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

**OBJECTIONS BY FREDDIE MAC TO PROPOSED PLAN OF REHABILITATION**

The Federal Home Loan Mortgage Corporation ("Freddie Mac") hereby submits the following objections to the proposed Plan of Rehabilitation. Based on the applicable law discussed below, Freddie Mac respectfully requests that the Court enter Freddie Mac's proposed Order Denying Motion for Confirmation (submitted separately herewith), which provides that the Plan must be further supported, and modified, in the respects identified below, before it may be resubmitted to the Court for further consideration.[1]

***Preliminary Statement***

The Wisconsin Insurance Commissioner, acting in his capacity as Rehabilitator ("Rehabilitator") of the Segregated Account of Ambac Assurance Corporation ("Ambac"), has moved the Court for "confirmation" of a proposed Plan of Rehabilitation (the "Plan") for the Segregated Account. The Rehabilitator seeks "confirmation" of the Plan on the basis that it

[1] Freddie Mac was established by Congress in 1970 to provide liquidity, stability and affordability to the nation's residential mortgage market. In support of this mission, Freddie Mac purchases mortgages from lenders across the country and either packages the mortgages into securities that can be sold to investors or retains them in its own portfolio. To increase the supply of money available for mortgage lending and the availability of funding for new home purchases, Freddie Mac actively manages its retained portfolio. Freddie Mac's portfolio investments include, among other things, residential mortgage-backed securities ("RMBS"), commercial mortgage-backed securities ("CMBS") and mortgage revenue bonds ("MRB"). Freddie Mac is the owner of approximately $2 billion in RMBS insured by policies issued by Ambac that appear to have been allocated to the Segregated Account. Freddie Mac also is the owner of approximately $2.5 billion in CMBS and MRB that are insured by Ambac policies which appear to remain in the General Account. On September 6, 2008, Freddie Mac was placed into conservatorship and the Federal Housing Finance Agency ("FHFA") was appointed its Conservator pursuant to Section 1145(a) of the Federal Housing Finance Regulatory Reform Act of 2008, Pub. L. 110-289, 122 Stat. 2654 (the "Reform Act") (codified at 12 U.S.C. § 4617).

serves the purposes of rehabilitation and fairly protects the interests of policyholders, creditors and the public. *See* Rehabilitator's Motion for Confirmation of Plan ("Motion for Confirmation"), at 1. The Rehabilitator, however, has not demonstrated that the Plan treats policyholders "fairly and equitably," which is a basic purpose of Wisconsin's Insurance Code. Wis. Stat. § 601.01(2). Most fundamentally, the Rehabilitator has failed to demonstrate that policyholders will receive at least the liquidation value of their claims under the Plan, and the Plan fails to provide that policyholders may dissent from the Plan and receive the liquidation value of their claims.

In addition, the Plan contains a number of provisions which are beyond the Rehabilitator's legal authority and/or are unfair and inequitable to policyholders. In particular:

- Sections 4.04(g) and (h) of the Plan impermissibly require policyholders to surrender significant rights without first being paid in full, thus foregoing the consideration required by statute and contradicting the law of subrogation and principles of basic fairness and equity.
- The Plan impermissibly and unfairly reduces the priority of policyholder claims by subordinating them to a status lower than that of general creditor claims in the event of an ultimate liquidation.
- The provisions in Article 9 of the Plan providing for immunity and indemnification of Ambac are impermissibly overbroad and inequitable to policyholders.
- The Plan impermissibly treats credit default swap counterparties as policyholders, without any basis for placing them in the same priority class as policyholders.

Accordingly, the Plan cannot be confirmed on the current record or in its current form.

