STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Case No. 10 CV 1576-I

SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW OF ALL STUDENT LOAN AND LLOYDS TSB BANK PLC

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FINDINGS OF FACT

Background

1. Ambac Assurance Corporation ("Ambac") is a Wisconsin-domiciled insurer authorized to transact surety and financial guaranty insurance. Through 2008, Ambac offered financial guaranty insurance on investment-grade municipal financial and private structured debt obligations, such as municipal bonds and RMBS.

2. Starting in late 2007, Ambac's financial stability began to deteriorate as RMBS and other financial instruments it insured or invested in suffered significant actual and expected future losses. Ambac's actual and expected losses continued to grow in 2008 and 2009, and downgrades in Ambac's credit ratings caused it to cease writing new policies and begin a functional run-off of its business. In 2009 alone, Ambac made approximately $1.6 billion gross claims payments, with the vast majority related to RMBS obligations.

3. Throughout the past two-plus years, oversight of Ambac by the Wisconsin Office of the Commissioner of Insurance ("OCI") was increasingly extensive. As Ambac's condition began to deteriorate in late 2007, OCI increased its regulatory oversight of Ambac's capital position, financial health, and business activities, and that oversight continued to increase as Ambac's financial situation worsened in 2008 and 2009.

4. In 2008 and 2009, Ambac made approximately $1.8 billion in commutation payments in 2008 and another $1.4 billion in commutation payments in 2009, which were vetted and "non-disapproved" by OCI under Wisconsin insurance law.

5. Ambac took the position that engaging in commutation negotiations with all Ambac policyholders and beneficiaries was impractical for a number of reasons. Ambac contended that, because it had almost 15,000 policies across approximately 20 distinct exposure categories, there was no practical way to identify the holders of some types of policies such as those insuring non-publicly traded securities or those held by intermediate trustees. Therefore, Ambac selected only certain policyholders with whom to negotiate commutations or provide advance warning of the fact that some policies could be moved into a Segregated Account where they would be paid only a percentage of their claims in cash and the remainder of the claims over a long period of time in surplus notes that were uncertain to be paid in full. Ambac also took the position that any non-confidential discussions with policyholders would have greatly enhanced the risk that parties would have exercised certain triggers in their contracts with Ambac, which would have had a disastrous effect on Ambac's financial condition.

6. In the fall of 2009, Ambac became aware that several large financial institutions that are parties to CDS in respect of ABS CDOs were forming a group (the "Bank Group") to negotiate with Ambac regarding a global commutation of those exposures. The Bank Group eventually consisted of 14 financial institutions that, together with their direct affiliates, are among the largest financial institutions in the world. As the negotiations continued into late 2009 and early 2010, OCI took an active role in overseeing, evaluating, and facilitating discussions between Ambac and the Bank Group.

7. On March 24, 2010, after months of protracted negotiations between

Ambac and the Bank Group (with OCI playing an increasingly active role), Ambac and the Bank Group entered a non-binding statement of intent to commute all Ambac's outstanding CDS in respect of ABS CDOs (the "Bank Group Settlement"). In exchange for commuting $16.5 billion in net par exposure, with an appraised present value of $8.7 to $12.9 billion ($7.7 to $12.9 billion using a 5.1% discount rate), Ambac agreed to transfer to the Bank Group in aggregate $2.6 billion in cash and $2 billion of newly issued surplus notes of Ambac.

Establishment of the Segregated Account

8. Ambac and OCI determined that while commutations improved Ambac's financial condition, they alone were insufficient to resolve the mounting financial challenges facing the company. As Ambac's claims payments and projected loss impairments mounted and its liquid claims paying resources were eroded, OCI determined that affirmative regulatory action under Chapter 645 of the Wisconsin Statutes would be necessary to slow the outflow of claims-paying resources and prevent the exercise of contractual insolvency and triggers by certain categories of policyholders. OCI determined that, absent regulatory action, there was a growing risk that Ambac would become insolvent before its in-force policy obligations were satisfied.

9. According to OCI, Ambac's condition prior to March 24, 2010, left OCI with only two choices: (1) place all of Ambac into a Chapter 645 rehabilitation proceeding, or (2) allow Ambac to establish the Segregated Account, allocate certain "troubled policies" or "policies with triggers" to the Segregated Account, while leaving most policies in Ambac's General Account, and commence immediate rehabilitation of

the Segregated Account.

10. OCI determined that the first option – placing all of Ambac into a Chapter 645 rehabilitation proceeding carried significant and unnecessary risks of harm to policyholders, which OCI referred to as "collateral damage". These included the policies insuring notes issued by sizable corporations such as Dunkin' Brands, Inc. (the franchisor of the Dunkin' Donuts and Baskin Robbins chains), Sonic Corporation (the franchisor of Sonic drive-in restaurants), and the Hertz Corporation (the owner of the Hertz rental car and equipment rental businesses). OCI asserts that Ambac "could" experience an excess of $1 billion in damages as a result of such collateral damage.

11. The OCI's evidence at the hearing on the Plan in support of the "collateral damage" was in the form of affidavits from representatives of Sonic, Dunkin and Hertz. However, the affidavits did not support the OCI's assertions that the collateral damages "would" occur or were even reasonably likely to occur. Rather, the affidavits only stated that "if" the policies were terminated, which they would not be in a full rehabilitation, only a liquidation, there "could" be damage.

