WISCONSIN COURT OF APPEALS
DISTRICT IV
Appeal Nos. 2010-AP-1291 and 2010-AP-2022
(Consolidated)

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

Appeal No. 2010-AP-1291

SEAN DILWEG and
OFFICE OF THE COMMISSIONER OF INSURANCE,

Plaintiffs-Respondents,

AMBAC ASSURANCE CORPORATION,

Interested Party-Respondent,

v.

WELLS FARGO BANK/Trustee of Bondholders,
BANK OF NEW YORK MELLON and
DEUTSCHE BANK NATIONAL TRUST COMPANY,

Defendants,

FEDERAL HOME LOAN MORTGAGE CORPORATION,

Defendant-Petitioner-Co-Appellant,

AURELIUS CAPITAL MANAGEMENT LP,
FIR FREE INC., KING STREET CAPITAL
MASTER FUND, LTD., KING STREET CAPITAL, L.P.,
MONARCH ALTERNATIVE CAPITAL, LP and
STONEHILL CAPITAL MANAGEMENT LLC,

Defendants-Petitioners-Appellants,

EATON VAN MANAGEMENT, NUVEEN ASSET
MANAGEMENT, RESTORATION CAPITAL
MANAGEMENT, LLC, and STONE LION CAPITAL
PARTNERS, LP,

Defendants-Co-Appellants-Petitioners.

In the Matter of the Rehabilitation of:

Segregated Account of
Ambac Assurance Corporation,

Appeal No. 2010-AP-2022

SEAN DILWEG and
OFFICE OF THE COMMISSIONER OF INSURANCE,

Plaintiffs-Respondents,

AMBAC ASSURANCE,

Interested Party-Respondent,

v.

WELLS FARGO BANK/Trustee of Bondholders,

Defendant-Co-Appellant,

BANK OF NEW YORK MELLON,
DEUTSCHE BANK NATIONAL TRUST COMPANY,
FEDERAL HOME LOAN MORTGAGE CORPORATION,
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STONEHILL CAPITAL MANAGEMENT, LLC,

Defendants.

EATON VAN MANAGEMENT, NUVEEN ASSET
MANAGEMENT, RESTORATION CAPITAL
MANAGEMENT, LLC, and STONE LION CAPITAL
PARTNERS, LP,

Defendants-Appellants.

Appeal from the Circuit Court for Dane County,
The Honorable William D. Johnston,
Presiding by Judicial Appointment
Circuit Court Case No. 2010-CV-1576

REPLY BRIEF OF DEFENDANT-PETITIONER-CO-APPELLANT FEDERAL HOME LOAN MORTGAGE CORPORATION

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

INTRODUCTION

On September 20, 2010, Defendant-Petitioner-Co-Appellant Federal Home Loan Mortgage Corporation ("Freddie Mac") filed a letter brief with this Court in which Freddie Mac informed the Court that it joined in the principal brief submitted by the "LVM Bondholders" in Appeal No. 2010-AP-1291 in its entirety (the "LVM Br."). Freddie Mac also joined in the argument contained in the principal brief filed by the "RMBS Policyholders" in the same appeal, captioned "The Circuit Court Erred In Failing to Review the CDS Settlement."

Freddie Mac now files this reply brief with respect to the following issue: "Whether the Circuit Court erred in approving the CDS Settlement." To the extent not addressed in this reply brief, Freddie Mac also joins in the sections of the LVM Bondholders' and RMBS Policyholders' reply briefs that address the CDS Settlement.

PRELIMINARY STATEMENT

The Circuit Court's May 27 Order approving the CDS Settlement should be reversed. This Court has already correctly rejected respondents' attempt to argue that the

appeal was simultaneously unripe and moot. On the merits of the appeal, court approval of the settlement was necessary because the court-supervised Segregated Account was required to agree to its terms, and respondents themselves invited review under standards borrowed from Bankruptcy Rule 9019. However, the Circuit Court abjectly failed to exercise the independent, informed judgment that is the hallmark of 9019 review. Denying objectors the ability to develop facts that would help the Circuit Court understand the merits of the claims being settled, and then merely cutting and pasting proposed findings prepared by the prevailing party without offering a shred of independent analysis, simply does not satisfy the Circuit Court's responsibilities. Approval of the settlement and denial of targeted discovery and intervention as an alternative ground for taking discovery should be reversed.

