACP") is a party because that entity is the direct counterparty in the CDS transactions to which the CDS Settlement pertains. In the construct designed by OCI, however, ACP is not an entity found on the General Account side of the wall that OCI has erected. Rather, it is property of the Segregated Account: the Segregated Account is the owner of 100% of the limited liability interests of ACP. *See* Rehabilitation Petition, § 8(a), at 6; Plan of Operation for the Segregated Account of Ambac Assurance Corporation (the "Plan of Operation"), § IV, at 3. As the sole owner of ACP, the Segregated Account has a vital interest in whether to proceed with a settlement involving billions of dollars of liabilities being asserted

against that wholly owned subsidiary. OCI's attempt to preclude this Court's jurisdiction to determine whether to approve the CDS Settlement by classifying it as a matter utterly unrelated to the Segregated Account and Chapter 645 of the Wisconsin statute fails by reason of the very interrelated structure OCI itself has created.

In a further effort to preclude this Court's consideration of the proposed transaction, OCI argues that as rehabilitator it is given significant discretion by the Wisconsin statute. *See* OCI Opp. Br., at 16-17. But the rehabilitator's authority is not unlimited, as Wis. Stat. § 645.33(2) makes clear. As courts in other states have recognized, a rehabilitator's ability to make decisions is "circumscribed by [the Courts'] mandate to act as a check on potential discretionary abuse and *to ensure equitable apportionment of loss*." *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990) (emphasis added). For example, courts may review rehabilitation orders to ensure that policyholders do not receive worse treatment in rehabilitation than they would get in liquidation, and that rehabilitation plans do not discriminate unfairly among different classes of policyholders and creditors. *See id.*; *In re Conservation of Alpine Ins. Co.*, 741 N.E.2d 663, 665-68 (Ill. App. Ct. 2000).

The RMBS Policyholders do not contend that the Commissioner, as rehabilitator, is required to seek Court approval for each and every decision made in the course of these proceedings. Rather, Wis. Stat. § 645.33(2) imposes the requirement of court approval only upon "action[s] he or she deems necessary or expedient to reform or revitalize the insurer." However this phrase might be applied in other circumstances, there can be no doubt here that OCI deems the CDS Settlement to be an action that is "necessary or expedient to reform or revitalize" the Segregated Account because the claims addressed by the CDS Settlement would

otherwise be allocated to the Segregated Account. Consequently, it falls within the requirement of prior court approval under the plain language of Wis. Stat. § 645.33(2).

The wisdom of the Wisconsin legislature in requiring prior court approval of transactions such as this is evident when viewed in light of comparable statutory schemes. Federal bankruptcy law, for example, which is instructive when a court is interpreting insurance rehabilitation/liquidation rules,[4] supports the conclusion that court approval is required for transactions outside the ordinary course of business.[5] Here, consent to a commutation of the CDS counterparties' claims in exchange for total consideration of $4.6 billion is far outside the ordinary course of business, and therefore requires this Court's approval. Authority to consent to a $4.6 billion settlement without court approval simply is not reasonable under any rational scheme of rehabilitation and/or dissolution, and in any event is not permitted by the plain language of the Wisconsin statute.

Alternatively, even if the Cooperation Agreement did not require the Commissioner's consent for material transactions entered into by AAC, the Court should review the CDS Settlement because it will have a significant impact on the assets available in the General Account, which is the sole source of capital and funding for the Segregated Account and, by extension, the rehabilitation plan. Under Wisconsin law, the Segregated Account must "have and maintain an adequate amount of capital and surplus." Wis. Stat. § 611.24(3)(a). When AAC

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[4] Federal bankruptcy law is frequently adverted to by state courts interpreting state statutes governing insurance rehabilitation and dissolution proceedings. *See, e.g., Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 969 F.2d 321, 324 (7th Cir. 1992) (looking to bankruptcy law regarding voidable preference doctrine is customary when interpreting a voidable preference dispute under state insurance law); *Ario v. Ingram Micro, Inc.*, 965 A.2d 1194, 1203 (Pa. 2009) (using bankruptcy law for guidance in interpreting ambiguous state insurance insolvency law is commonly accepted). Additionally, courts can look to similar statutes in other states for assistance in interpretation. *Creditor's Comm. of Jumer's Castle Lodge, Inc. v. Jumer*, 472 F.3d 943, 947 (7th Cir. 2007) (court looked to interpretations of "reasonably equivalent value" under Uniform Fraudulent Transfer Act for its analysis of same under Illinois Uniform Fraudulent Transfer Act). OCI and AAC themselves in their own pleadings have attempted to argue by analogy to concepts found in the Federal bankruptcy law. *See, e.g.*, OCI Brief in Support of Motion for Temporary Injunctive Relief, at 14-17; AAC Opp. Br., at 27-28.

