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 REPLY 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 12th day of November, 2010.

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TABLE OF CONTENTS

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 and in response to the various briefs opposing confirmation.[1] The Rehabilitator has also submitted a modified proposed Order confirming the Plan, which modifies the Plan to clarify and address certain concerns and questions reflected in the written objections to confirmation of the Plan, as well as amendments to the Disclosure Statement and written answers to those questions submitted by objectors that appear to represent genuine, factual inquiries (as opposed to questions resembling contention interrogatories, requests to admit, or other forms more suited for routine, two-party adversarial civil litigation than this non-adversarial regulatory proceeding).

INTRODUCTION

Once again in these proceedings, this Court has afforded policyholders, creditors and the public the right to be heard regarding this rehabilitation. And once again, that invitation

[1] The objectors include: Aurelius Capital Management, LP, Fir Tree, Inc., King Street Capital, L.P., King Street Capital Master Fund, Ltd., Monarch Alternative Capital LP, and Stonehill Capital Management LLC (collectively the "RMBS Funds"); Eaton Vance Management, Nuveen Asset Management, Restoration Capital Management LLC, and Stone Lion Capital Partners L.P. (collectively the "LVM Funds"); Depfa Bank, plc ("Depfa"); The Federal Home Loan Mortgage Corporation ("Freddie Mac"); Countrywide Home Loans, Inc. and Countrywide Home Loans Servicing L.P. (collectively "Countrywide"); Access to Loans for Learning Student Loan Corporation and Lloyds TSB Bank, plc (collectively "Lloyds"); One State Street LLC ("One State"); Wilmington Trust Company and Wilmington Trust FSB (collectively "Wilmington"); Federal National Mortgage Association ("Fannie Mae"); Deutsche Bank National Trust Company, Deutsche Bank Trust Company Americas, and U.S. Bank National Association (collectively "Deutsche"); Bank of America, N.A. ("Bank of America"); Wells Fargo Bank, N.A. ("Wells Fargo"); Wells Fargo Bank, N.A., as trustee for certain LVM bondholders ("Wells Fargo LVM"); The Consumer Asset Protection Company ("CAPCO"); and the Bank of New York Mellon ("BNY"); and the Treasurer of the State of Ohio (the "Treasurer").

has produced voluminous and often vitriolic briefs, replete with arguments from self-interested entities attempting to disguise their dangerous "run-on-the-bank," "law-of-the-jungle" psychology—the very psychology that threatens to render rehabilitation "a futile exercise," Wis. Stat. § 645.32 cmt.— as the law of the land for Wisconsin insurance rehabilitations. It is not. Indeed, this narrow self-interested mentality among those with an interest in the proceedings is the very reason that the Rehabilitator, with the oversight of the Court, "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).

Judging solely by the sheer volume of paper submitted by various objectors earlier this week, one might expect that the hearings on confirmation of the Plan would drag on for months. Fortunately, upon closer review of these objections, a relatively small universe of new, contested issues have arisen. As the Court aptly noted at the scheduling conference for the Plan confirmation process, "with all of the . . . tremendously extensive briefing that has occurred, everybody I think is up to speed on their particular issues[.]" (10/14/10 Hearing Tr. at Dkt. 469.) This reply will not address those prior issues, and it cannot possibly address each and every specific objection to the Plan mentioned in the 15 briefs received this week. Without waiving any argument about some minor overlooked new objection not resolved by the amended proposed order, revisions to the Disclosure Statement and the Rehabilitator's written responses to all of the objectors' written fact questions, this reply will address the few new issues that appear to be central to the various objections.

ARGUMENT

I. MOST OF THE OBJECTIONS CONCERN MATTERS THAT ALREADY HAVE BEEN RESOLVED.

A number of objections raise issues that have been resolved in past hearings and decisions or through recent actions of the Rehabilitator, and therefore do not warrant detailed discussion here. These objections fall into three categories.

First, many of the objections seem targeted at preserving legal arguments that this Court has heard and decided before. These include: (1) legal issues regarding the establishment of the Segregated Account, such as whether Wis. Stat. § 611.24(2) requires the segregation of policies by "type" or was contrary to the interests of a "class";[2] whether the establishment of the Segregated Account effected an unlawful novation of contract,[3] whether OCI abused its discretion in approving the capital structure of the Segregated Account,[4] and whether it was unconstitutional;[5] (2) whether parties-in-interest are entitled to conduct formal discovery in this non-adversarial proceeding;[6] (3) whether injunction provisions preserving the insurer's control rights[7] and prohibiting set-off of premiums[8] are lawful and appropriate; (4) issues relating to the

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[2] *See, e.g.*, Deutsche Br. at 14-16, 18-19; Fannie Mae Br. at 17-18; LVM Br. at 11-12.

[3] *See, e.g.*, Deutsche Br. at 19-20; RMBS Funds' Br. at 2.

[4] *See, e.g.*, Deutsche Br. at 16-18; Fannie Mae Br. at 18-19; Lloyds Br. at 11-15.

[5] *See, e.g.*, Depfa Br. at 24 n.15; Fannie Mae Br. at 20-22; LVM Br. at 19-21; RMBS Funds' Br. at 18.

[6] *See, e.g.*, Depfa Br. at 18-21; Deutsche Br. at 20; Fannie Mae Br. at 21; Lloyds Br. at 1-3.

[7] *See, e.g.*, BNY Br. at 5.

