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

**BRIEF IN SUPPORT OF LVM BONDHOLDERS' MOTION CHALLENGING ALLOCATION OF LVM BOND POLICY TO SEGREGATED ACCOUNT**

Certain beneficial holders (the "LVM Bondholders")[1] of a majority of the outstanding Las Vegas Monorail Project Revenue Bonds (the "LVM Bonds"), municipal bonds supported by an insurance policy (the "LVM Bond Policy") issued by Ambac Assurance Corporation ("Ambac"), submit this memorandum of law in support of their motion for an order (i) declaring that Ambac's allocation of the LVM Bond Policy to its Segregated Account, with the approval of the Office of the Commissioner of Insurance for the State of Wisconsin (the "Commissioner" or "OCI"), was unlawful, and (ii) granting the LVM Bondholders permission to intervene, to the extent the Court deems intervention necessary, and to take discovery in connection with this motion.[2]

[1] These holders are certain funds and accounts managed or owned by Eaton Vance Management, Nuveen Asset Management, Restoration Capital Management LLC, and Stone Lion Capital Partners L.P.

[2] On April 5, 2010, Wells Fargo Bank, N.A., as indenture trustee (the "Trustee") of the LVM Bonds, filed a motion challenging the lawfulness of the Segregated Account's creation on a number of grounds, including that the allocation of the LVM Bond Policy to the Segregated Account violated the Equal Protection Clause of the United States and Wisconsin Constitutions. The Trustee's motion is currently scheduled to be heard by this Court on July 9, 2010. We join in the Trustee's motion to the extent it challenges the lawfulness of the allocation of the LVM Bond Policy to the Segregated Account, but not to the extent it contends that the creation of the Segregated Account was otherwise unlawful.

We note that the Findings of Fact and Conclusions of Law entered by the Court on May 27, 2010, in connection with the emergency motions filed by the RMBS Policyholders and the LVM Bondholders (the "May 27 Decision"), addressed and rejected certain legal challenges to the Segregated Account's creation advanced by the RMBS Policyholders. The RMBS Policyholders did not challenge the lawfulness of the

## Preliminary Statement

The LVM Bondholders do not object to the principal actions taken by Ambac and the Commissioner at the commencement of this Rehabilitation: the creation of a Segregated Account, and the allocation to that account of the particular types of high-risk structured-finance obligations that were responsible for Ambac's demise – namely, the RMBS policies and the CDS agreements (other than those covered by the CDS Settlement). These actions served laudable goals, including the preservation of Ambac's claims-paying resources and the prevention of preferential payments to near-term claimants at the expense of long-tail claimants.

However, Ambac's and the Commissioner's actions departed in one crucial respect from bedrock principles of insurance law. At the same time that they (properly) left the vast majority of Ambac's municipal bond policies in the General Account, they allocated at least one municipal bond policy – the LVM Bond Policy – to the Segregated Account. Their rationale for doing so was that this policy, unlike the other municipal bond policies, was already in default and had substantial projected claims. In this respect, they said, the LVM Bond Policy was similar to most RMBS policies and CDS agreements, and its allocation to the Segregated Account was consistent with their overall approach of allocating policies that were in default or had material projected claims to the Segregated Account.

In other words, Ambac and the Commissioner allocated the LVM Bond Policy to the Segregated Account on the basis of that policy's claim status (as a defaulted policy with large claims), rather than its insurance type (as a municipal bond policy). In so doing, Ambac and the Commissioner violated a fundamental principle, embodied in Wisconsin's segregated account statute, Wis. Stat. § 611.24, and protected by the Equal Protection Clauses of the Wisconsin and

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LVM Bond Policy's allocation to the Segregated Account, and as a result, the May 27 Decision did not address that issue – *i.e.*, the issue raised by the present motion.

U.S. Constitutions: An insurer and its regulator must provide similar treatment to all policies of the same type, including those that are in default or expected to default. It may not segregate its policies based on their claim status, nor may it provide subordinated treatment to claims asserted under defaulted policies. Indeed, permitting an insurer to do so would defeat the very purpose of insurance, by depriving policyholders of the right to payment simply because they have asserted claims.

