STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of Rehabilitation of Segregated Account of Ambac Assurance Corporation	)) Case No. 10 CV 1576))))

MEMORANDUM OF LAW IN SUPPORT OF MOTION OF ONE STATE STREET LLC FOR DISSOLUTION OR MODIFICATION OF TEMPORARY INJUNCTION

One State Street LLC ("One State Street" or the "Headquarters Landlord"), which is the landlord for the world headquarters of Ambac, located in New York, hereby seeks dissolution or modification of the current Temporary Injunction that this Court has entered in this case (the "TRO"),[1] solely with respect to One State Street. Both Ambac Assurance Corporation ("AAC") and its parent company are party to the Headquarters Lease (defined below). Quite simply, the lease is not an insurance policy, a credit default swap, or any other sort of liability to be adjusted in this proceeding. Yet AAC and the Office of the Commissioner of Insurance (the "OCI") are attempting to place AAC's ordinary overhead lease liability into a newly created segregated account subject to a plan of rehabilitation (the "Segregated Account"), while at the same time leaving all other ordinary operating liabilities in the so-called general account of AAC. Indeed, AAC's and the OCI's own documents that implement the Segregated Account make clear that the Segregated Account was fundamentally intended to take only policy and swap liabilities, and not operating liabilities. For example, the backstop Secured Note and Reinsurance

[1] Capitalized terms defined in the TRO and not otherwise defined herein are used herein as defined in the TRO.

Agreement expressly do not backstop AAC's liability on the Headquarters Lease, while at the same time the OCI and AAC assert that these backstop credit arrangements are key protections for policy liabilities being placed in the Segregated Account. This Court's own Order for Rehabilitation rightly notes that this proceeding focuses on certain troubled areas of AAC's business, and says nothing about addressing operating liabilities. It is clear that in entering the TRO, this Court did not intend to affect the rights under the lease, or other overhead obligations of AAC, and it is equally clear that the OCI itself never focused upon or requested such relief. This Court must dissolve or modify the injunction so that it does not apply to the Headquarters Landlord, and find that any purported transfer of AAC's lease liability to the Segregated Account was not permitted, and cannot be protected by the TRO, which must be modified so that it does not apply to the Headquarters Landlord and the Headquarters Lease.

Factual Background

The facts herein are very simple. The lease in question was originally entered into in 1992 between South Ferry Building Company (the predecessor in interest of One State Street) and Ambac Insurance Company (the prior name of AAC) (the "Headquarters Lease"). In 2000, AAC assigned the Headquarters Lease to its parent company, Ambac Financial Group, Inc. ("AFG"). However, that assignment did not relieve AAC of liability. In fact, pursuant to the terms of the Headquarters Lease, AAC remains a primary obligor and AAC will be responsible for damages and payments due.[2] Furthermore, notwithstanding the assignment to AFG in 2000, AAC still operates its business from that same premises.

[2] AFG is in its own very serious financial difficulty. Its stock trades well below $1/share (a decline of over 95% since early 2009), and its debt rating has fallen from investment grade to junk.

The AAC Plan of Operation states that AAC is allocating "Financial Guaranty Insurance Policies" to the Segregated Account. *Verified Petition for Order of Rehabilitation* (the "Petition"), at Tab 1, Part IV, pp.1-2. Also allocated to the Segregated Account are "remediation claims, defenses, offsets and/or credits" with respect to those policies, ownership interests in certain related conduit entities, and certain reinsurance agreements. *Petition* at p.2. But the Plan of Operation then adds two totally unrelated items to the allocation: a purported allocation <u>of liabilities only</u> with respect to two leases – one of which is the Headquarters Lease. *Petition* at p.2-3. No other overhead assets or liabilities, other than these two leases, are assigned to the Segregated Account.

According to AAC and the OCI, a critical aspect of the Plan of Operation is the credit backstop that the remaining general account of AAC is providing to the Segregated Account. *OCI Brief in Support of Order for Rehabilitation* ("Rehabilitation Brief") at p.22. This credit backstop consists of two components: a $2 billion Secured Note and a Reinsurance Agreement. *Id.* The OCI specifically found that these backstop agreements were the feature that, in the view of the OCI, allowed for the formation of the Segregated Account since Wisconsin law requires that a segregated account must be adequately capitalized, and that a transfer to a segregated account must be for fair consideration, and only thereby not constitute a fraudulent conveyance. *See Findings of Fact and Conclusions of Law Regarding Motions of Certain RMBS Policyholders and Certain LVM Bondholders* (the "Court Decision") at ¶26. In a related recent ruling, this Court similarly concluded that the Secured Note and Reinsurance Agreement were a key part of the AAC Plan of Operation and rehabilitation program for the Segregated Account. *Id.*