12. The OCI determined that its second option – establishing and immediately rehabilitating the Segregated Account, while leaving Ambac's General Account outside the rehabilitation proceeding and subject to continued regulatory oversight – addressed Ambac's need for rehabilitation of certain troubled segments of its business while eliminating most of the drawbacks of a full rehabilitation. The Verified Petition filed by OCI does not, however, set forth the criteria for establishing which policies would be allocated to the Segregated Account and which to the General Account except in the most

general of terms.

13. On March 24, 2010, OCI granted its approval to formally establish the Segregated Account, supported by a $2 billion “Secured Note” and an Excess of Loss Reinsurance Agreement (“Reinsurance Agreement”), from the General Account. In doing so, OCI made the following findings:

- The Allocation is fairly balanced by AAC’s issuance of the Secured Note and Excess of Loss Reinsurance Agreement to the Segregated Account. By the terms of the Secured Note, the Segregated Account may make demands upon AAC under the note as needed to meet its expenses, including the payment of claims due in respect of policy liabilities and other liabilities allocated to the Segregated Account. Should the Segregated Account exhaust resources available under the terms of the Secured Note, the Excess of Loss Reinsurance agreement will attach to cover the Segregated Account’s liability under policyholder claims. AAC is obligated to make all payments under the Secured Note and Excess of Loss Reinsurance Agreement unless such payment would cause AAC’s surplus to fall below $100 million, or such higher amount as determined by OCI pursuant to the prescribed statutory account practice.

- OCI finds that the creation of the Segregated Account and the Allocation create a fair and appropriate balance between (i) those assets and liabilities allocated to the Segregated Account and (ii) those assets and liabilities remaining within AAC’s general account, both at present and according to future projections.

- OCI finds that the creation of the Segregated Account and the Allocation serve the interests of the public and policyholders.

- OCI finds that the creation of the Segregated Account and the Allocation was not done with the intent to hinder, delay, or defraud present or future creditors of AAC, but rather to preserve claims-paying resources for the benefits of all policyholders.

- OCI finds that the creation of the Segregated Account and the Allocation do not constitute fraudulent conveyances within the meaning of Wis. Stat. §645 or the Uniform Fraudulent Transfer Act and its predecessor act, the Uniform Fraudulent Conveyance Act.

14. The RMBS policies were allocated to the Segregated Account because the actual and projected impairments are substantial and short-term. From 2008 through March 24, 2010, Ambac paid over $2 billion in RMBS policy claims. These substantial claims payments were effectively reducing the cumulative sum of Ambac's claims-paying resources in favor of certain RMBS policyholders with mature claims while leaving insufficient resources to pay in full the many policyholders with longer-tail claims. Absent the claims payment moratorium presently in place with regard to Segregated Account policies, Ambac estimated that it would have paid another $300 million between March 25, 2010 and April 30, 2010.

15. The policies on the bonds related to the LVM also fit OCI's criteria for allocation to the Segregated Account. The present value of losses associated with LVM exposure could exceed $350 million – one of the highest projected individual deal losses in the Segregated Account.

16. OCI determined that other policies with public-finance components, such as swap sureties and leveraged lease transactions, should be allocated to the Segregated Account. They included forty-two public-finance policies (with an aggregate net par outstanding of more than $1.1 billion as of December 2009) and more than 150 swap surety policies (with initial notional amounts of more than $10 billion).

17. Approximately 13,000 policies remain in Ambac's General Account as of June 30, 2010. (Exhibit 27**,** Rehabilitator's Disclosure Statement, p. 57) . Those policies were not allocated because (a) they lacked material projected impairments, (b) the collateral damage of a rehabilitation proceeding as to those policies could outweigh the

benefits of allocation, and/or (c) the policyholders (namely the Bank Group) were subject to a forbearance agreement. Since the filing of the Verified Petition, Ambac has paid less than $10 million in claims with respect to policies in the General Account through June 30, 2010. (Exhibit 41, Supp. To Rehabilitator's Disclosure Statement, p. 26)

18. On March 24, 2010 the Segregated Account was established and the statement of intent between Ambac and the Bank Group was reached, OCI petitioned this Court for Rehabilitation of the Segregated Account, which this Court granted. The Court appointed Commissioner of Insurance Sean Dilweg as Rehabilitator of the Segregated Account, with all the powers authorized by Chapter 645 of the Wisconsin Statutes.

The ALL/Lloyds Policy Does Not Belong in the Segregated Account

19. Objector All/Lloyds filed Objections to the Plan and a Motion to Modify the Temporary Injunction Order challenging the inclusion of its policy (Financial Guaranty Insurance Policy No. 25599BE dated August 2, 2006 issued by AAC to the Insurance Trustee (as amended, modified or supplemented, the "Lloyds Policy") in the Segregated Account for a myriad of reasons, a primary one being that the Rehabilitator has not shown that it belongs in the account as compared to other policies allocated to the Segregated and General accounts.