The allocation of the LVM Bond Policy to the Segregated Account violated these settled rules of law. This action was unlawful and should not be permitted to stand.

## Statement of Facts

### Ambac

Ambac is a Wisconsin-domiciled financial guaranty company, whose traditional business was to insure municipal bonds. Historically, Ambac had AAA financial strength ratings. (Ambac Financial Group, Inc. Form 10-K for the year ended December 31, 2009, filed Apr. 9, 2010, at 3, annexed as Exhibit A to the Affidavit of Bryan K. Nowicki in Support of Motion to Modify Order for Temporary Injunctive Relief Filed by Certain RMBS Policyholders ("Nowicki Aff."), dated April 30, 2010.) More recently, however, Ambac began to guaranty "riskier" and "more speculative" structured finance obligations, including residential mortgage-backed securities, collateralized debt obligations of asset backed securities, and credit default swaps. (Commissioner's Brief in Support of Entry of Order for Rehabilitation ("Rehabilitation Brief"), dated Mar. 24, 2010, at 3, 15, 17.) These riskier products proved lethal to Ambac, just as they did to other major financial institutions. In 2007 and 2008, as the structured finance investments that it insured began to implode, Ambac's projected future liabilities grew, resulting in a dangerous reduction in capital. This peril was a principal reason for the commencement of the rehabilitation proceedings. (*Id.* at 2.)

**The LVM Bonds and the LVM Bond Policy**

The LVM Bonds are municipal bonds that were issued in 2000 by the Director of the State of Nevada Department of Business and Trust to finance the construction of a four-mile monorail system in downtown Las Vegas. The LVM Bond Policy issued by Ambac insures the payment of all principal and interest due and owing on the LVM Bonds. At the time of their issuance, Standard & Poors, Moody's and Fitch IBCA assigned triple-A ratings to the LVM Bonds.

Most of the LVM Bonds were purchased and are held by retail investors or mutual funds. Due to their triple-A rating, the LVM Bonds were believed to be a conservative municipal bond investment appropriate for college or retirement savings accounts and were widely held for those purposes, either directly or through mutual fund accounts. (*See* Declaration of Gavin Wilkinson in Support of Motion of Wells Fargo Bank, National Association, to Modify Temporary Injunction and to Intervene, dated Apr. 5, 2010, ¶ 7.)

Las Vegas Monorail Corporation ("LVMC"), which owns and operates the monorail, filed a voluntary petition for bankruptcy on January 13, 2010. The LVM Bonds are currently in payment default. The main source of repayment for these bonds is expected to be Ambac, through its obligations under the LVM Bond Policy.

Ambac has insured more than $500 million[3] worth of currently outstanding LVM Bonds. Ambac estimates that its total exposure for future payments of principal and interest under the LVM Bond Policy is approximately $1.163 billion, minus any payments of principal and interest made by LVMC. (*See* Declaration of Scott Zuchorski in Support of Motion of

[3] The value of the LVM Bonds outstanding continues to increase because approximately $99 million of the original issuance are "capital appreciation" bonds. That is, holders of these bonds do not receive any cash interest over the life of the bonds, but rather interest continues to accrue in kind until maturity.

[Ambac] for Dismissal of Chapter 11 Proceeding, dated January 13, 2010, ¶ 13, annexed to the Affidavit of Noreen J. Parrett dated May 5, 2010 (the "Parrett Aff.") as Exhibit A.)

**The Creation of the Segregated Account, and the Commencement of These Rehabilitation Proceedings**

On March 24, 2010, the Commissioner announced that Ambac, with the Commissioner's approval, had that day created the Segregated Account, pursuant to Wis. Stat. § 611.24, and had allocated to that account an assortment of policies and other liabilities, including residential mortgage-backed securities ("RMBS"), credit default swaps written on collateralized debt obligations, and certain student loan policies. (Verified Petition for Order of Rehabilitation (the "Petition"), at 5-6 & Tab 1 at 1-3.)

