

STATE OF WISCONSIN

CIRCUIT COURT

DANE COUNTY

In the Matter of the Rehabilitation of:

Case No. 10 CV 1576-I

SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

**REPLY BRIEF BY ALL STUDENT LOAN, 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 a 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 of various bonds issued by ALL Student Loan and purchased by Lloyds Bank and as a beneficiary of such Policies (hereinafter “Movants”), submit this Reply 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 recent pre-Rehabilitation Order actions by Ambac and the Commissioner of Insurance for the State of Wisconsin (the “Commissioner”). Movants are “Interested Parties” pursuant to paragraph 12 of the 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 their rights with respect to the three insurance policies placed into the Segregated Account.

The Wisconsin Office of the Commissioner of Insurance and the commissioner as the appointed Rehabilitator of the Segregated Account of Ambac (collectively “the Rehabilitator”), submitted two separate briefs on August 17, 2010 in opposition to the original brief filed by ALL and Lloyds on June 22, 2010 (the “Rehabilitator’s Opposition”). The first is a fourteen (14) page brief which also includes a response to separate Movants Depfa Bank, plc (“Depfa”) and KnowledgeWorks Foundation and the Treasurer of the State of Ohio (“KnowledgeWorks”).¹ The key issue for ALL and Lloyds are pages 6-7 of that brief that address the issue as to why

¹ The undersigned do not represent the interest of those separate Movants and, although Depfa is a bondholder under one of ALL’s policies (in which Lloyds has no interest), ALL and Lloyds stand separate from and do not adopt the arguments made by Depfa.

“The Allocation of the ALL Policies to the Segregated Account Was Appropriate.” The second is a forty-six (46) page brief that responds to the same parties in the first brief plus five additional parties. That brief specifically addresses the standing of ALL to bring its motions (page 9) and also addresses the specific challenges made by ALL and Lloyds to the lawfulness of the Segregated Account (pages 18-35).

ALL and Lloyds have four major points in reply to the Rehabilitator’s Opposition²:

1. The Rehabilitator asserts that the Segregated Account has “access to all of the assets of Ambac,” other than \$100 million, yet the limited documents made available and that it alleges support that contention either belie this contention or do not clearly provide for such. (Affidavits of Frederick J. Bingham, William C. Barbagallo, and Andrew Stuehrk) Further, the Rehabilitator refuses to permit either formal discovery or even informational requests to permit Movants to verify the basis for the Rehabilitator’s contention, which is arbitrary and unreasonable and amounts to a denial of due process. *Insurance Corp. of Ireland, Ltd. v. Compagnie des Bauxites de Guinee*, 456 U.S. 694, 708-09 (1982); *In re Yellowstone Mountain Club, LLC*, 2010 WL 3222534 at 31 (Bkrcty. D.Mont. 2010). Moreover, the Rehabilitator’s contention is wholly inconsistent with the other assertion by the Rehabilitator that the creation of the Segregated Account was necessary to protect the policies in the General Account, as the remaining policies in the General Account would not be protected if 98% of the assets of that General Account were available to pay claims of the Segregated Account.

2. Notwithstanding the inconsistent arguments by the Rehabilitator in #1 above, ALL and Lloyds agree with the Rehabilitator that, in order for that Segregated Account to have been able to “to have and maintain an adequate amount of capital and surplus” as required by

² ALL and Lloyds will address other points from other briefs filed by the Rehabilitator and Ambac in this brief.

Wis. Stat. § 611.24(3)(a) when it was formed, an amount of the assets of the General Account, other than \$100 million he specifies, must be pledged to the liabilities of the Segregated Account if the Segregated Account has any possibility of having “adequate ... surplus” as required by law. ALL and Lloyds contend that the term “surplus” in the insurance industry and under Chapter 611 was intended to ensure that there were more admitted assets than liabilities in the Segregated Account when that account was formed, and that those liabilities must include the projected future claims such as those against the ALL policies (i.e. case reserves discounted to present value). (Bingham Affidavit, ¶¶ 16-26) The Verified Petition provides for the possibility of a “Payment Plan” involving immediate cash payments and “interest bearing surplus notes”³ on the claims of the Segregated Account when they come due and payable, however, this does not satisfy the requirement of § 611.24(3)(a) to maintain adequate capital and surplus, since the Segregated Account cannot pay claims submitted in full pro-rata to all policyholders in the same class. *Id.* Payment of claims with surplus notes is an admission that there is not adequate surplus, as the ones being paid with the surplus notes are being subordinated to the other similarly situated policyholders.⁴ *See Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969). However, if the Rehabilitator will stipulate with ALL and Lloyds that the bondholders claims under the ALL policies, if and when those claims become due under the policies, will have access to the remaining assets of the Segregated Account and also have “access to all of the assets of Ambac,” less the \$100 million as set forth by the Rehabilitator, and will be paid to the full extent available from those assets when presented (and not at some future date), and have

³ A surplus note is a highly subordinated form of debt in that the note holder can only be repaid after all other operational debts have been satisfied.

⁴ The Verified Petition (¶12(c)) contains no detail as to the split between the cash payments and the surplus notes, and only states that it is a “formulated plan” to be set out in the Rehabilitation Plan which has yet to be published.

that stipulation approved by the court, then ALL and Lloyds will be willing to withdraw their motions.

