
In the Matter of the Rehabilitation of:

Case No. 10 CV 1576

Segregated Account of Ambac Assurance Corporation

**NOTICE OF AMENDED MOTION AND
AMENDED MOTION TO APPROVE PURCHASE OF SURPLUS NOTES**

I. NOTICE OF AMENDED MOTION

TO: All Parties-in-Interest

PLEASE TAKE NOTICE that the Commissioner of Insurance of the State of Wisconsin, as Rehabilitator of the Segregated Account of Ambac Assurance Corporation, has moved the Court by the amended motion detailed below to approve the exercise of two call options for the purchase of certain surplus notes by Ambac Assurance Corporation. The Rehabilitator's amended motion (the "Amended Motion") replaces and supersedes the Rehabilitator's original Motion to Approve Purchase of Surplus Notes that was dated, filed and served on May 16, 2012 (the "Initial Motion"). The Rehabilitator's Amended Motion is still scheduled to be heard by the Court on Monday, June 4, 2012, at 2 p.m. before the Honorable William D. Johnston at the Lafayette County Courthouse, 626 Main Street, Darlington, Wisconsin.

PLEASE TAKE FURTHER NOTICE that any interested parties may appear at the hearing telephonically pursuant to the Court's standard tele-court procedure. Anyone interested in appearing telephonically should make the appropriate arrangements in advance of the hearing by calling 800-924-5680.

PLEASE ALSO TAKE FURTHER NOTICE that any objections to the relief requested in this Amended Motion by the Rehabilitator should be in writing, and filed and served by no later than noon (Central Time) on Thursday, May 31, 2012.

II. AMENDED MOTION TO APPROVE PURCHASE OF SURPLUS NOTES

The Commissioner of Insurance of the State of Wisconsin, as the court-appointed rehabilitator (the “Rehabilitator”) of the Segregated Account (“Segregated Account”) of Ambac Assurance Corporation (“Ambac”), hereby moves this Court to approve Ambac’s purchase of approximately \$789 million in par amount of Ambac surplus notes (“Surplus Notes” or “Notes”), pursuant to the exercise of call options that were issued by two banks to Ambac as part of a June 7, 2010 settlement agreement. The Rehabilitator believes that exercising the two call options is in the best interest of Segregated Account policyholders because it should result in a significant increase to the recoveries they will receive.

As discussed more fully below, Ambac also holds a third option to purchase an additional \$150 million in principal amount of Surplus Notes issued to a third bank as part of the June 7, 2010 settlement agreement. The Rehabilitator’s Initial Motion included purchase of the Surplus Notes issued to this third bank as part of the requested approval, but the Rehabilitator has since decided not to pursue approval for Ambac to purchase the Notes issued to the third bank. The reasons for the Rehabilitator’s change in position from the Initial Motion to this Amended Motion, as well as the financial impact of dropping the third call option from the requested approval are detailed below.

The grounds for this Amended Motion are as follows:

1. On June 7, 2010, Ambac and its wholly-owned subsidiary, Ambac Credit Products, LLC (“ACP”), entered into a settlement of certain credit default swap exposures and related financial guarantee exposures with fourteen global banks (the “Bank Group Settlement” or “Settlement”). The consideration for the Settlement varied for each bank, depending upon Ambac’s and ACP’s liabilities. As part of the Settlement, Ambac issued each of the banks varying amounts of surplus notes, based upon Ambac’s and ACP’s liability exposure to each of them. Ambac negotiated call option agreements (each a “Call Option,” and collectively the “Call Options”) with three of those fourteen banks, pursuant to which Ambac obtained the right to repurchase approximately \$939 million of the Surplus Notes issued to each of those banks at specified prices. (*See* Seventh Affidavit of Roger A. Peterson (“Seventh Peterson Aff.”) ¶ 16.)

