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

LVM BONDS TRUSTEE'S AND LVM BONDHOLDERS' PROPOSED ORDER DENYING MOTION FOR CONFIRMATION OF THE PLAN OF REHABILITATION FOR THE SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

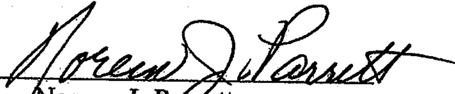
Wells Fargo Bank, National Association, as indenture trustee of the outstanding Las Vegas Monorail Project Revenue Bonds supported by an insurance policy issued by Ambac Assurance Corporation ("Ambac"), and Nuveen Asset Management, Restoration Capital Management LLC and Stone Lion Capital Partners L.P. (collectively the "LVM Bondholders"),[1] respectfully submit the annexed proposed Order Denying the Motion for Confirmation of the Plan of Rehabilitation for the Segregated Account of Ambac.

Dated: November 29, 2010

[1] Parrett & O'Connell, LLP and Kramer Levin Naftalis & Frankel LLP have withdrawn from their representation of Eaton Vance Management and will be filing a motion later today to confirm that withdrawal.

PARRETT & O'CONNELL, LLP

Attorneys for Nuveen Asset Management, Restoration Capital Management LLC, and and Stone Lion Capital Partners L.P

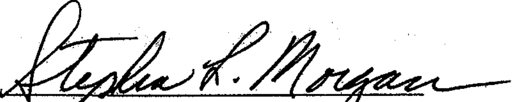
BY: 
Noreen J. Parrett
WI State Bar ID No. 1003686
Connie L. O'Connell
WI State Bar ID No. 1026209
10 East Doty Street, Suite 621
Madison, Wisconsin 53703
Telephone: (608) 251-1542
Facsimile: (608) 251-1996

Of Counsel:

Philip Bentley
Amy Caton
Susan Jacquemot
Daniel M. Eggermann
KRAMER LEVIN NAFTALIS & FRANKEL LLP
1177 Avenue of Americas
New York, New York 10036
Telephone: (212) 715-9100
Facsimile: (212) 715-8000

MURPHY DESMOND S.C.

Attorneys for Wells Fargo Bank, National Association, in its Capacity As Trustee for the LVM Bonds

By: 
Stephen L. Morgan
WI State Bar ID No. 1015099
Brittany S. Ogden
WI State Bar ID No. 1035853
33 East Main Street, Suite 500
Madison, Wisconsin 53703
Telephone: (608) 807-0262
Facsimile: (608) 257-2508

Of Counsel

Steven T. Whitmer
Kevin A. Wisniewski
LOCKE LORD BISSELL & LIDDELL LLP
111 South Wacker Drive
Chicago, Illinois 60606
Telephone: (312) 443-1869
Facsimile: (312) 443-0336

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

ORDER DENYING MOTION FOR CONFIRMATION OF THE PLAN OF REHABILITATION FOR THE SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

This matter came before the Court on the motion (the "Motion") of the Wisconsin Office of the Commissioner of Insurance ("OCI"), as Rehabilitator (the "Rehabilitator") for the Segregated Account (the "Segregated Account") of Ambac Assurance Corporation ("Ambac"), to confirm the Plan of Rehabilitation (the "Plan") for the Segregated Account filed on October 8, 2010, pursuant to Wis. Stat. § 645.33(5).

Based on this Court's review of the Plan and the briefs, affidavits, exhibits and other materials filed by Wells Fargo Bank, National Association ("Wells Fargo"), as indenture trustee of the outstanding Las Vegas Monorail Project Revenue Bonds (the "LVM Bonds"), and Eaton Vance Management, Nuveen Asset Management, Restoration Capital Management LLC, and Stone Lion Capital Partners L.P. (collectively the "LVM Bondholders"), and filings by other parties, as well as the testimony and argument presented at the hearing on confirmation of the Plan, and for good cause shown, IT IS HEREBY FOUND AND DETERMINED THAT:

FINDINGS OF FACT

1. The LVM Bondholders are the owners or managers of funds that collectively own a majority of the outstanding "1st Tier" bonds – *i.e.*, the LVM Bonds – issued by the State of Nevada to fund the construction of a four-mile monorail system in downtown Las Vegas (the "Monorail"). The LVM Bonds are to be repaid by the operator of the Monorail – *i.e.*, the Las Vegas Monorail Company ("LVMC") – out of the Monorail's net revenues.