***Freddie Mac's Objections to the Plan and Requested Relief***

The Rehabilitator's discretion to fashion a plan of rehabilitation is not unfettered. The Court is required to conduct a meaningful review of the Plan under Wis. Stat. § 645.33(5) to ensure that the Plan does not exceed the Rehabilitator's authority and otherwise is fair and equitable to policyholders. The Court may not affirm the Rehabilitator's exercise of power if "the power has been abused or exercised beyond the limits conferred by the legislature." *State ex rel. Knudsen v. Bd. of Educ., Elmbrook Sch., Joint Common Sch. Dist. No. 21*, 43 Wis. 2d 58, 67, 168 N.W. 2d 295, 299 (Wis. 1969); *see also Sheely v. Wis. Dep't of Health & Social Servs.*, 150 Wis. 2d 320, 339, 442 N.W. 2d 1, 10 (Wis. 1989) (an administrative official's exercise of authority "will not be sustained if it has no basis in 'the appropriate and applicable law'"). In addition, as recognized by the Rehabilitator at page 3 of its Motion for Confirmation, a "Commissioner's plan for rehabilitation cannot be implemented without a court finding that it is fair and equitable [to all parties concerned.]" *LaVecchia v. HIP of N.J., Inc.*, 324 N.J. 85, 91, 734 A. 2d 361, 364 (N.J. Super. Ct. Ch. Div. 1999).

The more significant problems with the Plan from Freddie Mac's perspective – which render the Plan unlawful and unfair on the current record and in its current form – are discussed below, along with Freddie Mac's proposed remedies to these problems.[2]

1. *The Plan is not supported by the required analysis of whether policyholders will receive at least the liquidation value of their claims, and fails to provide policyholders with that option.*

The Rehabilitator's submissions in support of its Motion for Confirmation nowhere address whether policyholders in the Segregated Account will receive at least the liquidation

[2] Freddie Mac reserves the right to join in other objections that may be asserted by other parties.

value of their clams under the Plan. The Rehabilitator acknowledges as much, but contends that no such analysis is necessary to support Plan confirmation. *See* Rehabilitator's Brief in Support of Motion for Confirmation ("Rehabilitator's Brief"), at 14-15. The Rehabilitator is wrong. As this Court just recognized in its Decision on Motions Challenging the Legality of the Establishment and Structure of the Segregated Account, etc., filed October 26, 2010 (the "Decision"):

> "Fair and equitable treatment and operation of the Segregated Account under Wis. Stats. Sec. 601.01(2) . . . indicates that policyholders must receive at least the liquidation value of their claims from a plan of rehabilitation. . . . *Carpenter v. Pac. Mut. Life Ins. Co. of Cal.,* 74 P. 2d 761, 778 (Cal. 1938), *aff'd sub nom Neblett v. Carpenter*, 305 U.S. 297 (1938) (policyholders must receive at least the liquidation value of their claims in a plan of rehabilitation).

Decision, at 14 (emphasis added).

The Rehabilitator ignores the plain language of *Carpenter* when he argues that the hypothetical liquidation value alternative is not a necessary component of the rehabilitation plan. Rehabilitator's Brief, at 14, n.3. In *Carpenter*, the California Supreme Court found that the rehabilitation plan treated the life policyholders (whose coverage was assumed in full) and the non-cancellable health and accident policyholders (whose coverage was reduced) differently, but held that such difference in treatment was lawful because every policyholder was given the option "to accept or reject the plan." *Carpenter,* 10 Cal. 2d 307, 335-336, 74 P. 2d at 777-78. The court found that those who consented to the plan would enter into a novation, whereas those who dissented were entitled to receive "the liquidated value of his contract rights without unreasonable delay[.]" *Id.* at 335-336, 777-78. Furthermore, the court found:

> On these appeals, without the evidence before us, in support of the judgment, we must assume that evidence was introduced on these vital points, and that such evidence demonstrated that dissenters under the plan will receive as much, or more, as they would have received on liquidation.

*Id.* at 335-336, 777-78.

This Court similarly must require that the Rehabilitator present precisely this type of evidence in the present case. Like the policyholders in *Carpenter* whose coverage was reduced under the plan in that case, policyholders in the Segregated Account must be allowed the option to dissent from the Plan and receive the liquidation value of their claims. The United States Supreme Court, in affirming the *Carpenter* decision, also expressly recognized that a policyholder whose rights are impaired in a rehabilitation plan must be given an opportunity to opt-out and receive instead the liquidation value of his claim:

> This position [that the rehabilitation plan was *per se* unlawful] is bottomed upon the theory that the policy holders are compelled to accept the new company as insurer on the terms set out in the rehabilitation agreement. As has been pointed out, they are not so compelled but are given the option of a liquidation which on this record appears as favorable to them as that which would result from the sale of the assets and pro rata distribution in solution of all resulting claims for breach of outstanding policies.