3. The Rehabilitator's contention that the allocation of the ALL policies to the Segregated Account was appropriate is erroneous in that the Rehabilitator did not specify the amount of the future claims that may arise from the ALL policies when the policies were allocated to that account. Therefore, the Rehabilitator's actions in allocating the ALL policies to that account were without a reasonable basis. The Rehabilitator's affidavit testimony filed on August 17, 2010 only addresses the current shortfalls in the ALL Trust and not the future potential claims against the ALL policies in 2013 and 2018. The Rehabilitator's contention again assumes, without any actuarial or expert testimony, that there will be future losses by the bondholders Lloyds and Depfa, but refuses to permit either formal discovery or even informational requests to permit Movants to verify the contention. The Rehabilitator concedes that there has never been one claim on the ALL policies. Rather, he only argues about "material projected impairments," without presenting evidence as to ALL's policies of that projected impairment.⁵ Additionally, the Rehabilitator ignores the fact that, unlike the other policyholders in the Segregated Account, ALL and Lloyds are wholly innocent with respect to those potential, future losses, as the only reason that there is any potential for losses against the ALL policies is the financial downfall of Ambac. More specifically, it was the deterioration in the financial condition and the subsequent downgrade of Ambac's credit rating that resulted in Lloyds, in its capacity as Liquidity Provider for the ALL Series V Bonds, purchasing such bonds from the

⁵ "The Policies" have not had any previous claims against them, the risk of future claims is speculative, and the collateral is in the form of student loans that are guaranteed by the United Student Aid Funds, Inc., among others, and reinsured by the Department of Education, for at least 97% of any defaulted principal and interest accrued thereon guaranteed. (Peterson Affidavit., Ex. A. at ¶ 12-14)

existing bondholders, who were no longer comfortable with Ambac risk. The interest payable on bonds held by Lloyds was higher than that payable in the hands of the previous bondholders because it was designed to reflect the cost to Lloyds of funding the purchase, with the result that there was a deterioration in the Trust. Lloyds fully performed the obligations that it was contracted to do. (Affidavit of Thea Watkins) Thus, equity and fundamental fairness dictate that Ambac not place these policies in the Segregated Account at least unless and until there is evidence to support such action and until after other truly toxic policies are commuted, after which it may no longer be necessary.

4. The Rehabilitator's contention that ALL has no standing in this action but only Lloyds is wholly without merit. The two Financial Guaranty Insurance Policies 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 in question. ALL not only administers the loans but has the right as Obligor under the policies to have the Trustee submit the claim on its behalf and pay the proceeds to the beneficiary or have the third party beneficiary file a claim on its own behalf.

ARGUMENT

Before Movants address the merits of this Reply, the Rehabilitator has raised a procedural hurdle in an attempt to prevent the Court from following through on its promise to hear these motions to modify or dissolve this Court's Order. Paragraph 12 of the Order for Temporary Relief authorizes interested parties, such as the Movants, to file motions seeking modification or dissolution of the Order "no later than 90 days following the issuance of this Order." (Order for Temporary Relief at 13-14.) Under this paragraph 12, the Court could set a briefing and hearing schedule if timely motions were filed. Relying on the Order, on June 22, 2010, the Movants

timely filed their motion and initial brief. In response to the motions of the Movants and several other interested parties, the Court then set a schedule for further briefing and hearings on the motions.

The Movants fully complied with paragraph 12 of the Order for Temporary Relief by filing their June 22, 2010 motion. Nevertheless, the Rehabilitator, in an inconsistent argument, states that he “does not object to allowing Movants to be heard on the merits of their motions,” but that the Court’s prior findings and conclusions in this case can be the basis for denying applicable parts of the Movants’ motion, including the contention that the creation of the Segregated Account violated Wisconsin law. Rehabilitator’s “Consolidated Brief in Opposition to All Motions Scheduled for Hearing on September 9, 2010” (“Consolidated Brief”) at 8-9, 9 n. 9, and 12-17.) The right to be heard, however, is meaningless if the Court does not have to listen.

The Court should evaluate the Movants’ motion on its merits, not based on rulings it made from the May 25, 2010 and July 9, 2010 hearings. The Movants had not appeared in this case at all at the time of the May 25, 2010 hearing, and they did not receive any notice of their right to be heard on their objections to the Order for Temporary Injunctive Relief at either the May or the July hearing. On the other hand, they were explicitly notified in the Order for Temporary Injunctive Relief of their right to file motions by June 22, 2010. That Order unquestionably notified interested parties that the Court would evaluate timely motions within the scope of paragraph 12 of the Order for Temporary Relief⁶ on their merits and with an open

⁶ Although the Rehabilitator asserts that “many” arguments by interested parties “fall outside the spirit of paragraph 12,” it is not objecting to the scope of the motions. Consolidated Brief at 7-8.)

mind. Fundamental fairness and due process requires no less.⁷ Indeed, as stated by the Wisconsin Supreme Court in a venerable decision, “to say that [the] rights [of nonparties] had been concluded and cut off by proceedings had in the action before they had an opportunity to be heard would be little less than absurd.” *Castle v. City of Madison*, 113 Wis. 346, 349-50, 89 N.W. 156 (1902).

Resolving any part of the Movants’ motions on procedural grounds instead of on the merits requires some legal principle for doing so. There are several principles under which courts may rely on prior decisions or orders to procedurally bar a claim or argument; these include, for example, the doctrines of claim preclusion, issue preclusion, and law of the case.⁸ The Rehabilitator, not surprisingly, fails to rely on these or any other established legal doctrines, presumably because he correctly concluded that they do not apply to the Movants’ motion. (Claim preclusion and issue preclusion require a prior judgment on the merits in a separate proceeding and law of the case applies to the binding effect of appellate proceedings in the same case. *Kruckenberg v. Harvey*, 2005 WI 43, ¶¶ 19 n. 13 and 21; *Univest Corp. v. General Split Corp.* 148 Wis. 2d 29, 38, 435 N.W.2d 234 (1989)).