The same day, the Commissioner commenced rehabilitation proceedings with regard to the Segregated Account by filing the March 24, 2010 Petition with this Court. In the Petition, the Commissioner explained that his "restructuring and rehabilitation plan" had "three main components": (1) the creation of the Segregated Account, (2) the proposed CDS settlement, and (3) an "orderly run-off of the Segregated Account" policies under the supervision of the Commissioner. (Petition ¶ 8(a)-(c).) The Plan of Operation for the Segregated Account stated that that account was established "for the purpose of segregating certain segments of [Ambac's] liabilities, and consenting to the subsequent rehabilitation of the Segregated Account under Chapter 645 of the Wisconsin Statutes." (Petition, Tab 1, § II.)

**The Segregated Account's Subordination to the General Account**

According to the Commissioner's public filings, the Segregated Account has only two assets: (i) a $2 billion Secured Note issued by Ambac, and (ii) an aggregate excess-of-loss reinsurance policy issued by Ambac to reinsure the Segregated Account's liabilities. (Petition, Tab 1, § V.)

Crucially, Ambac's obligations to the Segregated Account under *both* the Secured Note and the reinsurance policy are effectively subordinated to all of Ambac's other obligations. Ambac is obliged to make payments under the Secured Note only so long as the General Account continues to have a surplus equal to at least $100 million, or such *higher* amount as OCI may set. (Petition, Tab 1, Ex. G, ¶ 1(c).) Ambac's payment obligations under the reinsurance policy – the Segregated Account's only other asset – are limited in the same manner. (Petition, Tab 1, Ex. H, § 1.04.) As a result, Ambac will have *no payment obligations whatsoever* to the Segregated Account in the event its surplus falls below $100 million. Ambac's payment obligations to the Segregated Account – and, as a result, that account's ability to make payments to its policyholders – will cease before policyholders in Ambac's General Account face any prospect of non-payment.

Policies allocated to the Segregated Account face a substantial risk of non-payment by virtue of that account's subordinated status. The obligations allocated to the Segregated Account are enormous: approximately $68 billion of net par exposure, according to Ambac. (Nowicki Aff., Ex. A at 4.) These obligations include, among others, the claims of RMBS policyholders, which OCI projects will demand payments in excess of $2 billion in 2010 alone. (*See* Affidavit of Roger A. Peterson, dated May 19, 2010 ("Peterson Aff.") at ¶ 6.) In contrast to these "short-tail" RMBS obligations, claims under the LVM Bond Policy are long-term; most do not come due until 2030, making them particularly vulnerable to a risk of non-payment.

It is uncertain, at best, whether Ambac will be able to satisfy its obligations to the Segregated Account without its surplus dropping below $100 million – in which case, as noted above, its payments to the Segregated Account will cease altogether. Acknowledging this

uncertainty, the Commissioner informed the press on March 25, 2010 that policies in the Segregated Account are expected to be paid only 25% in cash, with the remainder to be paid in "surplus notes" subordinated to Ambac's other obligations. *See* Andrew Frye & Jody Shenn, *Ambac Clients May Receive 25 Cents on Dollar in Cash*, http://www.businessweek.com/news/2010-03-25/ambac-clients-may-receive-25-cents-on-dollar-in-cash-update1-.html (quoting a Mar. 25, 2010 telephone interview with the Commissioner). In the same vein, the Commissioner stated in his March 24, 2010 Petition that the Segregated Account is in financially "hazardous" condition. (Petition at 8.)

**The Commissioner's Decision to Place the LVM Bond Policy in the Segregated Account, While Keeping Ambac's Other Municipal Bond Policies in the General Account**

The Commissioner has explained that he determined which policies to allocate to the Segregated Account by identifying those policies of Ambac that were considered to have "material projected impairments." (Rehabilitation Brief at 3-4.) Approximately 1,000 policies were transferred to the Segregated Account on the basis of such "projected losses and/or triggers." (Peterson Aff. ¶ 10; May 27 Decision at 12, ¶ 27.) Conversely, more than 14,000 policies were left in the General Account because (i) they "lacked material projected impairments," (ii) OCI concluded that the "the collateral damage of a rehabilitation proceeding as to those policies could outweigh the benefits of allocation," and/or (iii) the policyholders – namely the CDS Banks – signed a forbearance agreement with Ambac. (May 27 Decision at 13, ¶ 31.)