20. There are no averments in the Verified Petition or the Plan of Operation that details the reasons why the Lloyds Policy was placed into the Segregated Account. The First Affidavit of Roger Peterson, p. 8, ¶ 12, states that the policies that were left in the General Account were "Policies that were (a) without material projected losses, (b) for which collateral damage of rehabilitation could outweigh the benefits and/or (c) for

which policyholders signed a binding agreement to forbear from the exercise of contractual triggers and to commute certain impaired exposures at a substantial discount to likely loss levels were left in the General Account." The Fourth Affidavit of Roger Peterson and Second Affidavit of Catherine Matanle set forth only that there is a current shortfall in the "ALL Trust" and that there is "a <u>risk</u> of loss <u>if</u> the assets of the ALL Trust are not sufficient to pay the liabilities…." (Emphasis added.)

21. The OCI's witnesses at the hearing on the Plan could not present evidence of "the material projected losses" on the Lloyds Policy at the June 2013 maturity date when ALL/Lloyds could first make a claim. (11/17/10 Tr. p. 159; 11/19/10 Tr. p. 9). ALL/Lloyds agreed to waive any confidentiality to the disclosure of the loss data, thus obviating one of the reasons the OCI did not want to disclose the loss data. Moreover, ALL/Lloyds never exercised the "default rates" because of Ambac's below-investment-grade ratings (even though it had the option). Unlike other policyholders in the General Account, ALL/Lloyds was also not afforded the opportunity to continue to "forbear" the right to exercise the increased "default rates" on the interest rates that would have been the "trigger" to increase any potential claim under the Lloyds Policy. Thus, ALL/Lloyds were not provided the same opportunity as policyholders in the General Account to obviate one of the stated reasons for placing the Lloyds Policy in the Segregated Account. (11/17/10 Tr. p. 154; 11/19/10 Tr. p. 13)

22. ALL/Lloyds' projected losses are wholly tied to the projected differential in the future interest rates, all of which are variable for that policy. Commissioner Dilweg repeatedly admitted that the Rehabilitator's "estimates of future developments," such as

future interest rates, were “inherently uncertain” and that "The Rehabilitator's financial projections” should not be regarded by anyone as an indication that they “can or will be achieved.” (11/16/10 Tr. p. 76, l. 11-24) Moreover, the OCI’s Disclosure Statement (Exhibit 27, p. ii) concedes that the projections were not prepared with a view toward compliance with SEC, GAAP, SAP or even OCI permitted practices, were without “any warranty, express or implied, as to the accurateness or completeness of the information contained herein.” The Rehabilitator’s Disclosure Statement (p. ii) further provided that “no assurance can be given that such expectations will prove to have been correct.”

23. Commissioner Dilweg testified that he did not review the Lloyds Policy, and, although the OCI differentiated between which policies went into the Segregated Account and General Account based on whether they were “short tail” or “long tail,” he could not define “short tail” policies and “ you have other short-tailed policies in the General Account.”(11/16/10 Tr. p. 51, l. 15-17) Thus, the OCI did not set forth a basis for distinction of the Lloyds Policy and the other General Account policies on this basis as well.

24. The OCI’s witnesses admitted that without access to the policy and loss data related to the other policies in the General Account, there was no method by which ALL and Lloyds could determine if the alleged material projected impairment on their policy was comparable to the other policies in the General Account. (11/19/10 Tr. p. 14) However, Ambac could have supplied ALL/Lloyds with “redacted” versions of the list of policies left in the General Account from which ALL/Lloyds could determine if its policy’s impairment was any worse than others left in the General Account. (Id. at 15-

16.) However, no such data was provided to ALL/Lloyds, even though Ambac did possess the policy-by-policy loss data for the General Account. *Id*. at 16.

25. As the owner of all of the Senior Series V-A-3 through V-A-5 Bonds, Lloyds Bank is the sole "Holder" under and within the contemplation of the Lloyds Policy. (Affidavit of Thea Watkins, 6/21/10, ¶ 5) At the time they were issued, Standard & Poor's and Moody's assigned the Senior Series V Bonds their highest ratings of "AAA," and "Aaa", respectively, because they were insured by Ambac. *Id*. at ¶ 7.

26. Lloyds Bank fully expected that, under the Lloyds Policy, Ambac would make payments on the Lloyds Policy when and if a claim became due, because Ambac had agreed to make such payments when Ambac issued the Lloyds Policy for a substantial premium amount. *Id*. at ¶ 7.

27. Ambac did not provide Lloyds Bank with any consideration in exchange for the transfer of the Policy to the Segregated Account, nor did it provide any prior notice of the transfer into the Segregated Account. *Id*. at ¶ 9-10.

28. Lloyds Bank did not consent to the Lloyds Policy being placed in the Segregated Account. *Id*. at ¶ 11.

29. Lloyds Bank has not made a claim under the Lloyds Policy to Ambac, ALL Student Loan, or the Trustee. *Id*. at ¶ 12.

30. The collateral pledged to the Senior Series V Bonds is extremely strong, as the student loans are guaranteed by the California Student Aid Commission and United Student Aid Funds, Inc., among others, and reinsured by the U.S. Department of Education, for at least 97% of any defaulted principal and interest accrued. Thus, the

Lloyds Policy is wholly distinguishable from the other policies in the Segregated Account. *Id*. at ¶ 16.

