STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation Case No. 10 CV 1576

REHABILITATOR'S BRIEF IN SUPPORT OF MOTION FOR CONFIRMATION OF THE PLAN OF REHABILITATION

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

Dated this 21st day of October, 2010.

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INTRODUCTION

The Commissioner of Insurance of the State of Wisconsin, as Rehabilitator (the "Rehabilitator") of the Segregated Account of Ambac Assurance Corporation (the "Segregated Account"), submits this brief in further support of his Motion seeking confirmation of the Plan of Rehabilitation (the "Plan") for the Segregated Account. The Motion filed on October 8, 2010 explains the general legal context for the Rehabilitator's broad discretion in formulating plans of rehabilitation and the limited scope of judicial review for abuse of that discretion. *See* Motion ¶¶ 1-5. The Plan itself, as well as its accompanying exhibits and the Disclosure Statement, provide the factual support and rational basis for the Rehabilitator's conclusions regarding the fairness and necessity of the Plan.

As noted in the Motion and numerous other briefs, affidavits, and filings to date in this matter, and as evidenced in the Plan and Disclosure Statement, the substance of the Plan is a rational exercise of the Rehabilitator's delegated, broad discretion consistent with the flexibility that permeates Chapter 645 of the Wisconsin Statutes. *See, e.g.*, Wis. Stat. Ann. § 645.01 cmt. to subdiv. (4)(b) (noting rehabilitation should "emphasize the management process, not the legal process" and "[f]lexibility, informality, and expertise should be encouraged, as they are in this chapter"); Wis. Stat. Ann. § 645.32 cmt. (noting that rehabilitation orders are "formulated to emphasize flexibility and informality, and the rehabilitator is given broad powers"); 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."). Like all plans for insurance rehabilitation and restructuring, the Plan is necessarily tailored to address the particular circumstances facing Ambac and thereby serve the interests of policyholders, creditors, and the public generally. Wis. Stat. § 645.01(4). Therefore, this brief does not repeat all of those facts

and general legal principles supporting confirmation of the Plan as a rational exercise of the Rehabilitator's broad discretion. It is offered to demonstrate that the key tenets of the Rehabilitator's approach to addressing the deterioration of Ambac draw from, and are in conformance with, insurance rehabilitation precedents in other jurisdictions.

PLAN SUMMARY

The Plan calls for payments to policyholders for claims as they accrue in the form of a combination of cash and surplus notes, a structure which preserves claims-paying resources and allows for the consistent treatment of long-dated and short-dated policy claims. To promote fairness, transparency, and flexibility, the Plan requires the Rehabilitator to provide an annual report each June about the progress of the rehabilitation and to make a determination at that time as to the appropriateness of increasing the cash component of the policy claims payments.

The Plan also adopts the established priority scheme for equitable apportionment of losses set forth in Wis. Stat. § 645.68. Therefore, allowed administrative claims (*i.e.*, claims for fees and expenses necessary for administering the Segregated Account and implementing the Plan) will be paid in full in cash. Allowed policy claims (*i.e.*, claims that arise under the financial guaranty insurance policies allocated to the Segregated Account) will be paid with a combination of cash and surplus notes. The surplus notes will rank *pari passu* with surplus notes of Ambac (including the surplus notes issued in connection with the bank settlement agreement) and the Segregated Account (with the exception of the junior surplus notes). The surplus notes bear interest at the rate of 5.1% per annum, and principal and interest may only be paid with the approval of the Office of the Commissioner of Insurance ("OCI"). The principal amount of the surplus notes is scheduled to be paid on June 7, 2020, a date that was chosen so as not to disfavor

the surplus notes issued in connection with the Plan as compared to the surplus note issued in connection with the bank settlement agreement, or vice versa.

The Rehabilitator will seek an amendment to the Plan prior to June 1, 2020 to address the treatment of permitted policy claims expected to arise after June 1, 2020. While such treatment will depend on an updated evaluation at that time of the estimated liabilities and claims-paying resources of the Segregated Account, the Rehabilitator anticipates that, unless all permitted policy claims are being paid in full in cash at that time, a new series of surplus notes would be issued by the Segregated Account. This new series would rank *pari passu* with, and have terms essentially identical to, the issued and outstanding surplus notes, except that the new series of surplus notes would have a later maturity date.