Instead of trying to support a procedural bar on established principles, the Rehabilitator advances arguments that have no legal support.⁹ Though vigorously asserting that the Movants

⁷ Contrary to the Rehabilitator’s mischaracterizations of the Movants’ arguments (e.g., that they ask the Court to “adopt voluntary amnesia” or “pretend that it had not already ruled on [the] issues, *id.* at 13 and 17), the Movants’ simply seek a fair hearing on the merits of their arguments; in considering the arguments, the Court can, of course, review prior orders and decisions in this case (as well as decisions by Wisconsin courts or any other courts) as long as it does not give any binding effect to any prior orders.

⁸ In Wisconsin, the term “claim preclusion” replaced “res judicata,” and “issue preclusion” replaced “collateral estoppel.” *Kruckenberg v. Harvey*, 2005 WI 43, ¶ 18 n. 11, 279 Wis. 2d 520, 694 N.W.2d 879 (quoting and citing other cases).

⁹ The Rehabilitator’s reliance on *U.S. v. Blagojevich*, ___ F.3d ___, 2010 U.S. App. LEXIS 13631 (7th Cir. July 12, 2010), is misplaced. *Blagojevich* involved a motion to intervene by the press

are not parties, he nevertheless argues that they had “notice and the opportunity to be heard at the May 25 hearing” and at the July 9, 2010 hearing on the Wells Fargo and LVM Bondholders hearing. The Movants, however, had not been formally served with any process, nor were they informed that their rights would be adjudicated in the May or July hearing. More importantly, the notice they did receive explicitly gave them until June 22, 2010 to seek relief of modifying or dissolving the temporary injunction. And, by the time of the July 9, 2010 hearing, the Court had already issued formal notices of the September 9, 2010 and September 13, 2010 hearings on the June 22, 2010 motions. The Movants are entitled to be heard at those hearings and for their arguments to be considered on their merits.

I. The Segregated Account Does Not Have “Access to All of the Assets of Ambac” as the Rehabilitator Contends

A. The “Resources” Cited by the Rehabilitator to Support the Segregated Account are Conditional and Flawed

At the outset, Movants point out that the Rehabilitator’s Opposition emphasizes the wrong part of Wis. Stat. § 645.23(a) in his analysis. Section 645.23(a) provides:

Capital and surplus. The commissioner shall specify in the certificate of authority of a newly organized corporation the minimum capital or the minimum permanent surplus and the initial expendable surplus to be provided for each segregated account. *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.*

The Rehabilitator relies on the terms “minimum capital or the minimum permanent surplus” in the Segregated Account and the fact that the Commissioner has discretion in determining those minimum amounts. However, §§ 611.19 and 611.24(3)(a) refer to minimum

during the criminal trial of a former Illinois Governor on the issue of release of the names of jurors prior to the end of the trial; even though the press had actual notice of the issue two years before the trial began, the 7th Circuit held that a petition to intervene during trial was timely. In any event, case law involving the First Amendment rights of the press to report news is inapplicable to the Movants’ rights in this case.

capital and surplus requirements in the context of “Initial capital and surplus requirements” or “in the certificate of authority of a newly organized corporation.” As the Affidavit of Frederick J. Bingham points out, “There is no denying that the policies in question came from an existing corporation and the legislature’s mandate in that regard is mandatory, not discretionary, as it requires that the Segregated Account with established liabilities on existing policies “**shall...** have and maintain an adequate amount of capital and surplus....” Bingham Affidavit, ¶ 20. (Emphasis added.)

The Rehabilitator’s Consolidated Brief then goes on to ignore the importance of the words “adequate capital and surplus.” Instead, at page 18, he states that “the Segregated Account has access to all of the assets of Ambac, in pari passu with General Account policyholders, unless the payment of claims would cause Ambac’s **assets** to fall below \$100 million, a number that constitutes less than two percent of Ambac’s claim paying assets.” (Emphasis added.) First, it is assumed that the Rehabilitator intended to use the term “surplus” instead of “assets” in reference to the \$100 million amount. “Surplus” constitutes the amount by which a company’s admitted assets exceeds its liabilities. Bingham Affidavit, ¶ 18. Moreover, although Movants would like to take the Rehabilitator at his word and believe that “all assets” (or 98% of the assets) of Ambac are available to pay the future claims under the ALL policies, the only documents in support thereof (the Secured Note and Aggregate Excess of Loss Reinsurance Agreement), do not support that bold assertion.

Although Movants have attempted to obtain financial and other information to verify the assertions of the Rehabilitator with respect to the claims concerning the assets, surplus, Reinsurance Agreement, Secured Note and a myriad of other matters that form the basis for the assertions made in the Rehabilitator’s Opposition and in the Plan of Operation, the Rehabilitator

has failed to provide any such information. Affidavit of Lawrence Bensky, ¶¶ 1-3. This failure to provide documentation amounts to a violation of Movants' right to due process. *Insurance Corp. of Ireland, Ltd. v. Compagnie des Bauxites de Guinee*, 456 U.S. at 708-09 (denial of due process caused in producing documents led to party's failure to carry its burden of proof); *In re Yellowstone Mountain Club, LLC*, *supra* at 31 (Court did not allow the case to go forward because it denied a party its Constitutional right to fundamental due process.) Thus, Movants' only information as to what is available to the Segregated Account to cover the liabilities in that account is contained in the Plan of Operation and the documents referred to therein for its support.

Section V of the Plan of Operation, "Provision for Capital and Surplus," is specific to the relevant issue under Wis. Stat. § 645.23(a). It provides that "The Segregated Account will support the liabilities allocated to it with the following resources," and lists four resources.

(1) A Secured Note in the amount of \$2 billion, the principal of which is payable in forty (40) years, with 4.5% quarterly interest, subject to "mandatory prepayments" of cash for claim liabilities, loss settlements, commutations, surplus notes on Covered Policies (not defined) "in accordance with the Plan of Rehabilitation" (not yet published) and administrative expenses or other amounts "as ordered by the Rehabilitator" minus the liquid assets available to the Segregated Account.