31. Unlike the mortgage-backed securities and credit-default swap guaranty insurance losses, ALL and Lloyds are wholly innocent with respect to its potential, future losses, as the only reason that there is any potential for losses against the Lloyds Policy is the financial downfall of Ambac. More specifically, it was the deterioration in the financial condition and the subsequent downgrade of Ambac's credit rating that resulted in Lloyds, in its capacity as Liquidity Provider for the ALL Series V Bonds, purchasing such bonds from the existing bondholders, who were no longer comfortable with Ambac risk. The interest payable on bonds held by Lloyds was higher than that payable in the hands of the previous bondholders because it was designed to reflect the cost to Lloyds of funding the purchase, with the result that there was a deterioration in the Trust. Lloyds fully performed the obligations that it was contracted to do. (Affidavit of Thea Watkins, 8/31/10, ¶ 9)

There is a Lack of Adequate Capital and Surplus in the Segregated Account

32. Commissioner Dilweg instructed his staff to be "guided by the statutes" when performing the regulatory duties. However, he testified that he did not review the statues before he signed the Verified Petition and was not familiar with Wis. Stat. § 611.24 at the hearing. (11/16/10 Tr. p. 48, l. 5-12)

33. There are "no assets" in the Segregated Account according to the Commissioner. Moreover, Commissioner Dilweg "did not know" what assets the Plan of Operation referred to as being "available exclusively for satisfying liabilities attributed to

the Segregated Account," although he admitted that "there are liabilities in the Segregated Account." (11/16/10 Tr. p. 41, l.9-20; 22)

34. The OCI's purpose of approving the Segregated Account was "segregating out our short-term policyholders and providing <u>full payment</u> through a cash note split." 11/16/10 Tr. p. 49, l.5-7. (Emphasis added.)

35. The Segregated Account was also approved by the OCI for purpose of "simply reordering giving a time out to make sure that <u>the claims paying resources of the company</u> can be there for all policyholders." (11/16/10 Tr. p. 51, l.20-21; emphasis added.)

36. The OCI's Disclosure Plan presented four projected scenarios for payouts from the Segregated Account on the 75% Surplus Notes of "100 percent, 85 percent, 71 percent and 45 percent" (Exhibit 27 at p. 57, l. 2). However, the Disclosure Plan, p. (ii) states that none of the figures can be verified and that: "no assurance can be given that such expectations will prove to have been correct." Id. at 59, l. 16-23. Also, the Rehabilitator's Supplementations to the October 8th Disclosure Statement filed November 12, 2010 states that "no specific analyses have been created regarding the payment of the surplus notes on or about June 7, 2020, nor has OCI reached a conclusion regarding the payment of surplus notes at that time." (Id. at p. 62, l. 5-8)

37. There is "no increase of loss right now to the creditors of the General Account, they're still going to get paid a hundred percent on their claims." (11/16/10 Tr., p. 56, l. 4-23)

38. The Secured Note (Exhibit 5) and Aggregate Excess of Loss Reinsurance

Agreement (Exhibit 6) are the sole support for the OCI's statement that "the Segregated Account has access to all of the assets of Ambac, in pari passu with General Account policyholders, unless the payment of claims would cause Ambac's assets to fall below $100 million, a number that constitutes less than two percent of Ambac's claim paying assets." (Tr. 11/17/10 p. p. 175, l. 2-5; 187, l. 23-25.)

39. The Secured Note and Aggregate Excess of Loss Reinsurance Agreement were each signed by the same individual, Kevin Doyle, General Counsel for Ambac. He was authorized to sign on behalf of the Segregated Account by OCI and was acting as General Counsel for the Segregated Account. (Tr. 11/17/10 p. 175, l. 6-22; p. 176, l. 9-13)

40. The Secured Note provides that Maker (Ambac) has established Payee (the Segregated Account) pursuant to Section 611.24(2) and the Plan of Operation (Exhibit 2) "as amended from time to time." The Plan of Operation was approved by the Court but it has no provisions on modification or that require modifications to be approved by this Court.

41. The Secured Note and Reinsurance Agreement also each have two major conditions for payment: "due and payable are in accordance with the Plan of Rehabilitation and not otherwise disapproved by the Rehabilitator." (Exhibits 5 and 6; 11/17/10 Tr. p. 180, l. 2-11; p. 182, l. 5-21). The Reinsurance Agreement "gives the authority" to the Rehabilitator to disapprove payments of policyholders otherwise eligible for payments under the Plan of operation or Rehabilitation Plan and, therefore, under the policies. *Id.* Moreover, there are no controls over modifications to the Rehabilitation

Plan or the current or future Rehabilitator's ability to disapprove payments under the Secured Note or Reinsurance Agreement.