[8] *See, e.g.*, Depfa Br. at 29; Deutsche Br. at 24.

allocation of any contingent liabilities of the landlord to the Segregated Account;[9] and even (5) whether the Court's unopposed approvals of the Weinstein, JP Morgan, and Lehman settlements were proper.[10]

The Court has already received numerous briefs, affidavits and exhibits relating to these previously raised legal challenges, heard argument on them at multiple hearings, and issued written decisions on their merits. Neither the law (as expressed in the Rehabilitator's prior briefing) nor the underlying facts (as expressed in prior affidavits and exhibits) supporting this Court's decisions has materially changed since the time they were issued, and there is no reason to revisit those debates for a second, third, or fourth time in this Reply or at the hearings on the confirmation of the Plan.

Second, a number of objectors identify potential ambiguities and practical concerns regarding specific provisions of the Plan. Where appropriate, the Rehabilitator has attempted to address those concerns and better clarify the intended application of certain parts of the Plan through amendment of the Disclosure Statement and a revised proposed form of Order, each submitted today. For example, objectors point out that the scope of immunity provision of Section 8.01 of the Plan is overbroad on its face and could lead to unfair results, such as precluding tort liability where an employee for the Segregated Account's management services provider "sets fire to an office building which, by happenstance, is owned by a policy holder."[11] Obviously, that was not the purpose of the immunity provision, which is instead intended to

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[9] *See* One State Br. at 13-14, 16-18.

[10] *See, e.g.*, Depfa Br. at 22-23. Although Depfa appeared at the hearings regarding at least two of the settlements in question, it lodged no objections to the Court's approval of them. (Dkt. 490, 499.)

[11] One State Br. at 12.

shield individuals from liability for actions taken in connection with the establishment of the Segregated Account and the rehabilitation and effectuation of the Plan. The amended proposed order clarifies this intended scope.[12]

Other trustee objectors conversely assert that the immunity provision is too narrow because it fails to protect them from potential contractual liability for taking actions required by the Plan in distributing cash and surplus notes from the Segregated Account. The amended order also seeks to alleviate those concerns.

Third, several objections reflect concerns regarding the then-impending bankruptcy of Ambac Financial Group Inc. ("AFGI"), the holding company for Ambac Assurance Corporation ("AAC").[13] As the Court is aware, the Rehabilitator sought emergency injunctive relief on the morning of November 8, 2010 "to ensure that any disputes regarding claims of AFGI or its bankruptcy creditors or the IRS pertaining to the tax refund payments to AAC will be litigated in this proceeding" and to "prevent potential subordinate non-policyholder claimants such as the IRS and AFGI's creditors from circumventing the priority scheme for equitable distribution established by Wisconsin insurance law, and preserve the claims-paying resources of the Segregated Account." (Motion for Temp. Supp. Inj. Relief ¶¶ 12, 14 (dkt. 507).) The relief granted by the Court should address those concerns.

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[12] Similarly, multiple objectors note that the release could be interpreted as contractually requiring them to cease all objections and appeals in this proceeding, or precluding them from pursuing non-insurance claims in the AFGI bankruptcy proceeding. (*See, e.g.*, Depfa Br. at 32.) The Rehabilitator noted the intended scope of the release in the Brief in Support of Confirmation of the Plan, at 4: "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 amended order should dispose of this objection.

[13] *See, e.g.*, RMBS Funds' Br. at 2, 5, 13-14, 16-21, 26-27; Depfa Br. at 28.

II. THE REMAINING OBJECTIONS LACK MERIT.

Setting aside these three categories of objections—that is, those that amount to requests for reconsideration of prior rulings on issues of law, those that the Rehabilitator has sought to resolve or clarify through the amended proposed order and amendments to the Disclosure Statement, and those addressed by the Court's Nov. 8, 2010 Order for Temporary Supplemental Injunctive Relief—the remaining objections are limited in scope, and all are without merit.

Although some objectors purport to prefer a fire-sale liquidation of all of Ambac[14] while others would prefer a cautious, long-term rehabilitation of only the Segregated Account that keeps more assets in reserve,[15] none seriously dispute that the realities of Ambac's financial condition in March 2010 necessitated formal delinquency proceedings, or that a rehabilitation may, by necessity, "compromise individual interests in order to avoid greater harm to a broader spectrum of policy holders and the public." 1 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 5:22 (3d ed. 2008). Nor do they seriously contend that such compromises are impermissible as a general matter. *See Carpenter v. Pac. Mut. Life Ins. Co.*, 74 P.2d 761, 774-75 ("Neither the company nor a policyholder has the inviolate rights that characterize private contracts. The contract of the policyholder is subject to the reasonable exercise of the state's police power."). *Accord Minor*, 898 S.W.2d at 80 ("The policyholders' contracts as well as others with an interest in the company, are subject to a reasonable exercise of the state's police power."); *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1095 (Pa. 1992).

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[14] *See* RMBS Funds' Br. at 9-11, 14-16.

[15] *See* LVM Funds' Br. at 2-3, 21-25.