(2) An Aggregate Excess of Loss Reinsurance Agreement which provides that Ambac agrees to reinsure the Segregated Account, above the amounts covered under the \$2 billion Secured Note, whereby the Segregated Account may cede the losses under the undefined Covered Policies as they come due to Ambac according to the Plan of Operation.

(3) Surplus Notes: The Plan provides that the General Account may issue surplus notes to the policyholders of the Segregated Account if the cash payments and surplus notes from that account are insufficient to pay claims liabilities, again, "in accordance with the Plan of Rehabilitation."

(4) Collateral Security: The collateral that the Segregated Account will have in the General Account as security for the obligations of Ambac in the Secured Note, e.g. installment premiums for the policies and assumed reinsurance allocated to the Segregated Account, reinsurance recoveries on insurance policies, etc.

The above "resources" are in fact and law what the Rehabilitator's Consolidated Brief refers to as the basis for how the Segregated Account is "capitalized with more than 98 percent of

Ambac's current assets" and how it "has access to all of the assets of Ambac" except the 2% amount that would cause Ambac's assets to fall below the \$100 million surplus amount.

The first problem with the Rehabilitator's assertion is that the documents do not support them. The Secured Note is supposed to be exactly that – secured. It should set forth clear payment terms upon which both parties may rely for years to come such that the obligee (the Segregated Account policyholders and third party claimants) will know that, now that the insurance policies have been pulled out from under them and placed into the Segregated Account without notice or consent, at least the new terms of payment on those policies from the Segregated Account are clear. However, the terms for payment are all "in accordance with the Plan of Rehabilitation," which has yet to be published, over which the obligee has no control and which may be altered at any time. Bingham Affidavit, ¶ 22.

For example, the "mandatory prepayments" under the Secured Note call for payouts of "surplus notes" which must be subordinated to all other policyholder, claimant and beneficiary claims, and all other classes of creditors other than surplus note holders, and require that interest and principal repayments require prior approval of the Commissioner. *See* Statement of Statutory Accounting Principles No. 41 ("SSAP 41") in the Accounting Practices and Procedures Manual adopted by the National Association of Insurance Commissioners. In short, the Secured Note is based on conditional, uncertain payments that can be subordinated and modified if the Rehabilitator decides to modify the Plan of Rehabilitation.

The Bingham Affidavit summarizes why the value of the Secured Note is "dubious:"

Whatever value the Secured Note has for counting towards a calculation of surplus is dubious because of the numerous contingencies contained therein which make the terms, timing and amounts of payments very speculative. I have worked for and with state Departments of Insurance and with Plans of Rehabilitation under statutory language similar to the language in Wisconsin and the fact is that Plans of Rehabilitation are always subject to modification by the Rehabilitator

and Court. Moreover, the ‘mandatory prepayments’ under the Note call for payouts of “surplus notes’ which must be subordinated to all other policyholder, claimant and beneficiary claims, and all other classes of creditors other than surplus note holders, and require that interest and principal repayments require prior approval of the Commissioner. In short, the Note is based on conditional, uncertain payments, some of which can be subordinated and modified if the Rehabilitator and Court decide to modify the Plan of Rehabilitation.

Id. at ¶ 22.

The alleged backup support for the \$2 billion Note is the Aggregate Excess of Loss Reinsurance Agreement (“Reinsurance Agreement”). “Reinsurance is a contractual arrangement whereby one insurer (the ceding insurer) transfers all or a portion of the risk it underwrites pursuant to a policy or group of policies to another insurer (the reinsurer).” Barry R. Ostrager & Thomas R. Newman, *Handbook on Ins. Coverage Disputes* § 15.01[a] (12th ed. 2004) (citing *Colonial Am. Life Ins. Co. v. Commissioner*, 491 U.S. 244, 109 S.Ct. 2408, 105 L.Ed.2d 199 (1989)). See also *National Union Fire Ins. Co. v. American-Re Ins. Co.*, 441 F.Supp.2d 646, 650-652 (S.D.N.Y. 2006). In this case, the Rehabilitator is asserting that it is protecting the Segregated Account with 98% of the assets of Ambac by means of the Secured Note and Reinsurance Agreement (attaching above the Secured Note). Thus, the Reinsurance Agreement, which is issued by the same company that issued the underlying insurance policies it is now purporting to reinsure, should be airtight, with no conditions, i.e. as solid as the insurance policy that it replaces. Stuehrk Affidavit, ¶ 11-12.

In *National Union Fire Ins. Co. v. American-Re*, the Court discussed how this type of protection of the insurance policies by a reinsurer is accomplished, i.e. in the “follow the fortunes” and “follow the settlements” provisions of a reinsurance agreement:

While the reinsurer is not required to pay for losses that are not covered under the underlying policy, “[a] reinsurer cannot second guess the good faith liability determinations made by its reinsureds, or the reinsured’s good faith decision to waive defenses to which it may be entitled.” *Id.* § 15.04[b] (quoting *Christiana*

Gen. Ins. Corp. v. Great Am. Ins. Co., 979 F.2d 268, 280 (2d Cir. 1992), *citing in Int'l Surplus Lines Ins. Co. v. Certain Underwriters & Underwriting Syndicates at Lloyd's of London*, 868 F.Supp. 917, 921 (S.D. Ohio 1994)).