A closer study of these credit backstop arrangements reveals, however, that they do not cover liabilities of the Segregated Account relating to the Headquarters Lease. Both the Secured Note and the Reinsurance Agreement expressly provide that they apply exclusively to liabilities on "Covered Policies." *See Petition* Exhibit A (the "Secured Note") ¶ 1A. "Covered Policies" is defined to mean "certain insurance policy liabilities" and expressly excludes other liabilities, such as liability on the Headquarters Lease, that are allocated to the Segregated Account. *See Secured Note* Recital ¶ B.

Argument

I. **The Segregated Account Statute Does Not Permit AAC to Place the Headquarters Lease in the Segregated Account**

A. *AAC's Liability for the Headquarters Lease Is Not Part of Any Insurance Business of AAC, and Cannot Be Allocated to the Segregated Account*

The plain text of the Wisconsin statute governing segregated accounts makes absolutely clear what can be allocated to a segregated account – and the statute's language expressly provides that a segregated account may include classes and parts of the company's "insurance business" and "business". Wis. Stat. 611.24(1)-(2). The Headquarters Lease is fundamentally distinct from the type of asset, liability or contract within the statute's contemplation, and is, in fact, distinguishable from every other item that AAC is placing into the Segregated Account. AAC's liability under the Headquarters Lease is anything but a troubled insurance liability – AAC has been primarily liable and has conducted its business from the premises since the lease inception in 1992. This lease liability is a simple liability of AAC that is not part of any currently conducted business being transferred to the Segregated Account.

AAC's and the OCI's overall structure and approach to the Segregated Account reveals their appreciation for the scope of items contemplated by the statute as

appropriately allocated to a segregated account. This is reflected in the briefs of the OCI filed at the outset of this proceeding, where the purpose of the Segregated Account and the allocation to the account is described. Nowhere in those briefs is there any discussion of the Headquarters Lease. To the contrary, the OCI's briefs all address exclusively the need to segregate insurance policies. For example, in the very first paragraph of the OCI's brief in support of a TRO, the OCI speaks of "[t]he Segregated Account and the insurance policies allocated to it," and then says they are "more fully described in the . . . Brief in Support of Rehabilitation." *OCI Brief in Support of Motion for Temporary Injunctive Relief.* In turn, the OCI's Brief in Support of Rehabilitation provides that "full description" as follows:

> Ambac created the Segregated Account and allocated to it those policies with material projected impairments that insure the riskier investments described above ["RMBS" and "CDOs of ABS"]. The Segregated Account includes the books of business for RMBS, most of which will mature within approximately five years, and those CDOs of ABS policies not subject to the Statement of Intent, most of which will not mature for twenty or more years, as well as certain other policies with provisions that could result in loss of control rights or demands to pay non-economic, accelerated damages at the expense of other policyholders of Ambac.

OCI Brief in Support of Entry of Order for Rehabilitation ("Rehabilitation Brief"), at pp. 3-4 (emphasis added). The OCI addresses exclusively the financial danger to AAC of insurance policies, with no reference to AAC's overhead liabilities, such as real estate lease liabilities. Similarly, when this same OCI brief discusses the "Past and Present Business and Future Financial Hazards to Policyholders and the Public" (*see Rehabilitation Brief* Part III, pp. 13-20), there is no discussion of AAC's liability on the Headquarters Lease, in direct contrast to the OCI's repeated discussions of AAC's

exposures under actual insurance policies. Indeed, in the entire Rehabilitation Brief there is not a single mention of the Headquarters Lease liability.

These OCI statements reveal that the OCI fully appreciates the express language and intent of the Wisconsin segregated account statute. The statute provides for the segregation among the core business assets of an insurer. The statute neither allows for, nor has the intent of permitting, an obligor's transfer of a particular overhead liability to a segregated account. In light of the statute, AAC could not properly allocate the Headquarters Lease liability to the Segregated Account. This Court must, therefore, modify the TRO to exclude the Headquarters Lease from the terms of the TRO.