42. Ambac does not need to make payment to Segregated Account "until there's a cash payment on the Surplus Notes." (Id. at 182, l. 24-25)

43. The Reinsurance Agreement is issued by the same company (Ambac) that issued the underlying insurance policies it is now purporting to reinsure. There should be no conditions, that is, if it affords the same protection as the policy, it should be 100% reinsurance above the Secured Note and as solid as the insurance policy that it replaces. Moreover, each of the Secured Note and Reinsurance Agreement have provisions that make payment to the claimants contingent or conditional on various events that are unrelated to the policies that were originally issued by Ambac (the original insurer) (Affidavit of William C. Barbagallo, ¶ 12; Affidavit of Frederich J. Bingham, ¶ 17-25)

44. The term "surplus" is intended to ensure that there were more assets than liabilities in the Segregated Account when that account was formed. In this case, the Segregated Account was formed as an offshoot of a going concern, i.e. after Ambac was in existence for a long time and had policies in effect with active losses and premiums. Thus, the statute in question, 611.24(3)(a) titled "Special Provisions For Segregated Accounts," required that if such a "segregated account is established after a certificate of authority has been issued, the commissioner shall require the corporation to have and maintain an adequate amount of capital and surplus in the segregated account." (Affidavit of Frederich J. Bingham, ¶ 18)

45. The only way that it can be properly determined whether there was

adequate capital and surplus in the Segregated Account would have been, at a minimum, to determine the current paid losses and the future case and Incurred But Not Reported (IBNR) reserves for all of the Covered Policies that were being allocated to the Segregated Account, determining the ownership, value and liquidity of the assets pledged to the Segregated Account and then balancing the liabilities against the assets.

46. Section 4.01 of the Reinsurance Agreement purports to be a standard "follow the fortunes" clause. However, it has a significant caveat whereby the protection of the Segregated Account, as the cedent, under such a clause is illusory, as it states that the reinsurer's liability follows that of the cedent "except as modified by the Plan of Rehabilitation" and the Plan may be modified by the Rehabilitator and the Court at any time. This clause also has a clause after the words "provided however," that states that the General Account's liability may not be expanded "beyond what is specifically assumed under this Agreement." The only liabilities assumed under the Agreement are under section 1.02, and that section again is the "finite aggregate reinsurance" section that calls for payment of cash claim payments, including ALAE (allocated loss adjustment expenses), loss settlements, commutations and various other payments but only "in accordance with the Plan of Rehabilitation and not otherwise disapproved by the Rehabilitator." Moreover, it only authorizes payments of surplus notes issued to claimants in the Segregated Account if the cash or interest payments on those Surplus notes are authorized for payment by the Rehabilitator. (Affidavit of William C. Barbagallo, ¶ 12-14; Affidavit of Frederich J. Bingham, ¶ 18-25) The Disclosure Statement makes it clear that there is no assurance that any payment will ever be made by

the Rehabilitator.

47. The follow the fortune clause is one of the most significant protections for the cedent under a reinsurance clause and, if it is severely undercut in this manner, the reinsurance contract as a whole is severely undercut. (Affidavit of William C. Barbagallo, ¶ 15-16)

The Segregated Account Unlawfully Created Two Separate Classes of Creditors

48. There is "no increase of loss right now to the creditors of the General Account, they're still going to get paid a hundred percent on their claims." *Id*. p. 56, l. 4-23.

49. Payments to creditors of the Segregated Account are wholly conditional, as even the 25% cash payment is under the Secured Note, subject to conditions, including a provision that the claim is "not otherwise disapproved by the Rehabilitator." Further, as to payments of the 75% Surplus Note obligations, which are subordinated to all other obligations in both accounts, section 1.02 of the Reinsurance Agreement, only approves payments "in accordance with the Plan of Rehabilitation and not otherwise disapproved by the Rehabilitator," and only authorizes payments of surplus notes issued to claimants in the Segregated Account if the cash or interest payments on those Surplus notes are authorized for payment by the Rehabilitator. The Disclosure Statement makes it clear that there is no assurance that any payment will ever be made by the Rehabilitator.

50. The Plan of Rehabilitation creates preferences amongst the same class of claimants, i.e. policyholders, which is contrary to acceptable industry and statutory methods of fair treatment of creditors in a rehabilitation or liquidation. (Affidavit of

William C. Barbagallo, ¶ 15-16)

51. It was possible for Ambac and OCI to supply the creditors of the Segregated Account with the projected loss data on General Account policies in a redacted format, such that they could have the data to compare the basis for why their policies were allocated to the Segregated Account and not the policies left in the General Account at least with respect to the alleged "material projected losses." (11/19/10 Tr., p. 16, l. 15-22)

The Confirmation Hearing was Conducted Without Providing the Objectors any of the Requested Discovery or Information

52. Although the Court has previously ruled that the creditors of the Segregated Account were not entitled to various information and discovery based on confidentiality grounds, it became clear at the hearing that there was no valid reason for OCI and/or Ambac not to supply the creditors of the Segregated Account with the projected loss data on General Account policies in a redacted format, such that they could have the data to compare the basis for why their policies were allocated to the Segregated Account and not the policies left in the General Account at least with respect to the alleged "material projected losses." (11/19/10 Tr., p. 16, l. 15-22)

The Commissioner did not Present Evidence on Compliance with the Statutes Governing the Issuance of an Organizational Permit or Certificate of Authority

53. The OCI witnesses did not present evidence that all of the steps had been followed with respect to the issuance of an organizational permit or a certificate of authority under Wis. Stat. § 611.13 or § 611.20. Roger Peterson could not recall if an organizational permit was even issued. (11/17/10 Tr., p. 167, l. 16 – p. 169, l. 10) In

fact, Mr. Peterson argued that it was "not clear to me" whether the organizational permit was necessary because this was a "corporation within a corporation." *Id*.

