

September 16, 2010

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Honorable William D. Johnston
Lafayette County Circuit Court
Lafayette County Courthouse
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Darlington, Wisconsin 53530-0040

Re: *In the Matter of the Rehabilitation of Segregated Account of Ambac Assurance Corporation*, Case No. 10 CV 1576 (Dane County Circuit Court)

Dear Judge Johnston:

This letter is in response to Attorney Greenwald's letter to the Court, dated September 8, 2010, which requested the Court to set a briefing schedule and hearing date relating to the August 30, 2010 Motion to Clarify Order for Temporary Injunctive Relief (the "Motion"), filed by six hedge funds and securities brokers-dealers ("the RMBS Movants"). The Motion seeks an advisory opinion from this Court as to whether the RMBS Movants may proceed with a proposed lawsuit in New York state court against Ambac parent company Ambac Financial Group, Inc. ("AFG").

For the reasons detailed below, the Rehabilitator renews his suggestion that this matter be set for a scheduling conference.

The RMBS Motion involves several issues relating to the RMBS Movants and whether the relief they seek would improperly interfere with the ongoing rehabilitation proceedings. Without answers to certain threshold questions regarding the RMBS Movants' identity, interests, and intent in bringing the proposed lawsuit, the Rehabilitator is unable to take an informed position on the Motion. The Rehabilitator therefore opposes the truncated briefing schedule suggested by the RMBS Movants, and submits that the RMBS Movants' recent motions and actions raise fundamental questions that require more substantial inquiry.

These questions arise for several reasons. First, the face of the complaint of the proposed New York lawsuit raises doubts regarding whether the RMBS Movants are seeking this lawsuit in good faith, or rather as an end-around the rulings of this Court. For example,

- The proposed complaint appears to ask a New York court to decide challenges relating to the Bank Group Settlement that the RMBS Movants unsuccessfully raised in this Court in May (and continue to challenge on appeal).

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- Numerous allegations of the complaint concern matters covered by the Plan of Operation, and/or relate to the formation of the Segregated Account and OCI's involvement—matters that have been raised and ruled upon by this Court.
- The complaint also reiterates multiple times that OCI has refused to provide financial information they claim is necessary “to evaluate AAC’s financial condition fully.” Thus, it appears that one primary goal of the RMBS Movants’ lawsuit is to impose the same burdensome discovery on OCI and the Rehabilitator that this Court has not permitted in this rehabilitation proceeding.
- The relief requested is a remedy that belongs to the insurer and the Rehabilitator. Wis. Stat. §§ 617.21, 617.22, 617.225, 617.23, 617.25; Wis. Admin. Code Ins. § 40.18.
- It is wholly unclear how the RMBS Movants would have standing to seek the relief they request in the proposed complaint for several reasons, including the fact that they do not allege any factual support for the claim that they are, in fact, policyholders or beneficiaries authorized to be heard with regard to the policies in question under those policies’ trust documents.

Therefore, the bare face of the proposed complaint raises questions as to whether the RMBS Movants are pursuing this New York action with a reasonable, good-faith basis for obtaining the relief identified in their complaint, or whether they are merely seeking to circumvent certain adverse rulings by the Rehabilitation Court.

Certain events surrounding the filing of the Motion have also raised concerns regarding the motives of the RMBS Movants in seeking the New York lawsuit and the overbroad discovery of protected financial information. The enclosed press release of August 30, 2010 appears to have been authored by the RMBS Movants and sent to numerous media outlets at the same time the Motion was filed. The next day, Ambac bonds plummeted to a three-month low, as detailed in the enclosed article *Ambac Bonds Decline After Hedge Funds File Motion* (Bloomberg Businessweek, Aug. 31, 2010). The RMBS Movants also authored the attached, overtly slanted press release regarding this Court’s hearing on September 9, 2010—a hearing at which they did not even appear. The Rehabilitator’s concerns regarding improper motives are heightened by the RMBS Movants’ refusal to disclose the nature of their interest and to establish their ability to assert the rights of policyholders under any applicable trust documents.¹

