COURT OF APPEALS OF WISCONSIN
DISTRICT IV

In the Matter of the Rehabilitation of: Appeal No. 2010-AP-1291-LV

Segregated Account of
Ambac Assurance Corporation,

SEAN DILWEG and OFFICE OF THE
COMMISSIONER OF INSURANCE,

Plaintiffs-Respondent,

AMBAC ASSURANCE,

Interested Party-Respondent,

v.

WELLS FARGO BANK/Trustee of
Bondholders, BANK OF NEW YORK
MELLON and DEUTSCHE BANK
NATIONAL TRUST COMPANY,

Defendants,

FEDERAL HOME LOAN MORTGAGE
CORPORATION,

Defendant-Petitioner-Co-Appellant,

AURELIUS CAPITAL MANAGEMENT
LP, FIR TREE, INC., KING STREET
CAPITAL MASTER FUND, LTD.,
KING STREET CAPITAL, L.P.,
MONARCH ALTERNATIVE CAPITAL,
LP and STONEHILL CAPITAL
MANAGEMENT LLC,

Defendants-Petitioners-Appellants,

EATON VANCE MANAGEMENT, NUVEEN ASSET MANAGEMENT, RESTORATION CAPITAL MANAGEMENT, LLC, STONE LION CAPITAL PARTNERS, LP,

Defendants-Co-Appellants-Petitioners.

APPEAL FROM THE ORDER OF THE CIRCUIT COURT OF DANE COUNTY CASE NO. 10 CV 1576 THE HONORABLE WILLIAM D. JOHNSTON PRESIDING

BRIEF OF RMBS POLICYHOLDERS, DEFENDANTS-PETITIONERS-APPELLANTS

Bryan K. Nowicki
WI State Bar ID No. 1029857
Jessica Hutson Polakowski
WI State Bar ID No. 1061368
R. Timothy Muth
WI State Bar ID No. 1010710
Reinhart Boerner Van Deuren s.c.
22 East Mifflin Street, Suite 600
Madison, Wisconsin 53703
Telephone: (608) 229-2200
Facsimile: (608) 229-2100

Attorneys for Aurelius Capital *Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC*

Of Counsel:

David M. Greenwald
John B. Simon
Jenner & Block LLP
353 N. Clark Street
Chicago, Illinois 60654
Telephone: (312) 222-9350
Facsimile: (312) 840-7774

Patrick J. Trostle
Jenner & Block LLP
919 Third Avenue, 37th Floor
New York, New York 10022
Telephone: (212) 891-1665

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Appellants Aurelius Capital Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC (collectively, the "RMBS Policyholders"), submit this brief pursuant to Wisconsin Statutes Section 809.19.

ISSUES PRESENTED FOR REVIEW

1. Do the RMBS Policyholders have a right to intervene where their rights under their insurance policies were substantially altered by the creation of an inadequately funded Segregated Account that was completely dependent on the outcome of the rehabilitation proceedings, and their stated interests are diametrically opposed to those of OCI?

The Circuit Court denied the RMBS Policyholders' Motion to Intervene.

2. Was the formation of the Segregated Account and the transfer of the RMBS Policyholders' policies to the Segregated Account unlawful where the RMBS Policyholders' policies were transferred without any notice, consent, or consideration, the Circuit Court declined to permit discovery and conduct an evidentiary hearing into the adequacy of the Segregated Account, and the Circuit Court accepted the rehabilitator's

unsupported representation that the Segregated Account was adequately capitalized?

The Circuit Court held that the Segregated Account was formed in compliance with Wisconsin law.

3. Does the Circuit Court have the authority to review the CDS Settlement – a transaction that depleted the Segregated Account's principal source of funding and improperly benefited owners of CDS contracts over other creditors in violation of Wisconsin law?

The Circuit Court held that it does not have the authority to review the CDS Settlement.

STATEMENT ON ORAL ARGUMENT AND PUBLICATION

Oral argument is requested, as it will allow the parties to explain more fully the facts and law at issue in this case.

The Court's opinion in this case will meet the criteria for publication in Wis. Stat. § 809.23 because it will decide an issue of substantial and continuing public interest.

The outcome of this appeal has the potential to significantly impact the ongoing proceedings in the Circuit Court. Thus, the RMBS Policyholders submit that this is an appeal that merits the Court rendering a decision on a more expedited basis.

STATEMENT OF THE CASE

Nature Of The Case

The RMBS Policyholders are owners or managers of funds that own in excess of $1 billion par value of residential mortgage-backed securities and other securities. The performance of their securities is insured by Ambac Assurance Corporation ("AAC"). The AAC insurance was instrumental to the issuance of the securities, and like AAC's other policyholders, the purchasers of the RMBS securities have made substantial premium payments to AAC.

AAC encountered financial difficulties and devised a plan with the Wisconsin Office of the Commissioner of Insurance ("OCI") to divide AAC's business. AAC kept the "good" policies in its General Account, while the "bad" policies (including the RMBS policies) were isolated in a Segregated Account. The General Account holds all of AAC's claims-paying assets, while the Segregated Account has nothing but a promise that the General Account will provide money to pay claims, and a reinsurance policy issued by AAC.

The same day they adopted this plan, AAC and OCI initiated rehabilitation proceedings for the Segregated Account. At the time, AAC was negotiating with a group of banks to commute policies insuring credit

default swaps (the "CDS Settlement"). The settlement called for AAC to use General Account assets that were to pay Segregated Account claims to commute the CDS policies. OCI approved the CDS Settlement, apparently without regard to its effect on the Segregated Account's ability to pay claims.

As soon as the RMBS Policyholders learned of AAC's and OCI's actions, they sought to protect their interests by trying to obtain discovery and challenge the legality of OCI's and AAC's actions in the Circuit Court. However, rather than providing *any* discovery or meaningful review, the Circuit Court denied the RMBS Policyholders' motion to intervene and adopted wholesale OCI's findings of fact. Instead of reviewing the legality of the Segregated Account and the fairness of OCI's actions, the Circuit Court has insulated all of OCI's actions from meaningful review, thereby ignoring OCI's statutory requirements and the statutory mandate to the Circuit Court to oversee rehabilitation proceedings.

The Circuit Court built a wall of functional immunity around OCI's decision to authorize AAC's creation of an inadequately funded Segregated Account. It extended that immunity to OCI's decision to approve AAC's transfer of the RMBS Policyholders' policies to the Segregated Account, and to OCI's approval of the CDS Settlement. As a result, what were once

insurance policies backed by all of AAC's claims-paying resources, now languish in what is (for all practical purposes) a separate insurance company that has no dedicated funds to pay insurance claims. This immunity from judicial review is a novel development in this State, one that contradicts established law, deprives policyholders of constitutional rights, and advances unwise public policy. OCI should not be permitted to circumvent the statutory safeguards and disfavor certain policyholders without meaningful judicial review.

Facts

The Parties. AAC is a Wisconsin-domiciled insurer that provides financial guaranty insurance. (R. 1-1 - 1-2.) Among other financial guaranty products, AAC insures structured finance obligations, such as residential mortgage-backed securities ("RMBS") and credit default swaps. (*Id.*) Over the past three years AAC's financial position has deteriorated. (R. 1-3 - 1-4, at ¶¶ 5-7.)

The RMBS Policyholders own, or are managers of entities that own, insurance policies ("RMBS Policies") insuring the performance of securities in an amount in excess of $1 billion that have been allocated to the Segregated Account. (R. 38-1; R. 39-2, App. 22.)

AAC Rehabilitation. On March 24, 2010, AAC's Board of Directors, with the approval of OCI, established a Segregated Account to which AAC would transfer certain policies, including the RMBS Policies. (R. 1-8; R. 1-16.) AAC's Board of Directors then voted to place the Segregated Account – but not the remainder of the company – into rehabilitation. (*Id.*)

Also on March 24, 2010, OCI petitioned the Circuit Court to enter an Order of Rehabilitation for the policies assigned to the Segregated Account. (R. 1-13.) That day, the Circuit Court entered an *ex parte* Order for Temporary Injunctive Relief ("Injunction Order") at OCI's request. (R. 9, App. 5.) The Injunction Order prohibited any person from commencing any proceedings against the Segregated Account, AAC, and OCI – including addressing OCI's or AAC's actions immediately prior to the commencement of the rehabilitation proceedings – and prohibited the policyholders whose policies had been allocated to the Segregated Account from collecting on their policies. (*Id.*) Instead, all such actions would necessarily have to be brought as part of the rehabilitation proceedings. (*Id.*) The Circuit Court invited interested parties to seek a modification of the Injunction Order, which the RMBS Policyholders did in the proceeding that is now before this Court on appeal. (R. 9-13, App. 17.)

The Segregated Account was capitalized with a $2 billion non-marketable note from AAC and a reinsurance agreement with AAC, both of which are entirely dependent on the assets in AAC's General Account. (R. 1-18 - 1-19.) AAC is not obligated to make payments from the General Account to the Segregated Account if AAC's statutory surplus amount falls below $100 million or such higher amount as OCI may determine. (R. 1-64; R. 1-79.)