CONCLUSIONS OF LAW

1. This proceeding pertains to the approval of the Plan of Rehabilitation of the Segregated Account of Ambac Assurance Corporation under Wis. Stat. Ch. 645.

2. The Segregated Account was not formed in compliance with Wisconsin law, specifically Wis. Stat. §611.78(2), §611.24(2) and (3), § 611.13 and §611.20. Therefore, the Plan of Rehabilitation cannot be approved.

3. The OCI's approval of the Reinsurance Agreement on March 24, 2010 violated Wis. Stat. §611.78(2), "Transfer of business or assets", which provides that, "Any action by which an insurance corporation proposes to …reinsure any part of its business, other than in the normal and usual part of its business…shall be reported to the commissioner not less than 30 days in advance of the proposed effective date…." The Reinsurance Agreement was not one found in the "normal and usual part of [the Segregated Account or Ambac's] business" and, therefore, it should have been submitted to the Commissioner in a public filing for inspection by the public and review by the commissioner thirty days before it was approved. This would have provided for creditors of the Segregated Account to have the opportunity to object to it at that time. It is obvious that the OCI and Ambac did not want the potential creditors of the Segregated Account to have knowledge of the Segregated Account and, therefore, ignored this statutory requirement.

4. The OCI's approval of the Segregated Account on March 24, 2010 violated

§ 645.24(3)(a), which provides:

> *Capital and surplus.* The commissioner shall specify in the certificate of authority of a newly organized corporation the minimum capital or the minimum permanent surplus and the initial expendable surplus to be provided for each segregated account. *If a segregated account is established <u>after</u> a certificate of authority has been issued*, the commissioner shall require the corporation to <u>have and maintain an adequate amount of capital and surplus in the segregated account</u>.
> (Emphasis added.)

5. The Rehabilitator failed to comply with the requirement of § 645.24(3)(a) to "have and maintain adequate capital and surplus." This statute was not designed to enable the Commissioner to open a segregated account and simultaneously place the account into rehabilitation. The fact that the account was immediately placed into rehabilitation and unable to pay the creditors in that account 100% of their claims is evidence alone that the account could not "maintain adequate capital and surplus."

6. The OCI's argument that "the Segregated Account has access to <u>all of the **assets** of Ambac</u>, in *pari passu* with General Account policyholders, unless the payment of claims would cause Ambac's **assets** to fall below $100 million, a number that constitutes less than two percent of Ambac's claim paying assets" is without merit and is rejected. The Secured Note and Reinsurance Agreement are invalid, illusory and unenforceable against "all assets of General Account" because they have the broad contingencies and preconditions as set forth in the above Findings of Fact.

7. Payments to creditors of the Segregated Account are wholly conditional, as even the 25% cash payment is under the Secured Note, subject to conditions, including a provision that the claim is "not otherwise disapproved by the Rehabilitator." Further, as

to payments of the 75% Surplus Note obligations, which are subordinated to all other obligations in both accounts, section 1.02 of the Reinsurance Agreement, only approves payments "in accordance with the Plan of Rehabilitation and not otherwise disapproved by the Rehabilitator," and only authorizes payments of surplus notes issued to claimants in the Segregated Account if the cash or interest payments on those Surplus notes are authorized for payment by the Rehabilitator. The Disclosure Statement makes it clear that there is no assurance that any payment will ever be made by the Rehabilitator.

8. There was no evidence presented at the Plan Confirmation hearing that supplies the Court with information to properly determine whether there was adequate capital and surplus in the Segregated Account, as this would have required, at a minimum, to determine the current paid losses and the future case and Incurred But Not Reported (IBNR) reserves for all of the Covered Policies that were being allocated to the Segregated Account, determining the ownership, value and liquidity of the assets pledged to the Segregated Account and then balancing the liabilities against the assets.. More importantly, the statements that Ambac was in a hazardous financial condition before it moved the toxic policies to the Segregated Account in order to protect the policies with no claims that remain in the General Account are wholly contrary to a conclusion that there could possibly be adequate capital, much less "surplus" in the Segregated Account, given the contingencies contained in the Secured Note and Reinsurance Agreement that make payment on the policies contingent and conditional on events unrelated to whether the claims are payable under the terms of the policies themselves. In short, a claimant in the Segregated Account can fulfill all of the requirements under the policy originally

issued by Ambac, but its claim may not be paid based on contingencies unrelated to the validity of its claim based on the wording of the Secured Note and Reinsurance Agreement, which, therefore, do not protect the liabilities of the Segregated Account with 98% of the assets of the General Account as alleged by OCI.

9. The Rehabilitator's promise at the hearing to treat all creditors of the Segregated Account fairly and equitably is without foundation or merit based on the evidence presented at the hearing. The Rehabilitator testified that the Segregated Account would be "providing <u>full payment</u> through a cash note split." (11/16/10 Tr. p. 49, l.5-7; emphasis added.) However, the only credible evidence was that there would not be "full payment" to the creditors of the Segregated Account, but that any payment on the Surplus Notes was wholly speculative.