The “follow the fortunes” doctrine obligates the reinsurer to indemnify the ceding insurer (the “cedent”) for any payments the cedent makes for claims covered by the underlying insurance. *Id.* § 16.01[a]. “The purpose of this doctrine is to prevent the reinsurer from second-guessing the settlement decisions of the reinsured, thereby promoting good faith settlements by the reinsured.” *N. River Ins. Co. v. Employers Reins. Corp.*, 197 F.Supp.2d 972, 978 (S.D. Ohio 2002); *see also* Ostrager & Newman, *Handbook on Ins. Coverage Disputes* at § 16.01[a] (doctrine “preclude[s] wasteful relitigation by a reinsurer of defenses to underlying policy coverage in cases where the ceding insurer has in good faith paid a settlement”). The Second Circuit has held that the “follow the fortunes” doctrine “simply requires payment where the cedent’s good-faith payment is at least arguably within the scope of the insurance coverage that was reinsured.” *Mentor Ins. Co. (U.K.) v. Norges Brankasse*, 996 F.2d 506, 517 (2d Cir. 1993), *cited in Int'l Surplus Lines Ins. Co.*, 868 F.Supp. at 920. “This standard is purposefully low” and the decision making process of the ceding insurer is not subject to de novo review. *Int'l Surplus Lines Ins. Co.*, 868 F.Supp. at 921.

Id. at 650-652.

In fact, § 4.01 of the Reinsurance Agreement purports to be a standard “follow the fortunes” clause. However, it has a significant caveat whereby the protection of the Segregated Account, as the cedent-insurer, under such a clause is illusory, as it states that the reinsurer’s liability follows that of the cedent “except as modified by the Plan of Rehabilitation” and again, no such Plan has been filed and any such plan may be modified by the Rehabilitator and the Court at any time. The “follow the fortunes” clause is a very significant protection for the cedent under a reinsurance clause and, if it is severely undercut in this manner, the reinsurance contract as a whole is undercut. In the absence of a “follow the settlements” clause and with a “follow the fortunes” clause that has a caveat that makes it effectively unenforceable, the Reinsurance Agreement is hardly the same as permitting the creditors of the Segregated Account to have “access to all of the assets of Ambac.” Stuehrk Affidavit, ¶ 12; Barbagallo Affidavit, ¶¶ 12-15; Bingham Affidavit, ¶¶ 23-25.

In any reinsurance agreement where the cedent is seeking protection, there is also a “follow the settlements” clause. The “follow the settlements” provision has been interpreted in the same manner as the “follow the fortunes” clause, *i.e.* the reinsurer cannot second-guess the cedent’s claims handling. *See, e.g., North River Ins. Co. v. ACE American Reins. Co.*, 361 F.3d 134, 139 (2d Cir. 2004); *Travelers Cas. & Sur. Co. v. Gerling Global Reins. Corp. of America*, 419 F.3d 181, 193 (2d Cir. 2005). A typical such provision provides: “All claims involving this reinsurance, when settled by the Company, shall be binding on the Reinsurer, who shall be bound to pay its proportion of such settlements....” *See* Stuehrk Affidavit, ¶ 12. There is no such clause in the Reinsurance Agreement here. Rather, it has a clause that provides for somewhat the opposite, *i.e.* for the reinsurer *not* to be bound in certain instances. The Affidavit of Andrew Stuehrk summarizes the effect of this clause:

The Reinsurance Agreement, § 1.02 has a “finite aggregate reinsurance” section that calls for payment of cash claim payments, including ALAE, loss settlements, commutations and various other payments. It also provides for payments of secured notes but only for surplus notes issued to claimants if the cash or interest payments are authorized for payment by the Rehabilitator. However, all of these payments must be “in accordance with the Plan of Rehabilitation and not otherwise disapproved by the Rehabilitator.” This would effectively allow the Rehabilitator to order the Segregated Account to cover claims by amending the Plan of Rehabilitation while at the same time refusing to cover the same claim when presented to the Reinsurer, which is actually the General Account of what was the same company. This is not the case with contracts between a policyholder and an insurance company negotiated at arm’s length in the marketplace where a party may rely on the sanctity of the contract. In short, the reinsurance contract is capable of being rendered illusory, one-sided, of dubious value and may afford little actual protection for the policyholders.

Stuehrk Affidavit, ¶ 13; Barbagallo Affidavit, ¶¶ 12-15.

In short, the Rehabilitator’s statements are without merit as they are based on the proverbial “house of cards,” *i.e.* conditions in agreements that, if the policyholders are truly able to have access to the assets of the General Account as promised by the Rehabilitator, cannot be

conditional. If the Rehabilitator does not comply with the conditions in the Secured Note and Reinsurance Agreement or the surplus notes are not approved or cause the policyholders to be subordinated, or if there is less than \$100 million in surplus in the General Account, the promise of “all of the assets of Ambac” is hollow.

Once again, the Rehabilitator has rejected Movants’ requests for information for support behind the above documents provided and contentions made by the Rehabilitator. Thus, there is no question that the Court record upon which these Motions must be decided is one-sided, but this is the fault of the Rehabilitator. If the record cannot establish that there is adequate capital and surplus in the Segregated Account, the Court should set aside the same or not permit the Rehabilitator to go forward. *See Insurance Corp. of Ireland, Ltd. v. Compagnie des Bauxites de Guinee*, 456 U.S. at 708-09; *In re Yellowstone Mountain Club, LLC*, *supra* at 31.

The third “resource” for the Rehabilitator’s assertions are the alleged Surplus Notes. However, any surplus notes that the General Account may issue to the policyholders of the Segregated Account if the cash payments and surplus notes from that account are insufficient to pay claims liabilities must be analyzed under the criteria set forth in Statement of Statutory Accounting Principles No. 41 (“SSAP 41”) in the Accounting Practices and Procedures Manual adopted by the National Association of Insurance Commissioners (the “NAIC”). These must be followed when issuing these because surplus notes are susceptible to misuse, which is much more likely in a financially troubled company like this one. SSAP 41 requires surplus notes to be subordinate to policyholder, claimant and beneficiary claims, and all other classes of creditors other than surplus note holders, and it requires that interest and principal repayments require prior approval of the Commissioner. If surplus notes do not meet the aforementioned criteria, they are to be reported as debt instead of surplus. This SSAP also requires proceeds to be in the

form of cash or other admitted assets having readily determinable values and liquidity. It is highly suspect that a company as troubled as Ambac could or should be using surplus notes as a form of “collateral.”