Not surprisingly, the objections make clear that each objector would prefer a Plan that compromises the interests of *others* rather than their own. For example, some object that the Plan does not do enough to protect policyholders against subordinate claimants, who "should not receive a single penny until policyholder claims are paid in full,"[16] while others claim that "the provision of less than full recovery" to subordinate claimants is unconstitutional.[17] Some argue that the cash percentage should be raised substantially,[18] while others argue that any increase would exacerbate unfairness to long-tail policyholders.[19]

No rehabilitation plan, whether for the Segregated Account or Ambac as a whole, could address each and every one of these self-serving arguments, as it is self-evident that the maximum benefit for *all* interested parties does not equate to the maximum benefit for *each* particular party. Nor can it address arguments that ignore financial reality, such as the trustees' statements that they would prefer to be paid in all cash, rather than cash and notes.[20] Obviously, if that were feasible without threatening harm to policyholders or the public, this rehabilitation would have been unnecessary.

This brief will instead focus on: (1) persistent and mistaken factual assumptions that form the basis of numerous objections; (2) assertions that a liquidation is required, that a liquidation would have been more favorable than rehabilitation, or that an individualized

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[16] *See, e.g.*, RMBS Funds' Br. at 15, 21-22.

[17] One State Br. at 6-8.

[18] Fannie Mae Br. at 13 n.5.

[19] LVM Funds' Br. at 25. *See also id.* at 21-24 (objecting that the Plan does not require the Segregated Account to set aside cash reserves for long-tail policies and increase those reserves upon each redemption of Surplus Notes).

[20] *See, e.g.*, Deutsche Br. at 28-29; Wells Fargo Br. at 5-7; Bank of America Br. at 4-6.

liquidation analysis is necessary; (3) objections relating to subrogation; (4) objections regarding particular priority classifications of certain potential claimants; and (5) arguments that this Court lacks competency or jurisdiction to approve the Plan.

A. The Objectors' Factual Assumptions Regarding the General Account, the Surplus Notes, and OCI are Incorrect.

A recurring theme in virtually every objection (and virtually every prior dispute in this proceeding) is the assumption that because "favored" General Account policyholders *could* conceivably benefit at the expense of the "disfavored" Segregated Account policyholders, they necessarily *are* receiving unfair benefits. That is not the case, at least not in any material respect. As noted in the Fourth Affidavit of Roger Peterson, from the date of the Petition through the end of July, Ambac paid less than $13 million (gross, before netting recoveries) in claims on the 13,000 to 14,000 policies in force in the General Account over that period, versus the $784 million in claims presented on the approximately 700 policies remaining in the Segregated Account. (Fourth Peterson Aff. ¶ 16.) To put this in perspective, the policies in the Segregated Account constitute roughly 5 percent of the total policies in force of the General and Segregated Accounts combined, but accounted for *more than 98 percent of the total claims presented* during that time frame.[21]

In short, even assuming that there would be no collateral consequences in forcing a full rehabilitation of Ambac—the flawed assumption that most objectors make—a full rehabilitation would not materially change the cash percentage, the need for issuance of surplus notes, the likelihood of full payment on the Surplus Notes, or other elements of the Plan. Nor would it change Ambac's ultimate responsibilities to policyholders. As often as the objectors

[21] This differential has not materially changed since July.

assert without explanation that "[u]nder the Plan, Ambac will benefit greatly at the expense of Segregated Account policyholders,"[22] they never explain how. The General Account is ultimately responsible for all amounts owed to claimants, whether in cash or surplus notes, and will make such payments under the supervision of the Rehabilitator and this Court. No one will suffer more than Ambac if it is financially unable to fulfill those obligations.[23]

Similarly, most objectors pretend—as they must in order to keep their legal arguments from falling apart—that the surplus notes will be worthless. The basis for this assumption is unclear, but it certainly does not arise from the projections in the Disclosure Statement, which in four scenarios projects the payment of 100 percent (best case), 85 percent, 71 percent, and 45 percent (worst case) of all principal and interest owed under the notes, in addition to the immediate cash percentage payment. (*See* Disclosure Statement, Exs. D-G.) Not all projections provide 100 percent recovery with 100 percent certainty for policyholders, to be sure, but the notes are clearly expected to cover more than "a small fraction of their claims."[24]

Further, the contentions by the RMBS Funds that the surplus notes are not *pari passu* with the Bank Settlement surplus notes because the Bank Settlement notes have slightly different covenants are overblown. In making this argument, the RMBS Funds imagine a handful of scenarios in which such treatment *could* conceivably occur, but they barely mention

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[22] Freddie Mac Br. at 11.

[23] For this reason, it is unclear why some objectors wish to strip AFGI of its ownership of Ambac, presumably in lieu of surplus notes. (*See, e.g.*, Depfa Br. at 27-28, RMBS Br. at 21-22.) Even if, *arguendo*, the Rehabilitator could legally accomplish such a feat, policyholders would be trading their prioritized surplus notes for subordinate, Class 11 equity interests with no schedule for note payments and interest.

[24] RMBS Br. at 26. *See also* Depfa Br. at 27 (characterizing surplus notes as "hope certificates"); Fannie Mae Br. at 13 (calling surplus notes an "empty promise").

the key provision of both sets of notes: that payments on them "may be made only with the prior approval of the Commissioner." The surplus notes state that they will be treated *pari passu* with the Bank Settlement surplus notes, and that commitment (as well as the Commissioner's statutory duties to protect the interests of policyholders, creditors, and the public) will guide his discretion should any of the RMBS Funds' "what-if" scenarios arise.

