STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Case No. 10 CV 1576

SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

BRIEF BY ALL STUDENT LOAN AND LLOYDS TSB BANK PLC, IN SUPPORT OF THEIR MOTION TO MODIFY TEMPORARY INJUNCTION ORDER AND MOTION TO INTERVENE

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I. INTRODUCTION

Access to Loans for Learning Student Loan Corporation (“ALL Student Loan”), in its capacity as an Obligor and policyholder, under Financial Guaranty Insurance Policies (“The Policies”) issued by Ambac Assurance Corporation ("Ambac") that have been placed into the Segregated Account, and Lloyds TSB Bank plc (“Lloyds Bank”), in its capacity as bondholder under various bonds issued by ALL Student Loan and purchased by Lloyds Bank (hereinafter “Movants”), submit this brief in support of their Motion to Modify the temporary injunction entered on March 24, 2010 (the "Temporary Injunction"), and to grant them leave to intervene in this action to object to the Temporary Injunction and recent pre-Rehabilitation Order actions by Ambac and the Commissioner of Insurance for the State of Wisconsin (the "Commissioner") that resulted in the placement of The Policies into the Segregated Account. Movants are “Interested Parties” pursuant to paragraph 12 of this Court’s Order for Temporary Relief, which explicitly authorizes such interested parties to file a motion by June 22, 2010 to seek modification or dissolution of the Order. The actions by Ambac and the Commissioner leading up to March 24, 2010 severely and inequitably prejudiced the rights of ALL Student Loan with respect to the two insurance policies issued by Ambac and Lloyds Bank with respect to the one policy affecting its bonds.

Movants’ objections arise out of Ambac's March 21, 2010 decision, with the approval of the Commissioner, to establish a Segregated Account pursuant to Wis. Stat. § 611.24, and to transfer The Policies to the Segregated Account *before* this Court entered the Rehabilitation Order on March 24, 2010. The Policies insure a student loan program dedicated to increasing access to education by offering innovative, affordable and seamless student loan products to students and their parents. Most of the other insurance contracts Ambac transferred to the Segregated Account relate to credit default swaps, residential mortgage backed securities and similar toxic risks and

have had substantial claims experience in the past and lack substantial collateral behind the risk. The Policies, on the other hand, have not had any previous claims against them and the collateral is in the form of student loans that are guaranteed by the California Student Aid Commission and United Student Aid Funds, Inc., among others, and reinsured by the U.S. Department of Education, for at least 97% of any defaulted principal and interest accrued thereon guaranteed. (Peterson Affidavit, ¶¶ 12, 16, 18; Watkins Affidavit, ¶ 16.)

It is clear from the court filings that Ambac and the Commissioner had been reviewing restructuring Ambac and placing various policies into segregated accounts for many months. Nevertheless, neither Ambac nor the Commissioner gave *any* advance notice to Movants that The Policies were going to be moved to the Segregated Account. Neither Ambac nor the Commissioner sought Movants' consent to move The Policies to the Segregated Account. ALL Student Loan was not provided any consideration for moving The Policies to the Segregated Account. Most importantly, Movants do not consent to moving The Policies to the Segregated Account. (Peterson Affidavit, ¶¶ 13-15; Watkins Affidavit, ¶¶ 9-11.)

To the contrary, The Policies were unilaterally transferred to the Segregated Account on March 21, 2010 without notice, consent, or consideration from the General Account of Ambac, which was capitalized with a reported $8.5 billion in assets, to a Segregated Account capitalized with a non-marketable $2 billion dollar note with questionable value issued by Ambac, and non-marketable interests in certain affiliated limited liability companies. *(See* Plan of Operation at 3-4.) The Segregated Account has no cash or marketable securities or other liquid assets. (Watkins Affidavit, ¶ 15.) This note and the interests in the limited liability companies cannot possibly be sufficient assets to support the liabilities that have been transferred to the Segregated Account in light, among other reasons, of the Ambac board's simultaneous creation of the Segregated

Account and consent to the Account's immediate placement in rehabilitation proceedings. Thus, the assets in the Segregated Account were now substituted for the assets in the General Account of Ambac in support of The Policies, despite the requirement of Wis. Stat. § 611.24(3)(a) that the Commissioner should not have formed such a new Segregated account unless he "require(s) the corporation to have and maintain an adequate amount of capital and surplus in the segregated account." Obviously, this statutory requirement was not heeded at the time the Segregated Account into which The Policies were placed was formed.