B. *AAC Is Impermissibly Attempting to Separate the Liability on the Headquarters Lease from the Benefits of the Headquarters Lease*

The transfer of the Headquarters Lease to the Segregated Account, and the resulting application of the TRO, is inappropriate since the benefits of the lease continue to be enjoyed by AAC and its general account. This result would be wholly inconsistent with the purposes and structure contemplated by the segregated account statute, which allows for such transfer when both the benefits and burdens of a policy are to be transferred to a segregated account. Assigning the Headquarters Lease on the terms contained in the Plan of Operation seeks to bifurcate a contract into two parts – placing AAC's liabilities under the Headquarters Lease in the Segregated Account while leaving the benefits in the general account of AAC. This intent is reflected in the Plan of Operation for the Segregated Account, which states that AAC is allocating to the Segregated Account:

> *Lease with One State Street, LLC.* The Company is allocating to the Segregated Account its disputed contingent liability, if any, under the long-term lease with One State Street, LLC, effective January 1, 1992 and amended as of August 1, 1997.

Plan of Operation, p.2 (emphasis added). There is, of course, no authorization anywhere in the segregated account statute or Wisconsin's insurance rehabilitation law to allow an insurer to move to a segregated account only the liabilities under a contract while otherwise retaining the benefits of the contract outside of the Segregated Account, in the general account. It is noteworthy that the OCI, itself, views the allocated contracts as executory contracts, in order to support the ability of the OCI to assume or reject (affirm or disavow, under Wis. Stat. 645.46(11)) contracts. *See Injunction Brief* at pp.14-17. It is fundamental to the law of executory contracts that a contract must be either assumed or rejected in whole, and that benefits cannot be assumed while liabilities are rejected. *E.g., In re Action Transit, Inc.*, 2008 Bankr. LEXIS 513, at *4 (Bankr. E.D. Wis. 2008). *See also, e.g., Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741 (5th Cir. 1996); *City of Covington v. Covington Landing Ltd. P'ship*, 71 F.3d 1221, 1226 (6th Cir. 1995).

AAC's attempt to sever the benefits of the Headquarters Lease is especially brazen. In the first instance, AAC has always been a primary obligor on the Lease.[3] And now the actions of AAC, in creating the Segregated Account with commencement of an immediate rehabilitation proceeding which creates a default as to

[3] Lease Section 7.04 provides: "The liability of the tenant named in this Lease or any of its successors-in-interest under this Lease for the due performance of the obligations on its part to be performed under this Lease, shall not be discharged, released or impaired in any respect by an agreement or stipulation made by Landlord with assignee . . . and the tenant named in this Lease or any of its successors-in-interest shall continue to be liable hereunder . . . ."

the lease and AFG,[4] will impose accelerated liability on AAC and its Segregated Account. The accelerated liability that AAC is attempting to sever has in fact been made into a significant, immediate and non-contingent liability – a self-inflicted wound that AAC wants to slough off to the Segregated Account while remaining a direct, primary party to the Headquarters Lease. While the OCI has broad authority to address troubled situations, that authority is to be used for "the protection of the interests of insureds, creditors and the public generally." Wis. Stat. § 645.01(4). Accelerating a liability that could otherwise be left in place with the general account, and protecting that decision via the TRO, does not in any way protect insureds, creditors or the public.

Furthermore, AAC, and the ongoing business in its general account, continue to occupy the Headquarters Lease premises. Although AFG is currently an assignee Tenant under the Headquarters Lease, AFG is in serious financial difficulty itself, and may very well breach the Headquarters Lease (including the possibility of rejection of that lease in any AFG bankruptcy case, which rejection would constitute a breach by operation of law), and AAC would continue as Tenant.[5] Thus, the Plan of

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[4] See Section II.A infra.

[5] Lease Section 22.03 provides: "(a) If Tenant shall have assigned its interest in this Lease, and this Lease shall thereafter be disaffirmed or rejected in any proceeding under the United States Bankruptcy Code or under the provisions of any federal, state or foreign law of like import, or in the event of termination of this Lease by reason of any such proceeding, the assignor of any of its predecessors in interest under this Lease, upon request of Landlord given within ninety (90) days after such disaffirmance or rejection shall (a) pay to Landlord all Fixed Rent and Additional Charges then due and payable to Landlord under this Lease to and including the date of such disaffirmance or rejection and (b) enter into a new lease as lessee with Landlord of the Premises for a term commencing on the effective date of such disaffirmance or rejection and ending on the Expiration Date, unless sooner terminated as in such Lease provided, at the same Fixed Rent and Additional Charges and upon the then executory terms, covenants and conditions as are contained in this Lease, except that (i) the rights of the lessee under the new lease, shall be subject to any possessory rights of the assignee in question under this Lease and any rights of persons claiming through or under such assignee, (ii) such new lease shall require all defaults existing under this Lease to be cured by the lessee with reasonable diligence, and (iii) such new lease shall require the lessee to pay all Additional Charges which, had this Lease not been disaffirmed or rejected, would have become due after the effective date of such disaffirmance or rejection with respect to

