

In the Matter of the Rehabilitation of:
Segregated Account of Ambac Assurance Corporation

Case No. 10 CV 1576
Honorable William D.
Johnston

ONE STATE STREET LLC POST-CONFIRMATION HEARING BRIEF

Dated: November 29, 2010

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One State Street LLC (“One State Street”), which is the landlord for the world headquarters of Ambac, located in New York City, hereby submits this post-hearing brief on the Rehabilitator’s Motion for Confirmation of Plan of Reorganization, dated October 8, 2010 (the “Confirmation Motion”), which seeks confirmation of the Plan of Rehabilitation of the same date (the “Plan”), as well as all related prior interlocutory orders.¹ Both Ambac Assurance Corporation (“AAC”) and its parent company, Ambac Financial Group, Inc. (“AFG”), are party to the Headquarters Lease (as defined below) and both AAC and AFG have liability and obligations thereunder. Ambac and the Office of the Commissioner of Insurance (“OCI”) purported to place AAC’s liability on the Headquarters Lease into the Segregated Account while at the same time leaving all other ordinary operating liabilities in the so-called general account of AAC. As established at the hearing on the Confirmation Motion (the “Confirmation Hearing”), the Plan does not provide One State Street with the liquidation value of its claim as required under the United States and Wisconsin Constitutions. Despite the Rehabilitators’ repeated mantra that discretion is provided to the Rehabilitator under the statute, no amount of discretion excuses the Plan’s failure (i) to meet minimum constitutional requirements established more than seventy years ago by the United States Supreme Court and (ii) to comply with other requirements of law and equity, including the segregated account statute, the insurance rehabilitation statute, and fraudulent conveyance law (of both New York and Wisconsin).

FACTUAL BACKGROUND

The lease in question was originally entered into in 1992 between South Ferry Building Company (the predecessor-in-interest of One State Street) and Ambac Insurance Company (the

¹ Capitalized terms defined in the Plan and not otherwise defined herein are used as defined in the Plan. One State Street has filed an appeal from this Court’s prior order denying a motion to modify and/or dissolve a temporary injunction (the “Stay Order”). OCI has taken the position that the Stay Order is an interlocutory order; to the extent that is the case, this brief (i) argues that the prior relief (including approval of the segregated account and other matters) should not be confirmed and (ii) incorporates by reference all prior arguments made by One State Street.

prior name of AAC) (the “Headquarters Lease”). In 2000, AAC assigned the Headquarters Lease to its parent company, AFG. Pursuant to the terms of the Headquarters Lease, AAC remains a primary obligor and will be responsible for damages and payments due. Additionally, should AFG reject its obligations under the lease in its recently filed chapter 11 bankruptcy case, AAC is obligated to sign a new lease on comparable terms. Notwithstanding the assignment of the Headquarters Lease to AFG, AAC continues to operate its business from the leased premises.

Nevertheless, OCI and the Rehabilitator have tried to devise a plan of rehabilitation that would effectively foreclose One State Street from any possibility of recovery against *both* AAC and AFG. With respect to AAC, the Plan proposes to satisfy One State Street’s claim with a junior surplus note from the Segregated Account. The terms of the junior surplus note and the evidence elicited at the Confirmation Hearing, however, reveals that the “note” to be provided to One State Street has essentially no value. To make matters worse, the Rehabilitator then gratuitously tries to foreclose any claim by One State Street against AFG, an entity not before this Court or within the jurisdiction of this Court, OCI, or the Rehabilitator, by virtue of incredibly broad and ambiguous third-party releases that no insolvency court could approve and no precedent supports.

ARGUMENT

Although OCI and the Rehabilitator dispute any liability of AAC under the Headquarters Lease, they did not propose or attempt to resolve these New-York-law-specific disputes at the Confirmation Hearing. They instead seek to eviscerate One State Street’s rights via the Plan. The Plan, however, must provide One State Street with its constitutionally and statutorily mandated recovery if and when AAC’s liability under the Headquarters Lease is established under New York law. The Plan, however, fundamentally fails to meet even the minimum standards for confirmation with respect to the claim of One State Street.