In summary, the transfer of The Policies into the Segregated Account and the subsequent entry of the temporary injunction were unreasonable – and accordingly, illegal – applications of Wisconsin insurance and insurance rehabilitation and insolvency law. Moreover, the transfer and injunction violated the Movants' fundamental rights to due process and equal protection, including, for example, the rights to prior notice and the opportunity to be heard and the right not to be subjected to arbitrary governmental action. On March 21, 2010 Ambac transferred The Policies into the Segregated Account without prior notice to the Movants, and on March 24, 2010, the Commissioner sought and obtained the temporary injunction without prior notice to the Movants and without the Movants having the opportunity to be heard.

More specifically, there are four reasons why Ambac's and the Commissioner's transfer of The Policies to the Segregated Account was illegal and therefore ineffectual:

1. The Segregated Account did not have adequate capital and surplus at the time it was formed. Thus, the purported transfer of The Policies to the Segregated Account was in clear violation of Wis. Stat. § 611.24(3)(a) and was null and void, as that section provides that "if a segregated account is established after a certificate of authority has been issued, the commissioner shall require the corporation to have and maintain an adequate amount of capital and surplus in the segregated account."

2. The Commissioner exceeded the authority given to him by the Wisconsin legislature in the Wisconsin Insurance Code when he attempted to modify Ambac's obligations before the rehabilitation proceeding and outside the supervision of this Court.
3. The transfer of The Policies to the Segregated Account prior to the Order of Rehabilitation, without notice, consideration or their consent, breached Ambac's contractual obligations to the Movants, in part for example, because it was an ineffective novation. *Navine v. Peltier,* 48 Wis.2d 588, 594, 180 N.W.2d 613 (1970).
4. The Commissioner violated the Constitutions of the United States and Wisconsin when he approved the transfer of The Policies into the Segregated Account without any just compensation or due process, and because he treated Movants differently from similarly situated policyholders who did not have any poor claims experience.

Accordingly, for these reasons, as set forth below in more detail, Movants respectfully request that the Court modify the Temporary Injunction and remove The Policies from the Segregated Account and return The Policies to Ambac's General Account.

II. BACKGROUND

A. The Movants and the Policies with Ambac

The Movants, ALL Student Loan and Lloyds Bank, are "Interested Parties" pursuant to paragraph 12 of this Court's Order for Temporary Relief, which explicitly authorizes such interested parties to file a motion by June 22nd to seek modification or dissolution of the Order.

The Policies issued by Ambac that are at issue are provided in order to provide credit enhancement for several hundred million dollars of bonds, the proceeds of which are used to originate federally guaranteed loans to students pursuing a post high school degree. (Peterson Affidavit, ¶¶ 2, 3, 7, 8, 18, and 19.) The loans originated or acquired by ALL Student Loan are financed through the issuance of asset-backed bonds. These bonds are limited obligations of

ALL Student Loan and, as such, are payable solely from repayment of the student loans and other assets pledged under the applicable indentures. *Id.* at ¶¶ 3, 7-11. The bonds at issue were issued pursuant to a Trust Indenture described below. Because the loans are guaranteed by a state-affiliated guarantor and reinsured by the U.S. Department of Education, there is no deterioration in the underlying assets, unlike the situation with the mortgage backed securities, the underlying collateral for many of the Ambac policies placed in the Segregated Account. *Id.* at ¶ 18. There have been no claims made against The Policies. *Id.* at ¶ 16. The Policies clearly belong in the General Account.

Movant ALL Student Loan is a California 501 (c)(3) nonprofit public benefit corporation and is an exempt organization under Section 501 (c)(3) of the Internal Revenue Code of 1965. ALL Student Loan is a student lender dedicated to increasing access to education by offering innovative, affordable and seamless student loan products to students and their parents. It operates exclusively for the purpose of financing certain loans authorized under the Higher Education Act of 1965, as amended. ALL Student Loan finances student, parent, and consolidation loans that are guaranteed and reinsured under the Higher Education Act. *Id.* at ¶ 2.

There were two Financial Guaranty Insurance Policies that were issued to ALL Student Loan as "Obligor," policy #s 24368BE and 25599BE ("the Policies") simultaneously with the issuance of the Offering Bonds that finance the loans as set out in more detail below. *Id.* at ¶ 9. The Policies are attached as Exhibits A and B to the Affidavit of Martha Peterson. *Id.* at ¶ 9. The Policies insure payment of principal and interest on certain specified series of bonds that financed the student loans issued pursuant to a trust indenture dated August 1, 2005, supplemented from time to time, between ALL Student Loan, The Bank of New York Mellon Trust Company N.A. ("BNYM") currently acting as successor Trustee ("Trustee") and Tender

Agent under the Indenture. *Id.* at ¶¶ 3-11.