2. Wells Fargo is the trustee for all of the 1st Tier bonds, including those bonds held by the LVM Bondholders.

3. The 1st Tier "Current Interest" Bonds, in the original principal amount of $352,705,000, bear interest at an annual rate of 5.625%, payable semi-annually, and will mature on January 1 in each of the years 2032 (in the amount of $68,890,000), 2034 (in the amount of $55,930,000), and 2040 (in the amount of $227,885,000). An additional $98,743,217 in "Capital Appreciation Bonds" do not bear current interest, but accrete in value from issuance to date of maturity, and mature in varying amounts on January 1 of each year between 2007 and 2029. (*See* LVM Bond Indenture, Ex. 36, at 27-28.)

4. Ambac issued a municipal bond insurance policy (the "LVM Bond Policy") that insures payment of the principal and interest, as well as accreted value, on the LVM Bonds when such payment is due – as well as a surety bond in the amount of $20,991,807.50 guaranteeing payment of principal and interest on the LVM Bonds. (*See* LVM Bond Policy, Ex. 38.)

5. LVMC is presently in bankruptcy, having filed a voluntary Chapter 11 petition on January 13, 2010, and the LVM Bonds are currently expected to receive "minimal recoveries" in that proceeding. (Disclosure Statement Accompanying Plan of Rehabilitation,

dated Oct. 8, 2010, Ex. 23, at 12.) As a result, the main source for repayment of the LVM Bonds is expected to be Ambac, under the LVM Bond Policy. Under that policy, Ambac has insured a current outstanding amount of LVM Bonds of more than $500 million. (*See* Declaration of Scott Zuchorski of Ambac ("Zuchorski Declaration") filed in LVMC Chapter 11 case, Ex. 37, dated Jan. 13, 2010, at pp. 3-6.) Ambac estimates that its total exposure for future payments of principal and interest under the LVM Bond Policy is approximately $1.163 billion, minus any payments of principal and interest LVMC may make. (*Id.* at ¶ 13.)

6. On March 24, 2010, OCI announced that Ambac, with OCI's approval, had created the Segregated Account pursuant to Wis. Stat. § 611.24, and had allocated to that account certain policies and other liabilities considered to have "material projected impairments," such as residential mortgage-backed securities ("RMBS"), credit default swaps ("CDS") written on collateralized debt obligations (other than those covered by the settlement that was consummated in June 2010), and certain student loan policies.

7. The LVM Bond Policy was among the policies allocated to the Segregated Account. OCI's reason for that allocation was that LVMC had defaulted on the LVM Bonds and, as a result, there was the potential for Ambac to suffer "material losses" under the LVM Bond Policy. (Disclosure Statement, Ex. 23, at 11-12.) All or almost all of Ambac's other municipal bond policies were left in the General Account.

8. Under the Plan, LVM Bondholders will receive in satisfaction of their permitted policy claims cash equal to 25 percent of their permitted claim amount, as well as notes ("Surplus Notes") equal to 75% of the permitted claim amount. (Plan §§ 2.02, 1.08, 1.62.) The evidence presented at the hearing on confirmation of the Plan indicated that (i) the Surplus Notes are worth only "cents on the dollar," and (ii) by the time claims arise under the LVM Bond

Policy, Ambac may not have sufficient claims-paying resources to pay cash equal to 25% of these claims.

CONCLUSIONS OF LAW

1. The discretion of an insurance commissioner to fashion a plan of rehabilitation for an insurer is not unlimited. "The statutory authority [the Commissioner] exercises in that effort . . . is substantial in scope, but not boundless." *Commercial Nat'l Bank v. Superior Court of Los Angeles County*, 14 Cal. App. 4th 393, 398 (Ct. App. 1993). The Commissioner's authority is "circumscribed by [the courts'] mandate to act as a check on potential discretionary abuse and to insure equitable apportionment of loss." *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990) (emphasis added), *aff'd in part, remanded in part sub-nom., Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086 (Pa. 1992). *See also* Wis. Stat § 645.01(4)(d) (purpose of Wisconsin rehabilitation statute is "protection of the interests of insureds, creditors, and the public generally, . . . through . . . [e]quitable apportionment of any unavoidable loss") (emphasis added); Wis. Stat. § 601.01(2) (central purpose of insurance statutes is "[t]o ensure that policyholders, claimants and insurers are treated fairly and equitably").