[5] *See, e.g.*, 11 U.S.C. § 363 (requiring notice and a hearing before a sale of property outside the ordinary course of business).

and OCI presented the Plan of Operation to the Court, they represented, without any evidence or factual support, that "there is an adequate amount of capital and surplus in the Segregated Account pursuant to Wis. Stat. § 611.24(3)(a)[.]" Plan of Operation, § V, at 4. Neither OCI's nor AAC's response to the RMBS Policyholders' motion provides any support for this conclusory assertion. Even assuming, for purposes of argument, that this conclusory statement were true, the CDS Settlement threatens to reduce dramatically the capital in the Segregated Account by dissipating the assets against which that capital is drawn. Such an act clearly impacts the Segregated Account; for this reason alone, the Court therefore has – and should exercise – jurisdiction to review the CDS Settlement in connection with this rehabilitation action.

The RMBS Policyholders respectfully submit that this Court should enter an order as mandated by Wis. Stat. § 645.33(2) requiring OCI to submit the CDS Settlement for this Court's approval, and give the RMBS Policyholders an opportunity to present further evidence once targeted discovery described below has been conducted.

II. COURT REVIEW OF THE CDS SETTLEMENT IS NECESSARY TO DETERMINE WHETHER THE PRIORITY IT PROVIDES THE CDS COUNTERPARTIES VIOLATES WISCONSIN STATUTES.

This Court's review of the CDS Settlement is all the more critical in these proceedings because, if consummated, it would turn on its head the scheme of priority established by Wisconsin statute. The Wisconsin Insurance Code gives priority to the claims of insurance policyholders over an insurer's general creditors. As has been pointed out by the RMBS Policyholders, LVM Bondholders, and various other parties joining in their arguments, the CDS Counterparties are general creditors, not insurance policyholders. Indeed, neither OCI nor AAC disputes the merits of the movants' argument that the CDS Counterparties should not be treated as policyholders under the statutory priority scheme. Instead, OCI and AAC incorrectly argue that OCI took this into account as a "litigation" risk in reaching the CDS Settlement. *See* OCI

Opp. Br., at 18-20. As explained in Section A below, there is no equivalency between taking into account "litigation" risk and the Wisconsin statutes' clear mandate of statutory priorities and equal treatment of policyholders; the Wisconsin statute must govern. The Court can adequately assess the reasonableness of the settlement only after sufficient notice and a hearing, at which time parties can present full arguments and factual evidence on this discrete issue. Although other issues may require analysis in respect of the CDS Settlement (such as a fair and equitable determination), the narrow issue of whether the CDS Counterparties' claims should be subordinated can be promptly scheduled and the relatively brief time this will take will have no adverse effect upon the respective interests of the parties.

A. Claims Of The CDS Counterparties Must Be Subordinated To Those Of The RMBS Policyholders And Other Policyholders In Both The General And Segregated Accounts.

Policyholders must receive the same or better treatment in rehabilitation proceedings than they would if their insurer were subjected to liquidation. *See Grode*, 572 A.2d at 804; 44 C.J.S. INSURANCE § 249. The Wisconsin Insurance Code subordinates claims by an insurer's general creditors to those of insurance policyholders. Wis. Stat. § 645.68(3) ("claims under policies for losses incurred"); Wis. Stat. § 645.68(5). In the agreements that are subject to the CDS Settlement, AAC's non-insurance subsidiary, ACP, entered into credit default swaps ("CDS") with counterparties, and AAC then guaranteed ACP's resulting obligations. *See* Rehabilitation Petition, ¶ 4(a). These arrangements do not qualify as insurance and should not be treated as such for purposes of distribution. Yet, if the CDS Settlement is consummated, these CDS claims would be paid before those of rightful insurance policyholders, and would deplete the pool of assets from which policyholders may potentially recover. This would be true not only of policyholders in the Segregated Account but policyholders in the General Account as well.

As a general matter, a CDS is a contract between a CDS buyer and a CDS seller. A CDS buyer pays a periodic fee to a CDS seller in exchange for the CDS seller's promise to pay the CDS buyer compensation in the event that an underlying product identified in the contract, known as a "reference entity," experiences a default or some other specified occurrence as defined in the agreement between the CDS parties. *See Aon Fin. Prods., Inc. v. Société Générale,* 476 F.3d 90, 96 (2d Cir. 2007). While CDSs and insurance contracts are often compared to one another, a CDS is not insurance because CDSs "do not, and are not meant to, indemnify the buyer of protection against loss." *Id.* Instead, a CDS is used for financial speculation or to "allow parties to 'hedge' risk by buying and selling risks at different prices." *Id.*

Wisconsin statutes require that insurance policyholders have "an insurable interest in the subject of the insurance." Wis. Stat. § 631.07(1). This requirement, which is designed to prevent policyholders from "gambling" by insuring another's property, means that for an insurance policy to be valid, the policyholder must have a cognizable interest in the subject of the policy. *See Stebane Nash Co. v. Campbellsport Mut. Ins. Co.*, 133 N.W.2d 737, 742 (Wis. 1965). It follows that a party has an insurable interest in property only if he or she has "a reasonable expectation, based upon a real or legal right, of benefit to be derived from the continued existence of the property or of loss or liability from its destruction." *Id.* A party cannot incur loss from harm to property in which such party has no interest. *Cf.* Wis. Stat. § 645.68(3); *In re Liquidation of Reserve Ins. Co.*, 524 N.E.2d 538, 541 (Ill. 1988) (concluding that reinsurance agreements are not entitled to priority status as insurance policies, in part because they are divorced from an insured's risk of loss by reason of fire, death, or accident).