Initially, the cash percentage will be 25% and the surplus note percentage will be 75%. The Rehabilitator believes that the best way to reasonably ensure equitable treatment for all policyholders is to set the initial cash percentage at a level the Segregated Account should be able to continue to pay throughout the life of the exposures allocated to the Segregated Account. If the Segregated Account were unable to continue paying the initial cash percentage at some point during the administration of the Plan, holders of long-dated policy claims might be treated less favorably than holders of short-dated policy claims. Accordingly, the initial cash percentage had to be set at a conservative level that could withstand an outcome worse than any of the Rehabilitator's financial projections included with the Disclosure Statement. The cash percentage will be reassessed on an annual basis at the time of the annual June reports, and can be increased annually (with the approval of this Court) as and when the Rehabilitator has greater clarity and comfort concerning the range of potential outcomes.

Consistent with their junior priority status under Wis. Stat. § 645.68, permitted general claims (*i.e.*, claims against the Segregated Account that are not administrative claims or policy claims) will be paid with junior surplus notes that are expressly subordinate to both the surplus notes issued in respect of permitted policy claims and the surplus notes of Ambac. No payments of interest or principal may be made on the junior surplus notes until all permitted policy claims and all non-junior surplus notes have been paid in full.

The Plan provides that the satisfaction of claims (whether in cash, surplus notes, or a combination of cash and surplus notes) operates as a release of the Segregated Account with respect to those claims and only those claims. The Plan provides that throughout the period of the Rehabilitation, all prior orders of this Court, including the Order for Rehabilitation and the Injunction Order, will remain in full force and effect, and that this Court will retain exclusive jurisdiction over the Rehabilitation.

Finally, the Plan requires the Rehabilitator to submit a report to the Court no later than June 1 of each year advising the Court on the status of the rehabilitation. Among other things, each report will indicate whether the next scheduled interest payment on the surplus notes has been approved. In conjunction with the annual report, the Rehabilitator may also petition the Court to amend the Plan to increase the percentage of each permitted policy claim paid in cash. Any amendment of the Plan requires the approval of this Court, after such notice and hearing as prescribed by this Court pursuant to Wis. Stat. § 645.33(5).

In fashioning the Plan, the Rehabilitator's discretion was informed by the extensive business and financial investigation and analysis performed by consultants and advisors to the Segregated Account and staff at OCI. That exhaustive effort, starting in 2008, is

described in paragraphs 2-4 of the May 19, 2010 Affidavit of OCI's Roger Peterson on file in these proceedings.

The Disclosure Statement filed with the Plan includes a detailed summary of the Rehabilitator's findings and conclusions regarding this rehabilitation, the realistic regulatory alternatives for addressing Ambac's hazardous financial statement, and the Rehabilitator's rationale for rejecting other options. The Disclosure Statement also provides information regarding the current and projected financial condition of the Segregated Account and Ambac under four different scenarios, and explains the assumptions underlying those projections. In addition, the Court-approved Web site for these proceedings includes links to numerous other documents relevant to the financial projections and the operation of the Segregated Account under the Plan, including periodic financial statements of the Segregated Account and Ambac and documents establishing the relationship between the General Account and the Segregated Account and their management services. Thus, policyholders and the public have been given access to an abundance of information pertinent to the fact-based considerations that informed the Rehabilitator's discretion in formulating the Plan.

THE PLAN IS A WELL-REASONED EXERCISE OF THE REHABILITATOR'S DISCRETION

As noted in the Motion, it is well-settled that the Rehabilitator has broad discretion to structure a plan of rehabilitation for an insurer, and this Court's review of the Plan is narrowly limited to protecting against abuses of that discretion. *See, e.g.*, *LaVecchia v. HIIP of N.J., Inc.*, 734 A.2d 361, 364 (N.J. Super. Ct. Ch. Div. 1999); *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1091-92 (Pa. 1992); *In the Matter of Van Schaick*, 268 N.Y.S. 88, 95 (N.Y. App. Div. 1933); 1 *Couch on Insurance* § 5:22 (3d ed. 2009). *See also* Wis. Stat. § 645.32 cmt. (noting that the "court's control [of the Rehabilitator] should be liberal, not strict,

and should be provided without cumbersome procedures"). For all of the reasons described in the Disclosure Statement, the other documents on file in these proceedings, and the Plan itself, the Plan represents a studied, deliberate exercise of the Rehabilitator's discretion.

Although every rehabilitation plan is unique because it is tailored to meet the distinct problems of a particular insurer, the Rehabilitator's exercise of discretion in this case is firmly grounded in precedent. Based on prior motions and arguments by certain parties-in-interest, the Rehabilitator anticipates that five related elements of the Plan may draw objections: (1) its distinction between Segregated Account policyholders and General Account policyholders; (2) the Rehabilitator's decision to commence rehabilitation to facilitate the orderly run-off of liabilities, rather than liquidation; (3) the Rehabilitator's determination that rehabilitation is more advantageous to policyholders, creditors, and the public than liquidation; (4) the Plan's adherence to the priority structure provided in Wis. Stat. § 645.68; and (5) the Plan's use of deferred payments subject to possible annual adjustment to promote equity and flexibility. For the reasons discussed below, such challenges would lack merit here. The Rehabilitator acted not only within his broad discretion, but also exercised that discretion in a manner consistent with the court-affirmed actions of other insurance commissioners seeking to rehabilitate distressed insurers in the interests of policyholders and the public.