The fourth and last form of “resource in The Plan of Operation is “Collateral Security.” This is the collateral that the Segregated Account will have in the General Account as security for the obligations of Ambac in the Secured Note. More specifically, it sets out the installment premiums for the policies allocated to the Segregated Account, including those under direct and assumed reinsurance agreements as well as the reinsurance recoveries for those losses and remediation/reimbursement/collection rights associated with the policies. The difficulty with relying on “Collateral Security” without Movants having any support documentation for the same is that the use of the term “grant of a security interest” in installment premiums, reinsurance premiums, reinsurance recoveries and the like for the policies allocated to the Segregated Account, without information as to the amounts thereof or whether there are other security interests with priority, renders those statements without any force or effect. It is highly questionable that a company that the Rehabilitator admits was in “hazardous condition” prior to the Rehabilitation Order had no other parties with security interests in these premiums, etc., or that any new premiums are still in existence since the company reports that it stopped writing new business in this area years ago. Bingham Affidavit, ¶ 26.

Again, the Rehabilitator refuses to divulge support information, and it is his burden to comply with the statute on maintaining adequate capital and surplus. The Commissioner 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.”) Movants’ motions should be granted.

B. The Rehabilitator’s Positions are Wholly Inconsistent

There is another reason that Movants doubt the validity of the statement in the Rehabilitator’s Opposition that the Segregated Account has adequate capital and surplus because the policies of the Segregated Account have access to 98% of the assets of the General Account. It is because it is wholly inconsistent with the assertion by the Rehabilitator that the creation of the Segregated Account was necessary to protect the policies in the General Account. If the policies in the Segregated Account truly had access to 98% of the assets in the General Account, the policies in that General Account would not be protected. The only way that the Rehabilitator gets around that obvious contradiction is to create two tiers of policyholders, where the rights of the policyholders in the Segregated Account are subordinated to those in the General Account, or conversely, where the policyholders in the General Account receive preferential treatment to those in the Segregated Account. Bingham Affidavit, ¶¶ 26-29; Barbagallo Affidavit, ¶¶ 15-16.

C. The Necessary Outcome of the Rehabilitator’s Opposition is the Preferential Treatment of the Same Class of Policyholder/Creditor

The Rehabilitator’s Opposition begins with a citation to Wis. Stat. § 645.01(4)(d) for its admonition that the purpose of the Insurers Rehabilitation and Liquidation Act is “equitable apportionment of any avoidable loss.” (Emphasis added.) Unfortunately, the Rehabilitator only concentrates his attention on the avoidable loss language and disregards the word “equitable.” He also disregards the fact that the Wisconsin legislature sets forth a priorities statute in the same Chapter 645 for the “order of distribution” of assets in the event that a company cannot avoid liquidation. In § 645.68, Wisconsin adopts the Model Act language which has the distribution priorities language that calls for administrative expenses to be paid first as Class 1 claimants and then policyholders, including third party claims, to be paid next as Class 2 claimants. The point

is that the Chapter on “Rehabilitation and Liquidation” begins and ends with a requirement for equitable apportionment among policyholders, yet the Rehabilitation Order in this case calls for the policyholders in the General Account to be paid in full while those in the Segregated Account are paid part in cash and the rest in wholly uncertain and subordinated surplus notes. This is neither “equitable” nor the treatment required if the company is forced into liquidation and seems to be contrary to the underlying spirit of Chapter 645. Moreover, the experts for ALL and Lloyds contend that it is contrary to custom and practice in the industry to provide for unequal treatment among the same class of creditors. Bingham Affidavit, ¶¶ 26-29; Barbagallo Affidavit, ¶¶ 15-16.

The Rehabilitation statutes (Wis. Stat. §§ 645.31-645.35) are silent as to whether a Rehabilitation Plan may call for policyholders to be paid inequitably and there is as yet no published Plan of Rehabilitation, but it would be wholly illogical and contrary to legislative intent for the opening “intent” provision of § 645.01 as well as the liquidation distribution provision in § 645.48 to set forth provisions for “equitable” treatment of similarly situated policyholders and third-party claimants, and then have the Plan of Rehabilitation separate the same policyholders into separate classes that subordinated the rights of one to another. However, this is exactly what the Plan of Operation and the Segregated Account has done with the policyholders and third party claimants.

The Affidavit of Michael Van Sicklen attached as Exhibit 3 a Moody Investors Service article on Ambac and the Segregated Account. That article pointed out that the “surplus notes” that the Verified Petition calls for to be used to pay the claims of the Covered Policies of the Segregated Account, and that have already been used to pay the June 2010 settlement of the claims of ABS CDO, are “junior to the General Account policyholders’ claims and can be

deferred.” Moreover, the May 2010 Moody’s article attached as Exhibit B to the Affidavit of William C. Barbagallo states that: “In our [Moody’s] view, the policies allocated to the Segregated Account have been effectively subordinated to the policies remaining in the General Account.” In short, there is no question that the policies allocated to the Segregated Account are subordinated to those in the General Account and will not be paid for many years, if at all. This creates a two-tier system of policyholder and third party claimants arising out of this Rehabilitation. This violates the intent and letter of Chapter 645.