I. THE REHABILITATION PLAN CANNOT BE CONFIRMED BECAUSE IT FAILS TO PROVIDE ONE STATE STREET WITH THE VALUE THAT WOULD BE OBTAINED IN A LIQUIDATION.

In a blatant attempt to avoid any meaningful review of the Plan, the Rehabilitator has asked this Court to disavow nearly a century of black-letter constitutional law governing insurance rehabilitation, which requires claimants receive at least the liquidation value of their claims in plans of rehabilitation. In attempting to ignore this basic constitutional requirement set forth by the United States Supreme Court in *Neblett v. Carpenter*, 305 U.S. 297, 305 (1938), the Rehabilitator has incorrectly framed the issue as a second-guessing of OCI's decision in March 2010, to pursue a rehabilitation of the Segregated Account instead of a liquidation of AAC. This argument implies that somehow *Carpenter* is inapplicable, or has some discretionary component, in a rehabilitation.

The analysis mandated by *Carpenter*, however, is the backdrop against which OCI must make its decisions; OCI's discretion can be exercised only after it complies with the requirements of *Carpenter*, which does not have flexibility or any discretionary component. *Carpenter* simply provides a floor of recovery to creditors that must be provided in a rehabilitation plan. The evidence elicited at the Confirmation Hearing unequivocally established that One State Street is not receiving the minimum recovery it is entitled to under *Carpenter*. Indeed, the testimony at the Confirmation Hearing established that One State Street would be paid in full in a liquidation, but is receiving no value under the Plan.

As OCI readily admits, policies would be cancelled in a liquidation scenario and claims not incurred at the time of policy cancellation would not be entitled to any payment in liquidation. The Plan, in contrast, provides continual coverage for future claims. While providing continual coverage to policyholders may be a laudable goal, providing such continuous coverage to policyholders cannot be at the expense of One State Street's

constitutional rights to obtain the liquidation value of its claim. Indeed, by proposing a plan that denies One State Street any recovery but provides for payment of future, non-incurred policy claims, the Rehabilitator is effectively taking the recovery One State Street is entitled to under a liquidation analysis and using that value to fund continual policy coverage. *Carpenter* expressly forbids the Rehabilitator from taking away the liquidation value One State Street is entitled to receive.

A. Due Process and the Contracts Clause Requires That Claimants Fare At Least As Well In Rehabilitation As In Liquidation.

On October 25, 2010, this Court stated that claimants must receive at least the liquidation value of their claims in a plan of rehabilitation. Oct. 25, 2010 Order at 14 (“Fair and equitable treatment and operation of the Segregated Account under Wis. Stats. Sec. 604.01(2) does not create a private right of action. Rather, it indicates that policyholder must receive at least the liquidation value of their claims from a plan of rehabilitation.”) (citing *Carpenter v. Pac. Mut. Life Ins. Co. of Cal.*, 74 P.2d 761, 778 (Cal. 1938), *aff’d sub nom Neblett v. Carpenter*, 305 U.S. 297 (1938)). This statement of the law was, and is, completely unsurprising and uncontroversial because it comports with the United States Supreme Court’s 1938 ruling in *Carpenter* and its progeny. In *Carpenter*, the Supreme Court held that due process and the Contracts Clause of the United States Constitution require that all claimants in an insurance rehabilitation be provided at least the same rights and value for their claims as they would have received in a liquidation. *Neblett v. Carpenter*, 305 U.S. 297, 305 (1938). Other courts have expressly acknowledged the applicability of *Carpenter* to all plans of rehabilitation. *See, e.g., Foster v. Mutual Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1096 (Pa. 1992) (“[T]he creditors herein, at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding as mandated by the holding of *Neblett*.”). Indeed, *COUCH ON INSURANCE*, a leading treatise which

the Rehabilitator cites to for numerous black-letter law principles, expressly states that *Carpenter* requires all plans of rehabilitation to provide creditors with their liquidation value. 1 COUCH ON INSURANCE § 5:29 (3d ed. 2010) (stating that, in plans of rehabilitation, “[a]ll that the law requires is that the creditor or policyholder receive the liquidated value of his contract rights without any unreasonable delay”) (citing *Carpenter*). Similarly, the due process clause of the Wisconsin Constitution also mandates the liquidation value as the minimum recovery to creditors.