At the same time, AAC announced that the General Account intended to enter into a $4.6 billion settlement agreement with 17 primarily foreign financial institutions that held certain credit default swap ("CDS") contracts (the "Bank Group"). (*See* R. 72-4, 72-6 -72-7; R. 74-17.) AAC guaranteed the CDS contracts indirectly. (R.1-2.) AAC's non-insurance subsidiary, Ambac Credit Products LLC, entered into the CDS contracts to protect the counterparties from defaults of the underlying issuer. (*Id.*) AAC guaranteed certain obligations of its subsidiary. (*Id.*) OCI and AAC asserted the settlement discussions were justified because "Ambac's guarantees of the credit default swap ("CDS") obligations of its subsidiary loom as an even greater threat to policyholders as a whole." (R. 2-18.)

The RMBS Policyholders questioned whether the CDS Settlement subverted the priority scheme set forth in the Wisconsin Insurance Code.

(R. 104-7.) Under the CDS Settlement, AAC would pay $2.6 billion cash from the General Account and issue $2 billion of surplus notes to the Bank Group. (*See* R. 40-11.) Wisconsin law prioritizes the claims of insurance policyholders over an insurer's general creditors. Wis. Stat. § 645.68(3) ("claims under policies for losses incurred"); Wis. Stat. § 645.68(5). If AAC's obligation to the CDS Settlement counterparties was to general creditors, not insurance policyholders, as the RMBS Policyholders claim, then the CDS claims are subordinate to the policyholders of AAC and the disbursement of $4.6 billion in cash and notes from the General Account constituted preferential treatment to the Bank Group. (R. 104-7 -104-8.)

RMBS Policyholders Requested The Circuit Court To Review OCI's Actions. As soon as they learned that their policies had been transferred to the Segregated Account and of the proposed CDS Settlement, the RMBS Policyholders sought to obtain information about OCI's action. (R. 38-8 - 38-9.) They feared that the Segregated Account was not adequately capitalized and that the proposed settlement would improperly transfer a significant portion of the few remaining funds from AAC's General Account, further undermining the Segregated Account. (*Id.*) OCI and AAC refused to provide information, and pursuant to the procedure set forth in the Injunction Order, the RMBS Policyholders moved to modify

the Injunction Order and to intervene. (R. 38-6 - 38-9; R. 53.) The RMBS Policyholders (1) sought expedited discovery with respect to OCI's actions, (2) requested a meaningful opportunity to review the legality of the Segregated Account and the CDS Settlement, as required by Wisconsin law, and (3) asked the Circuit Court to prevent the CDS Settlement from closing until it reviewed the appropriateness and legality of OCI's actions. (R. 37.)

The matter was set for argument on May 25, 2010. (R. 127-1, App. 50.) Days before the hearing, OCI and AAC filed lengthy briefs. (R. 73.) Despite refusing discovery and arguing the matter could be resolved as a matter of law, OCI and AAC attached factual affidavits and documents. (*Id.*) OCI also submitted proposed findings of fact and conclusions of law. (R. 72.) Although thereby conceding that the propriety of the Segregated Account and CDS Settlement turned on factual issues, OCI and AAC refused to provide any information in response to discovery requests propounded by the RMBS Policyholders and others. (R. 38-6 - 38-9.)

Proceedings In The Circuit Court. The Circuit Court heard argument on the RMBS Policyholders' motion on May 25, 2010. As of May 25, 7 additional parties – representing more than $20 billion par value in AAC policies – filed papers in the Circuit Court and, like the RMBS

Policyholders, expressed concerns about the Segregated Account, the CDS Settlement, and the Circuit Court's procedure. (R. 108-3; R. 42-5; R. 151-17 - 151-23, 151-41 - 151-42, App. 33-39, 40-41.)

The Circuit Court orally denied the movants' request to intervene. The Circuit Court refused discovery. (R. 151-125 - 151-126, App. 42-43.) The Court refused the parties challenging OCI's actions, including the RMBS Policyholders, to develop factual support for their positions in response to OCI's last minute proposed findings of fact. (*Id.*) The Circuit Court heard no testimony and admitted no evidence during the proceedings. (R. 151-125 - 151-128, App. 42-45.)

As to the CDS Settlement, the Circuit Court stated that it lacked authority to review the transaction because it involved the General Account, which was not in rehabilitation. (R. 151-125 - 151-126, App. 42-43.) The Circuit Court stated OCI's actions relating to the CDS Settlement were "not under the authority of the court" and the Circuit Court cannot "dip into the activities and try to overview the activities of the Office of the Commissioner of Insurance." (R. 151-14, 151-125 - 151-26, App. 32, 42-43.) The Circuit Court did not address the capital adequacy of the Segregated Account. The Circuit Court indicated that it would issue a

written opinion reflecting its rulings. It refused to enjoin the settlement pending appeal. (R. 151-129 - 151-131, App. 46-48.)

The RMBS Policyholders filed a Preliminary Emergency Petition for Leave to Appeal and an accompanying Emergency Motion for Injunction Pending Appeal, seeking to enjoin the consummation of the CDS Settlement pending appeal of the Circuit Court's order. (Preliminary Pet.; Mot. for Inj. Pending Appeal.) On May 27, this Court denied the RMBS Policyholders' petition without prejudice, holding it was premature because the Circuit Court had not yet entered its written order. (R. 128-3.) The Court invited the RMBS Policyholders to renew their request for an injunction once the Circuit Court entered an order. (*Id.*)

That same day, shortly after receiving this Court's order, the RMBS Policyholders received the Circuit Court's written order denying all of the RMBS Policyholders' requested relief. (R. 127-14 - 127-17, App. 63-66.) Inconsistent with the Circuit Court's oral ruling on May 25 that the Circuit Court does not have authority to order the relief requested by the RMBS Policyholders (R. 151-14, 151-125 - 151-126, App. 32, 42-43), the Circuit Court's order contains 13 pages of "findings of fact," adopting virtually wholesale OCI's proposed findings of fact. (R. 127-2 - 127-14, App. 51-63.) The Circuit Court's order denied the RMBS Policyholders' Motion to

Intervene without analysis and adopted OCI's proposed findings and ruled that the Segregated Account was constitutional and formed in compliance with Wisconsin law. (*Id.* at 127-14 - 127-15.) The Circuit Court's order denied the RMBS Policyholders' request to enjoin the consummation of the CDS Settlement (*id.* at 127-16), and concluded that the RMBS Policyholders were not entitled to discovery because "policyholders such as [the RMBS Policyholders] cannot challenge the wisdom of OCI's decision-making, so long as OCI had a rational basis for its regulatory choices" (*id.* at 16-17).

The RMBS Policyholders timely filed a Notice of Appeal on May 28, 2010.[1]

CDS Settlement Closing. On June 7, 2010, AAC closed the CDS Settlement and transferred $2.6 billion in cash and issued $2 billion of surplus notes, to the Bank Group. (R. 149B; R. 40-11.)

[1] That same day, the RMBS Policyholders filed a motion to enjoin the closing of the CDS Settlement pending appeal. OCI filed a motion to dismiss the RMBS Policyholders' appeal of the denial of the motion to modify the Injunction Order. On June 2, 2010, this Court denied the RMBS Policyholders' request for an injunction pending appeal. (June 2, 2010 App. Ct. Order, at 5-6.) On June 18, 2010, this Court denied OCI's motion to dismiss, holding that the May 27, 2010 order was a final order and that appeal of the denial of the injunction was not moot even though the CDS Settlement had closed. (June 18, 2010 App. Ct. Order, at 4-5.)

STANDARD OF REVIEW

Whether to allow intervention as of right is a question of law that the appellate court decides independently of the Circuit Court, but benefiting from the Circuit Court's analysis. *Helgeland v. Wis. Municipalities*, 2008 WI 9 ¶ 41, 307 Wis. 2d 1, 745 N.W.2d 1.

The appellate court's review of questions of law is *de novo*. *Kocken v. Wis. Council 40, AFSCME, AFL-CIO*, 2007 WI 72, ¶ 26, 301 Wis. 2d 266, 732 N.W.2d 828; *Zizzo v. Lakeside Steel & Mfg. Co.*, 2008 WI App 69, ¶ 6, 312 Wis. 2d 463, 752 N.W.2d 889 (stating that where the exercise of a court's discretion turns on a question of law, the court of appeals reviews that question of law *de novo*); *Awve v. Physicians Ins. Co. of Wis., Inc.*, 181 Wis. 2d 815, 821, 512 N.W.2d 216, 218 (Wis. Ct. App. 1994) (issues of statutory interpretation are reviewed *de novo*). This standard applies to this Court's review of the Circuit Court's holdings that the formation of the Segregated Account and the transfer of the RMBS Policies to the Segregated Account did not violate Wisconsin or federal law, and the Circuit Court's holding that it lacked authority to review the CDS Settlement.

The standard of review for a circuit court's order granting, denying, or modifying injunctive relief is abuse of discretion. *See Wis. Ass'n of*

Food Dealers v. City of Madison, 97 Wis. 2d 426, 428-29, 293 N.W.2d 540, 542 (1980). This standard applies to review of the Circuit Court's refusal to enjoin the CDS Settlement.

ARGUMENT

I. The Circuit Court Erred In Denying The RMBS Policyholders' Motion to Intervene.

The Circuit Court erred when it concluded without analysis or explanation that the RMBS Policyholders have not satisfied the statutory requirements for intervention.