Because CDS buyers need not have any interest in the reference entity against which they are hedging, they may very well lack an insurable interest, in which case the CDS does not qualify as an insurance policy. As a result, such CDS claims should be subordinated to claims of policyholders under the priority scheme prescribed by the Wisconsin Legislature. Here, OCI admitted that it has not investigated the critical fact of whether the CDS Counterparties (who are the parties that matter for purposes of the priority statutes because it is their claims that would be paid under the CDS Settlement) have an interest in the reference entities for their respective CDSs. *See* OCI Opp. Br., at 19 (stating that it "is not at all clear" that the CDS Counterparties own the reference entities). This fundamental and critical issue brings into question the propriety of the CDS Settlement and should be determined by the Court prior to the settlement's consummation.

Therefore, the Court should require OCI to present the CDS Settlement for review by the Court before the Commissioner's consent, in his capacity as rehabilitator, can be effective. Otherwise, the CDS Counterparties will effectively be allowed to subvert the priority scheme established by the Wisconsin Legislature before this Court even has the opportunity to consider a rehabilitation plan for the Segregated Account that must treat all parties according to the priority scheme of the Wisconsin Insurance Code. Absent a considered determination by this Court, the CDS Counterparties will have effectively accomplished their own *sub rosa* rehabilitation plan in violation of Wisconsin statutes and without any hearing before this Court.

The RMBS Policyholders respectfully request that the Court allow the parties to conduct expedited discovery relevant to the priority issue, and that they be allowed to present evidence to

the Court following that limited discovery. At that time, the Court will have a record on which to rule on the merits of the CDS Settlement.[6]

B. The CDS Settlement Does Not Treat The RMBS Policyholders Fairly And Equitably.

Depending on how the Court rules on the priority issue, it may be necessary for the Court to hold a hearing on whether the proposed payments to the CDS Counterparties constitute preferential treatment vis-à-vis anticipated distributions to AAC policyholders. At this time, it is impossible to assess whether policyholders are being treated fairly and equitably because a rehabilitation plan for the Segregated Account has not been proposed and there is no factual information provided with respect to the estimated amount of claims and payments out of the Segregated Account. Despite repeated requests, OCI and AAC have refused to provide the RMBS Policyholders with any information that would enable them to evaluate the extent to which the CDS Settlement would allow the CDS Counterparties to recover a higher percentage of the value of their claims than the RMBS Policyholders stand to receive.[7] Moreover, as discussed below, the creation of the Segregated Account is likely invalid and the CDS Counterparties' claims must be considered in the context of a rehabilitation of AAC as a whole,

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[6] Because the CDS Settlement does not resolve the claims of all CDS counterparties, the Court will need to determine the priority issue at some point in time regardless of what happens with the CDS Settlement.

[7] The RMBS Policyholders have repeatedly attempted to obtain information from AAC and OCI, but they have been rebuffed at every turn. The RMBS Policyholders first sent letters to OCI and AAC on April 6, 2010, requesting certain limited categories of documents related to the CDS Settlement and the Segregated Account. *See* Affidavit of Dan Gropper dated April 30, 2010 and filed with the RMBS Policyholders' Motion, ¶ 4. The RMBS Policyholders subsequently met with AAC and OCI's counsel on April 13, 2010, where they were told that they would not be given access to any non-public information regarding the deal without a confidentiality agreement. *Id.* ¶ 5. Negotiations ensued, and the RMBS Policyholders sent a proposed confidentiality agreement to OCI's counsel on April 19, 2010. *See id.* ¶ 6. Because no agreement had been reached, the RMBS Policyholders sent a revised proposed confidentiality agreement to the Commissioner on May 7, 2010, but have received no response. On May 14, 2010, the RMBS Policyholders propounded document requests on OCI, AAC, and AAC's affiliates, ACP and Ambac Financial Group, Inc. ("AFG"). On May 23, 2010, counsel for AAC sent a letter to the RMBS Policyholders refusing to engage in any discovery activities and advising that counsel did not have authority to accept service of the subpoenas *duces tecum* sent on May 14. The RMBS Policyholders have received no response from OCI to the document requests.

which, according to OCI, is the likely outcome of finding the Segregated Account to be invalid. *See* OCI Opp. Br., at 16.