In an attempt to avoid the clear applicability of *Carpenter*, the Rehabilitator (i) requests that the Court disavow its October 25, 2010 clear, simple statement of the applicable law and (ii) then makes two further preposterous arguments. First, the Rehabilitator contends that the absence in the Wisconsin Statutes of an express restatement of the *Carpenter* rule means that the constitutional rule does not apply simply because a minority of states have adopted a clear statutory restatement of this constitutional requirement. Rehabilitator Brief at 15. However, it cannot be that the absence of a statutory provision precludes the applicability of protections afforded by the United States and Wisconsin Constitutions. Due process and the Contracts Clause trump any statutory provision (or, in the case of the Rehabilitator’s incredibly thin argument, the absence of a statutory provision).

Second, the Rehabilitator makes the bizarre argument that the key holding of *Carpenter* “is not that the rehabilitation plan in that case set the constitutional floor for all such plans, but rather that it was so clearly above any constitutional floor that it warranted no further discussion.” Rehabilitator’s Reply Brief at 15. Again, however, this argument ignores nearly a century of precedent in insurance rehabilitation proceedings in which claimants’ constitutional rights under *Carpenter* have been respected. Tellingly, the Rehabilitator has not (because it

cannot) pointed to a single insurance rehabilitation case in which a court ruled that *Carpenter* does not require claimants to receive the liquidation value of their claim.

B. The Rehabilitator Is Not Afforded Any Discretion In Determining Whether Claimants Are Receiving The Liquidation Value Of Their Claims.

In responding to every challenge to its action to date, OCI has essentially done nothing more than repeat a mantra that OCI is afforded great discretion and deference under the Wisconsin statutes in its regulation of insurance companies. This Court, too, has repeatedly ruled that OCI and the Rehabilitator are afforded significant deference in insurance rehabilitation proceedings under the Wisconsin statutes. *See, e.g.*, Oct. 25, 2010 Order at 9. However, no discretion or deference is afforded to OCI in determining whether the minimum constitutional requirements under *Carpenter* have been satisfied. *See, e.g., Hakes v. Labor and Indus. Review Comm'n*, 187 Wis. 2d 582, 586, 523 N.W.2d 155, 157 (Wis. Ct. App. 1994) (whether an agency's procedures denied due process is a question of constitutional fact that is reviewed without deference to the agency); *Sacred Heart Sch. Bd. v. Labor & Indus. Review Comm'n*, 157 Wis. 2d 638, 641, 460 N.W.2d 430, 432 (Wis. Ct. App. 1990) (holding questions of constitutional law are decided without deference to the administrative agency); *Wis. State Counsel, Knights of Columbus v. State of Wis. Bingo Control Bd.*, 151 Wis.2d 404, 409, 444 N.W.2d 447, 449 (Wis. Ct. App. 1989) (holding interpretation of the state constitution was "a task solely for the courts, and we therefore give no deference to the agency's interpretation"). Accordingly, for the Plan to be confirmed, OCI and the Rehabilitator were required to present evidence to this Court that claimants are receiving under the Plan at least the value they would have received in a liquidation, and this Court must make a *de novo* determination of whether the constitutional requirements of *Carpenter* have been met. With respect to One State Street, the Rehabilitator has fundamentally failed to establish that One State Street is receiving the

liquidation value of its claim. Indeed, the evidence elicited at the Confirmation Hearing established that One State Street would be paid in full in a liquidation, but is receiving no value under the Plan.

