

**In the Matter of the Rehabilitation of:  
Segregated Account of Ambac Assurance Corporation**

**Case No. 10 CV 1576**

Depfa Bank, plc

Case No. 10 CV 1576-B

Access to Loans for Learning Student Loan  
Corporation, and Lloyds TSB Bank plc

Case No. 10 CV 1576-I

KnowledgeWorks Foundation,  
and the Treasurer of the State of Ohio

Case No. 10 CV 1576-K

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**REHABILITATOR'S BRIEF IN OPPOSITION TO MOTIONS  
FILED BY ALL/LLOYDS, KNOWLEDGEWORKS, AND DEPFA  
RELATING TO STUDENT LOAN POLICIES  
SCHEDULED FOR HEARING ON SEPTEMBER 13, 2010**

**Wisconsin Office of the Commissioner of Insurance and  
Sean Dilweg, Commissioner of Insurance of the State of Wisconsin  
as Court-Appointed Rehabilitator of the  
Segregated Account of Ambac Assurance Corporation**

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Dated this 17th day of August, 2010.

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## PROCEDURAL POSTURE

The Wisconsin Office of the Commissioner of Insurance and the Commissioner, as the appointed Rehabilitator of the Segregated Account of Ambac Assurance Corporation (collectively, “the Rehabilitator”), submits this brief in opposition to the several policy-specific challenges to the Segregated Account and this Court’s March 24, 2010 injunction (presently scheduled for hearing on September 13) that were filed by the following entities (collectively “Movants”):

- Depfa Bank, plc (“Depfa”) (Dkt. 217-19)<sup>1</sup>;
- Access to Loans for Learning Student Loan Corporation and (“ALL”) (Dkt. 232-35);
- Lloyds TSB Bank plc (“Lloyds”) (Dkt. 232-35)<sup>2</sup>; and
- KnowledgeWorks Foundation and the Treasurer of the State of Ohio (collectively “KnowledgeWorks”) (Dkt. 237-38, 240, 248, 250-51).

This brief does not address objections and challenges set to be argued on September 9 that are commonly advanced by these and the other individual Movants. The Rehabilitator responds to those “common issues” in the separate briefing and affidavits filed today.

This brief addresses only the policy-specific challenges raised by Depfa, ALL/Lloyds, and KnowledgeWorks pertaining to the allocation of certain of their student loan

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<sup>1</sup> Depfa filed two separate motions, captioned and referred to by the parties as “Depfa I” and “Depfa II” (dkt. 220-23). The Depfa II motion pertains solely to a New York court interpleader action in which neither Ambac nor the Segregated Account are named parties. By agreement, Depfa and the Rehabilitator have postponed the briefing schedule on the Depfa II motion in anticipation of a consensual resolution of those issues. All but two of the issues raised in the Depfa I motion will be argued as “common issues” at the hearing on September 9, 2010. The two Depfa I issues to be argued on September 13, 2010 are identified in the undersigned’s August 13, 2010 letter to the Court. Note that, although the Depfa I issue pertaining to allegedly coerced settlements (Depfa’s “Morton’s Fork” argument) will be argued on September 13, the Rehabilitator addressed that argument in his brief pertaining to the “common issues” rather than here.

<sup>2</sup> ALL and Lloyds filed joint motion papers and a combined brief (dkt. 235), which the Rehabilitator hereinafter refers to as the “ALL/Lloyds Br.”

policies to the Segregated Account on March 24, 2010 or to the ongoing assessment process that may result in the allocation of additional student loan policies in the future.

## INTRODUCTION

Movants' briefs in opposition to the actions of the Rehabilitator argue that student loan policies should not be allocated to the Segregated Account or subjected to an assessment process that may result in such an allocation. The Movants claim that, unlike other policies allocated to the Segregated Account, their particular student loan policies are backed by good collateral and will not default. The Movants, however, ignore the fact that it is the underlying debt structure of these policies, and not just the performance of their collateral, that necessitate either allocation to the Segregated Account or further study in the assessment process. As explained further below, many student loan policies (and not just those subject to these objections) are subject to higher than normal interest rates and liquidity requirements that will cause losses to Ambac. Thus, the Movants' emphasis on collateral performance is not relevant to the risks these policies pose to Ambac's financial condition. It is the structure of these deals and the insufficient quantity of the collateral supporting the policies, not necessarily the quality of the collateral, that poses the hazard.

