STATE OF WISCONSIN DANE COUNTY CIRCUIT COURT

In the Matter of the Rehabilitation of:

SEGREGATED ACCOUNT OF
AMBAC ASSURANCE
CORPORATION

Case No. 10-CV-1576

PAGES 198, 199, 202, AND 203 OF EXHIBIT C TO THE AFFIDAVIT OF JAMES W. SCHACT

Attached please find pages 198, 199, 202, and 203 of Exhibit C to the Affidavit of James W. Schact, which were inadvertently omitted from Mr. Schact's affidavit when originally filed with the court on November 11, 2010.

Dated this 15th day of November, 2010.

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

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

R. Timothy Muth
WI State Bar ID No. 1010710
tmuth@reinhartlaw.com
Bryan K. Nowicki
WI State Bar ID No. 1029857
bnowicki@reinhartlaw.com
Jessica Hutson Polakowski
WI State Bar ID No. 1061368
jpolakowski@reinhartlaw.com

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

REINHART\5211740

merely suspected difficulty he has been unwilling to proceed because he was not sure of his ground for action and because the publicity attendant upon any proceeding was destructive of the company.

It is true that under former s. 200.09, the commissioner has had summary power to seize an insurance company in an emergency, but he has never used it. That restraint seems wise since the statute was devised to deal with bank insolvencies and is poorly designed for insurance companies. Hence it is necessary to equip the commissioner with a variety of discriminating weapons that will enable him to deal effectively and promptly with incipient difficulty, if he will use them. Unlike traditional regulatory tools, the new procedures are designed to eliminate unnecessary damage to the insurer and needless intervention in the industry.

There should be no reason why the commissioner would not use the new procedures. They are not novel devices; they have counterparts in the Wisconsin banking law and in similar procedures in the California insurance statutes. Nor are they dangerous. They are hedged about with procedural safeguards against arbitrariness by the commissioner, including quick and easy access to judicial review. Moreover, because they can be used with minimum publicity and less massive intervention, they can be used with less risk of destruction and interference with the company and are thus less dangerous than more formal methods.

The chapter creates two kinds of summary procedures, one a simple order, either mandatory or inhibitory, and the other a seizure order. Normally, the former type of order would be obtained after a hearing; in emergency situations the commissioner may issue such an order without hearing, but subject to immediate and speedy court control at the instance of the company. The seizure order would normally be issued by a court, and only in an emergency by the commissioner.

These devices will enable the commissioner to deal effectively with single practices that endanger the company solvency or the public interest. Where venal manipulation of assets is feared, he will be able to seize assets and books quickly enough to protect them and to learn what is happening. The prospect of immediate court supervision and the possibility of devastating criticism of his action in the insurance world where he values his reputation highly will suffice to keep the commissioner from abusing this carefully limited power. In addition, a commissioner will not be unaware of possible tort liability if he should act improperly. Indeed, the greater difficulty is to give the commissioner sufficiently discriminating weapons to induce him to act as soon as he should; nearly always he is inclined to do nothing until it is too late.

Formal Procedures

The summary proceedings just described will not always be appropriate. When difficulties have reached a certain point, more formal action is necessary. Statutes generally distinguish between rehabilitation and liquidation, and this distinction is retained. However, rehabilitation has been conceived heretofore in the same legalistic way as liquidation—the problem is seen erroneously as one of undertaking formalized legal action to save the company—perhaps through merger, consolidation, mutualization, conversion to the stock form, or other reorganization. Occasionally these formal devices may be useful, but the emphasis has been altogether misplaced.

What is needed for rehabilitation of an insurance company is new management with the capacity to see what is wrong and the power to correct it. This chapter, therefore, tries to devise a rehabilitation procedure with a focus on management expertise. The key to success is twofold. Early action is one-half and obtaining a satisfactory rehabilitator the other half. The rehabilitator cannot be the insurance commissioner, except in a formal sense, for the commissioner has too many other things to do and may or may not know how to manage an insurance company, however able he may be as a regulator. He should not be a practicing lawyer, unless he is also management oriented and trained. He should be a manager of talent and experience in the insurance business. It is important to draw from the industry an experienced executive of recognized ability who will regard it both as his public duty and his private opportunity to save the company.

To obtain the "right" person requires help from the industry. If they will, insurance executives can help find the man and can help convince him and his present employer that on the grounds of public service and private career opportunity he must take the job. He should be compensated liberally so that he does not lose financially. He should then be given wide discretion in management, subject only to general court supervision, so that he can take such action as is necessary to revitalize the company. Conceptually

he should be treated as new management with especially broad powers, including the power to propose to the court the formal legal reorganizational devices that have heretofore been the focus of rehabilitation but that should normally be subordinated in the future to the larger management task. This change is more one of "tone"-of attitude-than of change in the formally stated rules. But tone or attitude can be a decisive factor in achieving success in a complex undertaking.