Operation, by its plain terms, contemplates that, in such an event, the rent (and damages) would be paid by the Segregated Account (because only the liability is allocated), notwithstanding AAC's general account remaining as Tenant. AAC is currently an actual occupant of the premises, and this is in the form of AAC's general account, rather than the Segregated Account, since the court-approved Management Agreement provides that the AAC general account is to perform all actual operations, both on its own behalf, as well as the functions of the Segregated Account. *Petition* Exhibit A (Management Services Agreement). And thus the Plan of Operation, as implemented and protected by the TRO, severs the benefits to AAC of the Headquarters Lease (which are to remain with the AAC general account) from the lease liabilities (which are allocated to the Segregated Account).

The Wisconsin statute simply does not allow for the liabilities of a contract to be transferred to a segregated account, while leaving behind the benefits. As such, the TRO cannot possibly apply to the Headquarters Landlord and the Headquarters Lease.

C. *The Segregated Account Statute Is Inapplicable Because the Segregated Account Is Not Adequately Capitalized as to the Headquarters Lease*

As noted above, the OCI has acknowledged and this Court has confirmed, that the Wisconsin statute permits the creation of a segregated account only in the event that obligations transferred thereby are adequately protected. The OCI and this Court

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any prior period, subject to the right of such lessee to dispute such amounts. If the lessee shall fail or refuse to enter into the new lease within fourteen (14) days after Landlord's request to do so, then in addition to all other rights and remedies by reason of such default, under this Lease, at law or in equity, Landlord shall have the same rights and remedies against the lessee as if the lessee had entered into such new lease and such new lease had thereafter been terminated at the beginning of its term by reason of the default of the lessee thereunder.

have primarily grounded the views that this statutory requirement has been satisfied regarding the Segregated Account by virtue of the two credit backstop arrangements that the general account of AAC is providing to the Segregated Account. The OCI expressly noted that the Secured Note and the Reinsurance Agreement were critical to OCI's approval of the Segregated Account, and this Court has also, to date, approved the OCI's requests in this proceeding, including granting of the TRO, on this basis. The concept, of course, is that the credit backstops serve as the foundation of the Court's findings that allocations to the Segregated Account will not harm creditors and that transfers to the Segregated Account are being established for fair consideration. *Court Decision* at ¶ 26.

Shockingly, neither the Secured Note nor the Reinsurance Agreement cover any liability of the Segregated Account that may arise relating to the Headquarters Lease. By their express terms, these two backstop arrangements only pay amounts due on "Covered Policies," which are defined only to include insurance policies. The Secured Note states:

> The outstanding principal under this Note shall be payable . . . subject to mandatory prepayment from time to time on demand of Payee in an amount equal to . . . the cash portion of claim liabilities due and payable by the Payee under Covered Policies . . . .

Petition, Exhibit G, § 1(a). The Reinsurance Agreement contains the same terms:

> Reinsurer shall provide payments to the Ceding Company . . . in an amount equal to (A) the cash portion of claim liabilities . . . under Covered Policies . . . .

Petition, Exhibit H, § 1.02. "Covered Policies" is defined as "certain insurance policy liabilities" allocated to the Segregated Account, and excludes "other liabilities" (i.e. non-

insurance liabilities, such as the Headquarters Lease) that AAC allocated. *Petition*, Exhibit G, Recital B.[6]

As noted above, the Headquarters Landlord asserts that, by the statute's terms, this simple lease obligation cannot be transferred to the Segregated Account, in any event. But, even if this Court concludes that the lease obligation can be so transferred, the specific allocation of this Headquarters Lease to the Segregated Account violates the statute because the contemplated backstop arrangements that are intended to protect other Segregated Account creditors do not protect the Headquarters Landlord. Because the Segregated Account is not adequately capitalized as to the Headquarters Lease, and there is no fair consideration for the Segregated Account from the prospective of the Headquarters Landlord, the TRO cannot be used to protect the general account from liability to the Headquarters Landlord.