The Rehabilitator has acted to prevent a full rehabilitation of Ambac that would cause additional *avoidable* losses. The Segregated Account has been created to maximize Ambac's claims-paying resources and ensure an equitable apportionment of *unavoidable* losses.<sup>3</sup> The allocation of certain student loan policies to the Segregated Account – whether that has

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<sup>3</sup> As noted in an August 16<sup>th</sup> article by Moody's, a leading commentator on financial guarantee insurers like Ambac, the Rehabilitator's efforts to date have been extremely positive for Ambac's policyholders, creditors and the public. See Ex. 3, at page 2, to the accompanying Van Sicklen Affidavit.

already occurred or whether it will occur following the conclusion of the ongoing assessment process – is within the broad discretion Wisconsin law grants the Rehabilitator.

Were all student loan policies prevented from being allocated to the Segregated Account despite the problematic nature of their debt structures, Ambac's General Account would be imperiled, thus creating avoidable losses that would harm all of Ambac's policyholders. While the Movants may dislike or disagree with the Rehabilitator's decisions regarding their policies, they fail to show that his discretionary decisions were a manifest abuse of his discretion. Indeed, Movants ignore all the legal authority previously cited by the Rehabilitator (and adopted by this Court) for why these types of complex, discretionary choices are entitled to great deference and should not be second-guessed by policyholders or courts.

## **BACKGROUND**

The Rehabilitator has presented many of the facts giving rise to this proceeding in prior filings, including the Verified Petition and other first-day filings and the First Affidavit of Roger A. Peterson (dkt. 86), and the Court described much of the relevant background in its May 27, 2010 Findings of Fact and Conclusions of Law (dkt. 137). Therefore, the Rehabilitator provides only an abbreviated discussion below of those facts and the procedural history most relevant to Movants' objections.

### **I. The Allocation of Certain Student Loan Policies to the Segregated Account and the Assessment Process Governing Further Allocations**

As the Court is aware, the Rehabilitator, cognizant of the challenges created by Ambac's financial condition, sought to slow the outflow of claims-paying resources to prevent insolvency and *ipso facto* "triggers" by certain categories of policyholders. Thus, Ambac was allowed to allocate certain troubled policies or policies with triggers to the Segregated Account. May 27, 2010 Findings of Fact and Conclusions of Law (dkt. 137) ¶¶ 19-20. The Rehabilitator

did this to serve the interests of the public by preserving claims-paying resources for the benefit of all policyholders. (*Id.* ¶ 26.) Policies with actual and projected impairments that were substantial and short-term were allocated to the Segregated Account. (*Id.* ¶ 28.)

As described in the Plan of Operation for the Segregated Account, subject to the Rehabilitator's approval, Ambac allocated certain financial guaranty insurance policies to the Segregated Account. Certain student loan policies were included in that allocation. Some student loan policies were allocated immediately to the Segregated Account, while others were selected to:

... initially remain in the Company's general account, but shall be subject to an assessment process. The assessment shall begin following the entry of an Order for Rehabilitation with respect to the Segregated Account and shall continue for 180 days thereafter (the "Assessment Period"). During the Assessment Period and for a period of 90 days thereafter, any such student loan policy may be allocated to the Segregated Account.

(Verified Pet., Tab 1 at Section IV.4.b.) This Assessment Period is currently underway.

## **II. Objections to the Treatment of the Movants' Student Loan Policies**

ALL/Lloyds filed an objection to the placement of two student loan policies into the Segregated Account. Apart from the common objections to the establishment and structure of the Segregated Account addressed in separate briefing today by the Rehabilitator, ALL/Lloyds claims that these policies have "extremely strong" collateral that distinguish them from other "toxic" exposures allocated to the Segregated Account. (ALL/Lloyds Br. at 6.) ALL/Lloyds acknowledges that "the Commissioner's 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." (*Id.* at 7.)