10. The OCI's own witnesses and the Disclosure Statement admit that all projections as to payouts on the Surplus Notes are speculative. The OCI's Supplementations to the Disclosure Statement concedes that there has not even been any specific analyses created regarding the payment of the surplus notes on or about June 7, 2020, nor has OCI reached a conclusion regarding the payment of surplus notes at that time. The Rehabilitator's promise that the purpose of the Segregated Account was for "giving a time out to make sure that <u>the claims paying resources of the company</u> can be there for all policyholders" is again without merit based on the facts adduced at the hearing, as the claims paying resources of Ambac are not available for "all policyholders." (11/16/10 Tr. p. 51, l.20-21; emphasis added.)

11. The OCI's approval of the Segregated Account on March 24, 2010

violated Wis. Stat. § 611.13 and §611.20 in that the requirements for a Certificate of Authority were not followed before the alleged issuance of the certificate for the Segregated Account. Section 611.20 provides:

> **611.20 Certificate of authority.**
> **(1) Application.** The corporation may apply for a certificate of authority at any time prior to the expiration of its organization permit. The application shall include a statement by a principal officer of any material changes that have already taken place or are likely to take place in the facts on which the issuance of the organization permit was based, and if any material changes are proposed in the business plan, the additional information about such changes that would be required if an organization permit were then being applied for.
> **(2) Issuance.**
> (a) The commissioner shall issue a certificate of authority, if he or she finds:
> 1. That cash or property authorized under s. 611.14 (1) (a) has been received sufficient to satisfy the requirements of s. 611.19;
> 2. That there is no basis for revoking the organization permit under s. 611.16 (2); and
> 3. That all other applicable requirements of the law have been met.
> (b) The certificate of authority shall specify any limits placed on the insurance business that may be carried on by the corporation and may, within the powers given the commissioner by law, specify limits on its methods of operation.

12. There was no evidence adduced at the hearing that OCI complied with the provisions of § 611.20 for the Segregated Account, notwithstanding the fact that the Commissioner asserts that this account is a new, "separate insurer" and the optional segregated account at issue in these proceedings is governed by Wis. Stat. § 611.24(3)(a),which applies to a segregated account "established after a certificate of authority has been issued" with a requirement that "the commissioner shall specify in the certificate of authority of a newly organized corporation the minimum capital or the minimum permanent surplus."

13. Section 611.13 provides:

611.13 Organization permit and certificate of incorporation.
(1) Permit required. No person may, in the case of a stock corporation, solicit subscriptions for its securities, or in the case of a mutual, solicit applications for qualifying insurance policies or subscriptions for mutual bonds or contribution notes, until the commissioner has issued an organization permit.
(2) Application for permit. The application for an organization permit shall be signed and acknowledged by or on behalf of each incorporator, and shall include or have attached:

(a) The names, and for the preceding 10 years all addresses and all occupations of all incorporators and proposed directors and officers;

(b) For all corporate incorporators, their articles and bylaws, a list of the names, addresses and occupations of all directors and principal officers, and for the 3 most recent years their annual financial statements and reports;

(c) The proposed articles which shall be signed and acknowledged by or on behalf of each incorporator, and the proposed bylaws;

(d) All agreements relating to the corporation to which any incorporator or proposed director or officer is a party;

(e) The amount and sources of the funds available for organization expenses and the proposed arrangements for reimbursement and compensation of incorporators or other persons;

(f) The proposed compensation of directors and officers;

(g) The plan for solicitation of applications for qualifying insurance policies and for the corporation's securities;

(h) The forms to be used for stock subscriptions, certificates for shares, applications for qualifying insurance policies, subscriptions for mutual bonds and contribution notes, and the forms for bonds and notes;

(i) The proposed capital, or the proposed minimum permanent surplus, and the proposed initial surplus;

(j) The plan for conducting the insurance business, including:

1. The geographical area in which business is intended to be done in the first 5 years;

2. The types of insurance intended to be written in the first 5 years;

3. The proposed marketing methods;

4. To the extent requested by the commissioner, the proposed method for the establishment of premium rates;

(k) A projection of the anticipated operating results of the corporation at the end of each of the first 5 years of operation, based on reasonable assumptions of loss experience, premium and other income, operating expenses and acquisition costs; and

(l) Such other relevant documents or information as the commissioner reasonably requires.

(3) Issuance of organization permit and of certificate of incorporation. The commissioner shall issue an organization permit and a certificate of incorporation if:

(a) The commissioner finds that all requirements of law have been met;

(b) The commissioner is satisfied that all natural persons who are incorporators, the directors and principal officers of corporate incorporators, and the proposed directors and officers of the corporation being formed are trustworthy and competent and collectively have the competence and experience to engage in the particular insurance business proposed; and

(c) The commissioner is satisfied that the business plan is consistent with the interests of the corporation's potential insureds and of the public.

(4) Contents of permit. The organization permit shall specify the minimum capital or minimum permanent surplus required under s. 611.19, and may contain such other information as the commissioner deems necessary.