If funds are insufficient to purchase certain specified series of the bonds, funds are paid by Movant Lloyds Bank, as "Liquidity Provider," pursuant to the terms of the Trust Indenture and Lloyds becomes owner of those Bonds. More specifically, the Purchase Price of the Tendered Bonds is paid from funds provided under a Standby Bond Purchase Agreement dated August 1, 2006, among ALL Student Loan, the Trustee and Tender Agent and the Liquidity Provider. (Watkins Affidavit, ¶ 3.)

Unlike the other policies of insurance in the Segregated Account, the collateral that is pledged to the Senior Series V Bonds is extremely strong, as the student loans are guaranteed by the California Student Aid Commission and United Student Aid Funds, Inc., among others, and reinsured by the U.S. Department of Education, for at least 97% of any defaulted principal and interest accrued thereon, and the claim trigger rate against those guarantors has been historically less than 10 per cent. Thus, The Policies are wholly distinguishable from what Ambac and the Commissioner refer to as the "toxic" bonds in the Segregated Account where the underlying collateral was a major concern with the Ambac insurance policies (Peterson Affidavit, ¶ 18; Watkins Affidavit, ¶ 16.)

Without insurance that affords the opportunity for payment of 100% of the potential claims behind the student loans, as the General Account affords but the Segregated Account does not, the bonds that finance the ALL Student Loan program are severely prejudiced, which prejudices the entire program insofar as it makes it much more difficult to find funding for these loans. (Peterson Affidavit, ¶ 19.) This is inimical to public policy in this country as the most important asset that we have is the continued higher education of our next generation.

B. Ambac Stops Writing Insurance

According to information presented by the Commissioner in this proceeding, around 2008, Ambac stopped writing new policies because of its deteriorating financial condition and lowered credit rating. *(See* Commissioner's March 24, 2010 Brief in Support of Entry of Order for Rehabilitation (the "Rehabilitation Brief') at 1-6.) At the same time, Ambac's liabilities mounted as a number of policyholders either brought policy claims or were projected to have substantial policy claims in the near future. *Id.* These conditions led to the real possibility that Ambac would be unable to satisfy all claims made under the outstanding insurance policies. *Id.* Thus, around 2008, the Commissioner began conferring with Ambac regarding options to address its mounting financial obligations and deteriorating financial assets. *Id.*

C. The Policies are Transferred to the Segregated Account

On March 21, 2010, Ambac's board of directors, with the Commissioner's approval, voted to: (1) establish the Segregated Account that is the subject of this proceeding; and (2) take The Policies out of Ambac's General Account and transfer those policies to the Segregated Account, along with other liabilities. *(See* Petition for Rehabilitation at 8.) When deciding which liabilities should be transferred to the Segregated Account, Ambac claims to have targeted toxic risks with "material projected impairments," such as residential mortgage- backed securities ("RMBS"), collateralized debt obligations and credit default swaps. (Rehabilitation Brief at 3-4.) The Commissioner's clear purpose for transferring these toxic risks to the Segregated Account was to bring stability and certainty to policyholders in the General Account by alleviating concerns that the "toxic risks" would waste all of the assets in the General Account. But, along with these toxic risks, Ambac chose to transfer The Policies to the Segregated Account.[1]

[1] The only Ambac-insured student loan policies identified by the Commissioner as in the Segregated Account are listed in Exhibit D to Tab 1 of the Verified Petition for Order of Rehabilitation. Two of the ten policies listed are The Policies covered by this motion. Seven of the other eight are identified on the Commissioner's Policyholder website as "AAArdvark-IV"

Ambac did not provide Movants with any consideration in exchange for the transfer of The Policies to the Segregated Account, nor did Ambac provide Movants with prior notice of the transfer. (Peterson Affidavit, ¶¶ 13-14; Watkins Affidavit, ¶¶ 9-10.) Instead, Movants first learned of this transfer on March 25, 2010, after the Rehabilitation Order became public. *Id.* Movants have not, and do not, consent to The Policies being placed in the Segregated Account. *Id.* at 15 and 11. Nevertheless, pursuant to the resolution of the Ambac board, the Segregated Account purportedly became effective on March 24, 2010.