II. **As Applied to One State Street, the TRO (i) Is Unjustified According to the OCI's Own Rationale and (ii) Cannot Be Used to Eliminate Rights Under Fraudulent Transfer Law.**

A. *The Segregated Account and Injunction Is Being Justified on Grounds that there Would Be a "Run on the Bank," but It Is Totally Unnecessary as to the Headquarters Lease*

In its previous rulings, and by adopting the OCI's rationale, this Court found that the TRO and the establishment of the Segregated Account were appropriate since they were both necessary to preclude a "bank run" on AAC:

> As Ambac's claims payments and projected loss impairments mounted and its liquid claims paying resources were eroded, it became increasingly clear to OCI that some type of affirmative regulatory action under Chapter 645 of the Wisconsin Statutes would be necessary to slow the outflow of claims-paying resources and prevent

[6] The Reinsurance Agreement by definition excludes non-insurance liabilities, because it is a contract for reinsurance.

> the exercise of insolvency and *ipso facto* "triggers" by certain categories of policyholders. Absent regulatory action, there was a growing risk that Ambac would become insolvent before its in-force policy obligations were satisfied.

Court Ruling ¶ 19. Even a quick examination, however, shows that this rationale does not apply to the Headquarters Lease. In fact, it is only because of the transfer of the lease to the Segregated Account itself, that any threatening accelerated liability to AAC is created – beyond ordinary rent payments that are being covered by AFG.

Absent a transfer of the Headquarters Lease to the Segregated Account, there appears to be no current default under the Headquarters Lease. AAC's liability under the Headquarters Lease accelerates only if there is a default under the lease, and, because AFG is currently making the lease payments, the Headquarters Lease does not pose any current drain at all on AAC's cash resources. The allocation of the Headquarters Lease to the Segregated Account, however, and the subsequent commencement of a rehabilitation proceeding of the Segregated Account, did trigger a default under the Lease, providing the Headquarters Landlord with the option of terminating the lease and seeking damages from both AAC and AFG.[7] In other words, the only reason that the Headquarters Lease poses any liquidity threat to the Segregated Account and AAC (the stated rationale for the TRO being to prevent such liquidity threats) is due to the improper and ill-advised transfer of the lease to the Segregated Account. If AAC's Headquarters Lease obligations had simply been left in AAC's general account, there would not be any default event. It cannot possibly be the case that AAC and the OCI can justify placing the Headquarters Lease (which is not even an

[7] Lease Section 24.01 provides: "If this Lease is terminated (after notice and expiration of any applicable grace period) . . . Tenant [including predecessors] shall pay to Landlord as damages [various alternative calculations]."

insurance policy) in the Segregated Account and imposing the TRO while they themselves caused the default trigger event by the transfer of the lease to the Segregated Account as part of the rehabilitation scheme.

B. *As to the Headquarters Lease, the Allocation to the Segregated Account Violates Fraudulent Transfer Law*

The TRO, as currently in force, prohibits the Headquarters Landlord from enforcing rights against AAC's general account and certain related rights. Among those restricted rights are the rights of the Headquarters Landlord to prevent AAC from either (i) transferring property or (ii) incurring obligations, in each case in violation of the Uniform Fraudulent Transfer Act, Wis. Stat. § 242.01 et seq., as both an intentional and a constructive fraudulent conveyance. The allocation to the Segregated Account of AAC's liability on the Headquarters Lease violates the applicable prongs of Wisconsin fraudulent transfer law.

1. *The Allocation of the Headquarters Lease to the Segregated Account Plainly Is an Intentional Fraudulent Transfer*

A transfer made, or obligation incurred, with the intent to hinder or delay creditors violates fraudulent transfer law. Wis. Stat. § 242.04. There is no question as to the intent of the allocation of the Headquarters Lease to the Segregated Account. The pleadings filed before this Court expressly state that the allocations to the Segregated Account are intended to slow and prevent recourse of creditors against the remaining assets that are being left in the AAC general account. *See generally AAC's Brief in Opposition to Motion of Wells Fargo Bank.*

As to the Headquarters Lease, this intent is particularly striking. Absent the allocation of the lease to the Segregated Account and the rehabilitation proceeding, the Headquarters Lease would not even be in default, and would continue to be paid by

AFG as it is currently. In other words, AAC is actually triggering the default under the Headquarters Lease so that AAC can claim that there has been a cash flow crisis related to the lease, and thereby justifying assignment of the lease to the Segregated Account, limiting the recourse available to the Headquarters Landlord. This is fundamentally different than the allocations of all the various RMBS- and CDO-related contracts to the Segregated Account, which apparently pose more imminent threats to AAC because current obligations arising thereunder would not otherwise be paid currently. It is obvious that AAC and the OCI are taking the "opportunity" presented by the AAC's financial crisis, borne of AAC's insurance policies, to also eliminate a potential lease liability. But the immediate, non-contingent liability on the Headquarters Lease is entirely a problem of AAC's own making. This action cannot properly be protected by the TRO.