2. The agreements setting forth the Call Option with each of the three banks are attached as Exhibits A, B and C to the Seventh Affidavit of Roger Peterson in this case, filed in support of the Initial Motion. To address confidentiality provisions of the Bank Group Settlement, the Rehabilitator has not disclosed the names of the three banks in either the Initial or Amended Motions, and those names have been redacted from each Exhibit. (*Id.* ¶ 17.) The Rehabilitator believes the identity of the three banks is not relevant to this Amended Motion. If the Court disagrees, however, the Rehabilitator requests that it be permitted to disclose the names *in camera* for confidentiality reasons. For purposes of his Motions, the Rehabilitator has referred to the banks as Bank A, Bank B, and Bank C.

3. In this Amended Motion, the Rehabilitator is no longer seeking approval for Ambac to purchase the Notes subject to the Call Option with Bank B (the “Bank B Notes”). Dropping the Bank B Notes from the Rehabilitator’s approval request is the only material change from the Initial Motion to this Amended Motion.

4. Ambac’s agreement with Bank A grants Ambac the right to purchase \$500 million in principal amount of Surplus Notes initially issued to Bank A (the “Bank A Notes”). The total cash price for exercising the Call Option to purchase Bank A Notes is equal to \$.20 per dollar of principal amount, resulting in a total price of \$100 million for all such Bank A Notes. Ambac will remain obligated to pay all interest that has accrued on those Notes prior to the exercise of the Call Option, with the interest being payable as and when interest is paid on all surplus notes. (*See id.* ¶ 18 & Ex. A at 1.)

5. Ambac’s agreement with Bank B grants Ambac the right to purchase \$150 million in principal amount of Surplus Notes initially issued to Bank B. The purchase price to Ambac for exercising the Call Option to purchase Bank B Notes is \$.30 per dollar of principal amount of the Surplus Notes. Additionally, Ambac is obligated to pay an amount equal to the accrued unpaid interest on such Notes. The total cost that Ambac would pay in respect of its exercise of the Call Option for the Bank B Notes is approximately \$60.7 million. (*See id.* ¶ 19 & Ex. B at 1.) However, for the reasons noted below, Ambac and the Rehabilitator are no longer seeking approval for Ambac to exercise the Call Option to purchase the Bank B Notes.

6. Ambac’s agreement with Bank C grants Ambac the right to purchase approximately \$289 million in principal amount of Surplus Notes initially issued to Bank C (the “Bank C Notes”). Ambac’s Call Option with Bank C specifies a purchase price equal

to \$.20 per dollar of principal amount of the Bank C Notes. Additionally, Ambac is obligated to pay an amount equal to the accrued unpaid interest on such Notes. The Call Option with Bank C contains a “most favored nation” provision that requires the rate-per-dollar to be adjusted upward to equal the most favorable rate-per-dollar paid pursuant to the exercise of a call option agreement with any other party to the Bank Group Settlement granted prior to or contemporaneously with the call option granted by Bank C. (*Id.* ¶ 20 & Ex. C at 1.) Because the \$.20 rate-per-dollar of the Call Option with Bank A is identical to the \$.20 rate-per-dollar in the Call Option with Bank C, the “most favored nation” rate provision in the Call Option with Bank C is not triggered by the purchase of the Bank A Notes. Therefore, the total cost for exercising the Call Option in respect of all of the Bank C Notes is approximately \$88 million. Had the Rehabilitator not elected to amend his Initial Motion to drop the request for approval to purchase the Surplus Notes issued to Bank B and Ambac had exercised Bank B’s Call Option, which has a \$.30 rate-per-dollar price, the “most favored nation” provision in the Bank C Call Option would have required an upward adjustment in the price such that the total cost to exercise the Call Option in respect of all of the Bank C Notes would have been approximately \$117 million, rather than the approximately \$88 million price for which the Rehabilitator now seeks approval. (Eighth Affidavit of Roger A. Peterson (“Eighth Peterson Aff.”) ¶ 6.)