D. The Segregated Account Is Placed Into Rehabilitation and The Court Issues a Temporary Injunction.

Hours after The Policies were transferred to the Segregated Account on March 24, 2010, the Commissioner petitioned this Court for an order to place the Segregated Account into this rehabilitation proceeding. According to the Commissioner, the Ambac board of directors authorized the initiation of these proceedings for the rehabilitation of the Segregated Account. This Court granted the Commissioner's petition and placed the Segregated Account into rehabilitation pursuant to Wis. Stat. § 645.32. According to that Order, all matters relating to the Segregated Account must be brought before this Court.

On March 24, 2010, this Court issued the Temporary Injunction, which enjoined certain actions by policyholders and other third parties having interests in the Segregated Account. The Temporary Injunction states the following:

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and the eighth as "AAArdvark-XS." (URL: http://ambacpolicyholders.com/storage/cusip/CUSIPInformationExternal04262010.pdf). The Verified Petition, in Exhibit E to Tab 1, lists about 150 other Ambac-insured student loan policies which, although not in the Segregated Account, are in a special category under which they may be placed in the Segregated Account. The Commissioner has not identified similarities or differences among The ALL Student Loan policies, the AAArdvark policies, and the policies in Exhibit E.

> This Order shall remain effective until further order of the Court. If any interested parties believe any portion of this Order is unwarranted by the facts or the law, such parties may seek modification or dissolution of part or all of this Order by filing a written motion with this Court no later than 90 days following the issuance of this Order. If one or more such timely motions are received, the Court may set a schedule for responsive briefing and a hearing regarding the modifications or dissolutions sought....

(Temporary Injunction at 13-14)

Movants now ask this Court to modify the Temporary Injunction and remove The Policies from the Segregated Account and return the policies to Ambac's General Account.

III ARGUMENT

The inclusion of The Policies in this Court's Order for Temporary Injunctive Relief ("Temporary Injunction") by reason of their inclusion in Exhibit D to Tab 1 of the Commissioner's Plan of Operation is unwarranted by both the facts and the law. Factually, The Policies are unlike any of the other policies in the Segregated Account, at least as can be determined based on the limited factual information made available by the Commissioner. For example, The Policies are not "toxic" and they have excellent underlying collateral. Legally, there are four reasons why the Court should modify the Temporary Injunction and give Movants leave to intervene in this case: (1) the Segregated Account is a nullity because it was not formed in compliance with Wisconsin law strictly governing segregated accounts; (2) the Commissioner exceeded his authority; (3) Ambac breached its contractual obligations as a matter of law; and (4) the Commissioner's actions violated the Constitutions of the United States and Wisconsin.

1. THE SEGREGATED ACCOUNT IS A NULLITY BECAUSE IT WAS NOT FORMED IN COMPLIANCE WITH WISCONSIN LAW.

The pre-Rehabilitation Order actions by Ambac and the Commissioner violate statutory requirements for the formation of a "Segregated Account." Under Wisconsin law, a corporation seeking to form a Segregated Account must meet specified requirements. For example, the

corporation must obtain the approval of the Commissioner, and the assets and liabilities of the account must remain separate and apart from those of the corporation. Wis. Stat. § 611.24(2), (3)(c). In addition, the Segregated Account must *"have and maintain"* adequate capital and surplus to cover the account's liabilities. Wis. Stat. § 611.24(3)(a) (emphasis added). The Segregated Account, created by Ambac and approved by the Commissioner ***before*** this Court entered the Rehabilitation Order on March 24, 2010, was clearly not established with, and does not currently maintain, adequate capital or surplus. The Plan of Operation for the Segregated Account claims that "there is an adequate amount of capital and surplus in the Segregated Account pursuant to Wis. Stat. § 611.24(3)(a)." *(See* Plan of Operation (attached as Tab 1 to Petition for Rehabilitation) at 4.) The Segregated Account, however, is capitalized only with a non-marketable $2 billion dollar note with questionable value issued by Ambac and non-marketable interests in certain affiliated limited liability companies. *Id.* at 3-4. It has no cash or marketable securities or other liquid assets. *Id.* This note and the interests in the limited liability companies cannot possibly be sufficient assets to support the liabilities that have been transferred to the Segregated Account. This is proven by the fact that, just hours after the Segregated Account was formed, the Commissioner determined that the Segregated Account for all intents and purposes was a financially disabled insurer, and advised the Court that:

> The Segregated Account is in such condition that the further transaction of business without rehabilitation would be hazardous, financially or otherwise, to its policyholders, its creditors or the public.