III. THE RMBS POLICYHOLDERS ARE ENTITLED TO A MODIFICATION OF THE COURT'S ORDER FOR TEMPORARY INJUNCTIVE RELIEF.

If the Court concludes that judicial approval of the CDS Settlement is not mandated by Wisconsin law, the Cooperation Agreement, or prior orders of the Court, the Court should nonetheless modify the temporary injunction and prohibit the consummation of the CDS Settlement because the creation of the Segregated Account was likely invalid due to non-compliance with the Wisconsin Insurance Statutes and violated the federal and state constitutions.[8] Following the invalidation of the Segregated Account, the policies allocated thereto, including the RMBS policies, would be returned to the AAC's General Account. Failing to defer consummation of the CDS Settlement until a determination as to the validity of the Segregated Account can be made will irreparably harm the RMBS Policyholders, as well as all other AAC policyholders, and would be an injustice for the reasons set forth below. Consummation of the CDS Settlement would alter the *status quo* of assets presently available to satisfy policyholders' claims by dissipating billions of dollars that could ultimately be used to satisfy their claims.

A. The Segregated Account Is Likely Invalid.

Although the propriety of the Segregated Account is already scheduled for a July 9 hearing before this Court and should not be resolved at the May 25 hearing, for the following reasons there is a substantial likelihood it will be found improper; therefore, modification of the Injunction Order to preserve the *status quo* is appropriate. Under Wisconsin law, OCI must

[8] *See* RMBS Policyholders' Brief in Support of the Motion, at 26-29 (discussing the constitutional violations). As discussed above, the RMBS Policyholders agree with AAC that these issues should not be addressed at the May 25 hearing but rather should be presented pursuant to the schedule established by the Court for the motion filed by Wells Fargo Bank, N.A., with a hearing on July 9, 2010.

ensure that the Segregated Account "ha[s] and maintain[s] an adequate amount of capital and surplus." Wis. Stat. § 611.24(3)(a). OCI's response never provides more than a conclusory statement that this requirement was met when the Segregated Account was established. Instead, OCI argues that its judgment in creating the Segregated Account is virtually unassailable, and that the capital in the Segregated Account is sufficient because AAC contributed to it as much as it could. *See* OCI Opp. Br., at 22-23. The statute requires a segregated account to have *adequate* capital and surplus – not just whatever amount another entity is willing to contribute. OCI has offered no evidence to show that the funding of the Segregated Account meets the statutorily required amounts of capital and surplus. Notably, in OCI's March 24 letter to AAC approving the establishment of the Segregated Account, OCI made no finding that the Segregated Account maintained an adequate amount of capital and surplus. *See* Letter dated March 24, 2010 from OCI to AAC, attached as Exhibit 1 to the Peterson Aff.

Moreover, OCI's optimistic assertion that the RMBS Policyholders stand to recover 100% of their expected claims sheds no light on the issue. *See* OCI Opp. Br., at 10-11. OCI projects that 25% of policyholders' claims would be satisfied in cash, and 75% would be satisfied through notes. *Id.* However, OCI provides no explanation of the expected number of claims, timing of payouts, or whether the assets in the Segregated Account would be sufficient to satisfy all claims. Indeed, there is a strong likelihood that the potential losses on policies allocated to the Segregated Account far exceed the amount that AAC has recorded as reserves.

In fact, the Segregated Account may receive no funding at all. According to the terms of the Secured Note and the Reinsurance Agreement, rather than providing for a "cut through" by the Segregated Account policyholders to AAC's General Account, the Secured Note and Reinsurance Agreement expressly limit AAC's liability to make any payment to the Segregated

Account to the extent that such payment would result in AAC's statutory surplus falling below $100 million or such higher amount as may be required by OCI or the rehabilitation agent. *See* Secured Note, §1(c); Reinsurance Agreement, § 1.04. As of March 31, 2010, AAC's statutory surplus was only $160 million – approximately $640 million below the December 31, 2009 balance, just three months earlier. *See* AAC Quarterly Statement as of March 31, 2010 (the "AAC March 2010 Statement"), attached as Exhibit 2 to the Aff. of Cathleen J. Matanle (the "Matanle Aff."), at Q03. If this trend continues, the Segregated Account may receive nothing from AAC.

B. The RMBS Policyholders Will Be Irreparably Harmed By The CDS Settlement.

If the Court permits AAC to consummate the CDS Settlement by transferring $2.6 billion out of the General Account and causing the General Account to issue $2.0 billion in surplus notes, the General Account, which is the primary source of funding for the Segregated Account, will be materially diminished; and the RMBS Policyholders will find recovery of those amounts difficult or impossible for three reasons.

First, pursuant to the CDS Settlement, at least fourteen CDS counterparties would have their claims commuted in exchange for $4.6 billion in consideration. OCI and AAC have provided no information or documentation relating to the CDS Settlement, including how much money each CDS counterparty is to receive, or which of their agreements would be covered in the settlement. Once the CDS Settlement is effectuated, the lack of information and costs of litigation will make it very difficult, if not impossible, for the RMBS Policyholders to recover any funds from these parties, let alone be made whole.