2. The Commissioner's discretion is further "constrained by constitutional mandate." *Grode*, 572 A.2d at 804. The Equal Protection Clause of the United States Constitution – and of the constitutions of many states, including Wisconsin – requires that, in the rehabilitation context, "insureds of substantially the same class [must be] treated similarly." Lee

R. Russ & Thomas F. Segalla, *Couch on Insurance* 3D, § 5:24 (1997).[1] Under the seminal case of *Carpenter v. Pacific Mutual Life Ins. Co. of California*, 74 P.2d 761 (1937), *aff'd sub nom., Neblett v. Carpenter*, 305 U.S. 297 (1938), while the "contract of the policyholder is subject to the reasonable exercise of the state's police power," the state's action "*shall not be arbitrary or improperly discriminatory.*" 74 P.2d at 774-75 (emphasis added). *See also Commercial Nat'l Bank*, 14 Cal. App. 4th at 398 (rejecting proposed rehabilitation plan that used "dual valuation" system in which municipal-guaranteed investment contracts were valued at different rates, on ground that plan "improperly discriminate[d] between substantially identical policies in the same class"); *In re Conservation of Alpine Ins. Co.*, 318 Ill. App. 3d 457, 463, 741 N.E.2d 663, 668 (Ct. App. 2000) (rehabilitation plan that distinguished between policyholders insured solely by insurer undergoing rehabilitation and policyholders having additional insurance through other carriers was "impermissibly discriminatory and therefore illegal.").

The LVM Bond Policy Was Unlawfully
Allocated to the Segregated Account

3. OCI's allocation of the LVM Bond Policy to the Segregated Account, while leaving all or almost all of Ambac's other municipal bond policies in the General Account, violated Wisconsin's segregated account statute, Wis. Stat. § 611.24, which permits an insurer to segment its business by type of insurance but does not permit the segregation of policies based merely on their impaired status.

4. OCI's disparate treatment of the LVM Bond Policy also violated the Equal Protection Clauses of the United States and Wisconsin Constitutions, which require that insureds

[1] The Wisconsin Supreme Court "applies the same interpretation to the state Equal Protection Clause found in Wis. Const. art. I § 1, as that given to the federal provision, U.S. Const. amend. XIV § 1." *State v. Post*, 197 Wis. 2d 279, 318 n.21, 541 N.W.2d 115, 128 n.21 (1995). Thus, to the extent the Commissioner's actions violate the Equal Protection Clause of the U.S. Constitution (*see* Point IV below), they also violate the parallel provision of the Wisconsin Constitution.

of substantially the same type receive similar treatment in the context of a rehabilitation or liquidation. Discrimination of this sort violates the bedrock principles set forth in *Carpenter*, as well as the very purpose of insurance.

The Plan Impermissibly Requires Policyholders to Assign Contractual Rights to AAC

5. Sections 4.04(g) and (h) of the Plan together require the LVM Bondholders to assign their LVM Bonds, and any recoveries thereon, to Ambac upon receipt of the cash and Surplus Notes that they will receive under the Plan.

6. The LVM Bond Policy and the indenture governing the LVM Bonds create no contractual obligation for any LVM Bondholder to surrender the LVM Bonds, or any recoveries thereunder, to Ambac unless and until Ambac pays the LVM Bondholders in full and in cash. Accordingly, payment by the Segregated Account in a combination of Cash and Surplus Notes does not trigger the obligation of the LVM Bondholders to surrender or assign to Ambac their rights under the LVM Bonds. The assignment that is required under § 4.04(g) and (h) of the Plan is therefore unlawful in that it violates the terms of the LVM Bond Policy and the governing bond indenture.

7. Section 4.04 also violates basic principles of subrogation law, adopted by the Wisconsin courts under the "made whole" doctrine, because it requires the LVM Bondholders to assign their rights and recoveries under the LVM Bonds to Ambac before they are made whole. *See Ruckel v. Gassner*, 2002 WI 67, ¶ 17, 253 Wis. 2d 280, 287-88, 646 N.W.2d 11, 15 (Wis. 2002).