I. AS RECOGNIZED BY *CARPENTER*, RATIONALLY BASED DIFFERENTIATIONS IN TREATMENT BETWEEN POLICYHOLDERS OF THE GENERAL AND SEGREGATED ACCOUNTS ARE PERMISSIBLE.

As the Rehabilitator noted in the Verified Petition filed in March, this rehabilitation does not apply to policies in the General Account. The terms of such policies are therefore unaffected by the Plan or the Injunction Order, and General Account policyholders continue to receive full coverage. Segregated Account policyholders, meanwhile, are presently

subject to a moratorium on claims payments and will not receive payments under the Plan on the terms for claims payment that existed prior to the commencement of rehabilitation.

The General Account/Segregated Account distinction among policyholders has been explained, briefed, and argued at length in numerous motions previously before the Court, and the Rehabilitator has further described the rational basis for this distinction in the Disclosure Statement. This brief will not repeat those discussions, except to note that this Court has ruled that the establishment of the Segregated Account and allocation of certain policies thereto was a fair, reasonable, and lawful response to Ambac's financial condition. (*See generally* May 27, 2010 Findings of Fact and Conclusions of Law ("Findings" and "Conclusions," respectively); July 16, 2010 Order.)

This brief will instead address the recurring assertion by certain parties-in-interest that the Rehabilitator's distinction between policyholders in the General and Segregated Accounts is unprecedented and inconsistent with the purposes of rehabilitation. Those criticisms of the Plan lack merit, as can readily be seen by reference to one of the earliest and most heavily cited precedents for insurance rehabilitation: *Carpenter v. Pacific Mutual Life Insurance Co. of California*, 74 P.2d 761 (Cal. 1937) (en banc), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938) ("*Carpenter*"). Despite subsequent changes in the insurance industry and the nature of the challenges faced by financially hazardous insurers, courts across the country recognize that *Carpenter*'s fundamental reasoning remains as relevant and applicable to rehabilitation proceedings today as it was when decided more than 70 years ago.[1]

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[1] *See, e.g., Minor v. Stephens*, 898 S.W.2d 71, 78 (Ky. 1995); *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1092-94 (Pa. 1992); *Mendel v. Garner*, 678 S.W.2d 759, 761 (Ark. 1984); *In re Am. Investors Assur. Co.*, 521 P.2d 560, 561-62 (Utah 1974); *Kueckelhan v. Federal Old Line Ins. Co.*, 418 P.2d 443, 405-06 (Wash. 1966).

Carpenter's relevance here is particularly striking. Although there are some differences between *Carpenter* and Ambac in the nature of the financial challenges relating to the insurer and its business, in many material respects the problems, solution, and rehabilitation plan for Pacific Mutual (the insurer in rehabilitation in *Carpenter*) are substantially similar to the circumstances here. Moreover, rehabilitators in other states have employed the methods sanctioned by *Carpenter* in rehabilitation plans for insurers under similar circumstances, and the opinions approving those plans further support the confirmation of the Plan here. *See generally, e.g.*, *Foster*, 614 A.2d 1086; *Van Schaick*, 268 N.Y.S. 88.

A. Minority of Policies Threatening Harm; Risks of Collateral Damage.

Pacific Mutual, the insurer in *Carpenter*, was a nationwide insurance company with several billions of dollars of policies in force (adjusting $600 million in 1935 for inflation). *Carpenter*, 74 P.2d at 775-76. The California Insurance Commissioner examined the company and found that while its core business was generally sound, a discrete subset of policies (25 percent or less of the thousands of policies in force) was "draining the company to disaster" due to the insurer's failure to accurately account for the risks of such policies when they were issued, resulting in premiums that were inadequate. *Id.* at 767, 776, 778. "Obviously, if an insurance company gets into financial difficulties, something must be done to remedy the situation[,]" *id.* at 775, but the insurer on its own was legally "powerless to change the existing" policy terms that were creating the hazard, *id.* at 776. Therefore, it was necessary for the Commissioner to take action pursuant to the state's police power to protect policyholders and the public. *Id.* at 775, 776.