The LVM Bond Policy was among the policies allocated to the Segregated Account. According to the Commissioner, the LVM Bond Policy fit OCI's criteria for allocation to the Segregated Account because "LVM is in serious financial distress and filed for Chapter 11

bankruptcy in Nevada . . . in January 2010." (Peterson Aff. ¶ 13; May 27 Decision at 12, ¶ 29.) Ambac has acknowledged that "*virtually the entire insured municipal portfolio remains outside the rehabilitation proceedings*." (Ambac Press Release dated Mar. 25, 2010 (emphasis added), available at http://www.ambac.com/Press/032510.html; *see also* Peterson Aff. ¶ 15 (stating that "the far greater number" of public-finance transactions "that were not bankrupt like the LVM . . . were left in the General Account").)[4]

## ARGUMENT

### I. The Allocation of the LVM Bond Policy to the Segregated Account Was Unlawful

The allocation of the LVM Bond Policy to the Segregated Account violates both state and federal law. *First*, the allocation violates the terms and the express purpose of Wisconsin's segregated account statute, Wis. Stat. § 611.24, which permits an insurer to segregate its business by *type of insurance*, so as to separate the fortunes of the holders of hazardous types of insurance (e.g., mortgage guaranty) from those of the holders of more secure types of insurance (e.g., life). That statute does not permit an insurer to divide policies of the

[4] The LVM Bondholders have previously asserted in this proceeding that the LVM Bond Policy appears to be the *only* municipal bond policy allocated to the Segregated Account. (LVM Bondholders' Brief in Support of Emergency Motion to Enjoin Consummation of the Proposed Settlement Between Ambac and Certain CDS Counterparties dated May 5, 2010, at 6.) The Commissioner has taken issue with that assertion, insisting that other "policies with public-finance components, such as swap sureties and leveraged lease transactions," were also allocated to the Segregated Account. (Peterson Aff. ¶ 14; Findings of Fact and Conclusions of Law at 12, ¶ 30.) These supposedly include more than 42 "direct public-finance policies" and more than 150 "swap surety policies." (*Id.*)

It is unclear whether the "swap sureties" and "leveraged lease transactions" to which the Commissioner refers are in any way comparable to the LVM Bond Policy, and the Commissioner has not provided information that would allow the LVM Bondholders to make such a comparison. Most important, however, whether the policies are comparable is irrelevant to this motion. As discussed below, what matters is that Ambac has left most (apparently the great bulk) of its municipal bond policies in its General Account, while allocating at least one such policy (the LVM Bond Policy) to the Segregated Account, in violation of (i) the provisions of Wisconsin's segregated account statute, which permits the segregation of an insurer's business by type of insurance, but not by claim status, and (ii) the Equal Protection Clauses of the U.S. and Wisconsin Constitutions, which require that policies of the same type receive similar treatment.

*same type* into two groups – one for unimpaired policies, the other for policies that are impaired or expected to be impaired – and to put the latter policies into a segregated account receiving subordinated treatment. Yet that is exactly what Ambac has done: It has allocated the LVM Bond Policy to the Segregated Account on the ground that it is impaired, while leaving other (unimpaired) municipal bond policies in the General Account.

*Second*, in addition to violating Wisconsin's statute, the allocation of the LVM Bond Policy to the Segregated Account violates the Equal Protection Clauses of the United States and Wisconsin Constitutions. As the courts have long recognized, the Equal Protection Clause requires that insureds of substantially the same type, or class, receive similar treatment in a rehabilitation or liquidation proceeding. Here, however, the LVM Bond Policy is receiving distinctly inferior treatment to that given to other municipal bond policies: By virtue of its allocation to the Segregated Account, the LVM Bond Policy's right to payment is subordinated to that of the other municipal bond policies, and as a result, it faces a substantially greater risk of non-payment. The Equal Protection Clause prohibits precisely this sort of discrimination.