(Petition for Rehabilitation at 8.) The Segregated Account could not have had adequate capital and surplus in the morning of March 24, 2010, if it was financially "hazardous" to its policyholders in the afternoon of that same day.

Because the Segregated Account did not have adequate capital and surplus at the time it

was formed, the provisions of Wis. Stat. § 611.24(3)(a) were not satisfied. Accordingly, the Commissioner's approval and Ambac's establishment of the Segregated Account were a nullity. *See, e.g., Aetna Life Ins. Co. v. Mitchell*, 101 Wis.2d 90, 108, 113-14, 303 N.W.2d 639 (1981) (commissioner's rules promulgated in violation of statute were a nullity because the "Commissioner is never at liberty to substitute her judgment when the legislature has spoken in unambiguous terms. . ."). The Court should therefore order the Commissioner to remove The Policies from the Segregated Account and return them to Ambac's General Account.

The legislative history behind Wis. Stat. § 611.24(3) fully supports Movants' arguments. The "Note" in the Code pertinent to this section provides as follows:

> The basic idea behind segregated accounts is that different operations can be kept independent without formally creating a separate corporation. A segregated account is in some respects like a "corporation within a corporation." Its legal nature and treatment is prescribed in sub. (3). Sub. (3) (a) requires that a segregated account be equipped with an adequate share of the corporation's capital and surplus. This is indispensable if the account is to be expected to function and survive like a separate corporation. If it carries no risks not assumed by the corporation's general account, the commissioner may set the required figure at zero under s. 611.19 (I). There is no reason why a corporation which could create a subsidiary under s. 611.26 (2) for any portion of its insurance business should not be permitted to achieve the desired separation by establishing a segregated account, provided it is adequately capitalized to make it independently viable, and the commissioner approves its creation.

It is clear from this "Note" that the legislature expected that it was "indispensable" that the newly created Segregated Account was "expected to function and survive like a separate corporation" but "provided it is adequately capitalized to make it independently viable." There is no question here that the Segregated Account into which The Policies have been placed do not comply with either the legislative intent or the plain and ordinary meaning of the terms of Wis. Stat. § 611.24(3).

2. THE COMMISSIONER EXCEEDED HIS AUTHORITY WHEN HE ATTEMPTED TO MODIFY AMBAC'S OBLIGATIONS PRIOR TO THE ENTRY OF THE REHABILITATION ORDER.

The Commissioner only has the power and authority given him by the Wisconsin legislature in the Wisconsin Insurance Code. *See Duel v. State Farm Mut. Auto. Ins. Co.*, 240 Wis. 161, 170, 1 N.W.2d 871 (1942) ("[T]he insurance commissioner has only such powers as are conferred by statute and [ ] these must be found within the four corners of the statute.") The Insurance Code sets out the Commissioner's authority separately as Commissioner and as Rehabilitator. *See generally Allianz Underwriters Ins. Co. v. Crescent Garage, Inc.*, 145 Wis.2d 287, 293, 426 N.W.2d 104 (Ct. App. 1988) (discussing the Commissioner's statutory authority as Rehabilitator).

As Rehabilitator, the Commissioner admittedly has broad power to reorder the estate's obligations to maximize distribution of the assets to all creditors fairly. However, the Ambac board's action (at the direction of the Commissioner in his capacity as Commissioner, not in his capacity as Rehabilitator) attempted to modify Ambac's obligations outside the rehabilitation proceeding and outside the supervision of this Court. Effectively, the Commissioner, acting in his capacity as Commissioner, executed a key part of the rehabilitation plan without first placing Ambac in rehabilitation, without finalizing a plan of rehabilitation and without the statutorily mandated supervision of this *Court.* The Commissioner therefore exceeded his authority, and the actions he took beyond his authority are a nullity. *See, e.g., Wis. Compensation Rating & Inspection Bureau v. Mortensen*, 227 Wis. 335, 277 N.W. 679, 86 (1938) (insurance commissioner's actions in violation of statute were void because he "acted without and in excess of his powers")

The Commissioner does not have the authority as a rehabilitator (or even as a liquidator) to divide an insurer into two parts – one part subject to a rehabilitation or liquidation and the

other part exempt from rehabilitation or liquidation. Indeed, "the purpose of [Wis. ch. 645, Insurers Rehabilitation and Liquidation] is the protection of the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogatives of proprietors, through [among other things] … *equitable apportionment of any unavoidable loss*." Wis. Stat. § 645.01(4)(d) (emphasis added). By definition, subjecting some policyholders and insurance beneficiaries to an injunction preventing them from making claims and enforcing their insurance policies, while allowing others to remain free of rehabilitation or liquidation strictures treats those policyholders and beneficiaries inequitably. The Commissioner's attempt to get around his limited authority as a rehabilitator by authorizing Ambac to create a Segregated Account that treats policyholders and beneficiaries inequitably should be rejected by this Court.