As the owner of bonds issued by ALL, Depfa also filed an objection to the placement of one ALL policy in the Segregated Account, claiming that there “are no legitimate material differences” between the ALL policy in the Segregated Account and others remaining in the General Account. (Depfa Br. at 22.)

KnowledgeWorks filed a similar objection to the allocation of one policy to the Segregated Account and to the fact that two policies currently in the General Account are subject to the assessment process, which may result in their future allocation to the Segregated Account. KnowledgeWorks admits that the policy allocated to the Segregated Account is a “Surety Bond for Swap Agreement,” but argues that neither it, nor the two policies subject to the assessment process, are “of the type of toxic asset for which the Segregated Account is purportedly designed.” (KnowledgeWorks Br. at 27.) KnowledgeWorks claims that the placement of any of its three policies into the Segregated Account “does not meet the purported goal” of selecting risks “with ‘material projected impairments’ insuring risky investments such as residual mortgage-backed securities, collateralized debt obligations of asset backed securities and credit default swaps.” (*Id.* at 28.)

#### ARGUMENT<sup>4</sup>

The ALL and KnowledgeWorks policies at issue, and, indeed, any student loan policies subject to the assessment process that would be allocated to the Segregated Account, present exactly the type of “material projected impairments” that the Segregated Account was designed to include. Thus, the Movants’ objections should be denied because the placement of

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<sup>4</sup> The Rehabilitator incorporates the argument found in Part II.B of its response to the common objections filed today that it is inappropriate for ALL, the Ohio Treasurer and KnowledgeWorks to intervene on these issues as they are issuers of Ambac-insured bonds and not beneficiaries. Since these parties have not established how they would be adversely impacted by the Injunction Order, they have no right to be heard on their objections to that Order.

these policies in the General Account would only serve to deteriorate the assets of the General Account and prevent all Ambac policyholders from achieving the stability and certainty this proceeding seeks to provide.

**I. The Allocation of the ALL Policies to the Segregated Account Was Appropriate**

As described in the Fourth Affidavit of Roger A. Peterson and the Second Affidavit of Cathleen J. Matanle, a Managing Director of Ambac Assurance Corporation, Ambac insured certain bonds issued by ALL (the “ALL Bonds”). The policies insuring those bonds were allocated to the Segregated Account (the “ALL Policies”). (Second Matanle Aff. ¶ 13.) The ALL Bonds are payable by a trust that holds a portfolio of student loans as collateral (the “ALL Trust”). Ambac – and not any governmental authority -- insures the ALL Trust’s repayment obligations, so Ambac is liable to pay principal and interest on the ALL Bonds to the extent that the ALL Trust fails to do so. (*Id.* ¶ 14.)

Lloyds and Depfa are banks that have each purchased some of the ALL Bonds. (*Id.* at ¶¶ 15-17.) The ALL Trust must make principal payments from available cash flow four times a year to Lloyds and two times a year to Depfa. Both banks have the right to have their bonds redeemed in full in the relative near-term: Lloyds in 2013 and Depfa in 2018. (*Id.* at ¶ 19.) Prior to Depfa and Lloyds purchasing them, the ALL Bonds were not scheduled to be paid back until 2040 and 2041 and only interest would have been due in the interim. (*Id.*)

Additionally, once the ALL Bonds were purchased by Lloyds and Depfa, the bonds bore interest at much higher rates than those that were in effect prior to their acquisition by the banks. Upon the occurrence of certain defaults under the agreements at issue, the banks are entitled to charge even higher rates, which would materially deteriorate all the assets in the ALL Trust. (*Id.* ¶ 18.) Were it not for the Injunction Order, both banks would have had the contractual right to increase interest rates payable on the ALL Bonds, thus further depleting the



assets of the ALL Trust. Allocating the ALL Policies to the Segregated Account prevented that negative action. (*Id.*)

When the Segregated Account was created and this rehabilitation process began, the Rehabilitator and Ambac agreed that the ALL Policies should be placed into the Segregated Account because the ALL Trust does not have sufficient assets generating enough income to pay the obligations of the ALL Bonds. (*Id.* ¶¶ 20-21; Fourth Peterson Aff. ¶ 6.) The changes in interest rates and the acceleration of the principal payment schedule described above means that the ALL Trust must use principal payments received on the underlying student loans to pay interest on the bank bonds. Selling trust assets in that fashion will further degrade the ability of the ALL Trust to make future payments called for by the ALL Bonds. (Second Matanle Aff. ¶ 20.)