The court noted that applying a one-size-fits-all approach to the entire company, or a implementing a more severe form of delinquency proceeding, carried the risk of significant collateral damage. Altering the coverage under the majority of policies that did not threaten

financial harm risked impairing the "valuable intangible assets" of the company, which included agency organization, good will, and going concern value believed to be worth "several millions of dollars." *Id.* at 772, 776. It also may have risked an overall reduction in claims-paying resources due to other potential consequences (such as the inability to write new policies and lapses or surrenders of unimpaired policies), to the detriment of all policyholders. *Id.* at 778-79.

Here, similarly, Ambac is a massive insurer with billions of dollars of policies in force. Like the California Commissioner, the Rehabilitator here examined Ambac's business and identified a discrete minority of policies (less than 1,000 of the roughly 15,000 policies in force) that posed material risks to Ambac's financial condition through the exercise of *ipso facto* contract "triggers" and/or current or projected losses. (Findings ¶¶ 26-27, 31, 36.) Like Pacific Mutual, an interruption in coverage for the vast majority of Ambac policyholders risked the loss of intangible assets, such as the possibility of eventually writing new policies in the public-finance sector, the historic "core of Ambac's insurance business." (Findings ¶ 24.) Unlike the *Carpenter* situation, however, the risks here were more than intangible; subjecting policies on performing transactions to a delinquency proceeding would activate "triggers" in contracts with third parties that could render those transactions non-performing, resulting in additional losses of $1 billion or more. (Findings ¶ 21.) Further, the risks were not limited to Ambac's business and policyholders; economic leaders warned OCI of the systemic danger of a full-blown rehabilitation of Ambac, with "unpredictable risks to the broader economy." (Findings ¶ 23.)

B. Tailoring the Restructuring With a Scalpel, Not a Sledgehammer

The Commissioner in *Carpenter*, confronted with the dilemma of collateral damage on a less ruinous scale than here, responded by fashioning an innovative, surgical approach for the aggregate benefit of all policyholders of Pacific Mutual. Rather than liquidating the company as a whole, or rehabilitating it under a plan calling for blanket reductions in

coverage for all policyholders—both of which would have jeopardized intangible assets and the company's claims-paying resources as a whole—the Commissioner segregated the company's liabilities by separating the healthy policies from those that threatened the company's financial condition, as determined by his "examination of the business" of the insurer. *Carpenter*, 74 P.2d at 767.

To accomplish this segregation, he took possession of the assets of Pacific Mutual as conservator, created a "new" Pacific Mutual (the functional equivalent of the General Account here) owned by the "old" company, and transferred all assets except this ownership interest to the new company. *Id.* at 767-68. He also proposed a reinsurance agreement whereby the new company would reinsure the healthy policies on the same terms as before, and the hazardous policies at the same premium rates but with "a reduced benefit schedule" of up to 80 percent, with the possibility of partially or fully restoring these reduced benefits over time depending on the financial condition of the new company. *Id.* at 768, 770-71. The plan also provided an opt-out process by which policyholders who wished to terminate their policies could obtain the equivalent of the liquidation value of their claims. *Id.* at 778.

In short, the California Commissioner's plan offered continuing coverage to all policyholders, albeit at reduced levels on the selected policies that the Commissioner identified as hazardous to the financial condition of the company. This reduced coverage was necessary, as it was "quite clear that, since the [pre-rehabilitation insurer] was insolvent, the new company could not assume all liabilities of the old company or it too would be insolvent" and further collateral damage would result. *Id.* at 778. Thus, the Commissioner took a realistic, targeted approach that maximized claims paying resources, prevented avoidable losses, maintained full coverage for the vast majority of the insurer's policyholders, offered reduced coverage for

policies that collectively threatened the company's financial health, and retained flexibility to provide additional future payments if that financial health improved. The Commissioner's narrowly tailored approach preserved claims paying resources "in excess of what they would be on liquidation" and greatly benefitted policyholders and the public as a whole. *Id.* at 775, 778-79.

Here, similarly,

> [t]he formation of the Segregated Account, the allocation of less than 1,000 of Ambac's almost 15,000 policies thereto, and the commencement of this rehabilitation of the Segregated Account was a fair and reasonable response to Ambac's financial condition. It addresses the serious financial hazards the allocated policies presented to Ambac and all of its policyholders (including those allocated to the Segregated Account), maximizes claims-paying resources, and avoids the unpredictable and potentially substantial collateral damage to Ambac, its policyholders, and the public that would accompany a full rehabilitation of Ambac.

(Findings ¶ 36.)