2. *The Allocation of the Headquarters Lease to the Segregated Account Is a Constructive Fraudulent Transfer*

In addition, the Wisconsin fraudulent conveyance statute provides that any transfer of property or incurrence of an obligation can be avoided by a creditor if made at a time when the debtor (i) is insolvent or has unreasonably small capital, and (ii) does not receive back reasonably equivalent value.[8] The OCI's approval of the Segregated Account, and this Court's support thereof, is premised upon the finding that AAC as

[8] AAC has asserted that the liability on the Headquarters Lease is contingent and disputed. As noted above, now that AAC's own actions have caused a default, the liability is anything but contingent. In any case, even if the Court agreed with AAC's characterization of the liability, contingent and disputed creditors have full rights to bring fraudulent conveyance claims. Any "creditor" can bring an action, and a creditor is any person with a "claim." Wis. Stat. § 242.01(4). In turn, "'Claim' means a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured , disputed, undisputed, legal, equitable, secured or unsecured." Wis. Stat. § 242.01(3).

whole, and the Segregated Account itself, are in a situation where they have unreasonably small capital. That term is defined as the situation in which a entity, even if not insolvent, faces severe liquidity problems. *E.g., Boyer v. Crown Stock Distribution, Inc.*, 587 F.3d 787, 795 (7th Cir. 2009) (holding that a situation involving a company unable to pay debts when due constituted unreasonably small assets under Indiana Uniform Fraudulent Transfer Act). Of course, severe liquidity problems are (i) with respect to AAC as a whole, exactly what caused AAC to establish the Segregated Account, and (ii) with respect to the Segregated Account, exactly what caused the OCI to commence this rehabilitation proceeding.

Regarding reasonably equivalent value, it is true that the OCI generically concluded that the transfers of assets to the Segregated Account were "for fair consideration." *Court Findings* ¶ 26 (reciting the OCI's findings). However, as to the Headquarters Lease there was no consideration in return at all. The Plan of Operation purports to allocate only lease liability, leaving the benefits of the lease behind. The only path to providing fair consideration for the Headquarters Landlord would be AAC's general account retaining the entire lease, both the benefits and responsibility for payment.

Furthermore, the OCI's analysis of fair consideration, and this Court's agreement with OCI's conclusion, depended on the backstop arrangements from the AAC general account – the Secured Note and the Reinsurance Agreement. As described in detail above, however, those credit backstop arrangements for the Segregated Account – the very dimension that allegedly provided the fair consideration – do not cover amounts due on the Headquarters Lease. Thus, from the creditor's perspective of the Headquarters Landlord, the Segregated Account did not receive fair consideration or

reasonably equivalent value. Moreover, even if such credit protection were provided, from the perspective of the Headquarters Landlord, the lease assignment to the Segregated Account would be a constructive fraudulent conveyance because its credit recovery would be much greater than the other transferred policies absent the entire creation of the Segregated Account.

3. *The Allocation of the Headquarters Lease to the Segregated Account Is a Transfer and the Incurrence of a New Obligation*

In the first instance, to the extent that the Headquarters Lease is deemed to be allocated to the Segregated Account, the assets of the general account were transferred away from the Segregated Account, within the broad meaning of that term in fraudulent transfer law. "'Transfer' means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money, release, lease and creation of a lien or other encumbrance." Wis. Stat. § 242.01(12).

AAC and the OCI may argue that no transfer occurred because, for certain purposes under the Wisconsin Statutes, the Segregated Account is deemed to be the same legal entity as the general account. *AAC Brief in Opposition to Wells Fargo Motion* at p.8. This contention would fail with respect to fraudulent transfer law, which always looks to the substance of the transactions and ignores attempts to use legal forms to adversely change creditor recourse. *E.g., Boyer*, 587 F.3d at 793. First, there is no question that for relevant purposes (creditors-rights purposes) the Segregated Account is separate from the AAC general account, as evidenced by the ability of the Segregated Account to contract with the general account. *See Petition* Exhibits A & B (Management and Cooperation Contracts between Segregated Account and general account). If the Segregated Account and AAC's general account were the same entity, they could not

enter into contracts "between themselves." Moreover, the Segregated Account alone is subject to a rehabilitation proceeding, which proceeding is intended to be without effect on creditors of the AAC general account. Furthermore, Wisconsin law specifically recognizes the risk of there being fraudulent transfers from the Segregated Account prior to the petition for rehabilitation. Wis. Stat. § 624.11(h). *See also* § 645.52.