The Rehabilitator’s theory of protecting the assets of the General Account by segregating the “toxic policies” into the Segregated Account is contradicted by his other assertion that “the Segregated Account has access to all [except 2%] of the assets of Ambac, in pari passu with General account policyholders.” Again, the only way to accomplish such protection is if the Plan of Rehabilitation, which is yet to be published, would be to create preferences amongst the same class of claimants, i.e. policyholders, which is inimical to all acceptable industry and statutory methods of fair treatment of creditors in a rehabilitation or liquidation.

More specifically, the only way to protect the policyholders in the General Account who ostensibly do not have claims, from those in the Segregated Account, who do have claims, is not to pay the claimants in the Segregated Account when their claim are presented and due, but to pay them over time. The problem with this is that it creates a second-tier of creditors in the same class or, conversely, a “preference” among the same class of creditors by creating one subclass versus another subclass of the same class of creditors.

The “Payment Plan” for policies allocated to the Segregated Account set out in the Verified Petition, which refers to a “formulated plan” which apparently will later be set out in the Rehabilitation Plan, calls for a split between immediate cash payments and interest-bearing

surplus notes. Again, this nebulous concept would create a preference among the same set of creditors. It would also use surplus notes which are an extremely dubious form of payment in an account specifically set up because it is financially impaired. This clearly sets forth a preference between two classes of policyholder creditors.

II. The Rehabilitator Misconstrues the Term “Adequate Capital and Surplus”

Although Movants contest the Rehabilitator’s contentions that, in order to comply with Wis. Stat. § 611.24(3)(a)’s mandate that the Segregated Account should “have and maintain an adequate amount of capital and surplus” when it was formed, the Segregated Account has access to 98% of the assets of the General Account, Movants submit that they still should have such access to those assets to pay the bondholders’ claims when they come due. However, it is clear that, once the policies were allocated to the Segregated Account, this was impossible. The Rehabilitator’s use of the terms “capital” and “surplus” is contrary to the insurance industry standard and its proper context under Chapter 611. These terms have specific meaning and cannot be satisfied by a mere assertion in a brief that the capital and surplus is adequate when again, the only support documents (the Secured Note and Reinsurance Agreement) are conditional and non-binding. Moreover, the surplus of Ambac *prior* to the creation of the Segregated Account was less than \$1 billion, and creating an account only with the liabilities and insufficient assets -- by definition could not contain adequate capital and surplus.

The term “surplus” is intended to ensure that there were more admitted assets than liabilities in the Segregated Account when that account was formed. Bingham Affidavit, ¶¶ 18-19. However, the entire foundation for setting up that account belies and contradicts such a conclusion. On the day the Segregated Account was formed, there should have been a study of the paid claims, case and IBNR reserves (discounted to present value) of all policies associated

with the claims allocated to the account, including the liabilities from the projected future claims against the ALL policies. (Bingham Affidavit, ¶¶ 18-19).

Moreover, when the Rehabilitator states on page 19 that “the Segregated Account was capitalized with more than 98 percent of Ambac’s current assets, despite being allocated the liabilities of less than 1,000 of the 15,000 policies,” (emphasis added) this is a simplistic view of the term “adequate capital,” as adequate capitalization involves more than simply a company’s assets. The concept of being “adequately capitalized” involves financial strength and weaknesses through a number of measures in addition to bare assets. These measures include total fixed income, total equity, current liabilities, current loss and ALAE reserves, previous year’s net earned premium volumes, current statutory surplus and some review of the combined loss ratios. Bingham Affidavit, ¶ 21. *See also* Dynamic Financial Analysis, Capital Adequacy and Capital Allocation, Stephen W. Philbrick and Robert A. Painter, Casualty Actuarial Society.

In response to Movants’ argument that the Segregated Account was formed improperly in this instance because it was already in a “hazardous” financial condition at the time of its creation and, therefore, could not have adequate capital and surplus, Ambac states as follows:

[N]o segregated account would ever be able to enter rehabilitation because it would run afoul [of] the segregated account statute the moment it lacked enough capital and surplus to pay all claims. But Wisconsin law specifically contemplates delinquency proceedings for segregated accounts. *See* Wis. Stat. § 611.24(3)(e). This portion of the statute should not be rendered a nullity.

Ambac Assurance Corporation’s First Brief in Opposition to Various Motions and Objections to Injunction Order Ambac at p. 17.

Ambac misinterprets the Wisconsin statute as well as the Movants’ argument. Wis. Stat. § 611.24(3)(a) requires a segregated account to have an adequate amount of capital and surplus at the time the account is created and to maintain an adequate amount of capital and surplus after

creation. Wis. Stat. § 611.24(3)(e) states that a segregated account is subject to delinquency proceedings. These subsections simply provide that if a segregated account's financial condition deteriorates sufficiently, it will be subject to delinquency proceedings, as are other insurers. Contrary to Ambac and the Rehabilitator, the statute does not contemplate the commencement of liquidation or rehabilitation proceedings at the time of the creation of a segregated account as occurred here. Indeed, acceptance of Ambac's argument that one can create a segregated account that is automatically placed into rehabilitation clearly renders a nullity the statutory requirement for adequate capital and surplus at the time a segregated account is created.

Indeed, here, the Verified Petition provides for the possibility of a "Payment Plan" involving immediate cash payments and "interest bearing surplus notes"¹⁰ on the claims of the Segregated Account when they come due and payable, however, this does not satisfy the requirement of § 611.24(3)(a) to maintain adequate capital and surplus, since the Segregated Account cannot pay claims submitted in full pro-rata to all policyholders in the same class. Payment of claims with surplus notes is an admission that there is not adequate surplus, as the ones being paid with the surplus notes are being subordinated to the other similarly situated policyholders.¹¹ See *Harlan v. United States*, 409 F.2d 904 (5th Cir. 1969).