C. Affirming the Commissioner's Discretion

At the hearings to confirm the Commissioner's plan in *Carpenter*, "several hundred policyholders appeared in person or by counsel," *Carpenter*, 74 P.2d at 770, and raised numerous legal challenges, all of which were rejected. The court denied challenges claiming that the Commissioner lacked the legal authority to pursue rehabilitation via the use of structural changes to the corporation: "if to preserve such business—if to rehabilitate such business—a new corporation must be organized, the power clearly exists." *Id.* at 777. The court also denied challenges regarding the Commissioner's choice to implement a narrow rehabilitation and restructuring rather than more severe delinquency proceedings affecting all policyholders. *Id.* at 774-76. The court additionally denied challenges that the rehabilitation plan amounted to a fraudulent transaction, likening it to another case in which "the transfer to the new company of

the desirable assets of the old was in the ultimate interests of all creditors, and [] thereby valuable intangible assets were saved that by liquidation would have been lost." *Id.* at 777.

Most pertinently, however, the *Carpenter* court unequivocally rejected challenges to the rehabilitation plan's distinction between the majority of policyholders who would retain full coverage and the other policyholders who would receive reduced coverage under the plan. The court noted "[i]n the first place" that policyholders had the choice to opt out of the plan and receive the hypothetical liquidation value of their claim, which undermined challengers' contentions that the difference in treatment left them worse off than a broader delinquency proceeding. *Id.* at 777-78. But the court went on, however, to provide an alternative justification for the plan's distinctions among policyholders:

> Moreover, the record demonstrates that under the circumstances here existing the difference in treatment was justified. The life policyholders, and the commercial health and accident policyholders were paying adequate premiums for their insurance and these phases of the old company's business were highly profitable. The non-can policyholders were not paying adequate premiums, and this fact was the primary cause of the difficulties of the old company. The non-can policies were draining the old company to disaster. . . .

Id. at 778.

The court also flatly rejected the argument that the reduction in benefits should have been equalized, hypothesizing a number of rational bases justifying such a distinction among policyholders.

> The evidence might well have shown, and the conclusion seems to us quite a logical one, that, if life policies were reduced so as to be equalized with the non-can policies, such reduction would dangerously impair the possibility of writing new life insurance which would ultimately disorganize and destroy the agency organization. The evidence might well have shown (and probably did) that such reduction in life policies would cause lapses and surrenders in such policies, particularly of those still insurable in other companies, leaving only undesirable risks accepting the

> reduction. If the evidence showed these facts it might well be that the evidence also showed that equalization would produce less for the non-can policyholders than the plan adopted. In other words, the difference in treatment can be justified on the theory that such difference was necessary not only to preserve life policyholders' rights, but also the rights of non-can policyholders. Other grounds for the difference in treatment readily occur to us.

Id. at 778-79. In other words, a rehabilitation plan calling for reductions in coverage to some policyholders but not others, rather than an across-the-board cut to all policyholders, is rational and not "arbitrary or improperly discriminatory," *id.* at 775, when doing so could prevent collateral damage, preserve the core business of the insurer, provide for a greater ultimate recovery, or for any number of "other grounds" justifying such an approach.

For all the reasons described herein, and repeated in numerous briefs and affidavits on file in these proceedings as well as the Disclosure Statement, there are at least as many rational grounds justifying the difference in treatment between General and Segregated Account policyholders here as there were to support the differing treatment among policyholders in *Carpenter*.

II. REHABILITATION PLANS NEED NOT SEEK TO RESTORE THE INSURER TO ITS ORIGINAL CONDITION.

As noted in its introduction, the Plan does not seek to fully restore the Segregated Account or Ambac to its condition prior to the financial crisis, an outcome that could not realistically occur within the confines of a rehabilitation plan that fairly and equitably protected policyholders. Instead, the principal aim of the Plan is more modest: "the orderly run-off and/or settlement of the liabilities allocated to the Segregated Account." Plan, at 1.

Certain Movants who have previously raised challenges to the Injunction Order have argued or implied that this purpose is inappropriate for a rehabilitation, and that a liquidation is the sole proper vehicle for implementing an orderly run-off of liabilities. That is

not the law. While liquidation is one mechanism to achieve a run-off of liabilities—an unfair and negative one for policyholders under the circumstances here, for the reasons expressed in Part II.C.IV of the Disclosure Statement—rehabilitation is also an appropriate means to serve that purpose:

> The rehabilitation, in order to be legitimate, does not have to restore the company to its exact original condition. So long as the rehabilitation properly conserves and equitably administers 'the assets of the involved corporation in the interest of investors, the public and others, (with) the main purpose being the public good' the plan of rehabilitation is appropriate.