A. The RMBS Policyholders Satisfy The Statutory Requirements For Intervention As Of Right.

By approving the creation of an inadequately funded Segregated Account, and allocating the RMBS Policyholders' policies to it, OCI abridged the RMBS Policyholders' contractual rights. The RMBS Policyholders are entitled to intervene because no party, especially not OCI, is protecting the RMBS Policyholders' interests. Indeed, OCI's actions and statements make clear that OCI is harming the RMBS Policyholders' interests. Despite this, the Circuit Court concluded without explanation: "Because Movants have not satisfied the requirements for intervention under Wisconsin law, their motion to intervene in this proceeding is

denied." (R. 127-17, App. 66.) Contrary to the Circuit Court's conclusion, the RMBS Policyholders are entitled to intervene as a matter of right.

Wis. Stat. § 803.09(1) provides that:

> upon [A] timely motion anyone shall be permitted to intervene in an action when [B] the movant claims an interest relating to the property or transaction which is the subject of the action and [C] the movant is so situated that the disposition of the action may as a practical matter impair or impede the movant's ability to protect that interest, unless [D] the movant's interest is adequately represented by existing parties.

Wis. Stat. 803.09(1); *see also Helgeland*, 307 Wis. 2d 1, ¶ 38. Here, the RMBS Policyholders satisfied each of the statutory requirements for intervention.

First, the RMBS Policyholders' motion was timely. The Circuit Court's March 24, 2010 Injunction Order directed interested parties to move to modify or dissolve the Order within 90 days of its issuance. (R. 11, App. 1; R. 9, App. 5.) The RMBS Policyholders did just that. Within 60 days, and before any substantive hearings on the merits had taken place, the RMBS Policyholders moved to intervene. (R. 53.) OCI and AAC do not challenge the timeliness of the RMBS Policyholders' motion.

Second, as we show in greater detail in Section I(C), *infra*, the RMBS Policyholders have an interest relating to the property that is the

subject of the proceeding. In applying this requirement, "courts employ a 'broader, pragmatic approach to intervention as of right,' viewing 'the interest sufficient to allow the intervention practically rather than technically.'" *Helgeland*, 307 Wis. 2d 1, ¶ 43 (quoting *Bilder v. The Twp. of Delavan*, 112 Wis. 2d 539, 548, 334 N.W.2d 252 (Wis. 1983)). A movant "need not demonstrate [that it] has a judicially enforceable right to challenge a decision in order to intervene in the action." *Helgeland*, 307 Wis. 2d 1, ¶ 46 n.46.

Here, the RMBS Policyholders own in excess of $1 billion of policies that OCI allocated to the Segregated Account. (R. 38-1.) Under their policies, the RMBS Policyholders have a contractual right to receive payments from AAC if the underlying securities that AAC has insured cease to perform. (*Id.* at 7.) The purchasers of the securities have made and continue to make substantial premium payments to AAC. (*See* R. 39-4, App. 24.)

Third, the rehabilitation proceeding will impede the RMBS Policyholders' ability to protect their contractual rights. The RMBS Policyholders' interests will be directly affected by the outcome of the rehabilitation proceeding. Indeed, under the Injunction Order, the RMBS Policyholders are currently enjoined from "attempting to terminate, collect

on, or claim against" their policies. (R. 9-3, App. 7.) Whether and under what conditions the RMBS Policyholders' claims will ever be satisfied is dependent on OCI's plan to rehabilitate the Segregated Account. Consequently, the rehabilitation proceeding is having a direct, immediate, and significant impact on the RMBS Policyholders' contractual rights.

Fourth, the existing parties do not adequately represent the RMBS Policyholders' interests. The showing required for inadequate representation "should be treated as minimal." *Armada Broad., Inc. v. Stirn*, 183 Wis. 2d 463, 476, 516 N.W.2d 357, 362 (Wis. 1994). While there is a rebuttable presumption of adequate representation where a governmental officer charged by law with representing interests of the movant shares the same ultimate objective in the action, *Helgeland*, 307 Wis. 2d 1, ¶ 90, the presumption does not apply here. OCI's plan disadvantages the RMBS Policyholders (and others whose policies are now in the Segregated Account). The RMBS Policyholders challenge the first step of the rehabilitation process – creation of an inadequately funded Segregated Account. OCI or AAC will not challenge the plan they themselves authored. Here, OCI is not advocating for the RMBS Policyholders' interest. OCI has repudiated its responsibility to protect the interests of the RMBS Policyholders by stating they are "not policyholders

of either the Segregated Account involved in the subject rehabilitation proceeding or the General Account of Ambac." (OCI's Prelim. Obj. (June 1, 2010), at 1 n.1.) Moreover, OCI's and AAC's actions make clear they are acting together to deprive the RMBS Policyholders of rights under their RMBS Policies.

The Court should evaluate an intervenor's motion "practically, not technically, with an eye toward 'disposing of lawsuits by involving as many apparently concerned persons as is compatible with efficiency and due process.'" *Wolff v. Town of Jamestown*, 229 Wis. 2d 738, 742-43, 601 N.W.2d 301, 303-04 (Wis. Ct. App. 1999) (quoting *State ex rel. Bilder v. Twp. of Delavan*, 112 Wis. 2d 539, 548-49, 334 N.W.2d 252, 257 (1983)). Courts in other jurisdictions have recognized the right of policyholders to intervene in rehabilitation proceedings to protect their interests, as the Supreme Court recognized in *Neblett v. Carpenter*, 305 U.S. 297, 301 (1938). In the trial court proceedings in *Neblett*, policyholders were permitted to intervene, raise objections, propose alternate rehabilitation plans, and present evidence. *Id.*; *see also Koken v. Legion Ins. Co.*, 831 A.2d 1196, 1202 (Pa. Commw. Ct. 2003) (policyholders were permitted to intervene and present evidence).

The RMBS Policyholders satisfied every requirement for intervention as a right. Accordingly, the Circuit Court erred in denying the RMBS Policyholders' motion to intervene.

B. At Minimum, The RMBS Policyholders Are Entitled To Discretionary Intervention.

Discretionary intervention is permitted, when "a movant's claim or defense and the main action have a question of law or fact in common." Wis. Stat. § 803.09(2). Here, each of the RMBS Policyholders' claims share common questions of fact or law with the rehabilitation proceeding. Even assuming the RMBS Policyholders did not have a right to intervene, it was an abuse of the Circuit Court's discretion not to consider whether the RMBS Policyholders should be permitted to intervene. *See Wis. Ass'n of Food Dealers*, 97 Wis. 2d at 430, 293 N.W.2d at 542 ("an abuse of discretion may occur [when the] trial judge [fails] to consider and make a record of factors relevant to a discretionary determination in a particular case"). The Circuit Court's failure to perform such an analysis was an abuse of discretion. *See id.* at 430, 293 N.W.2d at 542.

C. The RMBS Policyholders Have Standing To Participate In The Proceedings.

The RMBS Policyholders have standing to participate in the Circuit Court proceedings and challenge the legality of the Segregated Account and

the CDS Settlement. In the Circuit Court, AAC argued that intervention was inappropriate because "individual policyholders lack standing to enforce insurance statutes" and because "[t]he creation of the Segregated Account did not magically endow them with standing to interfere with Ambac's every action." (R. 69-22, 69-23.) AAC's arguments are misplaced. The RMBS Policyholders do not seek to challenge every action in the rehabilitation, and have not. Yet the RMBS Policyholders have standing to question the legality of the actions of OCI that directly impact the RMBS Policyholders, including the creation of the Segregated Account and the dissipation of assets through the CDS Settlement. *See McConkey v. Van Hollen*, 2010 WI 57, ¶¶ 15-16, 783 N.W.2d 855.

The Circuit Court invited interested parties to participate in the proceedings. The Injunction Order specifically states: "If any interested parties believe any portion of this Order is unwarranted by the facts or the law, such parties may seek modification or dissolution of part or all of this Order by filing a written motion with this Court no later than 90 days following the issuance of this Order." (R. 9-13, App. 17.) The RMBS Policyholders are clearly interested parties, owning in excess of $1 billion face amount of RMBS Policies in the Segregated Account which has been placed into rehabilitation. (R. 38-1 n.1.)

Even without the express invitation of the Circuit Court, the RMBS Policyholders have standing under Wisconsin law. An insurer's rehabilitation is governed by Wis. Stat. Chapter 645. Chapter 645 is silent as to which parties have standing to participate in a rehabilitation. *See* Wis. Stat. §§ 645.01 - 645.90.

Because Chapter 645 supplies no intervention rule, the general intervention statute, Wis. Stat. § 803.09(1), not Chapter 645, applies to the motion to intervene in this case. Chapters 801 to 847 govern "procedure and practice in circuit courts of this state in all civil actions and special proceedings whether cognizable as cases at law, in equity or of statutory origin except where different procedure is prescribed by statute or rule." Wis. Stat. § 801.01(2). These provisions apply in all actions, including rehabilitations, unless expressly overridden. *See id.*; *see also In re the Commitment of Richard Brown*, 215 Wis. 2d 716, 721-22, 573 N.W.2d 884, 886 (Wis. Ct. App. 1997) ("Under § 801.01(2), the procedures established in Chapters 801 to 847, including § 801.58, automatically apply to civil proceedings except where a different procedure is prescribed by a statute or a rule."). Because the rehabilitation statute supplies no rules regarding standing, the question of standing in the Circuit Court is governed by Wisconsin's general standing laws. *Cf. In re Cam Constr. Co.*, 248 B.R.