This leads to the last flawed assumption, one that formed the basis of most of the contested motions to date and continues to form the basis of the objections: the assumption that OCI and the Rehabilitator *will* abuse their responsibilities and act in bad faith if given the chance, and the Plan should therefore predetermine or limit the decisions they (and this Court) can make in the future. Not surprisingly, the objectors cite no legal support. There is no basis for this assumption, which flies in the face of the bedrock principles of Wisconsin rehabilitation laws that are "formulated to emphasize flexibility and informality, and the rehabilitator is given broad powers." Wis. Stat. Ann. § 645.32 cmt. The Rehabilitator will not and cannot bargain away his statutory responsibilities to maintain the flexibility and authority necessary to confront evolving financial conditions and contingencies as they arise. As much as certain litigants pretend otherwise, the Plan is not just another Wall Street transaction document that is incapable of modification as and when circumstances warrant, and OCI and the Rehabilitator are not just another set of self-interested counterparties trying to squeeze every advantage over other claimants in some zero-sum, board-room negotiation. They are well-qualified civil servants fulfilling the responsibilities bestowed upon them by the legislature, and seeking only to "administer the matter for the maximum benefit of all interested parties." *Minor*, 898 S.W.2d at 76.

B. A Liquidation Would Not Maximize Benefits, and the Plan Does Not Have to Provide Each Potential Claimant With the Liquidation Value of its Claim.

1. The Liquidation of Ambac Would Have Been Disastrous for Policyholders, Creditors and the Public.

The RMBS Funds, like litigants in prior briefing, appear to argue that OCI made the wrong choice in March of this year. They argue that, rather than rehabilitating the Segregated Account, or even rehabilitating Ambac as a whole, OCI should have commenced a full liquidation.[25] Fortunately for current policyholders, creditors and the public, Chapter 645 did not put that decision in their hands.

The comments to Chapter 645 note that "although the criteria [in Wis. Stat. §§ 645.31 and 645.41] provide . . . informative direction for both the commissioner and the court, *they leave the commissioner considerable discretion to decide on direction depending on the specific facts of the individual case*, subject of course to court control." Wis. Stat. Ann. ch. 645, introductory cmt. to subch. III (emphasis added). As is clear from the Disclosure Statement as filed on October 8, and in the more detailed amendments to the Disclosure Statement filed today, OCI did not abuse its discretion in determining that a liquidation of Ambac would have disserved the interests of policyholders, creditors and the public.

A quick summary of the chaos: all Ambac policies would have automatically terminated 15 days after the entry of the liquidation order, Wis. Stat. § 645.43(1), and no policyholder presently in the Segregated Account could obtain anywhere near equivalent coverage at an equivalent premium (if they could, one would assume they would have already approached the Rehabilitator regarding a policy tear-up). The comments to Section 645.43 are not particularly sympathetic to their plight: "Some may have difficulty obtaining replacement

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[25] *See* RMBS Funds' Br. at 13-16.

coverage . . . . These will be hardship cases, if a loss should occur, but not all hardship cases can be avoided when there is a liquidation." Ambac would obtain no future premiums, and unearned premiums—primarily from policies now in the General Account, which are not expected to suffer material losses and therefore inure to the benefit of impaired Segregated Account policies—would be returned. Wis. Stat. § 645.68(4). *See generally* Liquidation Analysis in the accompanying Amendment No. 2 to the Disclosure Statement.

In the best-case scenario for policyholders, after paying all then-outstanding policy claims through the date of policy termination (which were relatively small), policyholders of the Segregated and General Accounts alike would join the pool of Class 5 claimants, engage in years of litigation to prove their contract damages, then share *pro rata* with claims of other general creditors—including the $12.8 billion automatically triggered mark-to-market claim by the Bank Group (dkt. 137, Finding of Fact 12) and other CDS policies outside the Bank Group—from a much smaller overall pool of claims-paying resources. Ironically, those who would arguably benefit most in this situation relative to the Plan are the very groups that the RMBS Funds claim the Rehabilitator has unfairly protected: the *Bank Group*, which under the CDS policy terms could have arguably had its collective $12.8 billion mark-to-market claim treated as a Class 3 claim for policy losses incurred; and/or *General Account* policyholders, who would receive a return of unearned premium above their expected future policy losses.

In the worst-case scenario, policyholders under terminated policies would recover nothing at all; Ambac would provide notice, pay its then-outstanding policy claims and other creditors with then-incurred claims (possibly including mark-to-market claims of CDS holders and other claimants with automatic triggers), and suffer no liability for losses not yet incurred

that would have otherwise been covered by the terminated policies, Wis. Stat. § 645.63(2), with any remaining funds going to AFGI, Wis. Stat. § 645.68(11).

To the extent the objectors presume a hypothetical liquidation of the Segregated Account *today*, rather than a liquidation of Ambac as a whole on March 24, the analysis still comes up short. A liquidation of the Segregated Account would legally require the rehabilitation of the General Account (increasing claims due to collateral damage, including mark-to-market claims), Wis. Stat. § 611.24(3)(e), and likely require, as a practical matter, the liquidation of the General Account due to its immediately hazardous condition (reducing the amount of claims-paying resources through the return of unearned premiums to General Account policyholders). Any hypothesis that assumes the Segregated Account could be liquidated without consideration for the General Account and the adverse consequences on the shared claims-paying resources of both accounts is meritless and ignores OCI's regulatory responsibilities to the General Account and its policyholders.