Despite the Commissioner's broad powers, he cannot act without legal authority as he has done here. And, as with any governmental official, he must exercise his authority reasonably. Regardless of the Court's conclusions about the legal breadth of the Commissioner's authority, his actions were unreasonable. The creation of the Segregated Account to subject only selected Ambac policies and assets to a Temporary Injunction and to Rehabilitation proceedings was unreasonable in part because it treated policyholders and beneficiaries inequitably. It was also unreasonable because the Commissioner has failed to specifically explain why certain policies were included and others were excluded from the Segregated Account. It is unfair and unreasonable to impose a stringent injunction order on hundreds of policyholders and bondholders based on broad generalizations and pages of policy numbers without explaining why the specific policies were included. Authorizing those, such as the Movants, to object to an injunction without explaining why they were selected to be covered by the injunction is unreasonable and, as will be briefly further addressed below, unconstitutional.

3. AMBAC'S ATTEMPTED NOVATION OF THE POLICIES WAS INEFFECTIVE UNDER THE LAW AND REFLECTS AMBAC'S GENERAL BREACHES OF THE POLICIES.

Ambac's creation of the Segregated Account, as part of its agreement for the Segregated Account to be placed in rehabilitation,[2] breached its obligations under the policies. Based on its action, for example, policyholders were no longer entitled to the full benefits under the policies. As a specific example of Ambac's breaches, under well-established Wisconsin law, Ambac's attempt to transfer The Policies to the Segregated Account before this Court entered the Rehabilitation Order on March 24, 2010, without notice, without Movants' consent and without providing Movants with *any* consideration, was an ineffective novation.

In Wisconsin, a "novation" occurs when there is a "substitution of obligations between the same parties as well as by substitution of parties." *Navine,* 48 Wis.2d at 594; *see also Siva Truck Leasing, Inc. v. Kurman Distributors, Div. of S. Abraham & Sons, Inc.,* 166 Wis.2d 58, 67, 479 N.W.2d 542 (Ct. App. 1991) ("Wisconsin recognizes novation by either substitution of obligations between the same parties or by substitution of parties").

For a novation to be effective, the burden is on the party alleging that a novation occurred to establish two points. First, "[a] clear showing of consent to a novation, either express or implied, is a prerequisite to a finding that a novation occurred." *Navine,* 48 Wis. 2d at 594. Without mutual consent, there is no novation as a matter of law. *See M & I Marshall & Ilsley Bank v. New England Builders, Inc.,* 2010 WL 173897, 1[18 (Ct. App., Jan. 20, 2010) (publication pending) ("In order to establish a novation, among other things, a party must establish the parties' consent to the substitution of obligations"). Second, the party seeking to

[2] Wis. Stat. § 611.24(3) was clearly not intended to authorize an insurer to consent to rehabilitation as provided in § 645.31(14) on the same day as it creates a segregated account to be placed in rehabilitation. On the contrary, the statute on its face tried to preclude such

establish a novation must demonstrate sufficient consideration to support the new obligation. *Siva Truck Leasing, Inc.,* 166 Wis.2d at 68; *Navine,* 48 Wis.2d at *597* (finding insufficient consideration defeated claim for novation).

Here, The Policies were contractual agreements between Movants and Ambac. When Ambac transferred The Policies to the Segregated Account, it attempted both the "substitution of obligations between the same parties as well as by substitution of parties." *Navine,* 48 Wis.2d at *594.* Specifically, Ambac substituted its obligation to Movants, and also substituted the obligor with whom Movants contracted - i.e., Ambac, a large insurance company - with an obligor with whom Movants did *not* contract - i.e., the Segregated Account, an account filled with toxic risks and questionable assets. This activity occurred before the Commissioner had any rehabilitation authority. Currently, Ambac is reporting a policyholders' surplus of nearly $892 million and assets of $8.5 billion. The Segregated Account, on the other hand, is capitalized by a $2 billion note that contains numerous restrictions on its payout, and appears to have no capital or surplus. *(See* Plan of Operation at 3-4.) In addition, Ambac will enter into a reinsurance agreement with the Segregated Account with extremely high coverage triggers and other restrictions that put in question whether there is any legitimate risk transfer. *Id.*

At no time did Movants give its consent, either express or implied, to the attempted novation. (Peterson Affidavit, ¶¶ 13-15; Watkins Affidavit, ¶ 11.) In fact, Movants first learned that Ambac was purportedly no longer Movants' obligor only *after* the Ambac board of directors unilaterally transferred Movants' Polices to the Segregated Account and *after* the Commissioner placed the Segregated Account into rehabilitation. *Id.* at ¶ 14 and 10.