134, 136 (Bankr. W.D. Wis. 2000) (because the Wisconsin lien statute is silent on whether the mechanic can assert a lien for work done on the debtor's premises, "the Court is constrained to interpret the statute in accordance with general common law principles relating to such liens"); *accord Clackamas Gastroenterology Assocs. v. Wells*, 538 U.S. 440, 447 (2003) ("[C]ongressional silence often reflects an expectation that courts will look to the common law to fill gaps in statutory text.").

OCI argues that Chapter 645's silence as to participation in rehabilitation proceedings supports their argument against standing, in part because Chapter 645 provides for judicial review of a summary special insurance hearing. (R. 2-13 - 2-15.) This is incorrect. Wisconsin civil practice rules are applied in all proceedings unless expressly overridden. Wis. Stat. § 801.01(2). An intent to override Wisconsin law expressly cannot be provided by silence.

Moreover, OCI's argument is inconsistent with other provisions of the insurance code that envision the Circuit Court hearing parties other than the rehabilitator and the insurer. For example, Wis. Stat. § 645.33(5) provides: "Upon application of the rehabilitator for approval of the plan, *and after such notice and hearing as the court prescribes*, the court may either approve or disapprove the plan proposed, or may modify it and

approve it as modified." (Emphasis supplied.) Such notice would be unnecessary if no other parties could appear.

Under Wisconsin law, the RMBS Policyholders have standing on two separate bases.

First, the RMBS Policyholders satisfy Wisconsin's general standing laws, which Wisconsin construes liberally. *McConkey*, 783 N.W.2d 855, ¶ 15; *In re Guardianship & Protective Placement of Carl F.S.*, 2001 WI App 97, ¶ 5, 242 Wis. 2d 605, 626 N.W.2d 330. Standing is not a matter of jurisdiction but rather of sound judicial policy. *McConkey*, 783 N.W.2d 855, ¶ 15. The purpose behind standing is to "ensur[e] that the issues and arguments presented will be carefully developed and zealously argued, as well as informing the court of the consequences of its decision." *In re Carl F.S.*, 242 Wis. 2d 605, ¶ 5.

In assessing standing, a court must "determine whether the party seeking standing was injured in fact, and whether the interest allegedly injured is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question." *Id.* A party meets the "injured in fact" requirement when it alleges a personal stake in the outcome of a controversy even when its claims are no more than a trifle.

Id; see also Bence v. City of Milwaukee, 107 Wis. 2d 469, 478-79, 320 N.W.2d 199, 203-04 (1982).

Here, the RMBS Policyholders have a personal stake as they own in excess of $1 billion of RMBS Policies that have been allocated to the Segregated Account, which in turn has been placed into rehabilitation. As Wisconsin Stat. § 645.01(4) indicates, the purpose of the Rehabilitation statutes is "the protection of the interests of insureds, creditors and the public generally, with minimum interference with the normal prerogatives of proprietors." The RMBS Policyholders have exactly the type of interests the statute is designed to protect.

Second, a beneficiary of an insured trust, such as the RMBS Policyholders, has standing to sue for damages to trust property when the trustee has failed to bring a meritorious claim. *Tallmadge v. Boyle*, 2007 WI App 47, ¶ 25, 300 Wis. 2d 510, 730 N.W.2d 173; *accord Klein v. Hartford Life & Accident Ins. Co.*, No. 09-C-562, 2009 WL 2160455, at *2-3 (E.D. Wis. July 17, 2009).[2]

[2] *Klein* is an unreported case in the Eastern District of Wisconsin and under the rules of that Court may be given precedential value. The RMBS Policyholders are aware of Wis. Stat. § 809.23(3) regarding the citation of unpublished opinions of the Wisconsin appellate courts, but note that § 809.23(3) applies to decisions of the Wisconsin appellate courts, not the federal courts.

Klein holds beneficiaries of an insured trust have standing to sue for damages to the trust property where a trustee fails to bring a meritorious claim. *Klein*, 2009 WL 2160455, at *2-3. In *Klein*, the beneficiary of an insurance policy sued an insurance company for wrongful denial of insurance proceeds. *Id.* at *1. The defendant moved to dismiss, arguing that the beneficiary lacked standing to sue. *Id.* The court denied the defendant's motion and reasoned that a beneficiary is a proper plaintiff, if the trustee failed to bring a meritorious claim. *Id.* at *2. The court held that the plaintiff proved that the trustee was unwilling to bring a meritorious claim and that, therefore, he was entitled to bring the suit. *Id.* at *3; *accord Tallmadge*, 300 Wis. 2d 510, ¶ 24.

Here, while certain of the Trustees, Bank of New York Mellon, US Bank, and Deutsche Bank, joined and supported in part the RMBS Policyholders in the Circuit Court, those Trustees have not yet joined the appeal. Consequently, because the Trustees have not joined this appeal, the RMBS Policyholders have standing because their interests are not being sufficiently represented by the Trustees.

OCI has not preserved any argument to the contrary. In a footnote to their brief before the Circuit Court, AAC commented that the RMBS Policyholders "may be precluded from bringing these motions by

provisions in the indentures governing their investments" and, as a result, "may very well lack standing to sue under the terms of their own governing agreements." (R. 69-22 n.2.) Mentioning a possible argument in a footnote is insufficient to have "raised" an argument below or to preserve it on appeal. *Badger III Ltd. P'ship v. Howard, Needles, Tammen & Bergendoff*, 196 Wis. 2d 891, 899 n.1, 539 N.W.2d 904, 908 n.1 (Wis. Ct. App. 1995) ("'We do not consider an argument mentioned only in a footnote to be adequately raised or preserved for appellate review.'" (quoting *United States v. Restrepo*, 986 F.2d 1462, 1463 (2d Cir. 1993)).

The failure of OCI to raise this argument below precludes its consideration in this Court. The parties did not litigate the issue, which has prejudiced the RMBS Policyholders' ability to address the argument in greater detail. Had the argument been raised properly below, the RMBS Policyholders would have shown that the RMBS Policyholders own securities in pools of mortgage-backed securities whose payments are managed by indenture trustees. The trustees contracted with AAC to obtain financial guaranty insurance on the performance of the securities for the benefit of the RMBS Policyholders. The holders of the securities, such as the RMBS Policyholders, are the holders of the insured obligations. As

such, the RMBS Policyholders are the beneficiaries of the insurance policies.

II. The Circuit Court Erred In Holding That The Formation Of The Segregated Account And The Transfer Of The RMBS Policies To The Segregated Account Was Lawful.

The Circuit Court erred by holding that the creation of the Segregated Account complied with Wisconsin law and that it was lawful for OCI and AAC to transfer the RMBS Policies to the Segregated Account, without notice, consent, or consideration. (R. 127-14 - 127-15, App. 63 -64.) The Circuit Court's holding is contrary to Wisconsin and federal law for three independent reasons. First, OCI and AAC violated Wisconsin law requiring that a segregated account be adequately capitalized. Wis. Stat. § 611.24(2), (3)(a), (3)(c). Second, the transfer of the policies to the Segregated Account, without notice, the consent of the RMBS Policyholders, or consideration, was an ineffective novation. Third, by transferring the policies to the Segregated Account without providing the RMBS Policyholders compensation or notice and an opportunity to be heard, OCI has committed a constitutionally prohibited taking and violated the RMBS Policyholders' due process rights.

A. The Inadequately Capitalized Segregated Account Was Formed In Violation Of Wisconsin Law.

A lawful segregated account must "have and maintain" adequate capital and surplus to cover the account's liabilities. Wis. Stat. § 611.24(3)(a). Wisconsin requires that segregated accounts have adequate capitalization because they are expected to function as separate corporations. Adequate capitalization is "indispensable if the account is to be expected to function and survive like a separate corporation." Wis. Stat. Ann. § 611.24, comments. An insurance company may not divide its business to hinder its policyholders. Instead, it may establish a segregated account only if "it is adequately capitalized to make it independently viable, and the commissioner approves its creation." *Id.*

Adequate capitalization is essential: "Since both assets and liabilities are insulated from the rest of the company's business, each segregated account must have adequate capital and surplus, or an appropriate substitute. The requirements . . . justify insulation of the account's business from the rest of the insurer's business." *Id.* Wisconsin law does not permit a newly-created segregated account to be placed immediately into rehabilitation or to be used for claims avoidance. Rather, the purpose of segregated accounts is to build a wall between different insurance lines,

where the lines on both sides of the "wall" are "adequately capitalized to make [them] independently viable, and the commissioner approves [their] creation." *Id.* The segregated account statute allows for the creation of a solvent segregated account *prior* to the issuance of policies, with full disclosure to policyholders that claims will be only paid from the segregated account's assets. *See* Wis. Stat. Ann. § 611.24 and comments.