¹ In their September 8th letter, the RMBS Movants state that—despite having refused for months to provide any information about the nature of their purported investments pertaining to

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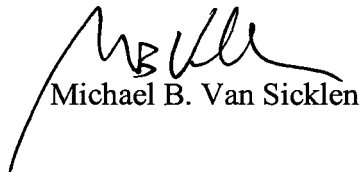
These threshold issues cannot be adequately addressed in the truncated briefing schedule suggested by the RMBS Movants. Nor is a truncated schedule necessary. While the RMBS Movants express concern that AFG's bankruptcy may be imminent, they do not suggest that a delay to address these important issues will materially affect whether they can prosecute their claims to judgment in New York state courts prior to such a bankruptcy filing.

Therefore, the Rehabilitator reiterates his suggestion that a briefing and hearing schedule relating to the RMBS Movants' August 30th Motion, as well as the RMBS Movants' pending Motion for an Information Sharing Order, be set during a scheduling conference at a date convenient for the Court and opposing counsel *after* an initial showing by the RMBS Movants that (1) they are policyholders or policy beneficiaries with a right to be speak on their own behalf in accordance with applicable trust documents; (2) there is a reasonable, good-faith basis for their belief that the relief sought by their proposed complaint could be granted, including the basis for their belief that they possess standing and the legal right to seek such relief; and (3) their proposed lawsuit will not interfere with the rehabilitation proceeding, including circumvention of rulings, approvals, and disapprovals of this Court or the Rehabilitator

Thank you for your attention to this matter.

Very truly yours,

FOLEY & LARDNER LLP



Michael B. Van Sicklen

Enclosure

cc: Counsel of Record (with enclosure, via email)
Jody Baux, Dane County Clerk (with enclosure, via first-class mail)

RMBS notes insured by the Segregated Account in response to the Rehabilitator's written and oral requests for them to do so—they are now willing to provide such information. *See* 9/8/10 ltr. at 2 (“the RMBS Policyholders are willing to provide to the Court and OCI, under seal and with a proper protective order, information regarding the specific trusts in which they hold AAC-insured RMBS”). The Rehabilitator is willing to enter into a protective order to keep the RMBS Movants' disclosure confidential, and urge the RMBS Movants to promptly identify the transactions, trusts and policies as to which their claimed investments relate, the dates of their alleged purchases, and the provisions of the trust documents which give them standing rather than the trustees.

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Ambac Policyholders Seek to Enjoin Ambac Financial Group from Benefiting from Fraudulent Transfer of Ambac Assurance's Assets

Posted on : 2010-08-30 | Author : Ambac Policyholders
News Category : PressRelease

NEW YORK - (Business Wire) Policyholders with over \$1 billion of securities and other indebtedness insured by Ambac Assurance Corporation ("AAC") and placed in a segregated account filed today a motion to enable litigation that would seek to enjoin AAC's parent, Ambac Financial Group, Inc. ("Ambac" or "AFG") (NYSE: ABK), from fraudulently accepting dividend payments from AAC and utilizing AAC's net operating losses without fair consideration being paid to AAC. The motion was filed with the Circuit Court of Dane County, Wisconsin, which is supervising rehabilitation proceedings of the segregated account into which over \$57 billion of policies insured by AAC were transferred.

Specifically, the complaint seeks to enjoin AFG from removing "assets from AAC without fair consideration at a time when AAC is failing to pay its policyholders' claims as they come due and AFG has publicly declared that it is likely to file its own bankruptcy proceedings under the United States Bankruptcy Code in the near future."

In addition, the complaint alleges that AAC paid in excess of \$230 million in dividends to AFG and certain preferred shareholders of AAC in 2008 and 2009 – at a time when AAC's financial condition was deteriorating precipitously, projected claims payments and loss impairments were mounting, and its liquid claims-paying resources were eroding. The complaint seeks to recover these amounts.