Second, the RMBS Policyholders are prohibited from suing the parties who are actually at fault for any improper release of the CDS Counterparties' claims. The Injunction Order

prohibits all persons and entities from commencing any actions against: (1) the Segregated Account; (2) AAC in respect of the Segregated Account or any policies allocated thereto; (3) subsidiaries of AAC, including ACP; and (4) the Commissioner. *See* Injunction Order, ¶ 1. As a result, the RMBS Policyholders could not sue the Segregated Account (which must approve the CDS Settlement), ACP (which is a counterparty to the CDS transactions at issue), or the Commissioner (who must sign off on the CDS Settlement in his role as rehabilitator) to challenge the CDS Settlement in a separate proceeding. Further, the CDS Settlement is inextricably linked to the Segregated Account, so the RMBS Policyholders could not sue AAC in a separate action to challenge the CDS Settlement. This leaves the RMBS Policyholders with no appreciable recourse against the parties who plan to close the CDS Settlement, thereby making recovery of monetary damages to redress the harm they will have suffered very unlikely.

Third, no other party can adequately represent the RMBS Policyholders' interests in challenging the CDS Settlement after it closes. While Wisconsin statutes would permit a liquidator to avoid the CDS Settlement as a preferential transfer if the liquidation were commenced within one year of the settlement's consummation, there is no guarantee that the Commissioner or other liquidator would initiate such proceedings. *See* Wis. Stat. § 645.54(1). Similarly, if the Court permits the CDS Settlement to close but finds the creation of the Segregated Account to be invalid, AAC likely would go into rehabilitation and OCI would have to pursue a fraudulent transfer action within one year of the initiation of AAC's entry into liquidation or rehabilitation. Wis. Stat. § 645.52(1). Again, there is no guarantee that OCI would put AAC into rehabilitation or liquidation within one year of the consummation of the CDS Settlement. Moreover, the proposed findings of fact and conclusions of law that OCI tendered to this Court on May 20, 2010 contain comprehensive findings and conclusions that

may render a later challenge difficult. *See* OCI's Proposed Findings of Fact and Conclusions of Law Regarding Motions of Certain RMBS Policyholders and Certain LVM Bondholders, ¶¶ 5-18.

Therefore, the RMBS Policyholders would be irreparably harmed by the consummation of the CDS Settlement because of the difficulties they will confront in seeking recovery of damages they suffer.

C. The Balance Of The Equities And Public Interest Supports Deferral Of The Consummation Of The CDS Settlement.

As explained above, the failure to defer the consummation of the CDS Settlement will cause irreparable harm to the RMBS Policyholders. However, deferring consummation of the CDS Settlement to permit those placed in the Segregated Account reasonable time to present the Court with a more complete evidentiary record would not harm AAC or the CDS Counterparties.

OCI and AAC have spent two years and millions of dollars to evaluate the creation and rehabilitation of the Segregated Account and the proposed CDS Settlement. *See* OCI Opp. Br., at 3; Peterson Aff., ¶¶ 6-37; AAC Opp. Br., at 7-14; Matanle Aff., ¶¶ 9-23. Given this lengthy period of investigation and analysis, OCI had ample information and opportunity to develop a rehabilitation plan to provide to the Court when it filed the Rehabilitation Petition. Instead, OCI has thrust the CDS Settlement on the Court and policyholders and insisted that it be consummated immediately – without opportunity for review or analysis – based on the speculative assertion that financial Armageddon will occur if it fails to close. At the same time, OCI has affirmatively excluded the Segregated Account policyholders (and other concerned parties) from the negotiations and discussions regarding the capitalization of the Segregated Account and terms of the proposed CDS Settlement and refused to even consider alternative

plans offered to reconcile and resolve fairly the disparate treatment of the Segregated Account policyholders.

Moreover, there is nothing to stop the CDS Counterparties from continuing their forbearance agreements. They have already agreed to extend these agreements beyond the May 23, 2010 proposed CDS Settlement date, so it would be reasonable for them to do so for the time necessary for the parties to conduct expedited discovery and present evidence for the Court's consideration and ruling on the important issues raised herein. Even if the CDS Counterparties do not continue their forbearance agreements, their contracts will be allocated to the Segregated Account making them subject to the Court's Injunction Order thereby prohibiting them from triggering the default provisions in their agreements. *See* Injunction Order, ¶ 14. This result will maintain the *status quo* as the CDS Counterparties will remain in the same position they currently occupy pursuant to the forbearance agreements.

Deferring the consummation of the CDS Settlement will also fulfill the Court's role in protecting the public interest by ensuring that OCI's yet unknown rehabilitation plan is fair and equitable. *See* Wis. Stat. § 645.33(5). It is undisputed that a Segregated Account must be adequately capitalized under Wisconsin law. *See* Wis. Stat. § 611.24(3)(a). Wisconsin law is structured to grant OCI authority to approve a Segregated Account when certain statutory safeguards are met. OCI cannot indiscriminately isolate certain of an insurer's policies, especially into a Segregated Account that is not proven to be adequately capitalized, without adhering to the necessary statutory safeguards which, in the case of rehabilitation, requires court approval. This statutory authority reflects Wisconsin's public policy of fairness in the treatment of all policyholders, the intent of which is to assure predictability and the avoidance of actions that are hostile to business interests or detrimental to the public.