Contrary to this clear statutory command, and the critical nature of the finding of capital adequacy, OCI presented absolutely no factual support to the Circuit Court at the time it established the Segregated Account to support OCI's conclusory assertion that there is an adequate amount of capital and surplus for the Segregated Account. (*See* R. 1-18 - 1-19.) There is no indication the Segregated Account can or will be rehabilitated – rather, the entire proceeding is an organized run-off or liquidation. OCI asserted that the Segregated Account is adequately capitalized and, without providing any underlying data or analysis of any kind, requested that the Circuit Court accept as true OCI's assertion. (*See* R. 1-19.) The Circuit Court did just that, without permitting discovery into OCI's assertion and without any evidence first being submitted. Despite lacking any reason to so hold, the Circuit Court again rubber-stamped OCI's bold assertion and concluded as a matter of law that "[t]he

Segregated Account was formed in compliance with Wisconsin law." (R. 127-14, App. 63.)

The Circuit Court abused its discretion by adopting OCI's conclusion that the Segregated Account was formed in compliance with Wisconsin law while at the same time refusing to allow the parties to conduct discovery and present evidence to determine whether that assertion is true. *See Wis. Ass'n of Food Dealers*, 97 Wis. 2d at 430, 293 N.W.2d at 542 ("an abuse of discretion may occur [when the] trial judge [fails] to consider and make a record of factors relevant to a discretionary determination in a particular case").

Rather than conduct a factual investigation, the Circuit Court merely adopted OCI's findings of fact. A side-by-side comparison between OCI's proposed findings of fact and law and the Circuit Court's findings of fact and law show that the Circuit Court only made six inconsequential changes to OCI's proposed findings before adopting it word for word. *Compare* OCI's Proposed Findings of Fact (R. 127), *with* Circuit Court's May 2 (R. 72).) (For this Court's convenience, the RMBS Policyholders include in the Appendix, a redline comparison between OCI's proposed findings and the Circuit Court's findings.)

The wholesale adoption of OCI's findings of fact and failure to articulate the factors upon which it based its decision constitutes reversible error. *See Trieschmann v. Trieschmann*, 178 Wis. 2d 538, 541-44, 504 N.W.2d 433, 434-35 (Wis. Ct. App. 1993). As this Court explained in *Trieschmann*, a trial court commits reversible error where, as here, it simply adopts one party's findings of fact and fails to articulate the factors upon which it based its decision. *See id.* at 541-44, 504 N.W.2d at 434-35. Indeed, "[t]he trial court's decision must be the product of a rational mental process by which the facts of record and law relied upon are stated and are considered together for the purpose of achieving a reasoned and reasonable determination." *Id.* at 541-42, 504 N.W.2d at 434 (internal quotations omitted). In *Trieschmann*, the trial court adopted, virtually verbatim, one party's memorandum brief. *Id.* at 540, 504 N.W.2d at 433. This Court reversed, holding the trial court was obligated to state not only its findings of fact and conclusions of law but also to "state the factors upon which it relied in making its decision." *Id.* at 542, 504 N.W.2d at 434. By "simply accept[ing one party's] position on all of the issues of fact and law without stating any reasons for doing so other than its belief that doing so was the 'only just solution,'" the trial court abdicated its responsibility. *Id.* at 542, 504 N.W.2d at 434. A trial court must justify its decision to credit one

party's version of disputed legal and factual issues over another's. *Id.* at 542-43, 504 N.W.2d at 434-35.

Here, the Circuit Court adopted OCI's proposed findings of fact and conclusions of law wholesale even though they were conclusory, unsupported by any evidentiary record, and the subject of significant legal and factual disputes. The Circuit Court's action was particularly egregious given the other procedural irregularities in the hearing. OCI resisted disclosing the factual basis for its actions in the weeks leading up to the hearing. (R. 104-10 n.7.) Then, OCI submitted its proposed factual findings five days before the hearing, while continuing to refuse discovery. (*See* R. 72.) The Circuit Court announced it was ruling as a matter of law (R. 151-125 - 151-126, App. 42-43), declared (erroneously) that it lacked the authority to review OCI's actions, and then blindly adopted all of OCI's proposed findings without permitting other parties to challenge those findings.

The Circuit Court further erred by adopting OCI's findings of fact regarding adequate capitalization without taking any evidence. Some evidentiary basis is required for findings of fact. *See Woodard v. Woodard,* 2005 WI App 65, ¶ 12, 281 Wis. 2d 217, 696 N.W.2d 211 (it is clearly

erroneous for a court to enter a factual finding that has no support in the record). The Circuit Court was obligated to ensure that it had a sufficient evidentiary basis to reach its findings. *Id.*

The RMBS Policyholders were entitled to conduct limited discovery into the capitalization of the Segregated Account to provide the Circuit Court with sufficient information to determine whether to approve the actions of OCI. Even limited discovery will reveal whether the Segregated Account is adequately capitalized and has an adequate surplus, which are statutory prerequisites to its creation. *See* Wis. Stat. § 611.24(3)(a).

Had the Circuit Court permitted any review of the legality of the Segregated Account, it would have discovered that the Segregated Account created by AAC and approved by OCI before the Circuit Court entered the Rehabilitation Order on March 24, 2010, was not established with, and does not currently maintain, adequate capital or surplus. (*See* R. 38-24, 38-25.) The Segregated Account is capitalized only with a non-marketable $2 billion note with indeterminate value issued by AAC and the Reinsurance Policy. (R. 1-18, 1-19.) There is no indication that the Segregated Account was created with *any* surplus, let alone an adequate surplus. By stating that the Segregated Account policyholders would receive only 25% of the amount of their claims in cash, and the remaining 75% in surplus notes,

OCI admitted as much. (*See* R.73-17, 73-18.) Indeed, AAC's decision to rehabilitate the Segregated Account immediately after its creation demonstrates OCI was aware, at a minimum, that it was unlikely that the Segregated Account was sufficiently capitalized. According to OCI, the same day that the Segregated Account was created "the Segregated Account [was] in precisely the type of precarious business situation for which the Legislature adopted the rehabilitation procedure." (R. 2-10.)

Because the Segregated Account did not have adequate capital and surplus at the time it was formed, it failed to meet the provisions of Wis. Stat. §611.24(3)(a), and it was invalid.

B. The Transfer Of The RMBS Policies To The Segregated Account Prior To An Order Of Rehabilitation, Without Notice, Consent Or Consideration, Was An Ineffective Novation.

The Circuit Court erred as a matter of law by holding that the allocation of the RMBS Policies to the Segregated Account was proper and not an ineffective novation. (R.127-15.) The Circuit Court held that "[t]he standards for novation, as recognized by the common law of contracts, are inapplicable to the allocation of certain policies to the Segregated Account, which was statutorily authorized under Wisconsin law." (*Id.*) This ruling was incorrect.

Novation is defined as a "'mutual agreement among all parties concerned for the discharge of a valid existing obligation by the substitution of a new valid obligation on the part of the debtor or another, or a like agreement for the discharge of a debtor to his creditor by the substitution of a new creditor.'" *Navine v. Peltier*, 48 Wis. 2d 588, 593, 180 N.W.2d 613, 615 (1970) (citing 39 Am. Jur. *Novation* p. 255, sec. 2). Novation can occur by either substitution of parties or by substitution of obligations between the same parties. *Siva Truck Leasing, Inc. v. Kurman Distributors, Div. of S. Abraham & Sons, Inc.*, 166 Wis. 2d 58, 67, 479 N.W.2d 542, 546 (Wis. Ct. App. 1991). Here, OCI and AAC have done both. AAC was obligated to the RMBS Policyholders under the terms of the policies. OCI and AAC severed AAC's obligation to the RMBS Policyholders by placing those policies in the Segregated Account, replacing AAC's obligation to the RMBS Policyholders with an obligation of the Segregated Account and altering that obligation so that claims will be paid only partly in cash, and the rest in notes.

For a novation to be effective, a party asserting the novation must demonstrate: (a) a clear showing of consent to the novation; and (b) sufficient consideration to support the new obligation. *Siva Truck Leasing*, 166 Wis. 2d at 68. AAC did not – and cannot – make either

showing. First, the RMBS Policyholders never consented to the attempted novation. Indeed, the RMBS Policyholders only learned that their obligation was transferred to the Segregated Account *after* AAC created the Segregated Account and placed it in rehabilitation. (R. 38-8.) Second, there was no consideration for the transfer. To the contrary, the transfer had the effect of stripping the RMBS Policyholders of significant value. After the transfer, the RMBS Policies were capitalized with a $2 billion Secured Note and a reinsurance policy from AAC, both of which are treated as subordinate in nature to the liabilities in the General Account and are of questionable value.

OCI argues that novation is inapplicable because OCI was acting under the insurance statutes. (R.73-33 - 73-34.) OCI is incorrect. OCI was not acting under the statutes because, as described in detail in Part II.A, *supra*, it was acting in contravention of the statutes by approving the formation and the transfer of the RMBS Policies to an inadequately capitalized Segregated Account.