8. The Rehabilitator's reliance on the Wisconsin Supreme Court's decision in *Muller v. Society Insurance*, 2008 WI 50, 309 Wis. 2d 410, 750 N.W.2d 1 (2008) is misplaced. While the *Muller* court held that the made-whole doctrine did not apply based on the

equities of the particular case, the facts in *Muller* are remarkably different from the facts here. *First*, in *Muller*, the insurer had satisfied its obligations under the policy by paying the insured in full and in cash. *Id.* at ¶ 6, 309 Wis. 2d at 417, 750 N.W. 2d at 4. Here, Section 4.04(g) and (h) requires the LVM Bondholders to assign their rights under the LVM Bonds to Ambac prior to Ambac's satisfying their obligations in full under the LVM Bond Policy and merely upon payment of 25 percent of their permitted claims in cash and 75 percent in Surplus Notes – Surplus Notes that, as the evidence at trial demonstrated, are worth only "cents on the dollar." Accordingly, unlike the insurer in *Muller*, Ambac is not paying LVM Bondholders in full under the LVM Bond Policy. In addition, central to the *Muller* court's holding was the fact that the insurer and the insured there were not competing against one another for a limited source of funds. *Id.* at ¶87, 309 Wis. 2d at 449, 750 N.W.2d at 20. Here, to the contrary, the LVM Bondholders and Ambac are competing against each other to the limited source of value to be paid by LVMC in its bankruptcy proceedings – value that the Rehabilitator has acknowledged will translate into "minimal recoveries" for the LVM Bondholders. (Disclosure Statement at 12.)

9. Section 4.04 also exceeds the Rehabilitator's authority under Wisconsin's rehabilitation statute. The Rehabilitator "derives his . . . authority from the statute and cannot act against or beyond the statute." *Selcke v. Hartford Fire Ins. Co. (In re Rehabilitation of Centaur Ins. Co.)*, 606 N.E.2d 291, 295 (Ill. App. Ct. 1992), *aff'd* 632 N.E.2d 1015 (Ill. 1994) (citation omitted). Chapter 645 of the Wisconsin Statutes establishes the position of the rehabilitator, identifies the property over which a rehabilitator exercises authority, and outlines the manner in which that authority may be exercised.

10. Chapter 645 does not empower the Rehabilitator to modify or overrule the "made whole" doctrine. Moreover, while the Rehabilitator is empowered to deal with the

property and business of the *insurer*, *see* Wis. Stat. § 645.33(2), the statute does not authorize the Rehabilitator to exercise control over the personal property or contract rights of individual policyholders. Rights under the LVM Bonds are inherently personal to the LVM Bondholders, as they reflect a separately enforceable contract directly between the LVM Bondholders (represented by the LVM Bond Trustee) and LVMC. There is no basis under the Wisconsin rehabilitation statute to seize those rights for the benefit of Ambac.

11. Even if Chapter 645 could be read to authorize the forced assignment of the LVM Bondholders' rights against LVMC, this result would constitute a taking of the LVM Bondholders' property in violation of the Fifth and Fourteenth Amendments to the United States Constitution, as well as Article 1, § 13, of the Wisconsin Constitution. This Court must construe the statute to avoid such an unconstitutional result. *See Milwaukee Journal Sentinel v. Wis. Dep't of Admin.*, 2009 WI 79, ¶ 41, 319 Wis. 2d 439, 469, 768 N.W.2d 700, 715.

The Plan is Not Fair and Equitable to, and Impermissibly Discriminates Against, Holders of Long-Dated Claims

12. The Plan also fails to provide fair and equitable treatment to holders of long-dated claims. One of the central purposes of Chapter 645 of the Wisconsin Statutes is to ensure the "protection of the interests of insureds, creditors, and the public generally, . . . through . . . [e]quitable apportionment of any unavoidable loss." Wis. Stat. § 645.01(4)(d) (emphasis added); *see also* Wis. Stat. § 601.01(2) (purpose of insurance statutes is "[t]o ensure that policyholders, claimants and insurers are treated fairly and equitably") (emphasis added).

13. These principles require that holders of long-dated claims receive the same treatment as holders of short-dated claims. Where a rehabilitation plan provides for payment of claims that are projected to arise – such as the projected claims of approximately $1.163 billion that are projected to arise under the LVM Bond Policy – the plan must appropriately reserve for

such projected future claims so as to ensure that, when the claims arise, there will be sufficient resources to provide these future claims with the same percentage payment as earlier-qualifying claims. *See, e.g.*, *In re Western Asbestos Co.*, 313 B.R. 832, 842-43 (Bankr. N.D. Cal. 2003).