Additionally, the RMBS Policyholders also are suffering economic harm that is real, quantifiable, and continuing. The RMBS trusts continue to make premium payments to AAC. AAC, however, is no longer paying policyholder claims. Moreover, the RMBS trusts continue to make excess interest payments to AAC to reimburse AAC for amounts AAC should have paid to the RMBS Policyholders. Notwithstanding the fact that AAC is no longer paying its policyholders, the RMBS trusts continue to "reimburse" AAC for policyholder payments that AAC never made in the first place. Accordingly, the RMBS trusts – and therefore the RMBS Policyholders – are paying AAC for insurance coverage they have never received. *See* Memorandum of Law in Support of Motion by Deutsche Bank National Trust Company and Deutsche Bank Trust Company Americas, Each Acting Solely in Its Capacity as Trustee for Certain Securitization Trusts, to Intervene and Modify Order for Temporary Injunctive Relief, dated May 21, 2010, at 4-7 (seeking modification of the Court's injunction regarding certain setoffs).

Finally, AAC and OCI's demand that the RMBS Policyholders be required to post a bond of $9.3 billion is inequitable and unnecessary when the relief sought is merely the modification of an *existing* injunction already entered at the request of OCI – not the entry of a new injunction. *See* OCI Opp. Br., at 4. Despite the damage that the RMBS Policyholders and others have suffered and will suffer from the Court's entry of the Injunction Order and insistence upon closing the CDS Settlement before the Court and all parties have an opportunity to view and evaluate it, *OCI was not required to post a bond. See* Injunction Order, ¶ 11. Imposing a bond, let alone a $9.3 billion bond, would be highly inequitable, particularly given that the RMBS Policyholders and the LVM Bondholders are the ones being irreparably injured and are not acting solely for their own benefit, but are seeking relief that would protect the rights of all

similarly situated insureds. Should the Court decide that some security is required, it is respectfully suggested that that the $2.6 billion of cash and $2.0 billion surplus note provided for in CDS Settlement be placed in an interest-bearing escrow account while the parties take discovery, make additional submissions to the Court and the Court conducts further proceedings and rules upon these matters.

IV. EXPEDITED DISCOVERY IS AVAILABLE AND APPROPRIATE.

The RMBS Policyholders (and other concerned parties) have made repeated requests to OCI and AAC to obtain the information that would permit them to evaluate the CDS Settlement fully and fairly, yet both have steadfastly refused. *See supra* note 7. This lack of transparency concerns the RMBS Policyholders and many other interested parties. At a time of growing public skepticism arising from the actions of large financial institutions and governmental support/bailouts of those institutions, approval of the CDS Settlement with Citibank, N.A. and various large foreign banks without a full hearing would serve to conceal a multi-billion dollar deal from public scrutiny and thus further foster public distrust of government.

OCI asserts that there are too many policyholders with interests in the Segregated Account to afford them all process and participation in the proceedings. *See* OCI Opp. Br., at 33-34. Yet, OCI and AAC could have afforded ample notice and information to all policyholders by collaborating with the smaller number of entities serving as trustees for the residential mortgage-backed securities and other financial instruments that are insured by policies now relegated to the Segregated Account. Instead, the Commissioner and AAC, with no regard for public transparency, have engaged in lengthy and secret negotiations with the CDS Counterparties and plan to commute their claims, while at the same time they have obtained an *ex parte* temporary restraining order against the RMBS Policyholders and given them and others

who have had their interests imperiled by being placed in the Segregated Account no information whatsoever about the transaction.

To justify this conduct, OCI asserts that OCI "may refuse to disclose and may prevent any other person from disclosing . . . reports, records and information that are obtained, produced or created" pursuant to an inquiry as defined under Section 601.42 of the Wisconsin Code. Wis. Stat. § 601.465(1m)(a). But nowhere in its response does OCI address or attempt to demonstrate that any of the materials the RMBS Policyholders have requested were obtained, produced or created pursuant to such an inquiry. Even if OCI could establish this element, Section 601.465 does not provide OCI with a limitless privilege. Because the statute at issue here establishes a privilege, the statute must be construed narrowly. *See Davison v. St. Paul Fire & Marine Ins. Co.*, 75 Wis. 2d 190, 197, 248 N.W.2d 433 (1977). As a result, only those documents that OCI specifically created or obtained pursuant to that inquiry would fall within the privilege, and OCI bears the burden of demonstrating that documents withheld from discovery fall into this limited privilege. Further, there is no statutory provision that would prevent AAC, ACP, or AFG from providing the requested information.