### A. The Allocation of the LVM Bond Policy to the Segregated Account Violates Wisconsin's Segregated Account Statute

Section 611.24 of the Wisconsin Statutes permits, and in some instances requires, the creation of segregated accounts for particular classes, or types, of insurance. Thus, Section 611.24(1), entitled "Mandatory segregated accounts," requires the establishment of segregated accounts for three specified "classes of insurance business": mortgage guaranty insurance, financial guaranty insurance (in certain circumstances), and life insurance. Section 611.24(2), entitled "Optional segregated accounts," permits an insurer, with the Commissioner's approval, to create a segregated account "for any part of its business":

> With the approval of the commissioner, a corporation may establish a segregated account for any part of its business. The commissioner shall approve unless he or she finds that the segregated account would be contrary to law or to the interests of any class of insureds.

Wis. Stat. § 611.24(2) (2006).

On their face, these provisions of Wisconsin's segregated account statute make clear that such accounts must be created by "class," or type, of insurance. This is the clear import both of the statute's mandatory provision, which requires the creation of a segregated account for specified "*classes* of insurance business," and of its permissive provision – which allows the creation of a segregated account "for any part of [the] business," absent a finding that the account "would be contrary . . . to the interests of any *class* of insureds." (Emphasis added.)

The Official Commentary to Section 611.24 confirms that the Wisconsin Legislature's intent in enacting these provisions was to permit (and in some instances to require) segregation by type of insurance, so that "the fortunes of policyholders in hazardous and secure types of insurance should be separated":

> *Some branches of the insurance business are much riskier than others.* Traditionally, it has been considered desirable for certain kinds of business to be transacted by separate companies, so that adverse experience or failure in the more hazardous venture would not endanger the policyholders in the more stable types of business . . . . [I]nsurers have, for a variety of reasons, often found it desirable to establish separate corporations for certain divisions of their business, even within a single line. High risk automobile business is an illustration. . . . [I]t is not yet possible to abandon completely the notion that *the fortunes of policyholders in hazardous and secure types of insurance should be separated.*

Wis. Stat. § 611.24, Comments at L. 1971, C 260 § 72 (2006) (emphasis added).

Ambac's allocation of the LVM Bond Policy to the Segregated Account violates these clear principles. As discussed above, Ambac has left most, if not all, of its municipal bond policies in its General Account. At the same time, Ambac has allocated the LVM Bond Policy to

the Segregated Account. Its basis for doing so is not, and could not be, that the LVM Bond Policy differs in type from the other municipal bond policies remaining in the General Account; all are municipal bond policies – the traditional backbone of Ambac's business, prior to its expansion into the much riskier structured finance sector. Ambac's and the Commissioner's only basis for allocating the LVM Bond Policy to the Segregated Account is that it is in default and has "material projected impairments."

In short, Ambac and the Commissioner have allocated the LVM Bond Policy to the Segregated Account on the basis of its claim status – as an impaired policy that is expected to have substantial claims – rather than its policy type. This is an unauthorized use of a segregated account, in plain contravention of the terms and the express purpose of Wis. Stat. § 611.24.

Indeed, such a use of a segregated account not only contravenes the governing statute; it undermines the very purpose of buying insurance. The LVM Bondholders, like all municipal bond policyholders, bought insurance so that they would be paid on their policy if the issuer defaulted. And yet, precisely *because* the issuer has defaulted, the LVM Bond Policy has been pooled with other defaulted or soon-to-be-defaulted policies and given payment rights subordinate to those of Ambac's other municipal bond policyholders – and as a result, the LVM Policy now faces a substantial risk of non-payment. Such treatment is contrary to the most basic of insurance law principles, namely, the "equitable apportionment of loss." Wis. Stat. § 645.01(4)(d); *see also Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205 (1979)("The primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk. 'It is characteristic of insurance that a number of risks are accepted, some of which involve losses, and that *such losses are spread over all the risks* . . . .'") (quoting 1 G. Couch, *Cyclopedia of Insurance Law* § 1:3 (2d ed. 1959) (emphasis added)).