Second, the allocation of an obligation to the Segregated Account has the exact same effect as another very commonly recognized fraudulent transfer situation, where an obligor changes assets to which creditors have full recourse into assets that are exempt from recourse under state law. In such circumstance, while the assets remain with the same legal entity, the adverse change in creditor recourse is recognized as a transfer for fraudulent transfer purposes. An act that recharacterizes an obligor's property of the debtor, from being subject to recourse into property where the creditor does not have recourse, constitutes a transfer. *See Levine v. Weissing (In re Levine)*, 134 F.3d 1046 (11th Cir. 1998) (conversion of funds from non-exempt to exempt status constituted "transfer" for purposes of Uniform Fraudulent Transfer Act). Indeed, one older Wisconsin case demonstrates this principle quite clearly. In *Comstock v. Bechtel*, 63 Wis. 656, 24 N.W. 465 (1885), the Court held that when a person exchanged non-exempt property for exempt property, that the transfer to third parties was attackable under fraudulent conveyance law. The Court would not allow fraudulent conveyance law to unwind the actual exemptions of the debtor, <u>but only because the individual exemptions in that case were specifically grounded in the Wisconsin Constitution</u>. Here, there is no constitutional mandate to protect a financial guaranty insurance company. In addition, the statute itself recognizes that fair consideration must be given in establishing

the segregated account and recognizes that there can be fraudulent transfers from the account that must be recoverable.

Furthermore, fraudulent transfer statutes protect not only against transfers of assets out of an obligor, but also protect against an attempt by an obligor to create new obligations and liabilities that adversely affect creditors. Wis. Stat. 242.04 (speaking to "obligations incurred" as well as transfers of assets). Therefore, even if the creation of, and allocation to, the Segregated Account is not a "transfer," it still violated fraudulent transfer law and cannot be protected by the TRO. This arises from the substantially improved position of general account creditors, and the correlating prejudice to Segregated Account creditors, that result from the allocations to the Segregated Account. While the allocations do not completely eliminate the liability of the general account for those contracts, as Wis. Stat. § 611.24(e) provides that in a liquidation the general account remains liable for the contracts allocated to the Segregated Account, such liability is satisfied only after the general account creditors are paid. Thus, all general account liabilities, formerly *pari passu* with the liabilities allocated to the Segregated Account, have been replaced with new, super-senior priority obligations for the general account creditors, that in liquidation trump the liabilities allocated to the Segregated Account. Of course, especially with respect to the Headquarters Lease liability, AAC received nothing in return for undertaking these new super-senior obligations. Moreover, as AAC's general account continues to occupy the leased premises, there is no finding that the creation of the Segregated Account and its related rehabilitation scheme provide any benefit to the Headquarters Landlord, as opposed to the benefits that a rehabilitation may arguably provide to other AAC policy counter-parties.

Accordingly, whether considered as a transfer of assets away from the Headquarters Landlord, or as AAC's undertaking of new super-senior obligations in favor of general account creditors, the allocation of the Headquarters Lease liability to the Segregated Account violated Wisconsin fraudulent transfer law. The TRO must be dissolved as to One State Street or modified to permit One State Street to bring any appropriate remedial action.

III. The Allocation of the Headquarters Lease Violated Various Portions of the Segregated Account Statute, as Well as the Wisconsin and United States Constitutions

A. *Equal Protection Clauses*

The OCI's treatment of One State Street violates the equal protection clauses of both the United States Constitution and the Wisconsin Constitution since there is no basis for discriminating between the treatment of the Headquarters Landlord and of other similarly-situated creditors.