Expedited discovery is appropriate and available. At the outset, the RMBS Policyholders propose that the Court order limited discovery related to the CDS Settlement, provided that the parties have additional opportunities for supplemental discovery should it become necessary.[9]

V. THE COURT SHOULD PERMIT THE RMBS POLICYHOLDERS TO INTERVENE.

On May 14, 2010, the RMBS Policyholders filed their Motion to Intervene in these rehabilitation proceedings. As stated in that motion, the RMBS Policyholders do not believe that

[9] As noted above in footnote 7, the RMBS Policyholders have propounded discovery on OCI, AAC, ACP, and AFG. This discovery includes requests for documents related to the creation of the Segregated Account and the treatment of the RMBS Policyholders therein. These issues go beyond the CDS Settlement and can be conducted in parallel over a longer period of time than the targeted discovery relating to the CDS Settlement.

their formal intervention in this proceeding is required—paragraph 12 of the Court's Injunction Order permits "any interested party" to seek "modification or dissolution of part or all of [the] Order." Injunction Order, ¶ 12. As owners or managers of funds that own approximately $1 billion face amount of RMBS policies and other liabilities that have been allocated to the Segregated Account, the RMBS Policyholders respectfully submit that they qualify as an "interested party" in these proceedings as that term is used in the Court's Injunction Order and, therefore, they should be treated as parties in this proceeding and permitted to participate fully. Nonetheless, the RMBS Policyholders filed their motion to intervene in the event that the Court did not interpret its Injunction Order in the same manner.

Section 803.09(1) of the Wisconsin Statutes provides that:

> upon timely motion, anyone shall be permitted to intervene in an action when [A] the movant claims an interest relating to the property or transaction which is the subject of the action and [B] the movant is so situated that the disposition of the action may as a practical matter impair or impede the movant's ability to protect that interest, unless [C] the movant's interest is adequately represented by existing parties.

Each of these requirements is satisfied here for the RMBS Policyholders. By virtue of their beneficial ownership of certain residential mortgage-backed securities, the RMBS Policyholders plainly have an "interest relating to the property or transaction which is the subject of the [proceeding]." Wis. Stat. § 803.09(1). In light of the allocation of the RMBS policies to the Segregated Account and the immediate threat that is posed by the CDS Settlement, it is clear that "a disposition of the [proceeding] may as a practical matter impair or impede [the RMBS Policyholders'] ability to protect that interest." *Id.* Finally, in light of OCI's decision to approve the creation of the Segregated Account and to proceed with the CDS Settlement despite the

request of the RMBS Policyholders that it be deferred pending Court review, it appears that the RMBS Policyholders' interest is not "adequately represented" by OCI. *Id.*

OCI objects to RMBS Policyholders' (and LVM Bondholders') request to intervene as of right on the grounds that OCI is adequately representing the movants' interests. The case cited by OCI to support this position, *Helgeland v. Wis. Municipalities*, 745 N.W.2d 1 (Wis. 2008), is distinguishable from the facts of this instant proceeding. In *Helgeland*, the Wisconsin Supreme Court held that eight municipalities, municipal school boards, and school districts did not have the right to intervene in a lawsuit challenging the constitutionality of state employee trust fund statutes, which was filed by five state employees against the Department of Employee Trust Funds and related entities represented by the Wisconsin Department of Justice. *Helgeland v. Wis. Municipalities*, 745 N.W.2d 1, 5, 7 (Wis. 2008). The Wisconsin Supreme Court found that (i) the municipalities' interests were insufficiently related to the subject of the action; (ii) the disposition of the action did not impair the municipalities' ability to protect their interests; and (iii) the municipalities were adequately represented in the action by the Department of Employee Trust Funds and the Attorney General. *Id.* at 7. As noted above, the rehabilitation proceeding directly involves the RMBS Policyholders' property interests, impairs the RMBS Policyholders' rights, and was constructed, in a manner to which the RMBS Policyholders' object, *by OCI*, which accordingly cannot be found to adequately represent the RMBS Policyholders' interests.

OCI also argues that "permitting intervention would contravene this Court's position in prior Chapter 645 proceedings that policyholders are not proper parties." OCI Opp. Br., at 14, 34 (citing *In re Liquidation of Am. Star Ins. Co.*, No. 92-CV-4579 (Wis. Cir. Ct. Dane County Nov. 20, 1998) (the Honorable William D. Johnston presiding by judicial assignment)). This Court's order in *American Star* denied an insurer's sole shareholder's motion to intervene to

litigate disputed claims, stating that the motion was "denied for the reasons stated by the Court in its oral decisions from the bench." Order Denying the Pacific Bank's Motions, *In re Liquidation of Am. Star Ins. Co.*, No. 92-CV-4579, at 2 (Wis. Cir. Ct. Dane County Nov. 20, 1998). Nothing in the order itself, the circumstances surrounding the insurer's shareholder's motion, or the OCI's brief in opposition to the motion indicates that the Court's position is that policyholders are not proper parties. The case involved, and OCI's brief cited cases involving, shareholders' requests to intervene in a proceeding. *See Neblett v. Carpenter*, 305 U.S. 297, 300-301 (1938) (after court issued order directing all interested persons to show cause why the rehabilitation and reinsurance agreement should not be approved, officers, stockholders and policyholders presented evidence to the court over a two-week period).

Here, the RMBS Policyholders are policyholders whose rights have been affected by the creation of the Segregated Account and the Court's Injunction Order and will be affected by a consummation of the CDS Settlement and any rehabilitation plan that is proposed.