The lawsuit alleges that, "[t]he Policyholders, who are owners of or managers of funds that own securities and other indebtedness insured by AAC, have attempted to obtain a commitment from AAC and AFG that no value, which would otherwise be a fraudulent transfer, will be transferred to AAC's parent without fair consideration. AAC and AFG have refused to make such a commitment, though their decision-making on the issue is impeded by the systemic conflicts of interest between them. For example, the same law firm serves as the principal legal counsel for both AFG and AAC and has been advising them as to all of the events alleged herein. AAC and AFG also share the same financial advisor in connection with their financial restructurings, including the rehabilitation proceedings, the June Settlement [a June 2010 settlement of certain policies], and AFG's impending bankruptcy. The directors of AAC and AFG have been identical, and there is significant overlap between their officers. This common management further demonstrates the utter lack of arm's length dealing between these two entities despite their dire financial condition."

The complaint further alleges that, "[d]espite its dire financial condition, AAC has nevertheless insisted on preserving its ability to make dividend payments and to otherwise transfer substantial value to AFG for no consideration. For

example, under the terms of [the 'June Settlement'], AAC can transfer to AFG up to approximately \$59.5 million per year to cover AFG's own operating and debt service expenses. Similarly, because of a June 2010 amendment to a tax sharing agreement between AFG and AAC, AFG is permitted to utilize AAC's valuable net operating loss tax carryforward to offset certain forms of income without compensating AAC for such use. The amount of AFG's use of AAC's net operating losses could easily be more than \$1 billion." The complaint alleges that "[t]hese transfers should not be permitted. Absolutely no value should be transferred from AAC to its parent AFG while policyholders and creditors of AAC have claims that have not been paid in full."

In filing the motion, the plaintiffs stated that, "Despite our best efforts to obtain appropriate information to assure a rehabilitation plan for AAC that serves the best interests of all policyholders and is in the public good, the shared leadership teams of both Ambac and AAC have chosen to turn a deaf ear. Instead, they appear intent on engaging in an effort to pursue a plan using a process that lacks any transparency – at great cost to policyholders and to the detriment of the public – while at the same time diverting value to the parent company at policyholder expense."

Policyholders who had involuntarily been placed into the AAC segregated account include the plaintiffs, other policyholders of AAC-wrapped residential mortgage-backed securities, government-sponsored entities, insurance companies, pension funds and other institutional investors.

The complaint was included in a filing today asking the Wisconsin court to clarify an ex parte temporary restraining order issued on March 24, 2010, when the Wisconsin Office of the Commissioner of Insurance filed its initial petition to rehabilitate AAC's segregated account. Unlike holders of policies left in AAC's general account, holders of policies placed in the segregated account are barred from seeking any loss payments from AAC on their insurance policies. The temporary restraining order by its terms did not enjoin actions against AFG, AAC's parent. The plaintiffs are seeking clarification that the filing of the complaint against AFG will not violate the earlier court order restraining actions against AAC.

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Ambac Bonds Decline After Hedge Funds File Motion

August 31, 2010, 4:40 PM EDT

By Christine Richard and Dakin Campbell

(Updates with names of hedge funds in fifth paragraph.)

Aug. 31 (Bloomberg) -- Ambac Financial Group Inc. bonds fell to the lowest in almost three months after a group of hedge funds filed a motion to prevent the insurer from taking assets out of a bond-guaranty unit.

The policyholders filed the motion in the circuit court of Dane County, Wisconsin, to stop Ambac Financial Group from siphoning off dividends from its Ambac Assurance unit or using net operating losses without compensating the subsidiary, according to a statement yesterday. The holding company has said it may file for bankruptcy.

"Absolutely no value should be transferred from Ambac Assurance Corp. to its parent Ambac Financial Group while policyholders and creditors of Ambac Assurance Corp. have claims that have not been paid in full," policyholders said in the statement.

Ambac's \$400 million of 5.95 percent notes due in 2035 fell 4 cents to 26 cents on the dollar, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority. That's the lowest since June 10, Trace data show.

The group of hedge funds includes Aurelius Capital Management LP, Fir Tree Inc., King Street Capital LP, Monarch Alternative Capital LP and Stonehill Capital Management LLC, according to the court filing.

Peter Poillon, a spokesman for New York-based Ambac, said the firm doesn't comment on litigation.