In sum, Segregated Account claimants professing to complain that the Rehabilitator chose rehabilitation over liquidation either (1) have not actually considered the potential ramifications that a liquidation of Ambac would have had for them, or (2) are merely throwing rhetorical darts at the wall. Either way, liquidation would not have been a more prudent choice by OCI.

2. Neither the Wisconsin Statutes, the United States Constitution, nor Common Sense Require That the Rehabilitator Provide an Individualized Analysis to Ensure that Each Policyholder is Treated More Favorably Under the Plan Than They Would Be in Any and All Hypothetical Liquidation Scenarios.

Although almost every objector claims that the Plan cannot be confirmed without a finding that it accords Segregated Account policyholders treatment no less favorable than they would have received in a liquidation, none have acknowledged the myriad reasons why OCI and

the Rehabilitator concluded that liquidation was a far less favorable alternative for them. To the extent they actually intend to argue that liquidation would have been a preferable result for Segregated Account policyholders, taking into account all of the factors that lead the Rehabilitator to conclude otherwise, they are free to do so. Even if they could reasonably make that case, however—and they cannot (*see* Liquidation Analysis in the accompanying Amendment No. 2 to the Disclosure Statement)—it would not require rejection or modification of the Plan.

While virtually all objectors cite *Neblett v. Carpenter*, 305 U.S. 297 (1938), for the proposition that a rehabilitation plan *must* treat policyholders as favorably as a liquidation and/or *must* provide an opt-out provision that provides them with the liquidation equivalent, *Carpenter* does not (and could not) make that holding, because the Court there was not presented with that question. Although the plan in *Carpenter* did provide those two options, and the Court in *Carpenter* did find the plan constitutional, the *Carpenter* Court did not suggest that the former fact is necessary to make the latter conclusion.

In fact, a closer read of *Carpenter* suggests the opposite. The key paragraph of that short decision, and the one giving rise to the confusion at issue, states:

> The petitioners have no constitutional right to a particular form of remedy. They are not entitled, as against their fellows who prefer to come under the plan and accept its benefits, to force, at their own wish or whim, a liquidation which under the findings will not advantage them and may seriously injury those who accept the benefits of the plan. They are not bound, as were the dissenting creditors in *Doty v. Love*, 295 U.S. 64, to accept the obligation of the new company but are afforded an alternative whereby they will receive damages for breach of their contracts. They have failed to show that the plan takes their property without due process.

Id. at 305. Reading that paragraph out of context, it might appear that the *Carpenter* Court is upholding the plan against a takings challenge solely because, unlike the reorganization plan in

Doty, the plan in *Carpenter* had an opt-out provision. That might be a fair reading—until one actually looks at the holding in *Doty*.

Doty concerned a plan to reorganize a bank by allowing it to resume business as a means to maximize payments to creditors, rather than commence a liquidation. 295 U.S. at 70. Dissenting depositor/creditors who preferred the liquidation alternative appealed the state superintendent's recommendation (and the court's approval) of the plan, arguing that "some of the assets of the old bank are placed at the risk of the business of the new one," that the plan unlawfully required them to release contractual rights, that they had no ability to opt-out, and other constitutional complaints similar to those raised by the objectors here. Justice Cardozo, writing for a unanimous Court, rejected each of them, noting that "[t]he Constitution of the United States does not confer upon the depositors a vested right to liquidation at the hands of a state official." *Id.* at 70. Therefore, "the appellants' grievance, if they have any, is this and nothing more, that there was an error in judgment to their prejudice in the approval of the plan with the compromise of liability as one of its important features. . . . Error of judgment in the compromise of liabilities is not a taking of property or an impairment of contract in derogation of the restraints of the Constitution of the United States." *Id.* at 73-74.

In that light, then, the message of the key paragraph of *Carpenter* is not that the rehabilitation plan in that case set the constitutional floor for all such plans, but rather that it was so clearly above any constitutional floor that it warranted no further discussion. To read it as the objectors do only raises the question of where such a seemingly legislative proclamation—what must be included within the content of a plan of rehabilitation—can be found in the Constitution. Most objectors dodge this question with references to "implicit holdings"[26] and "black-letter

[26] Depfa Br. at 23-26.

law."[27] Notably, however, none of the objectors point to any case where an appellate court reversed, or even criticized, approval of a rehabilitation plan because the plan and/or confirmation hearings did not include a policy-by-policy determination of a hypothetical liquidation value.

Similarly, to the extent the objectors contend that California rehabilitation law somehow limits the flexibility of rehabilitation plans under Wisconsin's Chapter 645, it is worth noting that the California Supreme Court's decision in *Carpenter* did not mandate a liquidation value opt-out, either. As noted in the Rehabilitator's opening brief (at 12-13), the California court affirmed the plan against constitutional challenge on two independent bases: (1) there was an opt-out provision, which undermined the factual predicate of the objectors' challenge, and (2) "*Moreover*, the record demonstrates that under the circumstances here existing the difference in treatment [among policyholders under the Plan] was justified." *Carpenter v. Pac. Mut. Life Ins. Co.*, 74 P.2d 761, 778 (Cal. 1937) (en banc) (emphasis added). *See also Com. Nat'l Bank in Shreveport v. Superior Ct.*, 14 Cal. App. 4th 393, 404 (1993) ("*Carpenter* provided an alternative justification for the disparate treatment by which holders of one type of policy were given relatively more favorable benefits than another. That discrimination is justified if it is founded on a rational basis related to effecting a successful rehabilitation.").