C. The Plan Provides One State Street With No Value Under The Plan.

The only evidence of the value to be received by One State Street under the Plan offered by the Rehabilitator is contained in the four scenarios of potential recoveries that are included as Exhibits D through G of the Disclosure Statement.² The only scenario in which class 5 claims, such as One State Street, are projected to receive any recovery is in scenario 1. Disclosure Statement Ex. D at 14, Ex. E at 14, Ex. F at 14, Ex. G at 14. The only difference in assumptions between scenario 1, which projects class 5 claimants to receive a recovery in the year 2050, and scenario 2, in which no recovery is projected for class 5 claims, is the projected recoveries (the “R&W Remediation Recoveries”) in litigation brought, and still to be brought, by Ambac and the Segregated Account, based on breaches of representation and warranties made by mortgage originators in obtaining insurance policies from Ambac. *See* Disclosure Statement at 66 (identifying assumptions underlying scenarios 1 and 2); Nov. 18, 2010 Transcript at 66:13-16 (testimony of Mr. Peterson admitting that the only difference between scenarios 1 and 2 is the assumption of R&W Remediation Recoveries).

Scenario 1 assumes that there would be \$2 billion in R&W Remediation Recoveries by the year 2013. No evidence was offered by the Rehabilitator or AAC to establish the basis for this \$2 billion projection that is the sole basis for any projected recovery to One State Street under the Plan. Instead, the testimony established that scenario 1 has no indicia of reliability because it is predicated on AAC’s estimates of \$2 billion in R&W Remediation Recoveries

² One State Street, along with other objectors, has objected to the admission of this analysis, which would leave OCI with no evidence whatsoever to fulfill its constitutional burden.

which the Rehabilitator disavowed at the Confirmation Hearing. Specifically, on cross-examination, Commissioner Dilweg admitted that OCI does not, in fact, agree with this \$2 billion estimate, that OCI has always had “concerns” with AAC’s estimates, and that AAC has, in the past, only recovered \$60 million per year in R&W Remediation Recoveries. Nov. 15, 2010 Transcript at 213:10-214:16; Nov. 16, 2010 Transcript at 106:15-107:6. Although the testimony established that OCI has a substantially lower view of potential R&W Remediation Recoveries, Mr. Peterson claimed a statutory privilege in response to questioning regarding OCI’s projections of R&W Remediation Recoveries and the basis for AAC’s estimates. Nov. 17, 2010 Transcript at 56:23-57:10; Nov. 18, 2010 Transcript at 66:24-70:6. Accordingly, no admissible evidence was presented at the Confirmation Hearing to support any estimate of R&W Remediation Recoveries. Similarly, no deference may be given to OCI’s projections under scenario 1 for three reasons: (i) the projections implicate constitutional issues under *Carpenter* and no deference is afforded to agency determinations implicating constitutional issues (as discussed in subsection C above), (ii) the R&W Remediation Recoveries that underlie scenario 1 are not even based on OCI’s analysis and, in fact, contradict OCI’s own views, and (iii) the \$2 billion estimate of R&W Remediation Recoveries is based on estimates of Ambac and its counsel who all possess fundamental conflicts of interest in these proceedings.³

Scenario 2, which contains the same assumptions as scenario 1 other than R&W Remediation Recoveries, provides no recovery for class 5 claims. Similarly, scenarios 3 and 4 provide no projected recovery to class 5 claims. In the absence of any evidence to support the \$2 billion in R&W Remediation Recoveries assumed in scenario 1, the only conclusion the Court may draw from the evidence is that One State Street is provided no value under the Plan.

³ For example, counsel for Ambac is also counsel for AFG, Ambac’s sole shareholder.

Further, the utter lack of value to be provided to One State Street under the Plan is found in other testimony. The testimony established that the Surplus Notes provided to the settling banks in the bank settlement are currently trading at “cents on the dollar.” Nov. 17, 2010 Transcript at 61:2-10. Those notes are to be *pari passu* with the senior Surplus Notes issued by the Plan, and therefore the uncontroverted testimony is that the senior Surplus Notes under the Plan are also of a current value of “cents on the dollar.” The testimony at trial then also established that the Junior Surplus Notes are worth less than the surplus notes based on the subordinated nature of the Junior Surplus Notes. Nov. 18, 2010 Transcript at 76:22-77:9. Accordingly, the junior surplus notes have effectively no value.