ARGUMENT

I. THE CIRCUIT COURT'S MAY 27, 2010 ORDER APPROVING THE CDS SETTLEMENT SHOULD BE REVERSED.

A. Respondents' Attempt to Re-argue Their Motions To Dismiss The Appeals From The May 27 Order Should Be Rejected.

OCI and Ambac attempt to resurrect their arguments that (1) the May 27, 2010 Order ("May 27 Order") approving the CDS Settlement was not final and appealable, and (2) the appeals from the May 27 Order are moot because the CDS Settlement transaction has been consummated. This Court explicitly rejected these arguments in its June 18, 2010 decision (the "June 18 Decision") denying respondents' motions to dismiss the appeals from the May 27 Order. With regard to finality, this Court held not only that the denial of intervention was final and appealable, noting appellants' concession on that point (*see* June 18 Decision at 5), but also that the May 27 Order "dispose[d] of the entire matter in litigation" at that stage of the rehabilitation – *i.e.*, the CDS Settlement – and therefore was "*final in all respects*." (*Id.*) (emphasis added)). As to mootness, this Court rejected respondents' argument because they affirmatively

represented, in order to defeat a stay, that the Settlement could be unwound if it were overturned on appeal. (*See* June 18 Decision at 5 (noting respondents' assertion that the Banks were "collectible"); *see also* OCI June 1, 2010 Br. at 24 (acknowledging that if the Settlement were overturned, "*the money paid out in accordance with the settlement . . . would be returned to the General Account*") (emphasis added).)[1]

B. Court Approval Of The Settlement Was Required.

Although OCI did not initially move the Circuit Court for approval of the Settlement, it did, in response to appellants' motions below, seek and obtain the Circuit Court's approval of the Settlement in the May 27 Order. Thus, OCI's argument that court approval of the Settlement was not required is of little practical consequence, as Ambac

[1] Respondents' reliance on *PRN Assocs. LLC v. State Dep't of Admin.*, 2009 WI 53, 317 Wis. 2d 656, 766 N.W. 2d 559, is misplaced. There, the court merely stated the obvious proposition that it could not unravel a construction contract where the building in question had already been completed and was in use. Here, as the Court noted in the June 18 Decision, the only "action sought to be enjoined was, in essence, the transfer of money." (June 18 Decision at 5.)

itself acknowledges. (Ambac Br. at 31 n. 23.) Nevertheless, OCI contends that appellants had "no legal basis" to challenge OCI's approval of the Settlement because the Settlement involved the General Account of Ambac, which is not in rehabilitation, and OCI approved the transaction merely in its "general regulatory authority." (OCI Br. at 48; *see also id.* at 50.)

OCI's argument ignores the central role played by the Commissioner *as Rehabilitator* in the Settlement. The Cooperation Agreement signed and filed by the Commissioner on the first day of the Rehabilitation requires the written consent of the Segregated Account for any transaction by Ambac involving more than $5 million, other than ordinary-course payments of policy claims – a clear recognition of the importance to the Segregated Account of Ambac's financial wherewithal. Ambac itself acknowledged below that the *Rehabilitator's* written consent was required to be given for the Settlement. (*See* R. 69 at 4 (stating that under the Cooperation Agreement, the written consent of the Segregated Account "is expected to be by *OCI, as the Rehabilitator* . . . . Indeed, the CDS Settlement cannot close

without it." (emphasis added).) And yet respondents' briefs on appeal *nowhere mention* the Cooperation Agreement, nor do they acknowledge that OCI approved the Settlement in its role as the Rehabilitator of the Segregated Account.

OCI further contends that the Rehabilitator's consent to the CDS Settlement was not subject to court approval under Wis. Stat. § 645.33(2) (requiring court approval for actions taken by Rehabilitator "to reform and revitalize the insurer"), because that action was taken "to reform and revitalize" only Ambac's General Account, and not the Segregated Account as the "insurer" in rehabilitation. (OCI Br. at 49-50.) But OCI repeatedly asserted below that absent the Settlement, the Banks' claims against Ambac could be as high as $12.86 billion, and that the claims had been settled to avert the need that would otherwise exist to allocate all of the CDS guaranties to the Segregated Account, which might jeopardize the viability of the Rehabilitation. (R. 74 ¶¶ 34-35.) In other words, OCI plainly viewed the settlement as an essential step in "reform[ing] and revitaliz[ing]" the Segregated Account. Indeed, OCI sought and obtained a finding from the Circuit Court that the Settlement was "a fair

and reasonable compromise that will benefit policyholders of *both the General and Segregated Accounts*." (LVM App. 30; R. 127 at 14.)