Foster, 614 A.2d at 1094 (quoting 2A *Couch on Insurance* 2d § 22.10).[2]

III. OCI ACTED WITHIN ITS DISCRETION IN CHOOSING REHABILITATION OVER LIQUIDATION.

Nor does an evaluation of this rehabilitation plan necessarily require a detailed, hypothetical analysis of how policyholders may have fared had OCI instead opted to liquidate the Segregated Account or Ambac as a whole.[3] A minority of states have legislatively enacted

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[2] Similarly, although there are basic procedural distinctions between "reorganizations" under Chapter 11 and "liquidations" under Chapter 7 of the federal Bankruptcy Code, it is well-settled that Chapter 11 reorganization plans may be premised on orderly liquidation (run-off) of the debtor's business over time. *See, e.g.*, 7 *Collier on Bankruptcy* § 1100.01, at 1100-4 (16th ed. 2010); Alan N. Resnick, *Bankruptcy Practice and Strategy* § 22.01[5][e], at 22-15 (1987).

[3] Contrary to some of the arguments that have been raised at various hearings, *Carpenter* did not hold that any rehabilitation plan, to be a valid exercise of discretion, must provide every policyholder or group of policyholders with at least the hypothetical value they might have received had the Rehabilitator opted to liquidate all or part of the insurer rather than taking a less severe approach. The plan in *Carpenter* provided that alternative for policyholders seeking to "opt-out" of the plan and instead receive the hypothetical liquidation value of their contract rights, but nothing in *Carpenter* suggests that it is a necessary component of all rehabilitation plans; indeed, by providing an alternative justification for the plan's differing treatment of a certain subset of policyholders, it suggests the opposite. *Carpenter*, 74 P.2d at 778-79. Further, the Supreme Court in its decision in that case mentions the liquidation-value option as undermining the *factual* premise of the policyholders' legal challenges, 305 U.S. at 305, at least one of which is inapplicable here because Chapter 645 was enacted well before the issuance of any Ambac policies in force and "the contract clause applies only to legislation subsequent in

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the requirement that rehabilitation plans must "provide no less favorable treatment of a claim or class of claims than would occur in liquidation," *see* Tex. Ins. Code § 443.103(c)(1); Utah Code § 31A-27a-303(3)(a), but Wisconsin has not joined them. Instead, this state's legislature has consistently preserved OCI's "considerable discretion to decide on direction depending on the specific facts of the individual case" in choosing the type of Chapter 645 delinquency proceeding to employ. Wis. Stat. Ann. ch. 645, introductory cmt. to subch. III.

These proceedings highlight the wisdom of that legislative choice to grant discretion to OCI to determine how best to protect the interests of policyholders and the public. Given the complex, individualized transactions and contractual triggers at issue, and the uncertainties regarding the potentially massive liabilities that were avoided through the bank settlement (but would have remained had OCI petitioned for liquidation), as well as uncertainties regarding policyholders' and third parties' responses to a liquidation, the outcomes of multi-fronted litigation that would have likely ensued in response, and any number of other factors, the variables in assessing a hypothetical liquidation value are innumerable. The multi-faceted disadvantages of the liquidation option rejected by OCI are summarized in Part II.C.4 of the Disclosure Statement. Needless to say, the protracted litigation that would certainly accompany such a procedure here stands in stark contrast to Wisconsin's view of rehabilitation as a "management rather than as a legal task." Wis. Stat. Ann. § 645.32 cmt.

The difficulties of the regulatory choices before OCI prior to March 24, 2010 are illustrated by the various positions taken by parties-in-interest before this Court: some have denounced the Segregated Account structure and urged that they would benefit more from a full

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time to the contract alleged to have been impaired." *Munday v. Wis. Trust Co.*, 252 U.S. 499, 503 (1920).

rehabilitation or liquidation of both the General and Segregated Accounts (*see, e.g.*, Sep. 1, 2010 Depfa Reply at 2 (dkt. 387)); some have applauded the Segregated Account rehabilitation as necessary and reasonable for certain policies other than their own (*see, e.g.*, June 9, 2010 LVM Bondholders' Br. at 2 (dkt. 167)); and some have stated that any delinquency proceeding involving the General Account could have severe adverse effects on their businesses, even those businesses that are not contributing to insured losses (*see* Affidavits of Kate Lavelle, R. Scott Massengill, and Stephen C. Vaughan (dkt. 87-89)).