Grounds for Formal Proceedings

Traditionally the grounds upon which action might be instituted against an insurer were the same for rehabilitation as for liquidation, the choice between remedies depending on an estimate of probable success if the former were attempted. The chapter retains this notion in part but tries to tailor it to reality. Rehabilitation is not appropriate at a point where a company has been allowed to approach insolvency, unless substantial additional resources are poured into the enterprises immediately by contributors of capital funds. A serious error in recent insurance regulation has been the futile hope that insolvent enterprises might yet survive, held long after it was too late. Consequently the grounds are now separate: those that suggest insolvency are grounds for liquidation while those that indicate only difficulty of a different order are now grounds for rehabilitation. Flexibility is preserved (1) by making either procedure possible on any ground, though the chapter points the procedure in one direction or the other, depending on the situation, and (2) by permitting conversion from one type of proceeding to the other.

One indication of approach is the elimination of failure to remedy an impairment of capital after a commissioner's order as a ground for liquidation. Insolvency now includes every case of impairment of capital; whenever an order to restore impaired capital is necessary, it is too late and the company should be put into liquidation. Generosity on this matter would be misplaced. The only exception to a rule that such a company should be liquidated immediately is if money is poured into the enterprise so quickly that it is again clearly solvent before the commissioner irreversibly commits the company to the liquidation process. He should not wait to begin to do what is necessary to protect the public while efforts are made to find money.

Liquidations

Liquidation is an unfortunate end to an enterprise, to be handled as efficiently and expeditiously and economically as possible and with as equitable as possible an allocation of the inevitable loss.

The influence of the Federal Bankruptcy Act is quite apparent in the sections dealing with liquidation. That act provides a time tested, though not ideal, source for liquidation procedures. But the Act has not been blindly followed, when the special problems of insurance liquidation and regulation or other considerations urge a departure from the model.

The chapter tries to provide for an orderly and complete procedure; for a technique for the handling of claims, especially third party claims, in which everyone makes some concessions to the common necessity and no one suffers too much; for a system of priorities in claims that will enable some classes of claims to be paid earlier than they are now and that will ensure that the insurance company comes as close as possible to performing its social function even in its death throes; for powerful and discriminating devices to recover assets improperly dissipated while the patient was in a coma.

Interstate Problems

The chapter adopts the Uniform Insurers Liquidation Act, formerly ch. 616, in substance and effect. In form, however, the Uniform Act has been broken up and integrated into the fabric of this completely reorganized treatment of delinquency proceedings. Some changes, fully noted where they appear, have also been made. By integrating the Act in this chapter, a more logical structure was achieved. At the same time, all benefits of enactment of the Uniform Act's provisions are retained. It is still appropriate to regard this state as a "reciprocal state" within the meaning of the Uniform Act, as that term is defined as s. 645.03 (9) and in the Uniform Act. Although the Uniform Act may be regarded as the cornerstone of the chapter's approach to interstate problems, that Act is both modified and extended to assume more efficient regulation of interstate delinquency problems.

Sub. (5) is intended to preserve exactly the status of peripheral insurance-type organizations so far as insurance delinquency proceedings are concerned. The basic provisions of former Wisconsin insurance law dealing with delinquent and insolvent insurers, s. 200.08, was made applicable to nonprofit service plans by s. 200.03 (18). But in the absence of express provisions, nonprofit service plans are not subject to the insurance laws. See e.g. s. 148.03 (2). For this reason, nonprofit service plans must be specifically mentioned in this section, or they would not be included, however general the language. Nonprofit service plans include plans for sickness care pursuant to s. 148.03; for hospital service pursuant to s. 182.032; for dental care pursuant to s. 152.53; and for prepaid prescription plans pursuant to s. 151.17.

The general definition section of the insurance code, s. 201.01, defines "company" to include "all corporations, associations, partnerships, and individuals engaged as principals in the business of insurance, except mutual benefit societies." Despite this exclusion of mutual benefit societies from the meaning of companies," they were expressly covered under s. 200.08 dealing with delinquency proceedings. Further, fraternals are declared by s. 208.02 (1) to be synonymous with mutual benefit societies. For clarity, they were also listed specifically in s. 200.08. Hence as a precaution, mutual benefit societies and fraternals are both expressly listed here as subject to this chapter. This does not alter the prior rule.

Not all specialized insurance-type organizations are catalogued in this section however, because many are exempt from present Wisconsin insurance law dealing with delinquent insurers. This category would include ch. 185 organizations, specifically co-operative sickness care plans under s. 185.981 and voluntary benefit plans in schools under s. 185.991. Also in this category are annuity organizations under ch. 199, motor club service organizations under s. 201.71 and employee welfare funds under ch. 211.