There would have been no reason for Movants to consent to Movants being treated so

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manipulation by requiring the segregated account to be adequately capitalized.

differently from the other policyholders of Ambac. No creditor without notice or consultation would elect to exchange an obligor holding $8.5 billion in assets for one with no cash, marketable securities or other liquid assets. For Ambac and the Commissioner to deny Movants full coverage, and at the same time treat other Policyholders and bondholders differently, is not contemplated by any law of contracts, statutory provisions of the Insurance Code or basic common sense. In addition, as noted above, to treat Movants differently from other similar policyholders violates the precise intent of Wis. Stat. § 645.01(4)(d), which requires treating Movants to "[e]quitable apportionment of any unavoidable loss."

In sum, for these reasons, Ambac's transfer of The Policies to the Segregated Account was an ineffective novation under the law. Accordingly, as a matter of law, there was no novation. *Navine,* 48 Wis.2d at 597. Movants therefore respectfully requests that the Court modify the Temporary Injunction and remove The Policies from the Segregated Account and return the policies to Ambac's General Account.

4. THE TRANSFER OF THE POLICIES TO THE SEGREGATED ACCOUNT VIOLATES THE CONSTITUTIONS OF THE UNITED STATES AND WISCONSIN.

The Commissioner violated the Constitutions of the United States and Wisconsin when he approved the Segregated Account and the transfer of The Policies to that account, because (1) he took Movants' property without providing just compensation; (2) he did not provide Movants due process; and (3) he improperly treated Movants differently from the other insureds.

A. The Commissioner took Movants' property without providing just compensation.

The Commissioner's actions resulted in an unconstitutional "taking." It is axiomatic that the Constitutions of the United States and Wisconsin prohibit the Commissioner from taking Movants' private property for public use, without providing just compensation. U.S. Const.

amend. V, cl. *5* (private property shall not "be taken for public use, without just compensation");Wis. Const. art. I, § 13 ("The property of no person shall be taken for public use without just compensation therefor").

Movants have a valid and constitutionally protected property interest in their insurance contracts with Ambac. *See, e.g., U.S. Trust Co. of N.Y. v. N.J.,* 431 U.S. 1, 19 n.16, 97 S.Ct. 1505 (1972), *reh'g denied*, 431 U.S. 975, 97 S.Ct. 2942 (1977) ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid."); *Wis. Retired Teachers Ass'n, Inc. v. Employee Trust Funds Bd.,* 207 Wis.2d 1, 18, 558 N.W.2d 83 (1997) (recognizing that individuals have constitutionally-protected property interests in contractual rights).

When the Ambac board created and the Commissioner approved the Segregated Account, that action was taken, as a matter of law, on behalf of Wisconsin. *See, e.g., Zinn v. State,* 112 Wis.2d 417, 426-27, 334 N.W.2d 67 (1983) (state agency violated the Wisconsin Constitution when in the exercise of its statutory authority it took private property for public use without just compensation). Indeed, over the course of two years, the Commissioner worked closely with Ambac to create the Segregated Account, which the Commissioner then approved pursuant to Wis. Stat. § 611.24. Through his "extensive involvement" in implementing Ambac's multi-step restructuring plan, the Commissioner was also apparently intricately involved in selecting which of Ambac's liabilities should, and should not, be transferred to the Segregated Account. *(See* Rehabilitation Brief at 3.)

The actions the Commissioner took on behalf of Wisconsin severely impaired Movants' contract rights.[3] Under The Policies, they had a contractual right to make claims against an

[3] This constitutional principle is made applicable to the states by the Fourteenth Amendment. *See, e.g, Kelo v. City of New London,* 545 U.S. 469, 472 n. 1, 125 S.Ct. 2655, 2658, n. 1 (2005)

insurer with a policyholders' surplus of nearly $892 million and assets of $8.5 billion. The Commissioner took that contractual right and substituted it with new contracts requiring the Movants to make claims only against the Segregated Account that appears to have no capital or surplus.