The Fourteenth Amendment to the United States Constitution guarantees all citizens "equal protection of the laws," and Article 1, section 1 of the Wisconsin Constitution provides that "[a]ll people are born equally free . . . ." Similarly, Wisconsin cannot improperly discriminate between citizens in drafting or enforcing laws. Generally, the state may only discriminate between citizens where there is a rational basis for the discrimination that is reasonably related to a legitimate state purpose. *See Heller v. Doe*, 509 U.S. 312, 320 (1993); *see also In re Commitment of Burgess*, 262 Wis. 2d 354, 378, 665 N.W.2d 124, 135-136 (2003) (under Wisconsin constitution, "[w]hether a legislative distinction between otherwise similarly situated persons violates equal protection depends upon whether there is a reasonable basis to support it.") Furthermore,

the state act is sufficient to withstand review so long as "any state of facts reasonably may be conceived to justify it." *Dandridge v. Williams*, 397 U.S. 471, 487 (1970).

The OCI justified its approval of allocations to the Segregated Account, commencing this rehabilitation proceeding and seeking the TRO by finding that absent such steps there would be a "run on the bank" against AAC. But, as described in detail above, that rationale has no conceivable relationship to the Headquarters Lease because AFG is currently performing all Headquarters Lease obligations and the only current defaults are generated precisely by the allocation of the lease to the Segregated Account and the commencement of the rehabilitation proceeding.

Moreover, in approving the arrangements for the Segregated Account and seeking to impose the TRO, the OCI has flagrantly discriminated against the Headquarters Lease by excluding it from the backstop arrangements of the Secured Note and the Reinsurance Agreement. Even if the Headquarters Lease is properly allocated to the Segregated Account, it cannot be excluded from the benefits of the backstop arrangements.

Finally, no justification has been proffered nor available to distinguish between obligations relating to the Headquarter Lease and other overhead liabilities of AAC.

B. *Takings Clauses*

The OCI's approval of the AAC Segregated Account scheme is an unconstitutional taking without just compensation under both the United States Constitution and the Wisconsin Constitution, because the OCI's actions caused One State Street to forfeit its rights to payment and its interest in all of AAC's property without just compensation.

The Fifth Amendment to the United States Constitution, as well as section 13 of article I of the Wisconsin Constitution, prevent a state from taking private property "for public use without just compensation." Contract rights may constitute private property for the purposes of the so-called Takings Clause. *See, e.g., Wis. Retired Teachers Ass'n, Inc. v. Employe Trust Funds Bd.*, 207 Wis. 2d 1, 19, 558 N.W.2d 83 (1997) ("an individual's contractual rights in a public employee retirement system create a property interest in his or her retirement system as a whole" for the purposes of the Takings Clause). Taking certain private persons' property for the use of other private persons (which use is intended to have economically beneficial effects) without just compensation may constitute a violation of the Takings Clause. *See Kelo v. City of New London,* 545 U.S. 469, 125 S. Ct. 2655 (2005); *Chicago, B. & Q. R. Co. v. Chicago,* 166 U.S. 336, 239 (1897) (Fifth Amendment applicable to the States).

By approving the segregated account scheme, the OCI has effected a taking of One State Street's property without any compensation. The scheme takes a *pari passu* interest in unencumbered property previously available to satisfy its claims against AAC and transfers that interest to other AAC claimants. It similarly takes One State Street's contractual rights as an unsecured creditor and grants in return only the rights of a subordinated creditor. Finally, the OCI's actions take the rights to payment away from One State Street while retaining the benefits of the Headquarters Lease in the general account. The OCI has admitted that this scheme is meant to serve a public purpose, *see Rehabilitation Brief* at 1, 20, but has never sought to provide compensation for the use of One State Street's property interest to serve this public purpose. Accordingly, the scheme is a taking without just compensation.

Summary

It may very well be the case that, on balance, AAC and the OCI were entitled to create the Segregated Account, place massive RMBS- and CDO- related liabilities into the Segregated Account, and to commence immediate rehabilitation proceedings. But the inclusion of the assignment of the Headquarters Lease is a blatant attempt to include improperly an ordinary operating liability, in violation of the applicable statute. Indeed, the sole rationale for the creation of the Segregated Account and its rehabilitation is that AAC is in imminent danger of accelerating, defaulting obligations on those financial guaranty contracts. Such rationale, of course, is completely inapplicable to the Headquarters Lease. Absent the actions of AAC and the OCI, the Headquarters Lease would not even be in default, and AFG continues to pay the rent currently. The TRO cannot be used to protect AAC's completely hypocritical action and allocation when it violates the statute, fraudulent transfer law and constitutional principles. The TRO must be modified or dissolved to entirely exclude the Headquarters Landlord and Headquarters Lease.

Respectfully submitted on June 22, 2010.

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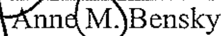

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