The problem with these policies lies not in the quality of the collateral, but rather in its limited quantity. Because Ambac will be liable when the ALL Trust fails to meet its obligations, the deterioration of the assets of the ALL Trust presented an ever-growing threat to Ambac. Ambac expects to receive substantial loss claims resulting from the ALL Policies. (*Id.* ¶ 20.) The liabilities of the ALL Trust currently exceed its assets by \$19.8 million, a figure roughly one-third higher than it was just six months earlier. (Fourth Peterson Aff. ¶ 6.) If these policies were not allocated to the Segregated Account, they would imperil the condition of the General Account.

## **II. The Allocation of the KnowledgeWorks Swap Policy to the Segregated Account Also Was Appropriate**

As described above, KnowledgeWorks objects to the treatment of three Ambac policies pertaining to student loan-backed bonds issued by the Treasurer of the State of Ohio (the “Ohio Bonds”). These policies are numbered 23838BE, 26053BE and SW0240BE (the “Ohio

Policies”). One of the Ohio Policies, SW0240BE (the “Swap Policy”), was allocated to the Segregated Account. The other two Ohio Policies were allocated to the General Account, but are subject to the ongoing assessment process. (Second Matanle Aff. ¶¶ 23, 31-34.)

The Swap Policy at issue differs from the other two Ohio Policies in that it insures payment due from the issuer of the Ohio Bonds under a swap agreement, as opposed to payment of the Ohio Bonds themselves. The purpose of this Swap Policy is to provide a hedge against a mismatch between the interest that must be paid on the Ohio Bonds and the interest generated by the student loans held by the trust that must repay the bonds. (*Id.* ¶ 25.)

The underlying swap insured by the Swap Policy is governed by an agreement entitling the swap counterparty to terminate the swap based on the occurrence of certain bankruptcy or insolvency events involving Ambac or upon the financial condition of Ambac. (*Id.* ¶ 26.) Earlier in this proceeding, similar contractual provisions were described as *ipso facto* triggers. In connection with any such termination, the issuer might be required to pay a settlement amount to the swap counterparty. Should the issuer default on such an obligation, the swap counterparty could demand payment from Ambac. (*Id.* ¶¶ 27-28.)

In the absence of the Injunction Order, which prevents the exercise of such termination rights in relation to policies allocated to the Segregated Account, the issuer and Ambac would be exposed to the risk of termination. (*Id.*) If the Swap Policy were removed from the Segregated Account, thus allowing termination of the swap agreement, the trust could be required to make a substantial termination payment. Ambac would be liable to make this termination payment if the trust were unable to do so. (*Id.*)

Ambac and the Rehabilitator allocated many policies having similar contractual triggers to the Segregated Account. Approximately 150 other similar policies insuring

obligations under swap agreements, referred to as swap surety policies, are allocated to the Segregated Account. The Swap Policy related to the Ohio Bonds is being treated in the same manner as these other swap surety policies. (Fourth Peterson Aff. ¶ 7; Second Matanle Aff. ¶ 29.) KnowledgeWorks' objection fails to explain why its Swap Policy should be treated differently than the other swap policies. Because of the contractual triggers embedded in them, all of the swap policies merit allocation to the Segregated Account under the criteria developed by OCI and the Rehabilitator. (*See Verified Pt., Tab 1 at IV.*)

### **III. The Assessment Process for Student Loan Policies and Their Potential Future Allocation to the Segregated Account Is Appropriate**

The other two Ohio Policies at issue in the KnowledgeWorks objection, No. 23838BE and No. 26053BE, were provisionally allocated to the General Account for disposition pursuant to the assessment process. These two policies, along with numerous other student loan policies, are subject to the assessment process defined in the Plan of Operation for the Segregated Account. (*See also* Second Matanle Aff. ¶¶ 31-34; Fourth Peterson Aff. ¶ 8.) Many of these policies have debt structures similar to those of the ALL Policies (where the limited assets are being depleted to pay higher-than-expected interest rates and face an accelerated principal payment schedule) or are like the two Ohio Policies (where higher-than-expected interest rates will be paid over the long-term life of the policies due to the failure of auctions to set the interest rates of the securities). At the time the rehabilitation of the Segregated Account began, the Rehabilitator determined that further study of certain of the student loan policies was warranted before making a final decision as to which should or should not be allocated to the Segregated Account. (Second Matanle Aff. ¶ 32; Fourth Peterson Aff. ¶ 8.)