There is no dispute that the Commissioner formed the Segregated Account for the use and benefit of the public. The Commissioner underscores this point in his recent submission to this Court:

> [T]he creation and rehabilitation of the Segregated Account offers the greatest protection and most equitable treatment of policyholders, creditors, and the public given the deteriorating financial condition of Ambac and the varying terms and risks associated with the policies allocated to the Segregated Account.
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> These restructuring efforts have sought to protect the interests of all policyholders and the public by maximizing policyholder claims payment resources and avoiding punitive termination provisions, by providing an orderly and equitable claims payment process, and by minimizing disruptions in coverage to the greatest possible extent.

(Rehabilitation Brief at 1, 20)

Because the Commissioner took these actions for the public, he was required to provide Movants with just compensation." *See, e.g., U.S. Trust Co. of N.Y,* 431 U.S. at 19 n.16 ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid.") The Commissioner did not provide Movants with *any* compensation, however, even though his actions likely diminished Movants' contract rights by hundreds of millions of dollars.

B. The Commissioner did not provide Movants due process.

When the Commissioner took these actions, he did not provide Movants with *any* due process. Although the Commissioner had discussions with policyholders before creating and

approving the Segregated Account *(see* Petition for Rehabilitation at 4), he did not give Movants advance notice or seek Movants' consent to the creation of a segregated account. (Peterson Affidavit, ¶¶ 13-15; Watkins Affidavit, ¶ 11.) This was a violation of the Due Process Clauses of the federal and state Constitutions. *See* U.S. Const. amend. XIV, § 1; Wis. Const. art. I, § 1; *County of Kenosha v. C&S Management, Inc.*, 223 Wis.2d 373, 393, 588 N.W.2d 236 (1999) ("While the language used in the two constitutions [the United States and Wisconsin's] is not identical ... the two provide identical procedural due process protection.").

The Commissioner cannot remedy his constitutional violations through an after-the-fact hearing, because Movants were entitled to notice and an opportunity for a hearing prior to the state's deprivation of their property rights. *See Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 436, 102 S.Ct. 1148 (1982); *see also Milwaukee Dist. Council 48 v. Milwaukee County*, 2001 WI 65,1148, 244 Wis.2d 333, 627 N.W.2d 866 ("The fundamental requisite of due process of law is the opportunity to be heard') (citations omitted). Indeed, the Commissioner was required to give Movants a hearing at a "meaningful time and in a meaningful manner." *Milwaukee Dist. Council 48*, 2001 WI at 1148 (citations omitted); *Capoun Revoc. Trust v. Ansari*, 2000 WI App. 83,1115-18, 234 Wis.2d 335, 610 N.W.2d 129.

C. The Commissioner Treated Movants differently.

The Commissioner's actions contravene the Equal Protection Clauses of the Constitutions because he treated Movants differently from other similarly situated policyholders and policy beneficiaries. *State ex rel. O'Neil v. Town of Hallie*, 19 Wis.2d *558, 567*,120 N.W.2d 641 (1963) (the Equal Protection Clause of the 14th Amendment is violated when a statute is "applied and administered by public authority with an evil eye and an unequal hand, so as practically to make unjust and illegal discriminations between persons in similar circumstances,

material to their rights . . ." (citing *Yick Wo v. Hopkins*, 118 U.S. 356,6 S.Ct. 1064 (1886)). Based on the publicly available information provided by the Commissioner, policies (other than The Policies) that are not "toxic," that continue to have excellent collateral despite the economic upheavals of the recent past were not placed in the Segregated Account. Moreover, again based on the limited information available, very few if any, school loan programs with the type and extent of public guarantees applicable to the Policies, were placed in the Segregated Account.

In sum, because the Commissioner's actions violated Movants' constitutional property, due process and equal protection rights, those actions had no legal effect. *Bohiman v. Green Bay & M Ry.* Co., 40 Wis. *157,* 1876 WL *3915,* at *3 (1876) (commissioner's award violated the constitution and was therefore void). The Court should modify the Temporary Injunction and remove Movants' insurance contracts from the Segregated Account and return the contracts to Ambac's General Account.

IV. CONCLUSION

For these reasons, Movants respectfully request that the Court (1) modify the Temporary Injunction and grant Movants leave to intervene, (2) enter an Order removing The Policies from the Segregated Account and return those policies to Ambac's General Account, and (3) grant such other and further relief as the Court deems necessary.

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