14. With respect to policies like the LVM Bond Policy, where Ambac has already projected substantial liabilities, these principles require Ambac to set aside (a) at the outset, an amount of cash equal to 25 % of the projected future liabilities, and (b) thereafter, a *pro rata* share of any cash distributions that Ambac makes under the Surplus Notes. The need for such reserve is underscored by the evidence at the confirmation hearing, which indicated that by the time claims arise under the LVM Bond Policy, Ambac may not have sufficient claims-paying resources to pay cash equal to 25% of these claims. Since Ambac projects that future claims under the LVM Bond Policy will be approximately $1.163 billion (*see* Zuchorski Declaration, Ex. 37, ¶ 13), it must reserve approximately $290 million at the outset on account of the LVM Bond Policy, plus appropriate additional amounts in the event it makes distributions under the Surplus Notes.

The Plan's Release, Injunction, and Immunity
Provisions are Impermissible and Overbroad

15. Section 8.01 of the Plan contains exceptionally broad injunction and release provisions. While the intended scope of the provisions are unclear, they could be read to bar policyholders from prosecuting pending or future appeals of orders of this Court, in violation of the statutory right of appeal under Wis. Stat. § 808.03(1), or from commencing or continuing proceedings in this Court, in violation of the policyholders' legal entitlement to appear and be heard in this case. These provisions are therefore unlawful.

The Plan Improperly Affords Policyholder Priority to CDS

16. Under Wis. Stat. § 645.68, claims for losses under insurance policies are entitled to be paid prior to the claims of general creditors.

17. Under section 1.48 of the Plan, claims ("CDS Claims") arising under Ambac's guaranties of CDS entered into by its wholly-owned non-insurance subsidiary, Ambac Credit Products, LLC ("ACP"), are to be treated as insurance policies with Class 3 priority status, rather than as general creditor claims with Class 5 (subordinated) status. Based on the language of section 1.48, as well as the colloquy at the confirmation hearing between counsel for the LVM Bondholders and counsel for OCI, it appears that CDS Claims are intended to include not only the claims of CDS counterparties who were not parties to the CDS Settlement reached in March of this year, but also the claims of the CDS Banks who *were* parties to that Settlement, in the event that Settlement is vacated as a result of the pending appeals challenging that Settlement.

18. Credit default swaps are not insurance, because swap buyers are not required to own the underlying debt or to incur any loss. *See, e.g., Aon Fin. Prods., Inc. v. Societe Generale*, 476 F.3d 90, 96 (2d Cir. 2007). The financial institutions that created and marketed CDS have taken the position that CDS are not insurance. (*See, e.g.,* "Frequently Asked Questions About CDS" published by the Securities Industry and Financial Markets Association ("SIFMA"), Ex. 39.) Moreover, the record evidence is insufficient to establish that the holders of CDS Claims own the securities covered by the guaranteed CDS, or that they have suffered any losses. For all of these reasons, it has not been established that the CDS Claims are entitled to priority treatment under Wis. Stat. § 645.68(3).

19. The record evidence also shows that, at the time ACP entered into the CDS, its assets were nominal in relation to the exposures it faced. As a result, Ambac's guaranties of ACP's CDS obligations were, in economic substance, no different than CDS written directly by Ambac, and claims arising under these Ambac guaranties (i.e., the CDS Claims) cannot properly be considered claims for losses arising under insurance policies..

20. Consequently, the CDS Claims are not entitled to Class 3 priority status. *See, e.g., In re Rehab. of Mutual Ben. Life Ins. Co.*, 1993 N.J. Super. LEXIS 940, at **92-98 (N.J. Chancery 1993). Instead, holders of CDS Claims are merely general creditors of the Segregated Account, that is, holders of General Claims under Class 5. The Plan violates Wisconsin law by affording these claims Class 3 priority.

NOW, THEREFORE, IT IS HEREBY ORDERED THAT:

21. The Plan is unlawful in the specific ways enumerated above, and cannot be confirmed unless and until it is modified to address the defects noted by the Court. The Motion is therefore DENIED.

Dated: ____________________

BY THE COURT

____
Honorable William D. Johnston
Lafayette County Circuit Court Judge
Presiding by Judicial Appointment