Moreover, the RMBS Policies were altered *prior* to any rehabilitation. AAC's board, as directed by OCI, modified AAC's contractual obligations to the RMBS Policyholders prior to the commencement of the rehabilitation proceedings. (R. 1-8 - 1-10.) This

action took place outside the rehabilitation proceedings and outside the supervision of the Court. The authority to modify a contract as part of a rehabilitation begins when the rehabilitation is initiated.[3] OCI exceeded its authority by modifying AAC's obligations prior to the rehabilitation. OCI's powers are limited by the power and authority given by the Wisconsin legislature in the Wisconsin Insurance Code. *Duel v. State Farm Mut. Auto. Ins. Co.*, 240 Wis. 161, 170, 1 N.W.2d 887, 891 (1942); *see also Aetna Life Ins. Co.*, 101 Wis. 2d 90, 108, 113-14, 303 N.W.2d 639, 650 (1981). Effectively, OCI acting in its capacity as regulator (not rehabilitator), executed a key part of the rehabilitation plan without first placing AAC in rehabilitation, without finalizing a plan of rehabilitation, and without the statutorily mandated supervision of the Court.

Because OCI and AAC cannot demonstrate that a novation occurred or that it complied with the requirements of Wisconsin law, the Circuit Court's holding that the transfer of the RMBS Policyholders' policies to the Segregated Account was proper should be reversed.

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[3] *Cf.* Wis. Stat. § 645.32(1) ("An order to rehabilitate . . . shall appoint the commissioner and his or her successors in office rehabilitator and shall direct the rehabilitator to take possession of the assets of the insurer and to administer them under the orders of the court."); Wis. Stat. § 645.33(2) ("Subject to court approval, the rehabilitator may take the action he or she deems necessary or expedient to reform and revitalize the insurer."). The

C. The Transfer Of The RMBS Policies To The Segregated Account Violated The Constitutions Of The United States And Wisconsin.

1. The Transfer Of The RMBS Policies To The Segregated Account Was A Taking.

OCI's actions in transferring the RMBS Policies to the inadequately capitalized Segregated Account constituted a constitutionally impermissible taking. The Circuit Court erred as a matter of law when it held that the transfer was not a taking. (R. 127-15, App. 64.) The Circuit Court summarily concluded, without any analysis or citation to proof, that "the allocation of Movants' policies to the Segregated Account did not effectuate a taking of Movants' property." (*Id*.) The Circuit Court's conclusion was incorrect as a matter of law. An unconstitutional taking occurs where, as here, an individual's property is taken for public use without providing just compensation. U.S. Const. amend. V, cl. 5; Wis. Const. art. I, §13.

The RMBS Policyholders have a valid and constitutionally protected property interest in their insurance contracts with AAC. *See, e.g., U.S. Trust Co. of N.Y. v. N.J.*, 431 U.S. 1, 19 n.16, 97 S.Ct. 1505, 1516 (1972) ("Contract rights are a form of property and as such may be taken for a

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Commissioner is clothed with the authority to take actions to revitalize the insurer only

public purpose provided that just compensation is paid."); *Wis. Retired Teachers Ass'n, Inc. v. Employee Trust Funds Bd.*, 207 Wis. 2d 1, 18, 558 N.W.2d 83 (1997) (Wisconsin Retirement System annuitants had a property interest and the use of the account to pay a dividend to certain annuitants was a taking of the plaintiffs' property). When the AAC Board of Directors created and OCI approved the Segregated Account without adequately capitalizing it, thereby replacing AAC's obligations with a different obligation of the Segregated Account, that action was a taking as a matter of law. *See, e.g., Zinn v. State*, 112 Wis. 2d 417, 426-27, 334 N.W.2d 67 (1983) (Department of Natural Resource's ruling that had the effect of converting 200 acres of the plaintiff's property to public land, was a taking).

OCI has acknowledged that it formed the Segregated Account for the use and benefit of the public. (*See* R. 2-3, 2-22.) In the Circuit Court, OCI argued that "[t]hese restructuring efforts have sought to protect the interests of all policyholders and the public by maximizing policyholder claims payment resources and avoiding punitive termination provisions, by providing an orderly and equitable claims payment process, and by

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after the court appoints him or her as rehabilitator.

minimizing disruptions in coverage to the greatest possible extent." (*Id.*; *see also* R. 73-23, 73-30 - 73-32.)

Those actions impaired the RMBS Policyholders' contractual rights. Under the RMBS Policies, the RMBS Policyholders had a contractual right to make claims against an insurer with a policyholders' surplus of nearly $892 million and assets of $8.5 billion. (R. 38-27.) OCI took that contractual right and substituted it with new contracts requiring the RMBS Policyholders to make claims only against the inadequately capitalized Segregated Account, which OCI admits will not be able to make full cash payments to the RMBS Policyholders. (*See* R. 73-17, 73-18.)

OCI challenges the RMBS Policyholders' taking claim by arguing that "[n]either Ambac nor its policyholders can use private contracts to restrict the exercise of OCI's authority." (R. 73-36.) But OCI cannot use its authority to violate the constitutional rights of the RMBS Policyholders. *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990) ("Of course, the Rehabilitator is constrained by constitutional mandate."), *aff'd in part sub nom., Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086 (Pa. 1992). Because OCI took these actions for the public, it was required to provide the RMBS Policyholders with "just compensation." *See, e.g., U.S. Trust Co. of N.Y.,*

431 U.S. at 19 n.16 ("Contract rights are a form of property and as such may be taken for a public purpose provided that just compensation is paid."); *Wis. Med. Soc'y, Inc. v. Morgan*, 2010 WI 94, __ Wis.2d __, __ N.W.2d __ (health care providers have a constitutionally protected interest in the Injured Patients and Families Compensation Fund, such that the transfer of money from the fund was an unconstitutional taking of private property without just compensation). Instead, OCI impaired the RMBS Policyholders' contract rights and did not provide the RMBS Policyholders with any compensation. Indeed, OCI approved the placement of the RMBS Policies into a Segregated Account that was not adequately capitalized as required by Wisconsin law. Accordingly, the Circuit Court erred as a matter of law by holding that the transfer of the RMBS Policies to the Segregated Account was not a taking.

2. The Transfer Of The RMBS Policies To The Segregated Account, Without Notice And An Opportunity To Be Heard Violated The RMBS Policyholders' Due Process Rights.

The Circuit Court erred as a matter of law when it held that "[m]ovants also had no due process right to notice and a hearing prior to OCI's approval of the Segregated Account." (R. 127-15, App. 64.) The due process clauses of the Constitutions of the United States and Wisconsin

ordinarily require advance notice and an opportunity to be heard prior to the deprivation of property rights. *See* U.S. Const. amend. XIV, § 1, Wis. Const. art. I, § 1; *Soc'y Ins. v. Labor & Industry Review Com'n*, 2010 WI 68, ¶ 28 n.11, 786 N.W.2d 385 ("the due process clause in our state constitution is the 'substantial equivalent' to its counterpart in the federal constitution."). As such, the RMBS Policyholders were entitled to notice and an opportunity for a hearing *prior* to the state's – through OCI – deprivation of their property rights. *See Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 436, 102 S.Ct. 1148 (1982) ("absent 'the necessity of quick action by the State or the impracticality of providing any predeprivation process,' a post-deprivation hearing . . . would be constitutionally inadequate") (citations omitted); *see also Milwaukee Dist. Council 48 v. Milwaukee County*, 2001 WI 65, ¶ 48, 244 Wis. 2d 333, 627 N.W.2d 866 ("'The fundamental requisite of due process of law is the opportunity to be heard'") (internal citations omitted).

Even if a post-deprivation hearing would be sufficient, the RMBS Policyholders have been denied that as well. By denying the RMBS Policyholders the right to intervene in the Circuit Court proceedings, the RMBS Policyholders have received neither a pre-deprivation nor a meaningful post-deprivation hearing. OCI violated the RMBS

Policyholders' due process rights by transferring their policies to the Segregated Account without even the most minimal due process protections. *Cf. Huber v. Martin*, 127 Wis. 412, 105 N.W. 1031, 1040 (Wis. 1906) (statute was unconstitutional where it "authorizes the appropriation of the property of one private corporation . . . to the use of another private corporation").

OCI argues that none of the policyholders were required to receive notice because "Ambac has approximately 15,000 policies, making it impossible for OCI to conduct discussions on a confidential basis with all policy beneficiaries." (R. 73-38.) OCI also argued that the parties could have exercised their insolvency triggers before the Circuit Court entered the Injunction Order. (*Id.*) In other words, OCI argues that the RMBS Policyholders are not entitled to any due process rights because of unsupported confidentiality and feasibility concerns. OCI's arguments are misplaced. It is not constitutionally proper to deprive a party of its due process rights simply because the state complains that it will be hard for it to keep certain matters confidential or there are too many parties to work with. Interestingly, OCI had no secrecy concerns about negotiating the CDS Settlement with 17 mostly foreign banks, which represented a potential claim of approximately $12 billion in comparison to the trustees'

claims of $38 billion. Moreover, to protect against the insolvency triggers, OCI could have executed forbearance agreements as it did with the banks with which it negotiated the CDS Settlement. (R. 1-7.)

In sum, the RMBS Policyholders were entitled to notice and an opportunity for a hearing *prior* to the state's – through OCI – deprivation of their property rights. The Circuit Court's holding to the contrary was in error.