D. One State Street Would Obtain A Full Recovery In A Liquidation.

In a half-hearted attempt to provide a liquidation analysis, the Rehabilitator submitted a skeletal liquidation analysis on the eve of the Confirmation Hearing.⁴ The skeletal liquidation analysis, however, demonstrates its own internal flaws and inadequacy. It was based on worst-case assumptions that contradicted OCI’s own views, and was based on an incorrect valuation date. In the liquidation analysis, the Rehabilitator again frames the issue under *Carpenter* as whether OCI correctly chose rehabilitation over liquidation. *Id.* (“This analysis provides additional detail concerning the reasons why OCI rejected liquidation of AAC as an alternative to the rehabilitation of the Segregated Account.”). That is simply not the issue. The proper inquiry under *Carpenter* is not whether OCI made some “correct” choice in March, 2010. Instead, *Carpenter* requires, as a matter of law, that in constructing a rehabilitation plan, the OCI must provide claimants with the liquidation value of their claim at the time of plan confirmation.

⁴ One State Street has objected to the last-minute inclusion of the analysis, which was provided to One State Street after the close of business on the eve of the Confirmation Hearing. Further, One State Street was denied the opportunity for any discovery by which it could have presented direct testimony regarding the proper calculation of the liquidation value of its claim, and was limited to identifying the liquidation value of its claim through cross-examination.

1. *Liquidation Value Must Be Viewed As Of The Effective Date of the Plan.*

The first fundamental flaw with the liquidation analysis submitted by the Rehabilitator is that the analysis is purported to be conducted as of March 24, 2010, the date the Rehabilitator filed the Segregated Account for rehabilitation. Exhibit 40 at 6. Conducting a liquidation analysis as of March 24, 2010, excludes the benefits of the bank settlement which commuted approximately \$13 billion in mark-to-market damage claims. The settlement occurred prior to the Plan of Rehabilitation and the settlement's benefits cannot be excluded from the liquidation analysis. *See, e.g., Commercial Nat'l Bank in Shreveport v. Superior Ct. of Los Angeles Cty.*, 14 Cal. App. 4th 393, 419 (Cal. Ct. App. 1993) (“[V]aluing the estate as of the conservation date will not yield the total net value of the estate available for distribution to claimants . . . Calculation of the ‘liquidation’ value of assets as of the distribution date of a rehabilitation plan is more functional. It pragmatically fixes the total distributable asset value of the very date the liquidation distribution is to actually occur.”).

Calculating the liquidation value as of the effective date of the Plan is consistent with analogous bankruptcy law, which is governed by the exact same constitutional and Supreme Court restrictions. In chapter 11 reorganizations, creditors are required to be provided with the liquidation value of their claim under the so-called “best interests of creditors test,” which is calculated as of the effective date of the plan. 11 U.S.C. § 1129(a)(7) (providing that each class of claims must receive “value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7”). Indeed, other courts have acknowledged the consistency between the principles of *Carpenter* in insurance rehabilitation and the best interests of creditors test under the Bankruptcy Code. *See, e.g., Commercial Nat'l Bank in Shreveport*, 14 Cal. App. 4th at 419 (“Contemporaneous valuation of assets also is consistent with the method employed in the analogous area of

bankruptcy. Principles of bankruptcy law may be considered as instructive in the context of insurance insolvency where analogous procedures and issues are concerned . . . In chapter 11 proceedings, which are analogous to insurance rehabilitations, plans must provide each creditor with at least the amount he or she would receive if the liquidation value of the estate assets were calculated on ‘the effective date of the plan.’”).

2. *Calculation of Liquidation Value Must Exclude Future, Non-Incurred Policy Claims.*

The second fundamental flaw of the liquidation analysis presented by the Rehabilitator is that it includes future, non-incurred policy claims as being entitled to payment. OCI has repeatedly stated that, in a liquidation scenario, all policies would be terminated within fifteen days. *See, e.g.*, Exhibit 40 at 6. Accordingly, future, non-incurred policy claims would not be entitled to any payment in a liquidation. *See* Exhibit 40 at 6-7 (“A strong argument exists under Wisconsin insurance law – which the Rehabilitator does not waive by submitting this analysis – that no amount would be due for non-yet-incurred future potential losses on the terminated policies.”); Nov. 18, 2010 Transcript at 81:3-18 (Mr. Peterson testifying that “as the claims would develop after the termination of the policy, a position would be taken that the policies were effectively terminated and so forth”). In contradiction to OCI’s own views, as expressed in this clear on-the-record testimony, the last-minute, skeletal liquidation analysis presented by the Rehabilitator includes \$6 billion and \$9.4 billion for payments of projected, non-incurred policy claims that are projected to arise in the future under the base case and stress case, respectively. *See* Exhibit 40 at 6-7 (“For purposes of this analysis only, such claims are assumed to be treated as class 5 claims.”).