Insurance Unit

Ambac, the second-largest bond insurer before the onset of the credit crisis, was stripped of its AAA credit ratings in 2008 after a surge in losses on securities backed by mortgages. In March, Wisconsin Insurance Commissioner Sean Dilweg said he was splitting the insurance unit in two to segregate policies on which the bond insurer is expected to pay claims.

The policyholders own more than \$1 billion in securities and other instruments insured by Ambac, according to the statement.

Dilweg said he would take over Ambac's policies on residential mortgage-backed securities and halt some payments, preserving capital to back the policies of municipal bondholders. Claims set for payment to mortgage investors threatened to deplete Ambac's reserves, Dilweg said.

Ambac lost its ability to take dividends from the insurance unit and said it was considering bankruptcy-court protection after the stoppage of payments threatened the holding company's ability to cover expenses, according to a June 8 filing.

Mortgage Losses

Ambac has already settled with other investors holding insurance against mortgage losses. In June, Ambac said it had torn up its remaining \$16.4 billion of obligations tied to collateralized debt obligations backed by subprime mortgages. The bond insurer said it would pay \$2.6 billion in cash and \$2 billion of newly issued surplus notes to a group of banks, including Deutsche Bank AG and Royal Bank of Scotland Group Plc, which had purchased default protection on the CDOs.

Calls to Dilweg's office weren't returned.

The case is In the Matter of Rehabilitation of Segregated Account of Ambac Assurance Corp., 10-cv-1576, Circuit Court, Dane County, Wisconsin.

--Editors: Chapin Wright, Pierre Paulden

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Earthtimes.org (Press Release)[Print this Page](#)[Close Window](#)**AMBAC Segregated Account Structure Challenged in Wisconsin Court**

Posted on : 2010-09-10 | Author : RMBS Policyholders Group
News Category : PressRelease

NEW YORK - (Business Wire) The RMBS Policyholders Group today stated that the arguments challenging the legality of the Ambac Assurance Corporation ("AAC") segregated account (the "Segregated Account") presented yesterday by, among others, Deutsche Bank, U.S. Bank, Depfa Bank, Wells Fargo, Bank of America and Lloyds TSB Bank, in their capacity as trustees for securities insured by AAC, in the Circuit Court of Dane County, Wisconsin, underscore the inequitable treatment of policyholders and the lack of transparency in the Wisconsin insurance regulator's rehabilitation case of the Segregated Account. In separate reply briefs and oral arguments, these banks have challenged the legality of the Segregated Account, which includes over \$57 billion of policies insured by AAC that were involuntarily transferred into that account.

The challenges, arguments, and concerns presented in Court, in conjunction with briefs filed by the parties last week, raise fundamental fairness issues in the rehabilitation proceedings including:

The unequal treatment afforded to policyholders whose policies have been allocated to the inadequately capitalized Segregated Account in violation of Wisconsin law.

Depfa Bank, in its statements before the Court, criticized "the lack of any rational basis for making any distinction between the policies in the General and Segregated accounts" and said that this segregation "amounts to an abuse of discretion on the part of the [Insurance] Commissioner." Regarding assurances that the Segregated Account structure has resulted in capital adequacy, Depfa explained that splitting AAC's liabilities between a segregated account and a general account cannot, without more, transform a defunct insurer such as AAC into two healthy ones. In other words, moving liabilities from one account to a new account does not suddenly make the new account adequately capitalized and it "smacks of Enron accounting." Depfa also noted that the Segregated Account structure would be impermissible in any bankruptcy court in America.

Lloyds Bank argued before the Court that the assets that supposedly serve to capitalize the Segregated Account are merely "a house of cards upon which the Segregated Account and the Court order are built." Lloyds called the Commissioner's statement that policyholders would be treated equally a "sham." Lloyds asked that if such treatment were really the case, then why would the Commissioner create the Segregated Account in the first place? Instead, Lloyds alleged that the more favorable treatment given to general account creditors amounted to a "preference" that violated fundamental insurance principles.