7. Note that, consistent with the correspondence from OCI dated May 15, 2012, disapproving Ambac’s request to pay accrued interest due on certain surplus notes scheduled to mature on June 7, 2020 and issued by Ambac Assurance Corporation on June 7, 2010 (inclusive of the Call Option Surplus Notes), amounts paid by Ambac to purchase the Call Option Surplus Notes shall not satisfy any accrued interest due on the Call Option

Surplus Notes, and such accrued interest shall be paid only upon approval of OCI. (*See* Affidavit of OCI's Regina Frank, filed May 16, 2012 with the Initial Motion, at ¶ 7 and Tab A (hereinafter "Frank Aff.").)

8. The Call Option with Bank A must be exercised no later than June 7, 2012. (*See* Seventh Peterson Aff. ¶ 21 & Ex. A at 1.) The deadline for exercising the Call Option with Bank C is November 30, 2012, with no more than three pro rata exercises being permitted prior to such date. (*See id.*, Ex. C at 2.) The Rehabilitator presently believes that it is advantageous to exercise the Call Option with Bank C at this time, but requests the flexibility to exercise the Call Option with Bank C at any time after the Court grants this Amended Motion but before the November 30, 2012 contractual deadline.

9. The Rehabilitator has elected to amend his Initial Motion because of a question which arose after it was filed regarding the correct methodology for calculating the exercise price for the Bank A Call Option. One of the current holders of the Bank A Notes suggested that, under the most favored nation provision in the Bank A Call Option, the rate-per-dollar paid for the Bank B Notes arguably could be determined by combining the stated rate-per-dollar paid for the Bank B Notes (which is \$.30) with an amount equal to interest accrued on the Bank B Notes through the date of purchase. Construed in that fashion (which the Rehabilitator and Ambac believe would be incorrect), the rate per dollar cost of exercising the Bank B Call Option as of June 7, 2012 could be interpreted as being approximately \$.405. Under that interpretation, if Bank B's Call Option were exercised prior to or simultaneously with purchase of the Bank A Notes, the cost of the Bank A Notes could, under that interpretation, more than double. The Rehabilitator and Ambac believe that such interpretation would contravene the intent and plain language of the Call Options.

However, the Rehabilitator also believes that being able to consummate the purchase of the Surplus Notes pursuant to the Bank A and Bank C Call Options as requested in this Amended Motion, without the cost, time delay and potential uncertainty of outcome associated with having to deal with a possible dispute about the correct price for purchasing the Bank A Notes, is in the best interest of Segregated Account policyholders. (Eighth Peterson Aff. ¶¶ 3-5.)

10. The Rehabilitator believes that, while exercising the Call Option with Bank B even at the arguable higher cost would still improve Segregated Account policyholder recoveries, the purchase of the Bank B Notes is not warranted under the circumstances presented here. Among other factors, the relatively small amount of the Notes subject to the Bank B Call Option, as compared to the other two Call Options, means that the potential for improving policyholder recoveries from buying the Bank B Notes is limited and less likely to offset the potential costs, delays and uncertainties of outcome associated with addressing the potential dispute that might then arise about the correct exercise price for purchasing the Bank A Notes. (*Id.* ¶ 5.)

11. The bottom-line difference between the cost of exercising all three Call Options versus exercising only the Call Options with Banks A and C, can be briefly summarized as follows. The total cost of exercising the Call Options with Banks A and C (but not Bank B) is approximately \$188 million, comprised of \$158 million of exercise proceeds based on a \$.20 call price and an amount equal to the approximately \$30 million of accrued interest associated with the Bank C Notes, all in exchange for reducing Ambac's liability to third parties for principal and accrued interest under all issued and outstanding surplus notes by approximately \$819 million, representing an effective exercise price of

\$.23. By comparison, the cost of exercising all three of the Call Options as set forth in the Rehabilitator's Initial Motion is \$278 million, comprised of approximately \$232 million in exercise proceeds based upon a \$.20 call price for the Bank A Notes, a \$.30 call price for the Bank B and Bank C Notes and an amount equal to the approximately \$46 million of accrued interest associated with the Bank B and Bank C Notes, all in exchange for reducing Ambac's liability to third parties for principal and accrued interest under all issued and outstanding surplus notes by approximately \$985 million, representing an effective exercise price of \$.28. (*Id.* ¶ 6.)