3. *Liquidation Value Calculated As Of The Correct Date, Using OCI's Own Views And Assumptions, Establishes That One State Street Would Obtain A Full Recovery In A Liquidation.*

One State Street's cross-examination of Mr. Peterson established, using OCI's own assumptions and projections, that a liquidation analysis performed as of the effective date of the Plan would provide One State Street with a full recovery on its claim. Nov. 18, 2010 Transcript at 86:15-91:10. Specifically, a liquidation which incorporates the commutation of the CDS mark-to-market damage claims effectuated in the bank settlement and excludes future, non-incurred policy losses, would provide One State Street with a 100% recovery using the same \$2 billion in R&W Remediation Recoveries included in scenario 1 (discussed above), or a minimum of a 72.8% recovery assuming no R&W Remediation Recoveries. *Id.*

4. *One State Street's Liquidation Value Must Take Into Account The Value Of Policies That Could Be Transferred In A Liquidation.*

The liquidation analysis submitted by the Rehabilitator also assumes, without justification, that all policies of Ambac would simply be terminated within fifteen days of a liquidation. *See, e.g.*, Exhibit 40 at 6. The Wisconsin statutes, however, provide that policies can be transferred to a third-party insurer instead of being terminated. WIS. STAT. § 645.43(d). Indeed, on cross-examination, Mr. Peterson admitted that OCI had calculated the runoff value of the municipal bond policies, but claimed a statutory privilege when questioned as to the value OCI placed on the municipal bond policies. Nov. 18, 2010 Transcript at 93:8-94:12. Similarly, Mr. Peterson admitted that OCI had received inquiries from interested buyers to purchase such policies, but again claimed a statutory privilege⁵ when questioned as to the consideration proposed. *Id.* at 94:20-95:3. As Mr. Peterson admitted, the liquidation value of One State

⁵ By claiming a statutory privilege regarding the prospective claims-paying resources, a fundamental component of any liquidation analysis, OCI has forfeited any claim of deference to agency action with respect to the liquidation analysis.

Street's claim increases by any value that could be realized in a sale of the policies. *Id.* at 95:4-15.

The policies that are currently in the General Account are the only assets backing the \$2 billion secured note issued in favor of the Segregated Account that is the predicate for the payment of the Segregated Account's obligations. Accordingly, the only conclusion that can be drawn from the evidence is that the policies in the General Account have a value of at least \$2 billion. Using OCI's own assumptions and views, and increasing the claims-paying resources by this \$2 billion in value that could be realized in a liquidation, One State Street would obtain a 100% recovery in liquidation even if no R&W Remediation Recoveries are realized.⁶ Accordingly, using OCI's own assumptions and views, One State Street is entitled to a full recovery under any plan of rehabilitation.

This proper liquidation valuation, with full recovery to One State Street calculated as of the effective date of the Plan, is entirely consistent with OCI's representations to the Court made on the record at the September 9 hearing:

I submit that there would be one and only one beneficiary had OCI chosen liquidation . . . and who would that one party be? It would be the shareholders of Ambac because it would create a tremendous value for them. . .

Sept. 9, 2010 Hearing Transcript at 77:4-9. The admitted recovery to shareholders in a liquidation scenario, which implies full recovery to the few existing general (nonpolicyholder) creditors such as One State Street, leads to the unavoidable conclusion that the provision of less than full recovery to One State Street in the Plan violates the Supreme Court's mandate in

⁶ As set forth in subsection 3 above, a liquidation analysis which incorporates the commutation of the CDS mark-to-market damage claims effectuated in the bank settlement and excludes future, non-incurred policy losses, would provide One State Street with a 100% recovery assuming \$2 billion in R&W Remediation Recoveries. Replacing the \$2 billion in R&W Remediation Recoveries with the \$2 billion that would be realized in the sale of policies results in the same liquidation recovery, namely a 100% recovery to One State Street.