*Neblett v. Carpenter*, 305 U.S. 297, 305 (1938).

In the present case, the Rehabilitator completely skirts this obligation. Not only does he fail to offer a liquidation analysis, he provides such scant information that a policyholder is completely unable to perform such an analysis on his own. The limited information that the Rehabilitator does provide in his Disclosure Statement, including the four scenarios in Exhibits D through G thereto, is of little value without knowledge of the critical underlying assumptions, such as the projected housing prices and unemployment rates which would be necessary components in the analysis. Furthermore, the Rehabilitator does not provide any background regarding the models used or the credibility of the firm that conducted the analysis. In the

absence of such and other information,[3] neither this Court nor policyholders can assess the probability and feasibility of these four scenarios, which is necessary to an assessment of whether policyholders are likely to receive at least the liquidation value of their claims under any of the scenarios.

Lastly, it is critical to note that giving a Segregated Account policyholder the right to dissent from the Plan and receive its liquidation value is not merely academic. Under the terms of the trust documents for many residential mortgage-backed securities ("RMBS"), Ambac is entitled to reimbursement for insurance claims it pays. In the case of some trusts, Ambac receives its reimbursement "off-the-top" of the mortgage payments that the trust receives the following month. It appears that, under Section 4.04 (g) of the Plan, Ambac would be entitled to full reimbursement from the trust each month, in cash, for claims it paid the prior month – even though the claim was only paid 25% in cash and 75% in surplus notes. The economics of these transactions are such that a policyholder may well prefer to dissent from the Plan and receive the liquidation value of its claim, rather than continue to "reimburse" Ambac in full each month, in cash, for claims Ambac has only partially paid.

For these reasons, the Court must require that the Rehabilitator provide evidence of whether the Plan affords Segregated Account policyholders at least the liquidation value of their claims. Furthermore, the Plan must be amended to provide that Segregated Account policyholders may dissent from the Plan and receive the liquidation value of their claims. This is

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[3] For example, many of the policies moved to the Segregated Account are simply called "Private Leveraged Lease Transaction" and "Swap Surety Policy." There are no CUSIP numbers for any of the insured securities or any other identifying information that would permit an analysis of the risk and amount of loss the securities may generate.

particularly important since the Plan provides for what essentially is a private "run-off" and liquidation of the Segregated Account.[4]

2. *Sections 4.04(g) and (h) of the Plan impermissibly require policyholders to surrender significant rights without first being paid in full, thus foregoing the consideration required by statute and contradicting the law of subrogation and principles of basic fairness and equity.*

Section 2.02 of the Plan provides that Holders of Permitted Policy Claims[5] will receive a cash payment equal to 25% of the total amount of the claim and a Surplus Note for the balance. The amount policyholders will recover on these Surplus Notes is complete conjecture, as the Rehabilitator has provided insufficient information to support a fulsome analysis, as discussed above. In addition, payments under the Surplus Notes are subject to prior approval of the Rehabilitator (which is discretionary), and the Surplus Notes are backed by security in the form of the General Account Surplus Note and the Reinsurance Agreement, which similarly are subject to regulatory approval and under which payment is contingent upon Ambac having a minimum surplus. Full payment under the Surplus Notes, therefore, may not ever occur, and, in fact, probably will not occur.[6]

*Assignments*

Section 4.04(h) of the Plan contemplates that in return for the 25% cash payment and the issuance of the Surplus Note, there will be a full and complete assignment of the policyholder's rights to payment under the underlying instruments or contracts. As explained (in bold type) in the Disclosure Statement:

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[4] Rehabilitation, by its nature, is meant to provide a vehicle to enable a company to emerge as a going concern. There is no such fiction here. The Plan itself recognizes that the true nature of this proceeding is a "run-off." Plan, at 1.

[5] Capitalized terms not defined herein have the meanings set forth in the Plan.