## B. The Allocation of the LVM Bond Policy to the Segregated Account Violates the Equal Protection Clause of the U.S. Constitution

It is a fundamental tenet of insurance law that the power of the state to modify a policyholder's contractual rights in connection with the rehabilitation or liquidation of an insurer is not unlimited. To the contrary, that power is constrained by the Equal Protection Clause of the United States Constitution – and of the constitutions of many states, including Wisconsin – which, among other things, requires that "insureds of substantially the same class [be] treated similarly." *Couch on Insurance* 3D, § 5.24.[5]

This constitutional prohibition against discrimination among insureds of the same class has been recognized at least since the seminal case of *Carpenter v. The Pacific Mutual Life Ins. Co. of California*, 10 Cal. 2d 307 (Cal. 1937), *aff'd sub nom Neblett v. Carpenter*, 305 U.S. 297 (1938). In that case, the California Supreme Court – in a decision affirmed by the U.S. Supreme Court – ruled that, while the "contract of the policyholder is subject to the reasonable exercise of the state's police power," the state's action "*shall not be arbitrary or improperly discriminatory.*" *Id.* at 329 (rehabilitation plan that treated life insurance policies more liberally than non-cancellable accident and health policies, but that gave equal and non-discriminatory treatment to all claims within each class, did not violate equal protection); *see generally Couch on Insurance* 3D, § 5.24 ("[d]ifferential treatment of classes of insureds does not violate equal protection as long as insureds of substantially the same class are treated similarly").[6]

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[5] The Wisconsin Supreme Court "applies the same interpretation to the state Equal Protection Clause found in Wis. Const. art. I § 1, as that given to the federal provision, U.S. Const. amend. XIV § 1." *State v. Post*, 197 Wis. 2d 279, 318 n.21, 541 N.W.2d 115, 128 n.21 (1995). Thus, to the extent the Commissioner's allocation of policies violates the Equal Protection Clause of the U.S. Constitution, it also violates the parallel provision of the Wisconsin Constitution.

[6] These general anti-discrimination principles are embodied in multiple sections of the Wisconsin Insurance Statutes. For example, Wis. Stat. § 645.68 expressly provides that "no subclasses shall be

Courts considering the actions of state insurance agencies in insurance rehabilitations have not hesitated to enforce this settled principle when the agency's action would discriminate among insureds of substantially the same class. For example, in *Commercial Nat'l Bank v. Superior Court of Los Angeles County*, 14 Cal. App. 4th 393 (Cal. Ct. App. 1993), the court rejected a proposed rehabilitation plan that utilized a "dual valuation" system in which municipal guaranteed investment contracts ("Muni-GIC's") were valued at different rates. *Id.* at 414. Observing that all of the Muni-GIC's were structured as single premium annuities, with a stream of periodic payments generated by an internal rate of interest, the court held that the plan "improperly discriminate[d] between substantially identical policies in the same class," because it "ignore[d] the substantively similar benefits promised in all of the annuities and focuse[d] instead upon the relatively insignificant formal difference that one group of contracts specifie[d] a guaranteed interest rate and initial accumulation values while the other [did] not." *Id.* at 399, 414. *See also In re Conservation of Alpine Ins. Co.*, 318 Ill. App. 3d 457, 741 N.E. 2d 663 (Ill. Ct. App. 2000), in which the Illinois Court of Appeals rejected as "impermissibly discriminatory and therefore illegal" a rehabilitation plan that distinguished between policyholders insured solely by the insurer undergoing rehabilitation, and policyholders having additional insurance through other carriers. The court explained that the state insurance code "does not provide for the punishment of multiple policy claimants insureds based on the fortuitous circumstance of their seeking out additional coverage." *Id.*, 741 N.E. 2d at 665, 668.

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established within any class." *See also, e.g.,* Wis. Stat. § 601.01(2) (central purpose of insurance statutes is "[t]o ensure that policyholders, claimants and insurers are treated *fairly and equitably*") (emphasis added); Wis. Stat. § 645.01(4)(d) (purpose of rehabilitation statute is "protection of the interests of insureds, creditors, and the public generally . . . , through . . . *[e]quitable apportionment of any unavoidable loss*") (emphasis added).