The Plan of Operation sets forth a timeframe for an Assessment Period to continue for 180 days following the entry of the Order of Rehabilitation. During that

Assessment Period and for 90 days thereafter, any identified student loan policy may be allocated to the Segregated Account. (Fourth Peterson Aff. ¶ 8.) That Assessment Period is ongoing. The Rehabilitator is overseeing the development and application of the criteria to assess the student loan policies in the General Account to decide which will need to be allocated to the Segregated Account because they carry material risks of future losses. (*Id.* ¶ 9.) Notably, had the ALL Policies and the KnowledgeWorks' Swap Policy been left initially in the General Account for the Assessment Period, they would have been allocated to the Segregated Account under any of the assessment tests the Rehabilitator is considering. (*Id.* ¶ 10.)

Apparently, KnowledgeWorks is objecting to the mere study of these policies and the possibility that they may be allocated to the Segregated Account. By objecting to even the assessment of these policies and their effect on all Ambac policyholders, KnowledgeWorks ignores the broad discretion Wisconsin law grants the Rehabilitator. As with the objections relating to the ALL Policies, KnowledgeWorks bases its argument on a distinction without a difference. The distinction all the Movants point to is the alleged quality of the underlying collateral, but the debt structure of these policies, and, indeed, all policies subject to the assessment process, mean that the risks inherent with these policies are no different than those of the other policies allocated to the Segregated Account.

The Rehabilitator will carefully monitor the selection and application of criteria to the student loan policies subject to the assessment process. Those policies that would increase the risk of a larger insolvency because they have projected losses, triggers, or other characteristics that pose threats to the fair and equitable distribution of Ambac's limited claims-paying resources will be subject to allocation to the Segregated Account under the same rationale under which the other policies have already been allocated to the Segregated Account. (*Id.* ¶ 9.)

The assessment process and the eventual allocation of policies currently subject to the assessment process are being undertaken in order to advance the best interests of all Ambac policyholders.

**IV. The Rehabilitator's Actions With Regard to Student Loan Policies Has Been Reasonable and Does Not Violate the Equal Protection Clause**

Movants also allege that the Rehabilitator's actions violated the Equal Protection Clause of the United States and Wisconsin Constitutions by supposedly treating the Movants differently from other similarly situated policyholders and policy beneficiaries. (ALL/Lloyds Br. at 19-20; Depfa Br. at 22; KnowledgeWorks Br. at 15-16, 27-28.) These arguments mirror those already attempted by Wells Fargo and the LVM Movants and rejected by this Court. (*See* July 16, 2010 Order Denying Motions of Wells Fargo Bank and Certain LVM Bondholders.)

The Equal Protection Clause does not render unconstitutional any government action that makes distinctions among individuals, groups, beneficiaries of insurance policies, or, as in this case, the insurance policies themselves. As long as the distinction does not impair a fundamental right or a "suspect class," courts will uphold the classification drawn if "any state of facts reasonably may be conceived to justify it." *Dandridge v. Williams*, 397 U.S. 471, 485 (1970) (emphasis added, internal quotation omitted). Even if it results in a disparity in treatment, "[s]uch a classification cannot run afoul of the Equal Protection Clause if there is a rational relationship between the disparity of treatment and some legitimate government purpose." *Heller v. Doe*, 509 U.S. 312, 320 (1993).

Movants' Equal Protection challenge to the allocation of student loan policies fails for several reasons. First, it is important to note that allocation decisions were not made on the basis of whether the policy at issue insured student loans or "toxic" assets. Rather, allocation decisions were made based on whether the policy at issue had material projected losses and/or

triggers that jeopardized Ambac's liquid claims-paying resources and thus put all Ambac policyholders at risk, regardless of the type of collateral in the transaction that was insured by the policies in question. In light of the Rehabilitator's statutory mission to protect policyholders and the public while rehabilitating financially distressed insurers, Wis. Stat. § 645.01(4), that classification is not irrational. Moreover, the policies at issue squarely fit that classification. Thus, these policies are similarly situated to other policies allocated to the Segregated Account.