[6] One ready indication that the Surplus Notes will not be paid in full is that the notes issued to the bank credit default swap ("CDS") counterparties pursuant to their settlement, which the Rehabilitator has stated will be treated in *pari passu*, are callable at around 22% of par. This indicates that the CDS bank counterparties do not expect the value of these notes to be materially higher than 22% of par.

> This assignment of rights . . . entitles [Ambac] to recover from the primary obligor on the relevant Ambac-insured instrument or contract 100% of the cash amount such obligor was contractually obligated to pay but failed to pay, even if the Holder of the Permitted Policy Claim receives less than (or is anticipated to receive less than) 100% in Cash on account of such Permitted Policy Claim under the Plan.

Disclosure Statement, at 32. Thus, Section 4.04(h) impermissibly contemplates that a complete assignment will occur prior to any payment on the Surplus Note.

*Reimbursements and Litigation Recoveries*

Similarly, Section 4.04(g) of the Plan impermissibly contemplates that Ambac would be entitled to a 100% cash reimbursement or recovery for claims which it pays only partially – i.e. 25% in cash and 75% in Surplus Notes. Section 4.04 (g) of the Plan provides:

> Notwithstanding . . . the satisfaction of Permitted Policy Claims with Surplus Notes in lieu of Cash, [Ambac] shall be entitled to recover the full amount of all recoveries, reimbursements, and other payments . . . .

Plan, at 19-20. This provision arguably would apply to reimbursements from the RMBS trust, as discussed under Objection 1 above, as well as litigation recoveries on RMBS trust assets. Ambac is actively pursuing recovery for improperly underwritten loans from certain loan issuers.[7] To the extent Ambac receives recoveries from such litigation, its recoveries should not exceed amounts actually paid on the underlying policy claims.

Section 4.04(h) regarding assignments, and Section 4.04(g) regarding reimbursements and litigation recoveries, are unfair and inequitable to Segregate Account policyholders in violation of Wis. Stat. § 601.01(2), and also are without fair consideration in violation of Wis. Stat. 611.24(h).[8] In addition, these provisions violate Wisconsin's "made whole" doctrine, a "'traditional equity principle' under which a party claiming subrogation rights may not recover

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[7] *See, e.g., Ambac Assurance Corporation v. Countrywide Home Loans, Inc., et al.*, Supreme Court of New York, filed September 28, 2010.

[8] Section 611.24(h) provides: "The corporation may by an identifiable act transfer assets for *fair consideration* among the segregated accounts, the general account and any trust accounts of the corporation." (Emphasis added.)

until the insured is fully compensated for his or her losses." *Ruckel v. Gassner*, 2002 WI 67, ¶17, 253 Wis. 2d 280, 287, 646 N.W. 2d 11, 15 (Wis. 2002). Under the made whole doctrine, "an insured must be made whole before the insurer may exercise subrogation rights against its insured, even when unambiguous language in an insurance contract states otherwise[.]" *Id.*, 2002 WI at ¶4, 253 Wis. 2d at 283, 646 N.W. 2d at 13.

The Plan and the form Surplus Note thus must be amended to provide that (1) an assignment of a policyholder's rights to Ambac will be deemed to occur only to the extent of the cash distributions actually received by the policyholder, (2) any litigation recovery can be retained by Ambac only to the extent of the cash distributions actually received by the policyholder, with the balance to be paid over by Ambac to the appropriate RMBS trust, and (3) reimbursement to Ambac from the RMBS trust will be allowed only to the extent of the cash distributions actually received by the policyholder.

*3. The Plan impermissibly and unfairly reduces the priority of policyholder claims by subordinating them to a status lower than that of general creditor claims in the event of an ultimate liquidation.*

Section 8.01 of the Plan provides that Distributions in respect of a Permitted Claim shall effect a full and complete release, discharge and termination of any Liens or other claims, interests or encumbrances upon the Segregated Account and Ambac with respect thereto. The term Distributions as defined in Section 1.20 includes those made in the form of Surplus Notes.