12. Ambac's right to exercise the Call Options with Banks A and C, and to purchase the Bank A Notes and the Bank C Notes is binding upon those banks' transferees, assigns, and successors and their respective transferees, assigns and successors. Most of the Bank A Notes and the Bank C Notes are now held by parties other than those banks. Ambac believes that it knows the identity of those parties and is prepared to notify them as and when it exercises the Call Options should the Court grant this Motion. (Seventh Peterson Aff. ¶ 22.)

13. Because the Segregated Account, the Rehabilitator, and OCI are not parties to the Bank Group Settlement or any of the Call Option agreements, the Rehabilitator does not believe it is legally required to seek this Court's approval for Ambac to exercise any of the Call Options. However, Ambac is required to obtain advance approval by OCI and the Rehabilitator before purchasing the Bank A Notes and the Bank C Notes. Because exercising the Call Options involves the use of significant resources, and because the Bank Group Settlement has been the subject of prior disputes in the rehabilitation court

proceedings, the Rehabilitator has exercised his discretion to make approval by this Court a condition for granting Ambac approval to proceed as requested in this Amended Motion.

14. Exercising the Call Options with Banks A and C is in the best interest of Segregated Account policyholders because it should significantly increase the claims-paying resources available to the Segregated Account and result in larger total cash payments to policyholders over the course of the Rehabilitation. (Seventh Peterson Aff. ¶ 30; Eighth Peterson Aff. ¶¶ 7-8.) Note that the validity of the approval being sought from this Court by the Rehabilitator for Ambac to purchase all of the Bank A Notes and the Bank C Notes shall not be affected or limited in the event that, despite Ambac's efforts, it is unable to complete the purchase of all such Surplus Notes.

15. In order to assess the merits of exercising the Call Options with the three banks, Special Deputy Commissioner Roger Peterson, on behalf of the Rehabilitator, and the Rehabilitator's financial advisors, Jefferies & Co. and Gordian Group, LLC, compared the financial effects of (i) exercising all three Call Options; (ii) exercising the Call Options negotiated with Banks A and C; and (iii) exercising none of the Call Options. (See Seventh Peterson Aff. ¶ 23; Eighth Peterson Aff. ¶ 7.) They analyzed four economic scenarios that represent a broad range of financial outcomes for Segregated Account policyholders. Each of the scenarios assumes that holders of Segregated Account policy claims will receive an initial distribution, in cash, equal to 25% of the amount of each policy claim. The unpaid balance of each policy claim is assumed to be satisfied either through the issuance of a surplus note or another type of deferred payment obligation. (See *id.*) The portion of each policy claim that is not paid in cash in the initial distribution (the "Non-Cash Consideration") is assumed to be *pari passu* with surplus notes (including the Surplus

Notes that are the subject of this motion), consistent with the stated positions of OCI and the Rehabilitator. (See Frank Aff. ¶ 8.)

16. The primary variables in each of the four scenarios are: 1) the amount of estimated losses for both the General Account and the Segregated Account, and 2) the amount of estimated recoveries to be received from remediation efforts for residential mortgage-backed securities (“RMBS”) policies allocated to the Segregated Account. Projected losses were estimated under “base case” and “stress case” scenarios using a 5.1% discount rate. The base case losses (including accrued but unpaid claims) for the General Account and the Segregated Account are estimated to be, respectively, \$570 million and \$7.4 billion. The stress case losses (including accrued but unpaid claims) for the General Account and the Segregated Account are estimated to be, respectively, \$1.0 billion and \$9.0 billion. Total projected RMBS remediation recoveries were calculated to be \$2.4 billion, applying a 5.1% discount to Ambac’s projections. The four scenarios assume that Ambac recovers either 100% or 50% of that \$2.4 billion. All of the estimates are based on financial data for the fiscal quarter ending September 30, 2011. (Seventh Peterson Aff. ¶ 10.)