Here, in virtually every filed affidavit and brief, the Rehabilitator has repeatedly pointed out the rational basis for the Segregated Account/General Account separation and its relation to a successful rehabilitation that prevents avoidable losses and maximizes claims-paying resources for the benefits of all. As the case law above shows, the supreme law of the land does not require this Court to conduct a series of needless and hopelessly speculative mini-

[27] One State Br. at 4-5; Freddie Mac Br. at 4-6.

trials regarding the hypothetical liquidation value of dissenting Segregated Account policyholders.[28]

C. Section 4.04(h) of the Plan Does Not Violate the "Made Whole" Doctrine.

The Plan provides that, "upon receipt of a payment with respect to a Permitted Policy Claim, each such Holder shall be deemed to have assigned its rights relating to payment under the underlying instrument(s) or contracts to AAC." (Plan ¶ 4.04(h).)

A number of objectors contend that this assignment provision violates subrogation law, namely the "made whole" doctrine, which provides that, as a principle of equity, "a party claiming subrogation rights may not recover until the insured is fully compensated for his or her losses." *Ruckel v. Gassner*, 2002 WI 67, ¶ 17, 253 Wis. 2d 280, 646 N.W.2d 11 (2002) (citation omitted); *see also Rimes v. State Farm Mut. Auto. Ins. Co.*, 106 Wis. 2d 263, 271, 316 N.W.2d 348, 353 (1982) (when insurer has paid out on its policy and has a subrogation claim against party that damaged its insured, "such insurer is to be allowed no share in the recovery from the tortfeasor if the total amount recovered by the insured from the insurer and the wrongdoer does not cover his entire loss") (citing *Garrity v. Rural Mut. Ins. Co.*, 77 Wis. 2d 537, 253 N.W.2d 512 (1977)). These objections are mistaken.

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[28] The Rehabilitator recognizes that this Court, in adopting part of an argument in a brief submitted by Ambac, repeated in *dicta* the holding of *Carpenter* that the objectors now urge. Although the Court need not reconsider that statement to conclude that the Plan is more favorable to Segregated Account policyholders than a liquidation, the Rehabilitator respectfully requests such reconsideration in light of the extreme arguments presented in the written objections.

In any event, even if the Court were to adopt the broadest possible reading of *Carpenter*, it applies only to policyholders—not general creditors seeking to circumvent the priority structure, such as One State. (One State Br. at 6-8.)

As the Wisconsin Supreme Court explained more recently in *Muller v. Society Ins.*, 2008 WI 50, ¶ 60, 309 Wis. 2d 410, 750 N.W.2d 1, a case that the objectors conspicuously omit from their discussion of the issue,

> [T]he made whole doctrine of *Garrity* and *Rimes* is not a simplistic or absolute rule. Subrogation depends upon the application of equitable principles to the facts of each case, and those principles are concerned with preserving the rights of both the insured and subrogated insurer.
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> There are several lessons we can take from the cases following *Garrity* and *Rimes* . . . . First, the made whole doctrine *is not applicable in all situations*, and thus the test of "wholeness" stated in *Rimes* is not the sole criterion for determining whether an insurer may pursue its subrogation interest. Second, the made whole doctrine, as stated in *Garrity* and *Rimes*, *does not apply when the inequitable prospect of an insurer competing with its own insured for limited settlement funds is absent.*

2008 WI 50, ¶¶ 46, 60 (citations omitted, emphasis added).

> As to subrogation generally, the *Muller* court explained:
>
> . . . The doctrine of subrogation enables an insurer that has paid an insured's loss pursuant to a policy of property insurance to recoup that payment from the party responsible for the loss.
>
> Subrogation rests upon equitable principles. In part, the law invokes subrogation to avoid unjust enrichment. *Once an insured has been fully compensated for his loss, any additional recovery by the insured would constitute unjust enrichment.*
>
> Subrogation effectuates an equitable adjustment among parties to prevent unjust enrichment in at least two ways. First, subrogation compels payment of a debt by one who in equity ought to pay, namely, the tortfeasor. Second, *subrogation precludes an insured from recovering twice for the same loss.*

Id. at ¶¶ 22-24 (citations omitted, emphasis added).

Thus, the made whole doctrine does not apply where, as here, it is not warranted by the equitable considerations in the case. Moreover, unlike *Garrity* and *Rimes* where the

insurer was suing its own insured in subrogation, the policyholders and the subrogated insurer here are "not competing for a limited pool of funds." *See Muller*, 2008 WI 50, ¶¶ 47, 50. By objecting to the assignment of their underlying allowed claims against defaulting issuers, objectors ask the Court to allow them to recover on their policy claims *and* also to pursue a separate recovery against defaulting issuers. This is the essence of the inequitable "double recovery" prohibited under *Muller*.

Even if the made whole doctrine were applicable, the Plan explicitly calls for each holder of an allowed policy claim to receive full satisfaction of that claim in the form of cash and surplus notes. (Plan §§ 2.02, 4.04(c), (d).) In short, every policyholder's claims will be paid in full. Objectors contend that their contracts "insured the periodic *cash* payments of interest and principal," not cash and surplus notes. (LVM Objection at 16.) But, as discussed above, it is well-settled that policyholders' contractual rights are subject to the reasonable exercise of the state's police power, and OCI has thoroughly explained the facts giving rise to this rehabilitation proceeding and the rationale for the Plan's claims payment structure.