Thus, in the event of any liquidation of the Segregated Account, the basis for asserting a claim under a Surplus Note would be as a Surplus Note holder and not as a policyholder, which would result in a lower payment priority in the liquidation proceeding. Indeed, the form Surplus Note provides as much: "In a proceeding commenced under Chapter 645 of the Wisconsin Statutes, claims for interest on, principal of, or any redemption payment with respect to, the Notes constitute Class 10 claims under Section 645.68, as currently in effect." Plan, Exhibit B, Form of Surplus Note, at 11, ¶10(b).

This potential subordination of a policyholder's payment priority from Class 3 (Loss claims) to Class 10 (Contribution notes) is grossly unfair and inequitable in violation of Wis. Stat. § 601.01(2), and also violates the priority rules and prohibition against creating subclasses embodied Wis. Stat. § 645.68.[9] Both the Plan and the form Surplus Note to be issued in connection with Policy Claims must be modified to specifically provide that the holder shall have the right to make a claim based on the Surplus Note in the capacity of a policyholder if the Segregated Account is made subject to a liquidation proceeding.

*4. The provisions in Article 9 of the Plan providing for immunity and indemnification of Ambac are impermissibly overbroad and inequitable to policyholders.*

Article 9 of the Plan gives broad immunity and corresponding indemnity rights to Ambac (and its related persons and entities) as respects itself, the Segregated Account and in its capacity as services provider for the Segregated Account, with the exception of instances of intentional fraud or willful misconduct as determined by a Final Order (as defined in Section 1.24). This provides Ambac with near total immunity, to the potential detriment of Segregated Account policyholders, and in violation of Wisconsin law.[10]

The purpose of this rehabilitation is to preserve the assets of the Segregated Account for the ultimate benefit of Segregated Account policyholders. However, Ambac – which now has improved the financial condition of its General Account by virtue of the creation of the Segregated Account and stands to receive significant payments, at full value and on a priority basis, from the Segregated Account's assets in its capacity as a services provider – has little

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[9] Section 645.68 establishes priorities of claims in insurance rehabilitation and liquidation proceedings and provides 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. No subclasses shall be established within any class."

[10] The official comments to Wis. Stat. § 645.34 prohibit the rehabilitator from insulating the insurer from liability through rehabilitation: "The rehabilitator should not be permitted to escape actions and proceedings instituted against the insurer—if he needs to do that the insurer should be liquidated, not rehabilitated—but he should be given time to reconsider strategy."

accountability and would be virtually immune from liability for significant overcharges to the Segregated Account were they to occur.

Ambac's relationship with the General and Segregated Accounts is fraught with potential conflicts of interest. Consequently, policyholders should not be required to surrender all rights to seek damages for conduct by Ambac which damages the Segregated Account, except in the case of intentional fraud or willful conduct. This is not a case where an unrelated third party consultant or services provider is brought in to assist the rehabilitation. Under the Plan, Ambac will benefit greatly at the expense of Segregated Account policyholders, and should not be entitled to hide behind such broad immunity.

In this case, the interests of Ambac and its General Account are clearly favored, to the detriment of policyholders in the Segregated Account. The immunity and corresponding indemnity given to Ambac and its related persons and entities must be modified to permit policyholders to seek damages for any conduct which damages the Segregated Account.

*5. The Plan impermissibly treats credit default swap counterparties as policyholders, without any basis for placing them in the same priority class as policyholders.*

The term "Policy Claim" as defined in Section 1.49 of the Plan includes a Claim under a "Policy," which in turn is defined in Section 1.48 to include a ". . . financial guaranty insurance policy, surety bond or other similar guarantee allocated to the Segregated Account pursuant to the Plan of Operation." Section 2.02 contemplates that payment can be made as a Policy Claim with respect to guarantees by Ambac of the obligations of its subsidiary, Ambac Credit Products, LLC ("ACP"), to counterparties under related credit default swaps that ACP entered into. However, it is not clear whether these guarantees are in fact insurance policies issued by Ambac, as opposed to corporate parental guarantees of Ambac.[11] Nor is it clear whether, even if the