In its brief, Depfa Bank asserted that, "the Commissioner's actions fail to protect 'policyholders as a whole' and instead place the entire financial burden

of Ambac's failure on the Segregated Account policyholders...Depfa will call a pig a pig...Prejudicing a minority of Ambac's policyholders (those with claims) in order to protect the majority of policyholders (those without claims) is a patent violation of his acknowledged fiduciary duty to protect 'policyholders as a whole.'"

Moreover, Deutsche Bank and U.S. Bank stated in their brief that "Notwithstanding the fact that, by law, [the Commissioner] as rehabilitator must represent the best interests of the *policyholders in the Segregated Account*...[The Commissioner] persists in treating Ambac General [Account] policyholders as its primary constituency...[C]onsistently when faced with conflicting interests of the General versus Segregated Account policyholders, OCI has chosen to side with the interests of the Ambac General policyholders, often at the expense of the Segregated Account policyholders....Given this behavior, [the Commissioner]'s failure to represent the best interests of the Segregated Account policyholders cannot seriously be disputed."

A fundamental lack of transparency, disclosure and due process

In its oral arguments before the Court, Deutsche Bank and U.S. Bank discussed the predicament of policyholders in the Segregated Account to seek redress: "We as policyholders are in a bit of a Never Never Land."

The Rehabilitation proceedings require policyholders in the Segregated Account to continue paying premiums to Ambac even though the company suspended benefit payments to policyholders. At the same time, the Court has issued a Temporary Restraining Order that prevents legal action against AAC and that prohibits exercising the right of setoff. Moreover, policyholders have been deprived of the legal right to obtain basic information about the rehabilitation.

ALL Student Loan and Lloyds TSB Bank in their brief argued: "The Rehabilitator asserts that the Segregated Account has 'access to all of the assets of Ambac'...yet the limited documents made available...either belie this contention or do not clearly provide for such... Further, the Rehabilitator refuses to permit either formal discovery or even informational requests..." The brief also stated that: "Although Movants have attempted to obtain financial and other information to verify the assertions of the Rehabilitator... [he] has failed to provide any such information...This failure to provide documentation amounts to a violation of Movants' right to due process."

The danger to Wisconsin insurance

In its oral arguments, Depfa Bank raised the potential deleterious effect of the Wisconsin Insurance Commissioner's plan on the Wisconsin insurance industry and posed the question, "Why would any person in their right mind ever buy a policy from a Wisconsin-domiciled insurance company? ... [This] effectively makes Wisconsin insurance policies unmarketable." In its brief, Depfa Bank further commented that: "[P]olicyholders of a Wisconsin insurer can have no assurance that their policies have any value or that their legal rights under their policies will be enforceable... [I]t is difficult to see why a rational purchaser would ever buy an insurance policy from a Wisconsin domiciled insurer." Depfa also alleged that the Commissioner's action amounted to "regulatory extortion" and an abuse of discretion because it threatened to

relegate policyholders in the Segregated Account unless parties agreed to the regulator's settlement terms.

The RMBS Policyholders Group said: "Much of the Ambac rehabilitation plan process to date has been inhibited by regulatory capture, that is, the OCI's favoring the company it is charged with regulating to the detriment of policyholders in the Segregated Account. Ambac appears to have been successful to date in ensuring that the regulator's plan is more supportive of Ambac and its equityholders than in exercising the OCI's statutory and fiduciary duty to ensure adequate capitalization for the benefit of all policyholders. We would hope that the Court will recognize the violations of due process that this process entails, as well as the enormous damage it may do to Wisconsin as a business center."

The judge said he would issue a written decision on the motions and made no decision at the hearing. Another hearing on related issues will be held on September 13, 2010.

Last week, the RMBS Policyholders Group, with over \$1 billion of securities and other indebtedness insured by AAC and placed in a segregated account, filed a motion to enable litigation that would seek to enjoin AAC's parent, Ambac Financial Group, from receiving dividend payments from AAC and utilizing AAC's net operating losses without fair consideration being paid to AAC. AFG has publicly stated that it is likely to file its own bankruptcy proceedings in the near future.

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