The related argument that appellants lacked "standing" to challenge Ambac's settlement with another policyholder (Ambac Br. at 18-20), fares no better. The cases cited at page 18 of Ambac's brief did not involve insurers in rehabilitation (where such settlements are subject to court approval), nor did they address the issue of "standing." Moreover, the argument that appellants lacked standing to challenge OCI's approval of the Settlement because Chapter 645 permits judicial review only of "summary orders" (Ambac Br. at 19) misses the mark entirely, as the motions below did not seek after-the-fact judicial review of a "discretionary act" by OCI (*id.*); rather, the motions sought to compel OCI to comply with its *own* statutory obligation, under Wis. Stat. 645.33(2), to seek judicial approval *prior* to consenting to the CDS Settlement on behalf of the Segregated Account. In any event, there is little doubt that, as policyholders in the

Segregated Account, appellants satisfy Wisconsin's liberal standing rules. (*See* LVM Br. at 33 n. 11.)[2]

C. The Circuit Court Abused Its Discretion By Failing To Make An Informed And Independent Judgment As To The Merits Of The Settlement.

The Circuit Court's review of the CDS Settlement was woefully inadequate when viewed under the analogous standards governing review and approval of settlements in the bankruptcy context. (LVM Br. at 21-31.) In concluding that the Settlement was a "fair and reasonable compromise," the Court utterly failed to conduct an informed and independent review of the Settlement's merits, and instead blindly accepted OCI's positions on all issues of fact and law, without stating any reasons for doing so and without apprising itself of key facts necessary to an informed assessment of the Settlement's fairness.

[2] Significantly, neither OCI nor Ambac challenged Freddie Mac's standing below, nor has either done so on this appeal.

1. Respondents Cannot Avoid The Analogous Standards Governing The Approval Of Settlements In The Bankruptcy Context.

Respondents purport to take issue with application of the bankruptcy standards for approval of settlements. (*See* Ambac Br. at 29, 31; OCI Br. at 51.) But they cannot avoid the bankruptcy analogy, because it was *Ambac* that initially invoked the bankruptcy rule in attempting to justify the settlement below. (*See* R. 69 at 27 (arguing "by analogy" to "the standard for court approval of settlements under the Bankruptcy Code," and citing cases under Rule 9019).) OCI, too, urged the Circuit Court to consult bankruptcy law for guidance on a variety of issues arising in the rehabilitation. (*See* LVM Br. at 21 n. 7.)[3] Indeed, once it is established that section 645.33(2) requires court approval of the Settlement, it is difficult to understand what other standard respondents would have the court apply. Rule 9019 merely requires that the approval process be meaningful and that the court reach

[3] Respondents' efforts to distinguish the governing bankruptcy cases based on the specific shortcomings of each of the settlements at issue are equally misguided, because it was the absence of full disclosure, and/or the failure of the court to consider all facts necessary for an informed and independent judgment of the merits of the settlement, that motivated the court's decision in each case. (*See* LVM Br. at 22-25.)

an informed and independent judgment as to the Settlement's fairness.

2. The Circuit Court's Decision Was Neither Independent Nor Informed.

Respondents concede that it is permissible for a court to adopt one party's proposed findings and conclusions instead of drafting its own only "where there is a thorough record that shows the court's reasoning." (Ambac Br. at 57; OCI Br. at 43.) *See Trieschman v. Trieschman*, 178 Wis. 2d 538, 544, 504 N.W.2d 433, 435 (Ct. App. 1993) ("If the court chooses to [accept one party's rationale and conclusions], it must indicate the factors which it relied on in making its decision and state those on the record."). Respondents' claim that the May 27 Order itself explains the Circuit Court's reasoning is completely circular – a set of findings and conclusions that were drafted by a party and adopted by the court *verbatim* cannot possibly demonstrate the *court's*

independent reasoning in deciding to adopt those same findings and conclusions.[4]

Respondents cite paragraph 17 of the May 27 Order, which includes a finding that "OCI considered such variables as . . . whether the ABS CDO policies could be viewed as subordinate to other policies under Wisconsin law." (LVM App. 23; R. 127 at 7.) (*See* OCI Br. at 52; Ambac Br. at 25, n. 14.) However, this single finding of fact – *supplied by OCI and adopted verbatim by the court* – only serves to highlight the inadequacy of the court's inquiry. Given the serious questions raised by appellants on this critical point, the court's refusal to permit any inquiry into the underlying facts that would bear on the issue, and its blind acceptance of OCI's conclusory representation that it had "considered" the issue, was an erroneous exercise of discretion.

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[4] The cases cited by OCI at pages 42-43 of its brief, regarding the standard of review to be applied to findings of fact supplied by a party and adopted by the trial court, are inapposite, as appellants have not asked this Court to review the *merits* of the Circuit Court's factual findings, but rather deficiencies in the *process* — *i.e.*, the absence of any meaningful inquiry – that led to the court's adoption of those findings. Moreover, not one of OCI's cited cases endorses the verbatim adoption of a party's proposed findings in the absence of evidence that "the findings issued by the [trial court] represent[ed] the judge's own considered conclusions." *Anderson v. City of Bessemer City*, 470 U.S. 564, 573 (1985).