17. The four economic scenarios used for purposes of assessing the merits of exercising the Call Options are as follows:

- (a) **Scenario One**: Assumes base case losses for both the General Account and the Segregated Account, and 100% realization of projected RMBS remediation recoveries.

(b) **Scenario Two**: Assumes base case losses for both the General Account and the Segregated Account, and 50% realization of projected RMBS remediation recoveries.

(c) **Scenario Three**: Assumes stress case losses for both the General Account and the Segregated Account, and 100% realization of projected RMBS remediation recoveries.

(d) **Scenario Four**: Assumes stress case losses for both the General Account and the Segregated Account, and 50% realization of projected RMBS remediation recoveries. (*Id.* ¶ 12.)

18. The Rehabilitator's analysis shows that under each of the four scenarios, the ratio of the present value of claims-paying resources to the present value of total expected policy claims is greater with the proposed purchase of the Bank A Notes and the Bank C Notes than without those purchases. As a result, under each of the four scenarios, purchasing such Surplus Notes results in a significant increase in the total projected claim recoveries for Segregated Account policyholders. (Eighth Peterson Aff. ¶¶ 7-8.) The chart below sets forth the present value of, and percentage increases to, total claim recoveries under each scenario. Cash amounts have been discounted using a discount rate of 5.1%. (*See id.*)

Benefit of Purchasing Bank A and Bank C Notes	Scenario One	Scenario Two	Scenario Three	Scenario Four	Four Scenario Average
Present Value of Increase in Total Claim Recoveries (in millions)	\$443	\$338	\$317	\$200	\$324
Increase in Percentage of Total Claim Recoveries	5.0%	3.8%	3.1%	1.9%	3.5%

19. As noted above in paragraph 11, the total cost of purchasing all of the Bank A Notes and the Bank C Notes will be approximately \$188 million. The total principal amount of the Surplus Notes and accrued interest payable to third parties that will be reduced as a result of such purchase will be approximately \$819 million. Thus, the total purchase price represents approximately \$0.23 per dollar of the underlying exposure. (*Id.* ¶ 6.)

20. The proposed purchase of such Surplus Notes will result in a reduction in the statutory surplus of Ambac's General Account equal to the amount paid to purchase the Surplus Notes. The Rehabilitator anticipates that the reduction in Ambac's statutory surplus due to the purchase of such Surplus Notes, together with an increase in reserves on both Segregated Account and General Account obligations will, as of the second quarter of 2012, cause the General Account to report statutory surplus of exactly \$100 million, and cause the Segregated Account to report negative statutory surplus. (Seventh Peterson Aff. ¶ 25.)

21. The anticipated negative statutory surplus does not affect the Rehabilitator's conclusion that the proposed purchase of the Surplus Notes pursuant to the Call Options with Banks A and C is in the best interest of the Segregated Account.

Statutory surplus does not provide an appropriate measure for evaluating the effect of various transactions and developments on Segregated Account policyholders, because it is calculated with respect to Ambac's (i) statutory reserves, which do not reflect a complete picture of Ambac's total liabilities, and (ii) admitted assets, which do not reflect a complete picture of Ambac's claims-paying resources over time. In particular, statutory accounting principles direct Ambac not to include any surplus note liability in its statutory reserves. Yet statutory accounting principles also dictate that the purchase price of the Surplus Notes be deducted from Ambac's admitted assets. Thus, no matter how much the purchase of Surplus Notes may increase the ultimate cash recovery of Segregated Account policyholders, the purchase will always reduce Ambac's statutory surplus, because Ambac's admitted assets will be reduced by the purchase price without a corresponding reduction in its statutory reserves. (*Id.* ¶ 26.)