Accordingly, if the Court deems it necessary for the RMBS Policyholders to be intervenors in this action to participate in discovery, to obtain any of the relief requested in the Motion, or to pursue any additional relief relating to the Segregated Account, the Injunction Order, and/or a rehabilitation plan, the RMBS Policyholders respectfully submit that their intervention is appropriate as of right for the reasons set forth herein.

CONCLUSION

Based upon the foregoing and for the reasons set forth in the RMBS Policyholders' initial brief and LVM Bondholders' filings, the RMBS Policyholders respectfully request that the Court grant their Motion and provide the relief requested therein, as modified by this Reply.

Dated this 24th day of May, 2010.

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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

RMBS POLICYHOLDERS' NOTICE OF MOTION AND MOTION *INSTANTER* TO EXCEED PAGE LIMIT

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PLEASE TAKE NOTICE that Aurelius Capital Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC (collectively, the "RMBS Policyholders"), in their capacity as owners of or managers of funds that own residential mortgage-backed securities ("RMBS") and other indebtedness insured by Ambac Assurance Corporation ("AAC"), by their attorneys, Reinhart Boerner Van Deuren s.c., will move and do hereby move the Court for an order

accepting for filing the RMBS Policyholders' proffered reply brief (being filed concurrently herewith) in excess of the 10-page limit provided for in local rule 115 of the Dane County Circuit Court.[1] In support thereof, the RMBS Policyholders state as follows:

1. On April 30, 2010, the RMBS Policyholders filed their Emergency Motion to Modify Order for Temporary Injunctive Relief and Motion Seeking Expedited Relief (the "Motion").

2. On May 14, 2010, the RMBS Policyholders filed the RMBS Policyholders' Notice of Motion and Motion to Intervene.

3. On May 20, 2010, the Wisconsin Office of the Commissioner of Insurance and Sean Dilweg, Commissioner of Insurance of the State of Wisconsin, as Rehabilitator of the Segregated Account of Ambac Assurance Corporation filed (i) their Brief in Opposition to RMBS Policyholders' and LVM Bondholders' Emergency Motions for Injunctive and Other Relief, (ii) OCI's Proposed Findings of Fact and Conclusions of Law Regarding Motions of Certain RMBS Policyholders and Certain LVM Bondholders, (iii) an Affidavit of Roger A. Peterson (OCI), (iv) Affidavit of Kate Lavelle (Dunkin' Brands, Inc.), (v) an Affidavit of R. Scott Massengill (The Hertz Corporation), and (vi) an Affidavit of Stephen C. Vaughan (Sonic Corp.).

4. That same day, Ambac Assurance Corporation filed (i) its Brief in Opposition to the Motion and the LVM Bondholders' Emergency Motion to Enjoin Consummation of the Proposed Settlement Between AMBAC and Certain CDS Counterparties, and (ii) an Affidavit of Cathleen J. Matanle.

5. The Lafayette County Circuit Court Rules do not contain any page limitations for reply briefs. However, the Dane County Circuit Court Rules limit reply briefs to 10 pages. In

[1] Except as otherwise defined herein, capitalized terms shall have the meaning ascribed to them in the Reply of RMBS Policyholders.

the event that the Court finds that the Dane County Circuit Court Rules apply to this rehabilitation proceeding, the RMBS Policyholders respectfully request that the Court accept the RMBS Policyholders' reply brief which addresses the following issues and arguments which are important to this rehabilitation proceeding:

A. Whether Wisconsin Statute § 645.33(2) requires that this Court review the CDS Settlement as part of the rehabilitation proceeding;

B. Whether Court review of the CDS Settlement is necessary to determine if the priority it provides the CDS Counterparties violates Wisconsin Statutes;

C. Whether Claims of the CDS Counterparties must be subordinated to those of the RMBS Policyholders and other policyholders in both the General Account and Segregated Account;

D. Whether the CDS Settlement treats the RMBS Policyholders fairly and equitably;

E. Whether the Court should modify its Injunction Order to prohibit the consummation of the $4.6 billion CDS Settlement;

F. Whether expedited discovery is appropriate and available; and

G. Whether the Court should permit the RMBS Policyholders to intervene.

6. Given the volume and nature of the issues presented to the Court for review, which require significant factual and legal determinations to be made, the RMBS Policyholders respectfully request that this Court grant this motion for leave to exceed the Dane County Circuit Court page limitation for reply briefs and enter an order accepting the RMBS Policyholders' proffered reply brief for filing.

7. The RMBS Policyholders reserve their right to file a brief in reply to any brief filed in opposition to this motion.

Dated this 24th day of May, 2010.

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STATE OF WISCONSIN DANE COUNTY CIRCUIT COURT

In the Matter of the Rehabilitation of:

SEGREGATED ACCOUNT OF
AMBAC ASSURANCE
CORPORATION

Case No. 10-CV-1576

CERTIFICATE OF SERVICE

I hereby certify that on this 24th day of May, 2010, I caused true and correct copies of the Reply of RMBS Policyholders, RMBS Policyholders' Notice of Motion and Motion *Instanter* to Exceed Page Limit, and this Certificate of Service to be served on the individuals listed below:

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