D. The Plan Honors the Priority Structure of Wis. Stat. § 645.68.

The Plan addresses claims in three classes under the priority structure established by Wis. Stat. § 645.68: Class 1 administrative claims, which are paid in cash; Class 3 policyholder claims, which are paid in cash and surplus notes; and Class 5 general creditors, which are paid in subordinate, junior surplus notes. The rationale for this method is uncomplicated; these are the only three anticipated classes of claims in the Segregated Account at this time.[29]

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[29] This method may be subject to revision should the recently allocated, contingent federal government claims (Class 3c) or claims of or on behalf of Ambac Financial Group, Inc. (likely Class 6 or Class 11) ripen and become actual claims. Given the speculative, contingent
(continued on following page)

Certain objectors complain that the potential claims of others are given too high a priority (*see* LVM Funds Br. at 32-34, RMBS Funds Br. at 32-33, Freddie Mac Br. at 11-12), or their potential claims are accorded too low a priority (*see generally* CAPCO Br.). This brief addresses each in turn.

1. Treatment of Credit-Default Swaps as Class 3 Claims

The LVM Funds, the RMBS Funds, and Freddie Mac seek to resume a debate they first raised in connection with the Bank Settlement, claiming that the Plan improperly treats those credit-default swaps (CDS) that were not previously commuted as part of the Bank Settlement as Class 3 policyholder claimants because, according to them, CDS policies are not "insurance" under Wisconsin law.

As these objectors have previously acknowledged, the issue of whether CDS constitute insurance is unsettled, and "[t]here are no cases one way or the other" on the issue. (Argument of Atty. Bentley, 5/25/10 Hearing Tr. at 119 (dkt. 128).) OCI has historically found that Ambac policies relating to CDS obligations are insurance (dkt. 112, Ex. B), and as demonstrated by the Bank Group's *amicus curiae* brief in opposition to efforts to enjoin the Bank Settlement (dkt. 112), there is substantial legal support for that characterization.

Even if the Rehabilitator were persuaded by the argument of these objectors that CDS should not be treated as insurance, however, the Rehabilitator sees no benefit in precipitating costly litigation on this issue of first impression. The three remaining CDS policies in the Segregated Account together account for loss estimates of $5 million (base case) to $20 million (stress case) over the extended lives of the policies—a relatively small exposure in light

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nature of these and other claims, the Rehabilitator does not presently see the need to seek approval for the issuance of additional categories of notes to account for these claims' positions under Section 645.68.

of the current Segregated Account claim rate of $100 to $200 million per *month*. (*See* Fourth Affidavit of Roger A. Peterson ¶ 16 (dkt. 345).)

2. Treatment of Reinsurance as Class 5 Claims

There is established precedent regarding the treatment of reinsurance claims, however, and it consistently supports the treatment of reinsurance claims as general creditor claims rather than policyholder claims under insurance priority statutes that are substantially identical in relevant part to Wis. Stat. § 645.68. *See, e.g.*, *State ex rel. Long v. Beacon Ins. Co.*, 359 S.E.2d 508, 509-11 (N.C. App. 1987); *Neff v. Cherokee Ins. Co.*, 704 S.W.2d 1, 6-7 (Tenn. 1986). CAPCO, a party to a reinsurance agreement allocated to the Segregated Account, argues that Wisconsin law has "repeatedly endorsed a broad definition of insurance, and there is nothing to suggest that insurance does not include reinsurance." (CAPCO Br. at 9)

CAPCO is incorrect. In *Peerless Ins. Co. v. Manson*, 27 Wis. 2d 601, 135 N.W.2d 258 (1965)—a case the Rehabilitator cited in the brief supporting confirmation—the Wisconsin Supreme Court distinguished insurance from reinsurance in the context of assessments by noting that the statutory chapter at issue included numerous references to "reinsurance" as a distinct concept from more generalized insurance, and therefore "as far as [the statutory chapter at issue] is concerned, the legislature treated reinsurance differently from insurance." *Id.* at 608.

Here, similarly, Chapter 645 is strewn with references to "reinsurance" or "reinsurance contracts," as distinct from insurance policies. *See, e.g.*, Wis. Stat. §§ 645.04(5)(b), 645.52(3) & 645.58. In light of this treatment, there are no grounds for concluding that the Wisconsin legislature intended to afford reinsurance claims different treatment than sister jurisdictions applying the same or substantially similar priority statutes. *Beacon Ins. Co.*, 359 S.E.2d at 509-11; *Neff*, 704 S.W.2d at 6-7. *See also Covington v. Ohio Gen. Ins. Co.*, 789

N.E.2d 213, 216 (Ohio 2003); *In re Liquidation 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).

E. THIS COURT HAS COMPETENCY TO ACT IN THESE CONTINUING SPECIAL PROCEEDINGS NOTWITHSTANDING AN APPEAL FROM ORDERS ARISING OUT OF THESE PROCEEDINGS.

Finally, despite having continued to participate in these proceedings for months following its appeal from a May 27 order denying an injunction and a motion to intervene, the RMBS Funds now claim that this Court has no jurisdiction to review, or approve, the proposed rehabilitation plan.[30] (RMBS Funds Br. at 12-13.) Contrary to the dated authority cited by the RMBS Funds, more current case law establishes that circuit court authority pending appeal is *not* a matter of jurisdiction; it is a question of competency. *See Hengel v. Hengel*, 120 Wis. 2d 522, 534, 355 N.W. 2d 856 (Ct. App. 1984). This is reflected in Wis. Stat. § 808.075(5) and (6), which allow circuit court action pending appeal by order of the Court of Appeals even in cases where the trial court has no authority to act pending appeal.