[11] The involvement of a financial guaranty insurer with a CDS obligation may arise in several ways, including (1) a subsidiary or affiliate of the financial guaranty insurer enters into the swap and the financial guaranty insurer issues a corporate parental guaranty (as opposed to a financial guaranty insurance policy) with respect to the obligations of the affiliate or subsidiary to the counterparty under the swap agreement, or (2) the insurer issues a

guarantees were in the form of an insurance contract, there was an insurable interest as opposed to "naked-swaps" (i.e., bets placed by the CDS counterparties on the failure of the securities held by others) pursuant to which the CDS counterparties have suffered no losses.[12]

By assigning CDS counterparties Class 3 priority claims as a matter of law, the Plan violates Wis. Stat. §645.68. The policies in question (if in fact they are insurance policies) are issued by Ambac to its subsidiary ACP. The counterparties are not themselves insureds. The proper status of these parties is, at best, unclear. These parties may well be general creditors and as such subordinated to Policy Claims. The Rehabilitator itself has recognized that this is an "open" issue. *See* Rehabilitator's Brief in Opposition to RMBS Policyholders' and LVM Bondholders' Emergency Motions, etc., filed May 20, 2010, at 20.

Therefore, any proposal by the Rehabilitator which would result in the guarantees on credit default swaps being treated as insurance policies must be preceded by an evidentiary hearing at which this "open" issue is addressed by the Court. The Plan must be revised to reflect the need for such a hearing before any swap counterparty is treated as a policyholder.[13]

***Conclusion***

This is an unprecedented proceeding which, contrary to the Rehabilitator's paternalistic attitude, requires careful judicial scrutiny. There is no other case that approves of the

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financial guaranty insurance policy insuring the obligations of its affiliate or subsidiary "transformer" under one or more referenced CDS agreements.

[12] Under Wis. Stat. § 645.68(3), policyholder priority attaches only to "claims under [insurance] policies for losses incurred[.]"

[13] The determination of whether the foregoing types of transactions constitute "insurance policies" involves more than simply a review of the terms of the CDS agreement. First, there should be a policy or insurance contract that should contain certain defined terms, such as a "no acceleration without consent" clause and a statement regarding lack of guaranty fund coverage. Although policy forms may not have to be approved in advance, they would typically need to be placed on file with applicable state insurance departments. Second, there also would be associated financial accounting requirements, including tracking and recording of premiums, establishment of contingency and other reserves and reflection in calculation of aggregate risk limits. Finally, there are other provisions of state law with respect to policy forms and rates that also would have had to be adhered to. The Rehabilitator has introduced no evidence on these issues and has in no way demonstrated that the CDS counterparties are entitled to policyholder status

segregation and run-off of certain policy claims by an insurance commissioner, to the benefit of other policyholders that are not subject to the "rehabilitation," on terms such as those contained in the proposed Plan here.

As discussed above, the Rehabilitator has failed to demonstrate that policyholders will receive at least the liquidation value of their claims under the Plan, and the Plan fails to provide that policyholders may dissent from the Plan and receive the liquidation value of their claims. Furthermore, the Plan contains a number of provisions which are beyond the Rehabilitator's legal authority and/or are unfair and inequitable to policyholders.

Accordingly, the Plan cannot be approved on the current record or in its current form. Instead, the Court should enter Freddie Mac's proposed Order Denying Motion for Confirmation, which provides that the Plan must be further supported, and modified, in the respects identified above, before it may be resubmitted to the Court for further consideration.

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Respectfully submitted

von Briesen & Roper, s.c.
411 East Wisconsin Avenue, Suite 700
Milwaukee, WI 53202
Telephone: (414) 276-1122
Facsimile: (414) 276-6281

David I. Cisar
WI State Bar ID No. 1009501
Christopher J. Stroebel
WI State Bar ID No. 1035182

By: _____
Attorneys for the Federal Home Loan Mortgage Corporation

*Of Counsel:*

Craig S. Bloomgarden
Manatt, Phelps & Phillips, LLP
11355 W. Olympic Boulevard
Los Angeles, California 90064
Telephone: (310) 312-4000
Facsimile: (310) 312-4224

and

Marcia D. Alazraki
Manatt, Phelps & Phillips, LLP
7 Times Square
New York, New York 10036
Telephone: (212) 790-4500
Facsimile: (212) 790-4545