§645.03 Definitions.

For purposes of this chapter:

(1) **"Commissioner"** means the commissioner of insurance or equivalent insurance supervisory official.

Comment on sub (1): This is the equivalent of former s. 616.01 (13). Context will determine to which commissioner a provision refers.

(2) **"Receiver"** means receiver, liquidator, rehabilitator or conservator, as the context requires.

Comment on sub. (2): This was s. 616.01 (12). It is s. 1 (12) of the Uniform Insurers Liquidation Act. For a discussion of that Act and its adoption by this chapter, see General Comment on Subchapter IV.

(3) **"Insurer"** means any person who is doing, has done, purports to do or is licensed to do an insurance business and is or has been subject to the authority of, or to liquidation, rehabilitation, reorganization or conservation by, a commissioner. For purposes of this chapter, all other persons included under s. 645.02 shall be deemed to be insurers.

Comment on sub. (3): This is similar to former s. 616.01 (1).

(4) **"Delinquency proceeding"** means any proceeding commenced against an insurer for the purpose of liquidating, rehabilitating, reorganizing or conserving such insurer, and any summary proceeding under ss. 645.21 to 645.24.

Comment on sub. (4): This is the same as former s. 616.01 (2), except for the reference to the summary proceedings, which is necessitated by the creation of those new proceedings. The word "delinquency" is not ideal but is now entrenched in the law.

(5) **"State"** means any state of the United States and the Panama Canal Zone.

Comment on sub. (5): This is similar to former s. 616.01 (3), part of the former Wisconsin version of the Uniform Insurers Liquidation Act, which created potential problems by omit-

ting "of the United States," and might therefore include foreign national states. Former s. 616.01 (3) also added the Panama Canal Zone.

The District of Columbia and Puerto Rico are not mentioned; they are within the general definition of "state" in Wisconsin law, s. 990.01 (40), and hence are included without explicit mention. So also are territories, which thus are put by Wisconsin law in the same position as states, without the need for express mention. To exclude them from coverage would be to treat them as foreign countries.

The Panama Canal Zone and some other covered jurisdictions now have no insurance commissioner, no insurance regulation as such, and have not adopted and could not adopt, in the present posture of their laws, the Uniform Insurers Liquidation Act. Nonetheless, they are within the general terms of this chapter, and if they should later adopt the Uniform Act, they would be considered reciprocal states.

(6) **"Foreign country"** means territory not in any state.

Comment on sub. (6): *This is the same meaning as former s. 616.01 (4).*

(7) **"Domiciliary state"** means the state in which an insurer is incorporated or organized or, in the case of an alien insurer, the state in which the insurer has, at the commencement of delinquency proceedings, the largest amount of its assets held in trust and on deposit for the benefit of policyholders and creditors in the United States.

Comment on sub. (7): *This is based on former s. 616.01 (5).*

(8) **"Ancillary state"** means any state other than a domiciliary state.

Comment on sub. (8): *This was s. 616.01 (6).*

(9) **"Reciprocal state"** means any state other than this state in which in substance and effect ss. 645.42 (1), 645.83 (1) and (3), 645.84 and 645.86 to 645.89 are in force, and in which provisions are in force requiring that the commissioner be the receiver of a delinquent insurer, and in which some provision exists for the avoidance of fraudulent conveyances and preferential transfers.

Comment on sub. (9): *This has the same meaning as former s. 616.01 (7).*

(10) **"General Assets"** means all property, real, personal or otherwise, not specifically mortgaged, pledged, deposited or otherwise encumbered for the security or benefit of specified persons or limited classes of persons, and as to specifically encumbered property the term includes all such property or its proceeds in excess of the amount necessary to discharge the sums secured thereby. Assets held in trust and on deposit for the security or benefit of all policyholders or all policyholders and creditors, in more than a single state, shall be treated as general assets.

Comment on sub. (10): *This is basically the same as former s. 616.01 (8), except for a change in the last sentence. If a trust or special deposit applied to all of the states and territories except one, the fund would then not fall within the definition of general assets. For that reason, the language of the Uniform Insurers Liquidation Act in the last sentence was changed so that funds or deposits applying to more than one state though less than all states would meet the definition of general assets.*

(11) **Preferred claim"** means any claim with respect to which the law accords priority of payment from the general assets of the insurer.

Comment on sub. (11): *This is similar to former s. 616.01 (9), but has been changed in one important respect. The definition here refers to "law," not to the law of a state or of the United States," because this chapter seeks to foreclose the priorities otherwise provided by federal law. See the comment on s. 645.68 (5) for discussion of this point.*