However, if the Rehabilitator will stipulate with ALL and Lloyds that the bondholders claims under the ALL policies, if and when those claims become due under the policies, will have access to the remaining assets of the Segregated Account and also have "access to all of the assets of Ambac," less the \$100 million as set forth by the Rehabilitator, that the claims will be

¹⁰ A surplus note is a highly subordinated form of debt in that the note holder can only be repaid after all other operational debts have been satisfied.

¹¹ The Verified Petition (¶12(c)) contains no detail as to the split between the cash payments and the surplus notes, and only states that it is a "formulated plan" to be set out in the Rehabilitation Plan which has yet to be published.

paid to the full extent available from those assets when presented (and not at some future date), and have that stipulation approved by the court, then ALL and Lloyds will be able to withdraw their motions.

III. The Rehabilitator's Arguments for Allocating the ALL Policies to the Segregated Account are Without Merit

The Rehabilitator has filed affidavits of Cathleen J. Matanle and Roger A. Peterson for the proposition that “OCI approved the allocation of the ALL policies because they are expected to incur substantial losses due to the structure of the transaction.” Peterson Affidavit, ¶ 5. The affidavits goes on to state that because Lloyds and Depfa purchased the bonds insured by the ALL policies, the principal on the bonds became subject to an accelerated payment schedule that moved the maturity dates from 2040 and 2041 to 2013 (Lloyds) and 2018 (Depfa). *Id.* Matanle Affidavit, ¶¶ 17-20. The Peterson affidavit asserts how the liabilities in the ALL Trust are increasing and that, but for the injunctive relief, both Lloyds and Depfa would have the contractual right to increase the current bond rates to default rates and “further materially deteriorate the assets in the ALL Trust.” *Id.* at ¶ 6.

The reason that ALL and Lloyds contest the inclusion of the ALL policies in the Segregated Account is that, unlike the mortgage-backed securities and credit-default swap guaranty insurance losses, ALL and Lloyds are wholly innocent with respect to its potential, future losses, as the only reason that there is any potential for losses against the ALL policies is the financial downfall of Ambac. More specifically, it was the deterioration in the financial condition and the subsequent downgrade of Ambac's credit rating that resulted in Lloyds, in its capacity as Liquidity Provider for the ALL Series V Bonds, purchasing such bonds from the existing bondholders, who were no longer comfortable with Ambac risk. The interest payable on bonds held by Lloyds was higher than that payable in the hands of the previous bondholders

because it was designed to reflect the cost to Lloyds of funding the purchase, with the result that there was a deterioration in the Trust. Lloyds fully performed the obligations that it was contracted to do. Affidavit of Thea Watkins, ¶ 9.

Moreover, Wisconsin law (§ 611.24(2)) provides that this kind of “Optional Segregated Account” may only be established “with the approval of the commissioner ... unless he or she finds that the segregated account would be contrary to the law or to the interests of any class of insureds.” Here, there is no question that, as set out in the Affidavits of Frederick J. Bingham and William C. Barbagallo, experts in the insurance and insurance insolvency field, it is contrary to Wisconsin law and the insurance insolvency and rehabilitation industry custom and practice to create a rehabilitation wherein the creditors of one company are segregated such that the Rehabilitation creates two separate classes of policyholders and third party claimants.

The Segregated Account clearly causes the ALL policies to be treated as a separate class of policies than when they were in the General Account. The Rehabilitator asserts that they have access to 98% of the assets of the General Account, but if that were true, they would be paid in the same manner. Instead, they can only be paid with one part in cash and the other part in subordinated surplus notes, which means that they may never be paid or if they are, it will be over an extended period of time wholly dependent on conditions beyond anyone’s control at this point in time.

Wis. Stat. § 645.01(4)(d) contains an admonition that the purpose of the Insurers Rehabilitation and Liquidation Act is “equitable apportionment of any avoidable loss.” (Emphasis added.) If the Commissioner had determined that he could not salvage Ambac by means of the Segregated Account, he would have been forced to place the company into liquidation. In that event, pursuant to § 645.68, calls for administrative expenses to be paid first

(class 1) and then all policyholders (e.g. the ALL policies and Dunkin Donuts), including third party claims (e.g. Lloyds), to be paid next as class 2 claimants. There can be no inequitable two-tiered system as the current Rehabilitation Order requires.

In this case, the Commissioner and Ambac went beyond the statutory authority. *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 only espoused reason for allocating the ALL policies to the Segregated Account is that there may be future losses against the policies. This is wholly unacceptable, however, as the reason that ALL policies were purchased, as with any insurance policy, was for protection against future losses. Now, that protection has been lost, not because of losses caused by the policyholder or even the third party claimant, but because of the credit rating of Ambac, i.e. the fact that it chose to write incredibly bad mortgage-backed securities and credit-default swap business. And the decision has been made to include the ALL policies in the Segregated Account merely because it had an expectation of future losses— exactly what an insurance policy is there to insure.

The actions of the Rehabilitator, Ambac and the Commissioner in including the ALL policies in the Segregated Account were arbitrary, capricious and unreasonable and should be set aside.

IV. The Rehabilitator's Argument on ALL's Lack of Standing is Erroneous

Any contention that ALL has no standing in this action is wholly without merit. The Rehabilitator's briefs and the Affidavits of Peterson (§ 5) and Matanle (§ 13) concede that ALL policies were "insuring the bonds" in question. ALL not only administers the loans but has the right as Obligor under the policies to have the Trustee submit the claim on its behalf and pay the

proceeds to the beneficiary or have the third party beneficiary file a claim on its own behalf. Any argument that a policyholder does not have standing in a rehabilitation proceeding in which its policies are the subject matter is not worthy of further response.

V. CONCLUSION

For these reasons, Movants respectfully requests 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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