22. The more appropriate measure for evaluating the benefits of this transaction involves comparing the present value of total claims-paying resources with the present value of total expected policy-level claims with the proposed transaction, and without the proposed transaction. Using such a measure, the Rehabilitator's financial analysis projects that in each scenario, the ratio of the present value of claims-paying resources to the present value of total expected policy-level claims is greater with the proposed purchase of the Bank A Notes and the Bank C Notes than without such purchase. As set forth above, the Rehabilitator projects that the purchase of all of the Bank A Notes and the Bank C Notes will result in Segregated Account policyholders recovering 1.9 to 5.0 percentage points more on their claims than would be the case if such Surplus Notes are not purchased. (*Id.* ¶ 27.)

23. The anticipated statutory surplus of exactly \$100 million in the General Account will not affect the ability of the Segregated Account to pay policy claims, and the assets of the General Account will continue to be available to pay Segregated Account policy claims through the Secured Note and Aggregate Excess of Loss Reinsurance Agreement (the “Reinsurance Agreement”). There are provisions in both the Secured Note (Section 1(c)) and Reinsurance Agreement (Section 1.04) which state that the General Account will not have any liability to make any payment to the Segregated Account under the Secured Note or Reinsurance Agreement, as applicable, to the extent that such payment would cause the statutory surplus of the General Account to fall below \$100 million. Those provisions are implemented by reducing the liability that the Segregated Account cedes to the General Account, such that the General Account’s statutory surplus stops decreasing when it reaches \$100 million and any further decreases in statutory surplus (*e.g.*, due to an increase in reserves or a decrease in assets without a corresponding decrease in reserves) will be reflected in the statutory surplus of the Segregated Account – not the General Account. (*Id.* ¶¶ 28-29.)

24. As shown above, the purchase of the Bank A Notes and the Bank C Notes is in the best interest of the Segregated Account because it resolves Ambac’s liability under such Surplus Notes for substantially less than Ambac would ultimately pay if it did not purchase such Surplus Notes. As a result, the purchase will increase the projected total claim recoveries for Segregated Account policyholders under all reasonable economic scenarios projected by the Rehabilitator.

25. Time is of the essence for obtaining approval of this transaction. As described above, pursuant to the terms of the Call Option agreement with Bank A, Ambac must notify the current holders of the Surplus Notes of its exercise of the Call Option thereunder no later than June 7, 2012. Because the Surplus Notes are now held by a number of parties, Ambac needs as much extra time as possible under the circumstances to ensure that notices are properly effected before the deadline. (*Id.* ¶ 31.)

III. CONCLUSION

For all of the reasons stated above, the Rehabilitator respectfully requests that the Court grant this Amended Motion and approve Ambac's purchase of the Bank A Notes and the Bank C Notes pursuant to the Call Options between Ambac and those banks.

Dated this 23rd day of May, 2012.

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In the Matter of the Rehabilitation of:

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Segregated Account of Ambac Assurance Corporation

**ORDER GRANTING REHABILITATOR'S AMENDED MOTION TO
APPROVE PURCHASE OF SURPLUS NOTES**

This matter came before the Court for a hearing on the Rehabilitator's Amended Motion to Approve Purchase of Surplus Notes (the "Amended Motion"). The Amended Motion came before the Court on proper advance written notice for hearing in open court. Appearances were noted on the record. All interested parties were afforded the opportunity to appear and be heard on the Amended Motion.

The Court having considered the Rehabilitator's Amended Motion and the information provided at the hearing, it is hereby **ORDERED** that the Rehabilitator's Amended Motion is **GRANTED**.

Dated this ____ day of _____, 2012.

BY THE COURT:

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