Here, like the dual-valuation system in *Commercial National Bank*, the Commissioner's allocation of the LVM Bond Policy to the Segregated Account is improperly discriminatory and violates the Equal Protection Clause. The Commissioner does not dispute that, as in *Commercial National Bank,* his disparate treatment of the LVM Bond Policy is *not* due to the bargained-for "substantive benefits" of the policy being materially different from Ambac's other municipal bond policies. *Commercial National Bank*, 14 Cal. App. 4th at 414. To the contrary, the risks insured under the AAA-rated LVM Bond Policy were of the same low level as those under Ambac's other municipal bond policies. And yet "virtually the entire municipal bond portfolio" of Ambac was kept in the General Account (March 25 press release), while the LVM Bond Policy and perhaps a limited number of other public-finance policies were allocated to the Segregated Account, where they will receive considerably less favorable treatment.

The Commissioner has explained that allocations were made to the Segregated Account based on the impaired status and projected losses associated with each policy. But it is simply not permissible for the Commissioner, in deciding which of Ambac's policies to place into rehabilitation, to cherry-pick from among all of the municipal bond policies of Ambac and relegate to a Segregated Account for rehabilitation purposes only those that happen to be in default. Such disparate treatment of substantially similar policies in the same class is "impermissibly discriminatory and therefore illegal." *Alpine,* 318 Ill. App. 3d at 463, 741 N.E. 2d at 668; *see also Ferdon ex rel. Petrucelli v. Wisconsin Patients Comp. Fund*, 284 Wis. 2d 573, 672, 701 N.W.2d 440, 489 (2005) (statutory cap on recovery in medical malpractice actions violated equal protection by discriminating against those who actually suffered damages in excess of the cap); *GTE Sprint Comm'ns. Corp. v. Wisconsin Bell, Inc.*, 155 Wis. 2d 184, 187,

454 N.W.2d 797, 798 (1990) (tax on certain telecommunications carriers and not others denied the taxed carriers "the constitutional guarantee of equal protection of the laws").

## II. The LVM Bondholders Are Entitled to be Heard, and to Take Discovery, in Connection With This Motion

The LVM Bondholders respectfully submit that, even without formal intervention, they are entitled to be heard – and, among other things, to take discovery – in connection with this motion. As a matter of common sense and fairness, many courts have recognized that major stakeholders in an insurance company insolvency proceeding are entitled to be heard on issues directly affecting their interests, without the need for an order authorizing their intervention. *See, e.g., In re Liquidation of Midland Ins. Co.*, 2008 WL 151786, at *3 (N.Y. Sup. Jan. 14, 2008) (permitting policyholders to be heard without formal intervention on selected issues affecting their interests); *O'Neal v. Oxendine*, 237 Ga. App. 171, 177, 514 S.E.2d 908, 912 (Ga. App. 1999) ("[a]lthough the trial court technically 'denied' [judgment creditor's] motion to intervene, it allowed [the creditor] to participate fully in the approval hearing and to raise objections to the reinsurance agreement."); *Lucas v. Manufacturing Lumbermen's Underwriters*, 349 Mo. 835, 849, 163 S.W.2d 750, 757 (Mo. 1942) (observing that "[t]he court is the forum where the parties interested may assert their rights and object to any proposal made by the superintendent [of insurance]."). Indeed, considerations of Due Process require that a policyholder be afforded the opportunity to be heard in connection with actions that materially compromise its contractual rights. *Milwaukee Dist. Council 48 v. Milwaukee County*, 244 Wis. 2d 333, 356, 627 N.W.2d 866, 877-888 (Wis. 2001) ("[t]he fundamental requisite of due process of law is the opportunity to be heard.").

Should the Court nevertheless determine that the LVM Bondholders are not entitled to be heard, or to take discovery, without formal intervention, we respectfully request leave to intervene as of right under Wis. Stat. § 803.09(1), which provides:

> [U]pon 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.