In dealing with a rapidly deteriorating insurer with limited claims paying resources, it is not realistic, or even possible, to fashion a restructuring arrangement that guarantees a best-case outcome for every party-in-interest. Each policyholder is not entitled to choose the form of remedy that suits it best, nor are policyholders entitled "to force, at their own wish or whim," their remedy of choice regardless of the impact on others. *Neblett*, 305 U.S. at 305. *See also Van Schaick*, 268 N.Y.S. at 497 (affirming a rehabilitation plan despite dissatisfaction of some creditors because the insurer "will most likely be saved millions of dollars by the method of rehabilitation proposed" and "[t]he plan as suggested seems feasible and to be for the benefit of all concerned"). Thus, "[t]he Commissioner is best qualified to perform the rehabilitation/liquidation process as he has no special interest in the outcome except to administer the matter for the maximum benefit of all interested parties." *Minor v. Stephens*, 898 S.W.2d 71, 76 (Ky. 1995).

Based on the information that *is* known and set forth in the Disclosure Statement, OCI found that the statutorily imposed financial consequences of a full-blown liquidation of Ambac would have had a severe and negative impact on the collective interests of policyholders and creditors of the Segregated Account, as well as policyholders and creditors of the General

Account, and the public generally. Among other consequences, a liquidation would have brought: (1) the termination of all policies in force (many insuring risks for which replacement coverage is uncertain), with resultant uncertainties about the existence, amount and priority of claims due on terminated policies; (2) the loss of future premiums; (3) the return of unearned premiums with the resultant loss of future claims-paying resources; (4) the non-consummation of the Bank Settlement and resulting claims by the Bank Group for mark-to-market damages; and (5) unnecessary economic and financial distress for certain policyholders due to the possible exercise of third-party trigger provisions conditioned on the General Account not being directly subject to delinquency proceedings. *See* Disclosure Statement at II.C.3-4; Findings ¶¶ 20-26.

In addition to avoiding these adverse consequences of liquidation, rehabilitation also provides affirmative benefits to policyholders, creditors, and the public that exceed the benefits of liquidation. The public interest in preservation of coverage provided by a troubled insurer through rehabilitation is an essential element in determining whether a plan of rehabilitation should be approved over policyholder objections and arguments for liquidation. *Carpenter*, 74 P.2d at 775. As the *Carpenter* court noted,

> Obviously, if an insurance company gets into financial difficulties, something must be done to remedy the situation. Either the company must be liquidated, and its assets distributed to creditors, thus immeasurably injuring many of its policyholders who are thus deprived of insurance protection, or the business must, if possible, be rehabilitated. The public has a grave and important interest in preserving the business if that is possible. Liquidation is the last resort.

Id. Moreover, the benefits of this rehabilitation thus far—including the continuation of contracts and the ability of the Rehabilitator to facilitate and reach agreements with third parties, such as the Bank Group, the Weinstein entities, JPMorgan, and the Lehman Brothers debtors—would not have been possible on the same terms in liquidation and would be excluded in a liquidation

recovery analysis. *See Van Schaick*, 268 N.Y.S. at 492-93 (affirming a plan of rehabilitation that provided liquidation value from designated funds established at the outset of the restructuring, rather than permitting the holders of liquidated policies to recover the benefits of a newly formed company in rehabilitation).

In light of such considerations, the Rehabilitator concluded that the Plan does not impose harsher consequences for the Segregated Account collectively than would liquidation.[4] The Plan here provides "the benefits of rehabilitation such as flexibility and the accelerated disposition of claims which the Commonwealth Court properly recognized as preferable to, and distinct from, the ordinary procedures of liquidation[,]" *Foster*, 614 A.2d at 1094, and it is clear that under the Plan "the assets are far in excess of what they would be on liquidation[,]" *Carpenter*, 74 P.2d at 778. OCI's choice to pursue rehabilitation rather than liquidation was a rational exercise of discretion, and it cannot now be collaterally challenged in the form of policyholder-by-policyholder litigation over the hypothetical outcome had OCI exercised that discretion differently.

IV. THE PRIORITY SYSTEM ESTABLISHED IN THE PLAN IS RATIONAL AND APPROPRIATE.

While the General Account/Segregated Account distinction and certain provisions of the Injunction Order seek to prevent avoidable losses, the priority scheme presented in the Plan seeks "[e]quitable apportionment of any unavoidable loss." Wis. Stat. § 645.01(4)(d). The Plan therefore adopts the priority scheme set forth in Wis. Stat. § 645.68, which was specifically structured to "apportion loss equitably." Wis. Stat. Ann. § 645.01 cmt. to subsec. (4)(d).

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[4] Note that liquidation of the Segregated Account would cause the further collateral damage that in large part prompted the Rehabilitator to establish the Segregated Account in the first place, *see* First Affidavit of Roger A. Peterson ¶ 9(a), because it would automatically trigger a rehabilitation of the General Account, Wis. Stat. § 611.24(3)(e).