The RMBS Funds' fail to acknowledge this distinction, with good reason: while objections to the Court's lack of subject matter jurisdiction cannot be waived, *see Wis. Envt'l Decade v. P.S.C.*, 84 Wis. 2d 540, 516, 267 N.W.2d 609 (1978), objections to competency are waivable, *Village of Trempeleau v. Mikrut*, 2004 WI 79, ¶ 27, 273 Wis. 2d 76, 681 N.W.2d 190. By filing additional motions, correspondence with the Court, and appearing at numerous hearings since taking its appeal, the RMBS Funds have long since waived any objection to the Court's competency arising out of an appeal that the Court of Appeals accepted in June.

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[30] Depfa appears to agree (Depfa Br. at 9-11), even though it made its first formal appearance in this proceeding four days *after* the Court of Appeals agreed to take the RMBS Funds' appeal, and Depfa has since availed itself of this Court's jurisdiction with multiple filings and in multiple hearings.

The RMBS Funds also ignore the fact that the order appealed from arises in the context of a series of special proceedings, and that an appeal from an order terminating one of those special proceedings does *not* divest the court of competency to continue the rehabilitation proceedings.

Court proceedings may be classified as actions or special proceedings. *See e.g.*, Wis. Stat. § 808.03(1) (appeals may be taken from final orders or judgments "whether rendered in an action or special proceeding."). Special proceedings often arise in the context of a separate ongoing action or series of proceedings. For example, contempt proceedings arise in the context of another proceeding but constitute a special proceeding. *In re Civil Contempt of Kroll*, 101 Wis. 2d 296, 302, 304 N.W.2d 175 (Ct. App. 1981). The person alleged to be in contempt "becomes a 'party' to the contempt proceeding, not to the principal action." *Id.* In such proceedings the appealable event is the finding and sentence of contempt which terminates the contempt proceeding, not the final disposition of the underlying action. *See M. Heffernan,* APPELLATE PRACTICE AND PROCEDURE IN WISCONSIN, § 4.10 (4th ed. 2010). Moreover, in special proceeding appeals, the Appellate Court has no authority to decide issues raised in the larger action out of which the special proceeding arose. *State v. Heyer*, 174 Wis. 2d 164, 168-69, 496 N.W.2d 779 (Ct. App. 1993).

Thus, the order appealed by the RMBS Funds—denying a motion to intervene and a motion for a preliminary injunction—at most terminated special proceedings pertaining to the RMBS Funds emanating from the underlying rehabilitation proceedings. Consistent with the independent nature of these proceedings, the circuit court retains competency to act on the underlying rehabilitation notwithstanding an appeal by one or several of the numerous parties-in-interest claiming to be affected by the rehabilitation.

It is strange that the RMBS Funds do not acknowledge this basic legal principle, as they themselves successfully argued it to the Court of Appeals in response to the Rehabilitator's motion to dismiss their appeal:

> Federal bankruptcy law, which is often instructive when a court is adjudicating rehabilitation proceedings, provides a useful comparison. In federal bankruptcies, where a court supervises an ongoing rehabilitation, a party may obtain review of a discrete dispute within a large case if the order disposing of the discrete dispute "leaves a claimant nothing more to do than await the outcome of third-party litigation." *In the Matter of Morse Elec. Co.*, 805 F.2d 262, 264 (7th Cir. 1986). *The rationale for this approach is that "there are not conventional 'judgments' in many of the claims that arise in bankruptcy; there are only dispositions on the way to the approval of a final plan."* *Id.* at 265. *This rationale applies with equal force to this case.*

(RMBS Funds' June 18, 2010 Response to Motion to Dismiss Appeal, at 6 (emphasis added), *available at* http://ambacpolicyholders.com /court-filings (June 18 filings).)[31]

As the RMBS Funds recognized in June, but have apparently chosen to ignore now, chaos would result if this Court is deemed to lose competency any time an interested "party" to this rehabilitation files an appeal from one of the orders entered in these complex, ongoing proceedings. If upheld, the position of the RMBS Funds could stop these proceedings indefinitely by repeated appeals taken by any one of the thousands of persons and entities claiming an interest, from Kentucky prisoners (2010AP2164) to litigants who are unhappy with this Court's scheduling orders (2010AP2721). This would allow Wis. Stat. § 808.075 to divest this Court and the Rehabilitator of their statutorily mandated rehabilitation authority and effectively block rehabilitation, the type of absurd result that Wisconsin courts avoid in statutory

[31] The Rehabilitator quotation of this passage does not reflect any concession that any particular orders in this case are, in fact, appealable on an interlocutory basis.

construction. *See, e.g., McQuestion v. Crawford*, 2009 WI App 35, ¶ 8, 316 Wis. 2d 494, 765 N.W.2d 822 (Wisconsin courts interpret statutes to avoid "absurd results").

CONCLUSION

For the foregoing reasons, the Plan of Rehabilitation for the Segregated Account should be confirmed as modified, and the Court should enter the amended proposed order submitted by the Rehabilitator.

Dated this 12th day of November, 2010.

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