14. There was no evidence adduced at the hearing that OCI complied with the provisions of § 611.13. The OCI witnesses did not present evidence of such compliance and could not recall if an organizational permit was even issued. In fact, Roger Peterson argued that it was "not clear to me" whether the organizational permit was necessary because this was a "corporation within a corporation." However, this was a "separate insurer" under § 611.24 and the Commissioner cannot argue out of both sides of its mouth. Moreover, the Commissioner's actions in ignoring the requirements of § 611.13 and § 611.20 further show that there was a design to avoid public notice of the Segregated Account so that the policyholders who would be placed in that account could not take preventative measures.

15. The failure to comply with Wis. Stat. § 611.13 and § 611.20 is fatal to the creation of the Segregated Account, as these are prerequisites for the establishment of a

valid “separate insurer.” The OCI cannot be held to a lesser standard regarding compliance with the Wisconsin statutes than any other party, especially when the non-compliance has the effect of creating a “short-cut” to proper oversight by all members of the OCI’s staff and the public.

16. The allocation of the ALL/Lloyds policies to the Segregated Account created two classes of policyholder creditors in violation of Wis. Stat. § 645.01(4)(d) and its admonition that the purpose of the Insurers Rehabilitation and Liquidation Act is “<u>equitable</u> apportionment of any avoidable loss.” (Emphasis added.) The OCI’s Plan also disregards the Wisconsin legislature’s priorities statute, § 645.68(3), which requires an “order of distribution” of assets in rehabilitation whereby all policyholders are treated the same. In creating this Segregated Account in lieu of a full rehabilitation, the OCI has subverted the requirements of this statute.

17. For the same reasons, the OCI’s approval of the Segregated Account on March 24, 2010 also violated Wisc. Stat. § 611.24(2), which provides with respect to ”Optional segregated accounts**”** that, “[w]ith the approval of the commissioner, a corporation may establish a segregated account for any part of its business. The commissioner shall approve <u>unless he or she finds that the segregated account would be contrary to the</u> law or to the <u>interests of any class of insureds</u>.” (Emphasis added.) Here, the creation of the Segregated Account was clearly contrary to the interests of the class of insureds who are not being paid 100% on their claims and have no reasonable hope of being paid 100% of their claims based on the evidence presented at the hearing.

18. The OCI has relied extensively on Moody Investors Services in these

rehabilitation proceedings, including a Moody Investors Service article attached as Exhibit 3 to an affidavit of Michael Van Sicklen which article provided that the "surplus notes" that the Verified Petition calls for to be used to pay the claims of the Covered Policies of the Segregated Account, and that have already been used to pay the June 2010 settlement of the claims of ABS CDO, are "junior to the General Account policyholders' claims and can be deferred." Moreover, the May 2010 Moody's article attached as Exhibit B to the Affidavit of William C. Barbagallo states that: "In our [Moody's] view, the policies allocated to the Segregated Account have been effectively subordinated to the policies remaining in the General Account." In short, there is no question that the policies allocated to the Segregated Account are subordinated to those in the General Account and will not be paid for many years, if at all. This creates a two-tier system of policyholder and third party claimants arising out of this Rehabilitation Plan. This violates the intent and letter of Chapters 611 and 645.

19. There were no significant differences between the contractual triggers in the General Account transactions compared to the contractual triggers in the Segregated Account transactions.

20. OCI could have asked this Court to enter an injunction to enjoin the exercise of triggers on the policies in General Account in the same fashion as it did on the exercise of the triggers in the Segregated Account.

21. The OCI's failure to provide the creditors of the Segregated Account with the projected loss data on General Account policies in a redacted format, such that they could have the data to compare the basis for why their policies were allocated to the

Segregated Account and not the policies left in the General Account, at least with respect to the alleged “material projected losses,” was unreasonable and denied the creditors due process. The OCI and Ambac had a method by which the creditors in the Segregated Account could compare their policies and how they were allocated to those left in the General Account but were wrongfully denied that opportunity.

22. The OCI did not present evidence at the hearing on the Plan that supported a reasonable or rational basis for allocating the Lloyds Policy to the Segregated Account as compared to the policies that remained in the General Account. ALL/Lloyds specifically challenged the OCI’s allocation of the Lloyds policy and agreed to waive confidentiality as to its future “material projected losses,” but OCI failed to present sufficient evidence as to the extent of those losses. Rather, OCI’s evidence was pure speculation.

23. Moreover, the Lloyds Policy is unlike the other policies that were allocated to the Segregated Account in important aspects, as unlike the mortgage-backed securities and credit-default swap guaranty insurance losses, ALL and Lloyds are wholly innocent with respect to its potential, future losses, as the only reason that there is any potential for losses against the Lloyds Policy is the financial downfall of Ambac. A policyholder should not be punished because its insurer caused the potential losses to occur. Therefore, the Lloyds Policy should be allocated back to the General Account.

Order

WHEREFORE, for these reasons set forth above, the Court hereby orders that (1) the OCI’s Proposed Plan of Rehabilitation is in violation of the various Wisconsin statutes set forth above and cannot be approved; (2) the ALL/Lloyds Policy should be removed from the Segregated Account and returned to Ambac's General Account, and (3) OCI should endeavor to propose a new rehabilitation plan to the Court that does not violate Wisconsin law.

November 29, 2010

/s/
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