Respondents' further contention that appellants failed to show that Ambac would have defeated the Banks' claim to priority in litigation misses the point. (Ambac Br. at 26; OCI Br. at 53-54.) In asking the Circuit Court to carefully review the Settlement, it was not appellants' burden to prove that the Banks' claims *must* be subordinated to policy claims, and they did not ask the Circuit Court to conclude on the limited record before it that the CDS guaranties are not insurance policies (nor do we ask this Court to reach such a conclusion). Rather, appellants identified serious questions as to whether the CDS claims were entitled to the preferential treatment being afforded them by virtue of the Settlement, and it was the Circuit Court's responsibility to permit a meaningful inquiry into the issue so that it could make a fully informed and independent judgment on the reasonableness of the settlement.

3. Respondents' Attempt To Minimize The Serious Questions Raised By Appellants On The Priority Issue Is Unsuccessful.

With regard to the specific questions identified by appellants concerning the priority to be afforded to the Banks'

claims, Ambac's principal argument is that it is irrelevant that the CDS contracts between ACP and the Banks are not insurance (a point Ambac appears to concede), because the agreements at issue are the *guaranties* of ACP's obligations under those contracts by Ambac, and those guaranties are insurance policies. (Ambac Br. at 27.) However, it is not clear whether these guaranties are in fact insurance policies issued by Ambac, as opposed to corporate parental guaranties of Ambac. Moreover, the distinction that Ambac draws is meaningless, since ACP appears to have no significant assets of its own. (*See* LVM Br. at 30-31.) As a result, the CDS guaranties are little more than disguised CDS between Ambac and the Bank counterparties. (*See* LVM Br. at 31.) Further, even if the guaranties were in the form of an insurance contract and are not treated as disguised swaps, it is not clear whether the Banks held an insurable interest pursuant to which the Banks have suffered losses.[5] Respondents successfully blocked appellants from taking discovery on these (and all other) issues.

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

Ambac dismisses as "speculative," but does not dispute, appellants' observation that the swaps covered by the CDS guaranties appear to be "naked" swaps. (Ambac Br. at 27.) Ambac argues that the Banks nevertheless did suffer a loss due to "ACP's inability to pay amounts due under the CDS." (*Id.*). However to the extent the Banks did not own the underlying reference obligation covered by the CDS (*i.e.*, to the extent the CDS are "naked"), then those "amounts due under the CDS" are pure profit to the Banks. (LVM Br. at 29-30.)[6]

Finally, respondents' argument that OCI has "historically found that Ambac policies relating to CDS obligations are insurance" (OCI Br. at 53; *see also* Ambac Br. at 27-28) is based on a misleading characterization of an April 1998 letter from OCI. (R. 93, Ex. B.) That letter stated that Ambac's guaranties of an affiliate's obligations under CDS contracts would be treated as "insurance contracts entered into in the ordinary course" under section

[6] As noted, appellants sought, but were denied, the right to take discovery that would have shed light on this critical unanswered question regarding the nature of the swaps covered by the Settlement.

40.03(3)(c)(4) of the Wisconsin Administrative Code – *i.e.*, would be exempt from annual reporting requirements that apply to other agreements and *non-ordinary course* transactions between an insurer and its affiliates – provided Ambac "charges similar rates and uses similar underwriting criteria in insuring this affiliate as would be applied to non-affiliates transacting similar business[.]" No such showing was made in the Circuit Court. Moreover, the letter had nothing to do with whether claims under any such guaranties would constitute "claims under [insurance] policies for losses incurred[,]" and therefore would be entitled to policyholder priority under Wis. Stat. 645.68(3) in the event that Ambac were placed into rehabilitation.

CONCLUSION

For the foregoing reasons, and for the reasons set forth in the portions of the LVM Bondholders' and RMBS Policyholders' briefs in which Freddie Mac has joined, Freddie Mac respectfully requests that this Court reverse the Circuit Court's May 27 Order and remand for further proceedings with respect to the CDS Settlement, including

targeted discovery and the development of a full factual record.

Respectfully submitted this 20th day of December, 2010.

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CERTIFICATION

I hereby certify that this brief conforms to the rules contained in WIS. STAT. § 809.19(8)(b) and (c), for a brief produced using proportional serif font. The length of this brief is 2,764 words.

Dated this 20th day of December, 2010.

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I hereby certify that:

I have submitted an electronic copy of this brief, excluding the appendix, if any, which complies with the requirements of s. 809.19(12). I further certify that:

This electronic brief is identical in content and format to the printed form of the brief filed as of this date.

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Dated this 20th day of December, 2010.

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CERTIFICATION OF FILING AND SERVICE

I certify that the brief was mailed to the Clerk of the Court of Appeals on December 20, 2010.

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