The requirements of Section 803.09(1) are satisfied here.[7] By virtue of their beneficial ownership of the LVM Bonds, the LVM Bondholders plainly have an "interest relating to the property or transaction which is the subject of the [proceeding]." Wis. Stat. § 803.09(1). Moreover, in light of the allocation of the LVM Bond Policy to the Segregated Account, and the disparate treatment that will be afforded to that policy in rehabilitation, it is clear that a "disposition of the [proceeding] may as a practical matter impair or impede [the LVM Bondholders'] ability to protect that interest." *Id.* Finally, the decision of Ambac and the Commissioner to afford such disparate treatment to the LVM Bond Policy, and their refusal to transfer the policy back to the General Account as requested by the LVM Bondholders, demonstrates that the LVM Bondholders' interest is not "adequately represented" by these parties. *Id.* The LVM Bondholders are therefore entitled to intervene as of right (and, among other things, to take discovery) to challenge the allocation of the LVM Bond Policy to the Segregated Account. *See, e.g., Koken v. Legion Ins. Co.*, 831 A.2d 1196, 1202 (Pa. Cmwlth.

[7] In its May 27 Decision, the Court denied the LVM Bondholders' request to intervene for the purpose of challenging the proposed CDS Settlement. The present motion seeks intervention for a different purpose – namely, to challenge the allocation of the LVM Bond Policy to the Segregated Account – and is therefore outside the scope of the Court's prior intervention ruling. As discussed in the text above, the requirements for intervention as of right turn on issues specific to the particular matter as to which intervention is sought, such as whether the movants' interests in that matter are "adequately represented by existing parties."

2003) (policyholders permitted to intervene in rehabilitation proceeding); *In re Ambassador Ins. Co., Inc.*, 184 Vt. 408, 413, 965 A.2d 486, 489 ¶ 8 n.4 (Vt. 2008) (policyholder permitted to intervene in liquidation proceeding); *Fewell v. Pickens*, 344 Ark. 368, 373, 39 S.W. 3d 447, 450 (Ark. 2001) (shareholders permitted to intervene in insurance company receivership proceeding).

We ask, finally, that the Court establish an orderly process for discovery and an evidentiary hearing (if needed) in connection with this motion. Specifically, if the Court rules that the LVM Bondholders are entitled to take discovery,[8] and if Ambac or OCI indicate that they may offer evidence or ask the Court to make factual findings in opposition to this motion, we ask the Court to schedule an evidentiary hearing for a date that affords the LVM Bondholders sufficient time to take needed discovery. We note, in this regard, that most of the facts that Ambac or OCI may claim are relevant are exclusively in their possession.

**Conclusion**

For the reasons set forth above, the LVM Bondholders respectfully request entry of an Order:

1. Declaring that the allocation of the LVM Bond Policy to the Segregated Account was unlawful;

[8] Ambac and OCI have taken the position that policyholders are not entitled to take discovery in connection with disputed matters in these Rehabilitation proceedings. Moreover, the May 27 Decision contains a conclusion of law denying the LVM Bondholders' and RMBS Policyholders' request for discovery in connection with their prior motions on the ground that, "[a]s policyholders, Movants do not have standing as parties to seek discovery in this rehabilitation proceeding.." (May 27 Decision, Conclusions of Law ¶ 8.) We ask, however, that the Court consider our entitlement to discovery in connection with the specific issues raised by the present motion, including our request to intervene in connection with this motion – a request that, as noted above, is properly treated on a motion-by-motion basis.

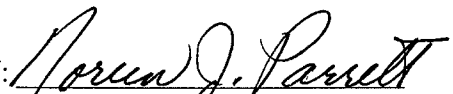
2. Authorizing the LVM Bondholders to be heard and to take discovery in connection with this motion, by means of an order authorizing their intervention as of right in the event the Court deems such intervention necessary; and

3. Granting such other and further relief as is just and proper.

Dated this 9th day of June, 2010.

Parrett & O'Connell, LLP
10 East Doty Street, Suite 621
Madison, WI 53703
Telephone: (608) 251-1542

Noreen J. Parrett
WI State Bar ID No. 1003686
Connie L. O'Connell
WI State Bar ID No. 1026209

BY: 

*Attorneys for Eaton Vance Management, Nuveen Asset Management, Restoration Capital Management LLC, and Stone Lion Capital Partners L.P.*

*Of Counsel*:

Philip Bentley
Amy Caton
Susan Jacquemot
Kramer Levin Naftalis & Frankel LLP
1177 Avenue of the Americas
New York, New York 10036
Telephone: (212) 715-9100
Facsimile: (212) 715-8000