III. The Circuit Court Erred In Failing To Review The CDS Settlement.

The Circuit Court erred in declining to review, and yet approving, the CDS Settlement. The settlement authorizes AAC to disburse $4.6 billion in cash and notes from the General Account to foreign banks to settle one class of claims. In the Circuit Court, the RMBS Policyholders raised serious questions about the proposed settlement. For example, the RMBS Policyholders questioned whether the CDS holders had any right to recover from AAC before policyholders were paid in full. If they had no such right, the effect of the settlement was to pay $4.6 billion to parties that were not entitled to recover anything before policyholders were paid in full. Significantly, there is no evidence that any of the CDS Counterparties has suffered any losses to date. Thus, the settlement may cripple the

rehabilitation, as the General Account remains the Segregated Account's sole source of funding. Factual discovery was needed to determine if the settlement was in the interests of the Segregated Account.

Rather than review this important transaction as the law requires, or even to permit discovery so the parties could explore these issues and present their arguments to the court in a developed fashion, the Circuit Court held it lacked authority to limit OCI's approval of the CDS Settlement because OCI was acting only as a regulator. (R. 151-14, 151-125 - 151-126, App. 32, 42-43.)

First, the Circuit Court erred as a matter of law when it ruled that it lacked authority to review the CDS Settlement, and instead adopted OCI's proposed findings of facts and conclusions of law regarding the settlement without admitting evidence or permitting discovery. (R. 151-125 - 151-128, App. 42-45.) As discussed in Part II.A, *supra*, the Circuit Court committed reversible error by making factual findings without any support in the record. *See Woodard v. Woodard,* 2005 WI App 65, ¶ 12, 281 Wis. 2d 217, 696 N.W.2d 211. The Circuit Court did not consider crucial questions in connection with whether the CDS Settlement is appropriate.

For example, the Circuit Court did not take any evidence or discuss the true value of consideration for the Settlement. (R. 121-34 - 151 -35.)

Second, the Cooperation Agreement between AAC and the Segregated Account makes clear that the CDS Settlement – even if it was a General Account transaction – was also a transaction of the Segregated Account, and therefore it was subject to judicial review. The Cooperation Agreement establishes the relationship between the Segregated and General accounts during the rehabilitation. That agreement requires the Segregated Account's written consent to consummate any transaction by AAC that involves consideration or other proceeds in excess of $5,000,000. (*See* R. 1-33.) The $4.6 billion CDS Settlement would, of course, exceed that threshold many times over. The need for the Segregated Account's consent for such transactions is understandable because the Segregated Account's sole source of funding, and its lifeblood for its reformation or revitalization, is the General Account.

By statute, the operation of the Segregated Account is subject to the authority of OCI. *See* Wis. Stat. § 645.32(1). OCI, therefore, has the obligation to approve important actions of an entity in rehabilitation, and the Court has the obligation to approve actions taken by the rehabilitator to "reform and revitalize the insurer." Wis. Stat. § 645.33(2). Wisconsin's

insurance rehabilitation statutes mandate Circuit Court approval of the CDS Settlement. (*See* R. 38-19 - 38-22; R.104-2 - 104-6.) The Circuit Court abdicated this responsibility and gave OCI unfettered discretion to enter into an extraordinary transaction when it failed independently to review the transaction. Indeed, at no point in the hearing did OCI or AAC proffer to the Circuit Court the documentation for the proposed transaction, or even a term sheet.

Third, even without the Cooperation Agreement, judicial approval of the CDS Settlement is required because the General Account is inextricably intertwined with the rehabilitation of the Segregated Account, over which the court has authority. Wis. Stat. § 645.33(2). The General Account is the principal source of funding for the company in rehabilitation and if AAC's statutory surplus falls below $100 million, or such higher amount as OCI may determine, due to the dissipation of its assets, such as through settlements, the General Account will no longer be obligated to contribute to the rehabilitation. (R. 1-64; R. 1-79.) The Segregated Account is completely dependent on the existence of the General Account, and if the General Account fails, the Segregated Account's funding will disappear. The CDS Settlement caused the immediate transfer of $4.6 billion of cash

and notes out of the General Account. If the exchange was unfavorable for the General Account, it will negatively affect the rehabilitation.

The RMBS Policyholders do not contend that OCI, as rehabilitator, is required to seek court approval for each and every decision made in the course of the rehabilitation. Rather, Wis. Stat. § 645.33(2) imposes the requirement of court approval upon "action[s] he or she deems necessary or expedient to reform or revitalize the insurer." However this phrase might be applied in other circumstances, there can be no doubt here that OCI deems the CDS Settlement to be an action that is "necessary or expedient to reform or revitalize" the Segregated Account. Without the settlement, the claims addressed by the CDS Settlement would otherwise be allocated to the Segregated Account. (R. 1-7.) ("The Commissioner presently contemplates that, at such time as one of the CDS Contracts is no longer the subject of a forbearance agreement in full force and effect, that CDS Contract will be allocated to the Segregated Account immediately.").

Consequently, the CDS Settlement falls within the requirement of prior court approval under the plain language of Wis. Stat. § 645.33(2). In failing to review the propriety of the CDS Settlement, the Circuit Court ignored the plain language of Wis. Stat. § 645.33(2) requiring the court to review the transaction.

Fourth, the CDS Settlement requires court approval because the entity responsible for the policies subject to the settlement has been transferred to the Segregated Account. Ambac Credit Products, LLC ("ACP") is a party to the CDS Settlement because it was the direct counterparty in the CDS transactions. ACP is not an entity found on the General Account side of the wall that OCI has erected. Rather, the Segregated Account is the owner of 100% of the limited liability interests of ACP. (R. 1-6; R. 1-17 - 1-18.) As the sole owner of ACP, the Segregated Account had a direct interest in whether to proceed with a settlement involving billions of dollars of liabilities being asserted against that wholly owned subsidiary. OCI's attempt to preclude the court's jurisdiction to evaluate the CDS Settlement by classifying it as a matter utterly unrelated to the Segregated Account and Wis. Stat. § 645 fails by reason of the very interrelated structure OCI itself has created. Thus, the arbitrary and unreviewed separation of AAC into a Segregated Account and a General Account does not, as the Circuit Court found, deprive the court of the power and statutory obligation to review OCI's actions.

Requiring judicial review of the CDS Settlement is consistent with decisions in other jurisdictions that hold that a rehabilitator's discretion is constrained by judicial oversight. As courts in other states have

recognized, a rehabilitator's ability to make decisions is "circumscribed by [the courts'] mandate to act as a check on potential discretionary abuse and *to insure equitable apportionment of loss*." *Grode*, 572 A.2d at 804 (emphasis added); *accord* Wis. Stat. § 645.01(4)(d) ("The purpose of this chapter is the protection of the interests of insureds, creditors, and the public generally . . . through . . . [e]quitable apportionment of any unavoidable loss.").

Requiring judicial review is also consistent with federal bankruptcy law, which is instructive when a court is interpreting insurance rehabilitation/liquidation rules,[4] and supports the conclusion that court approval is required for transactions outside the ordinary course of business. *See, e.g.*, 11 U.S.C. § 363 (requiring court approval before a sale of property outside the ordinary course of business); Fed. R. Bankr. P. 6004 (requiring notice and a hearing before a sale of property outside the ordinary course of business). Here, consent to a commutation of the CDS Counterparties' claims in exchange for total consideration of $4.6 billion is

[4] State courts often look to federal bankruptcy law when interpreting state statutes governing insurance rehabilitation and dissolution proceedings. *See, e.g.*, *Pine Top Ins. Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 969 F.2d 321, 324 (7th Cir. 1992) (looking to bankruptcy law regarding voidable preference doctrine is customary when interpreting a voidable preference dispute under state insurance law). OCI and AAC themselves in their own pleadings have attempted to argue by analogy to concepts found in the federal bankruptcy law. (*See, e.g.*, R. 7-16 - 7-19; R. 69-31 - 69-32.)

far outside the ordinary course of business and, therefore, requires the court's approval.

Thus, the Circuit Court erred in stating that it had no authority to review the CDS Settlement. Had the Circuit Court reviewed the CDS Settlement, as the law required, it would have concluded – at a minimum – that limited discovery into the merits of the settlement was needed. In the Court below, the RMBS Policyholders and other parties questioned whether the CDS Settlement subverted the priority scheme set forth in the Wisconsin Insurance Code. That statute gives priority to the claims of insurance policyholders over an insurer's general creditors. If the CDS Counterparties are general creditors, not insurance policyholders, as the RMBS Policyholders maintained, their claims would come after all of the policyholders of AAC. The settlement resolved this question – it treated the CDS Counterparties as insured parties. This was a contested factual issue dependent on the nature of the CDS contracts at issue. The Circuit Court never conducted the review necessary to determine if the CDS Counterparties were entitled to anything before policyholders were paid in full, and the Court refused to permit the discovery necessary to allow that analysis.

Therefore, the discovery and judicial review the RMBS Policyholders sought below was not simply a procedural issue. If, after review, the Circuit Court concluded that the CDS Settlement violated Wisconsin law, it should never have been approved. Now, if this Court were to reverse, OCI and the Segregated Account could attempt to recover the funds improperly disbursed to the CDS Counterparties, or to seek whatever relief would otherwise be available. (*See* June 2, 2010 App. Ct. Order, at 5-6.)

In sum, authority to consent to a $4.6 billion settlement without court approval is neither reasonable under any rational scheme of rehabilitation nor permitted by the plain language of the Wisconsin statute.

CONCLUSION

The RMBS Policyholders respectfully request that this Court reverse the Circuit Court's order denying the RMBS Policyholders' motion to intervene and motion to modify the temporary injunctive order.