Second, it is unclear how the formation of the Segregated Account has resulted in disparate treatment for beneficiaries of these policies, as compared to General Account policyholders. As noted in other filings by the Rehabilitator, all policyholders benefit from the rehabilitation proceeding in that it protects Ambac's liquid resources from an inefficient and inequitable "run on the bank," to the detriment of those policyholders who suffer losses beyond the near-term.

To the extent the Movants claim the allocation of certain policies to the Segregated Account establishes "inferior" treatment, removing these substantially impaired policies from the Segregated Account would not improve the treatment of those policies. Rather than receiving distinctly inferior treatment, Segregated Account policyholders are receiving the same treatment they would receive in a full-blown rehabilitation of all of Ambac, with a claims-paying resource pool at least \$1 billion greater due to smaller collateral damage strains on Ambac's assets. To allow individual policyholders to force removal of individual impaired policies from the Segregated Account would only benefit the Movants at the expense of all other Ambac policyholders. If the Movants were successful, beneficiaries of the policies at issue would become the *only* Ambac policyholders with substantial projected claims in the General Account, materially contributing to a "risk that Ambac will become insolvent before its in-force

policy obligations” to all other policyholders are satisfied. (Findings ¶ 19.) Removing these policies from the Segregated Account would not give Movants treatment equal to other policyholders. It would instead provide them superior treatment at the expense of the other policyholders of the General and Segregated Accounts.

Finally, as described at length in the Rehabilitator’s other briefing filed today, the Rehabilitator’s actions regarding the student loan policies were expressly authorized by clear statutory grants of discretion to the Rehabilitator, and those actions constituted a rational, practical exercise of his discretion in response to the threats posed by Ambac’s deterioration. The Rehabilitator is working to effectuate a long-deliberated solution to the complex problems of Ambac and the high stakes involved for policyholders and the public.<sup>5</sup> These allocations are reasonably related to the Rehabilitator’s legitimate goal of protecting Ambac policyholders from short-term demands that could exhaust Ambac’s ability to pay claims, and are thus constitutional. The allocation of certain student loan policies to the Segregated Account seeks to contain the outflow of claims-paying resources and equitably distribute the risk.

Movants’ objections are based on their own narrow interpretations of what they currently perceive to be in their best interests. By contrast, the Rehabilitator’s decisions are motivated by the desire to protect the interests of all policyholders and the public. Movants

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<sup>5</sup> Furthermore, even if Movants had identified some ambiguity regarding the Rehabilitator’s authority to take the actions at issue with regard to the student loan policies — and they have not — the Rehabilitator is entitled to have such ambiguities resolved in its favor. As the Court of Appeals has noted, “OCI is charged by statute with administering and enforcing Wis. Stat. chs. 600 to 655[,]” and Wisconsin courts “may give varying degrees of deference to an agency’s interpretation of a statute that it is charged with administering.” *Nat’l Motorists Ass’n v. Office of the Comm’r of Ins.*, 259 Wis. 2d 240, 251, 655 N.W.2d 179 (2002). Of those degrees of deference, “great weight deference” is appropriate where, as here, “an agency’s interpretation and application of a statute are intertwined with value and policy determinations inherent in the agency’s statutory decision-making function.” *Id.*; see Wis. Stat. § 611.24(2) (charging the Commissioner with determining whether a segregated account would be contrary to law or the interests of any class of insureds); Wis. Stat. § 645.01(4) (charging the Commissioner with applying the rehabilitation statutes for the “protection of insureds, creditors, and the public generally”).


make no effort to describe the effect their requested relief would have on the other Ambac policyholders. Their silence speaks volumes.

### CONCLUSION

The Rehabilitator respectfully requests that the Court deny Movants' objections related to the treatment of student loan policies and affirm the Injunction Order without modification.

Dated this 17th day of August, 2010.

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