Rehabilitation plans routinely adopt liquidation priority schemes for this purpose. *See, e.g.*, *State ex rel. Long v. Beacon Ins. Co.*, 359 S.E.2d 508, 509-10 (N.C. App. 1987); *Neff v. Cherokee Ins. Co.*, 704 S.W.2d 1, 6-7 (Tenn. 1986).

The Plan also provides for proper application of Wis. Stat. § 645.68 in its treatment of Segregated Account claimants. Section 645.68 establishes that "every claim in each class shall be paid in full or adequate funds retained for the payment before the members of the next class receive any payment." Here, allowed class 1 claims for administrative costs of the Segregated Account are paid in full and in cash as they arise; allowed class 3 policyholder claims are paid with 25 percent cash and 75 percent surplus notes as they arise; and allowed class 5 general creditor claims are paid with junior surplus notes that are subordinate to the surplus notes issued to class 3 claimants. Thus, class 1 claims will be paid in full before all others, and class 3 claims will be paid in full before class 5 claims. Therefore, the Plan's distribution honors the equitable payment priorities contemplated by Section 645.68.

In keeping with this priority system, the Plan treats reinsurance claimants as class 5 general creditors rather than class 3 policyholders. In doing so, the Plan follows the well-established principle that reinsurance claimants are subordinate in priority to direct policyholders. *See, e.g.*, *Covington v. Ohio Gen. Ins. Co.*, 789 N.E.2d 213, 216 (Ohio 2003); *In re Liquidations of Res. Ins. Co.*, 524 N.E.2d 538, 541-42 (Ill. 1988); *Foremost Life Ins. Co. v. Ind. Dep't of Ins.*, 409 N.E.2d 1092, 1097 (Ind. 1980). *See also Beacon Ins. Co.*, 359 S.E. 2d at 510-11 (affirming a rehabilitation plan treating reinsurers and reinsureds as class 5 rather than class 3 claimants, in part because "public policy considerations favoring protection of policyholders are not as applicable, however, to the business of reinsurance"); *Neff*, 704 S.W.2d

at 6-7 (same). *Cf. Peerless Ins. Co. v. Manson*, 27 Wis. 2d 601, 606-08, 135 N.W.2d 258 (1965) (highlighting relevant distinctions between reinsurers and policyholders under Wisconsin law).

V. THE DEFERRED PAYMENT STRUCTURE IS A NECESSARY AND REASONABLE RESPONSE TO THE PROJECTIONS OF LIMITED CLAIMS PAYING RESOURCES.

Deferring immediate and full cash payment, as the Plan provides for class 3 and class 5 claimants, is recognized as an appropriate element of a rehabilitation plan if it presents "a reasonable means of dealing with the critical financial situation of the insurer and the plan has the capacity to achieve the desired result of releasing the financial pressures on the corporation." 1 *Couch on Insurance* § 5:24 (3d ed. 2009).

The cash-note split basis for payment has appeared in various forms in other rehabilitation plans, from *Carpenter*—which imposed reduced coverage on some policyholders but made provision for restoration of "further benefits and possibly full benefits" over time depending on the future condition of the insurer, 74 P.2d at 771—to the rehabilitation plan Pennsylvania courts approved for the Mutual Fire, Marine & Inland Insurance Company. There, "the statutory rehabilitator was to determine, in her expertise and discretion, and on Court review, the percentage to be paid on each adjusted claim, given Mutual Fire's cash available." *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 688 A.2d 233, 234 (Pa. Commw. Ct. 1997). The plan also allowed the rehabilitator the flexibility to increase the payment percentage over time based on her ongoing assessment of the insurer's financial condition. *Id.* at 234-35. Such deferred payments and flexibility for adjustments "obviated the need to wait until every last estate asset was collected in order to ensure equitable distribution of those assets." *Id.* at 235. As with the Plan here, "[i]t meant immediate, albeit partial, payment on policyholder claims." *Id. See also In re Rehabilitation of Am. Mut. Reinsurance Co.*, 606 N.E.2d 32, 34-35 (Ill. App.

1992) (noting approval of plan calling for payment through a combination of cash and "surplus drafts").

The cash-note payment mechanism here is similarly structured and similarly necessary to relieve immediate, overwhelming drains on Ambac's claims paying resources while permitting partial cash payments. Thus, it preserves coverage to the extent reasonable given Ambac's financial condition, retains flexibility to adapt to changes in that condition, and conserves resources to ensure their equitable distribution.

CONCLUSION

For the foregoing reasons, the Plan of Rehabilitation for the Segregated Account should be confirmed in its entirety, and the Court should enter the proposed order submitted by the Rehabilitator.

Dated this 21st day of October, 2010.

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