Dated this 13th day of September, 2010.

Reinhart Boerner Van Deuren s.c.
22 East Mifflin Street, Suite 600
Madison, WI 53703
Telephone: (608) 229-2200
Facsimile: (608) 229-2100

Mailing Address:
P.O. Box 2018
Madison, WI 53701-2018

Of Counsel:

David M. Greenwald
John B. Simon
Jenner & Block LLP
353 N. Clark Street
Chicago, Illinois 60654
Telephone: (312) 222-9350
Facsimile: (312) 840-7774

Patrick J. Trostle
Jenner & Block LLP
919 Third Avenue, 37th Floor
New York, New York 10022
Telephone: (212) 891-1665
Facsimile: (212) 909-0835

Bryan K. Nowicki
WI State Bar ID No. 1029857
Jessica Hutson Polakowski
WI State Bar ID No. 1061368
R. Timothy Muth
WI State Bar ID No. 1010710

By /s/Jessica H. Polakowski
Attorneys for Aurelius Capital *Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC*

COURT OF APPEALS OF WISCONSIN
DISTRICT IV

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Plaintiffs-Respondent,

AMBAC ASSURANCE,

Interested Party-Respondent,

v.

WELLS FARGO BANK/Trustee of
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MELLON and DEUTSCHE BANK
NATIONAL TRUST COMPANY,

Defendants,

FEDERAL HOME LOAN MORTGAGE
CORPORATION,

Defendant-Petitioner-Co-Appellant,

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LP, FIR TREE, INC., KING STREET
CAPITAL MASTER FUND, LTD., KING
STREET CAPITAL, L.P., MONARCH
ALTERNATIVE CAPITAL, LP and
STONEHILL CAPITAL MANAGEMENT

LLC,

Defendants-Petitioners-Appellants,

EATON VANCE MANAGEMENT, NUVEEN ASSET MANAGEMENT, RESTORATION CAPITAL MANAGEMENT, LLC, STONE LION CAPITAL PARTNERS, LP,

Defendants-Co-Appellants-Petitioners.

FORM AND LENGTH CERTIFICATION

I hereby certify that this brief conforms to the rules contained in § 809.19(8)(b) and (c) of the Wisconsin Statutes for a brief produced with a proportional serif font. The length of this brief is 10,625 words.

Dated this 13th day of September, 2010.

Reinhart Boerner Van Deuren s.c.
22 East Mifflin Street, Suite 600
Madison, Wisconsin 53703
Telephone: (608) 229-2200
Facsimile: (608) 229-2100

Mailing Address:
P.O. Box 2018

Bryan K. Nowicki
WI State Bar ID No. 1029857
Jessica Hutson Polakowski
WI State Bar ID No. 1061368
R. Timothy Muth
WI State Bar ID No. 1010710

By */s/ Jessica H. Polakowski*

Madison, Wisconsin 53701-2018

Of Counsel:

David M. Greenwald
John B. Simon
Jenner & Block LLP
353 N. Clark Street
Chicago, Illinois 60654
Telephone: (312) 222-9350
Facsimile: (312) 840-7774

Patrick J. Trostle
Jenner & Block LLP
919 Third Avenue, 37th Floor
New York, New York 10022
Telephone: (212) 891-1665
Facsimile: (212) 909-0835

Attorneys for Aurelius Capital *Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC*

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ALTERNATIVE CAPITAL, LP and
STONEHILL CAPITAL MANAGEMENT

LLC,

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NUVEEN ASSET MANAGEMENT,
RESTORATION CAPITAL
MANAGEMENT, LLC, STONE LION
CAPITAL PARTNERS, LP,

Defendants-Co-Appellants-Petitioners.

CERTIFICATION OF COMPLIANCE WITH RULE 809.19(12)

I hereby certify that:

I have submitted an electronic copy of this brief, excluding appendix, if any, which complies with the requirements of s 809.19(12). I further certify that:

This electronic brief is identical in content and format to printed form of the brief filed as of this date. A copy of this certificate has been served with the paper copies of this brief filed with the court and served on all opposing parties.

Dated this 13th day of September, 2010.

Reinhart Boerner Van Deuren s.c.
22 East Mifflin Street, Suite 600
Madison, Wisconsin 53703
Telephone: (608) 229-2200
Facsimile: (608) 229-2100

Mailing Address:
P.O. Box 2018
Madison, Wisconsin 53701-2018

Of Counsel:

David M. Greenwald
John B. Simon
Jenner & Block LLP
353 N. Clark Street
Chicago, Illinois 60654
Telephone: (312) 222-9350
Facsimile: (312) 840-7774

Patrick J. Trostle
Jenner & Block LLP
919 Third Avenue, 37th Floor
New York, New York 10022
Telephone: (212) 891-1665
Facsimile: (212) 909-0835

Bryan K. Nowicki
WI State Bar ID No. 1029857
Jessica Hutson Polakowski
WI State Bar ID No. 1061368
R. Timothy Muth
WI State Bar ID No. 1010710

By */s/ Jessica H. Polakowski*
Attorneys for Aurelius Capital *Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC*

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Defendant-Petitioner-Co-Appellant,

AURELIUS CAPITAL MANAGEMENT
LP, FIR TREE, INC., KING STREET
CAPITAL MASTER FUND, LTD.,
KING STREET CAPITAL, L.P.,
MONARCH ALTERNATIVE CAPITAL,
LP and STONEHILL CAPITAL
MANAGEMENT LLC,

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NUVEEN ASSET MANAGEMENT,
RESTORATION CAPITAL
MANAGEMENT, LLC, STONE LION
CAPITAL PARTNERS, LP,

Defendants-Co-Appellants-
Petitioners.

CERTIFICATE OF SERVICE

I hereby certify that on September, 13, 2010, I served by first class mail, postage prepaid, upon counsel listed below the RMBS Policyholders' brief.

/s/ Jessica H. Polakowski

Ambac Assurance Corporation
c/o Daniel W. Stopher
Stafford Rosenbaum LLP
222 W Washington Ave., Suite 900
P.O. Box 1784
Madison, WI 53701-1784

and

c/o William G. Primps
Emily L. Saffitz
Allison H. Weiss
Peter A. Ivanick
Lynn Roberts
Dewey & Leboeuf LLP
1301 Avenue of the Americas
New York, NY 10019

Sean Dilweg, Commissioner of Insurance of the State of Wisconsin
c/o David G. Walsh
Michael B. Van Sicklen
Matthew R. Lynch
Foley & Lardner LLP
150 East Gilman Street
Madison, WI 53701

and

c/o Kevin G. Fitzgerald
Andrew A. Oberdeck
Foley & Lardner LLP
777 East Wisconsin Avenue
Milwaukee, WI 53202

Wells Fargo Bank, as Trustee of bondholders
c/o Steven T. Whitmer
Kevin A. Wisniewski
Lock Lord Bissell & Liddell LLP
111 South Wacker Drive
Chicago, IL 60606

and

c/o Stephen L. Morgan
Brittany S. Ogden
Murphy Desmond S.C.
33 East Main Street, Suite 500
Madison, WI 53703

LVM Bondholders
c/o Philip Bentley
Amy Caton
Susan Jacquemot
Kramer Levin Naftalis & Frankel LLP
1177 Avenue of the Americas
New York, NY 10036

and

c/o Noreen J. Parrett
Parrett & O'Connell, LLP
10 East Doty Street, Suite 621
Madison, WI 53703

Bank of New York Mellon
c/o Laura E. Callan
Solheim Billing & Grimmer SC
One South Pinckney Street, Ste. 301
Madison, WI 53701

and

c/o Dale C. Christensen, Jr.
Thomas Ross Hooper
Seward & Kissel LLP
One Battery Park Plaza
New York, NY 10004

U.S. Bank National Association
AND
Deutsche Bank National Trust Company, solely in its capacity as Trustee AND Deutsche Bank Trust Company Americas, solely in its capacity as Trustee
c/o Paul E. Benson
Paul A. Lucey
Nathan L. Moenck
Michael Best & Friedrich LLP
100 East Wisconsin Ave, Ste. 3300
Milwaukee, WI 53202

and

c/o John M. Rosenthal
Kristine Bailey
Morgan, Lewis & Bockus LLP
One Market St., Spear Street Tower
San Francisco, CA 94105

Wells Fargo Bank, as Trustee of RMBS certificate holders
c/o Jane C. Schlicht
Cook & Franke, S.C.
660 East Mason Street
Milwaukee, WI 53202

and

c/o Michael E. Johnson
William B. Macurda
Cele Ogawa
Alston & Bird LLP
90 Park Avenue
New York, NY 10016

Federal Home Loan Mortgage Corporation
c/o David I. Cisar
Susan E. Lovern
Christopher J. Stroebel
von Briesen & Roper, s.c.
411 East Wisconsin Avenue, Ste. 700
Milwaukee, WI 53202

and

c/o Robert A. Zeavin
Craig S. Bloomgarden
Manatt, Phelps & Phillips, LLP
11355 W. Olympic Blvd.
Los Angeles, California 90064

and

c/o Marcia D. Alazraki
Manatt, Phelps & Phillips, LLP
7 Times Square
New York, NY 10036

Melissa A. Kern
1103 Boundary Rd.
Middleton, WI 53562