Carpenter. The Rehabilitator is judicially stopped from asserting that One State Street would not be entitled to a full recovery under a liquidation analysis. *See Mrozek v. Intra Financial Corp.*, 281 Wis. 2d 448, 468, 699 N.W.2d 54, 64 (Wis. 2005) (“Judicial estoppel precludes a party from asserting one position in a legal proceeding and then subsequently asserting an inconsistent position.”). Accordingly, the Plan cannot be confirmed unless and until it is amended to provide One State Street with value equal to the entire amount of its claim on a present value basis. Notably, this adjustment would not require wholesale rejection of the Plan, since One State Street’s claim (a non-policyholder claim) is not particularly large in comparison to the entirety of AAC and its General Account.

II. THE TESTIMONY AT TRIAL FURTHER CONFIRMS THAT THE SEGREGATED ACCOUNT IS NOT ADEQUATELY CAPITALIZED AS TO ONE STATE STREET.

It is fundamental, as a matter of law, to OCI’s scheme that it have properly approved the formation of the Segregated Account. *See WIS. STAT. § 611.24(b)*. Throughout these proceedings, OCI has pointed to only one fact regarding adequate capitalization: that the backstop note and reinsurance agreement would provide for payment of One State Street. *See, e.g., Rehabilitator’s Brief in Opposition to Motion Filed by One State Street LLC Scheduled for Hearing on September 13, 2010 at 5* (“[I]f this Court were ever to allow any portion of the disputed Lease Liability as a valid claim against the Segregated Account, the Reinsurance Agreement will be available, along with the Secured Note, to fund that obligation.”); Nov. 18, 2010 Transcript at 59:9-25 (Mr. Peterson testifying that OCI’s determination of adequate capitalization was based on secured note and reinsurance agreement provided sufficient capital to meet the cash flow needs of the Plan).

However, the testimony now unequivocally establishes that these backstop arrangements are a sham as to One State Street. OCI’s own projected recoveries for One State Street show, in

three out of four scenarios, that One State Street recovers nothing – that is, that the Segregated Account is in fact not capitalized at all in a manner that would provide for any payment of One State Street’s claim. The only scenario showing any recovery – Scenario 1 – is, by OCI’s own admission (as discussed in detail above) based entirely on uncertain future litigation recoveries as estimated by Ambac, which OCI itself thinks are unrealistic.

The testimony at trial now conclusively reinforces One State Street’s prior objection – undermining a critical component of OCI’s scheme – that there is no meaningful consideration for the transfer to, and/or capitalization of, the Segregated Account, with respect to One State Street. Accordingly, the Plan cannot be approved because (i) it is dependent on a properly formed segregate account, which there has not been, and (ii) the allocation of the claim of One State Street to the Segregated Account violated both New York and Wisconsin fraudulent conveyance law. The arguments of One State Street as to adequate capitalization and fraudulent conveyance are set forth in detail in the briefs and argument submitted in connection with the September 9, 2010 hearing, and are incorporated herein by reference.

III. THERE IS NO BASIS OR JURISDICTION TO PROVIDE THE PROPOSED INJUNCTION, RELEASES, AND IMMUNITIES FOR THE BENEFIT OF THIRD PARTIES.

As set forth at length above, One State Street asserts that both AFG and AAC are liable under the Headquarters Lease. Although OCI and the Rehabilitator have taken the position that AAC has no liability under the lease, and that the only party to the lease is AFG, they have chosen not to litigate that issue at this time. Therefore, the Plan must simply provide any claim of One State Street against AAC with the treatment that is statutorily and constitutionally mandated, assuming that such a claim exists. The Plan as currently proposed, however, seeks to not only alter the rights of One State Street *vis-à-vis* AAC, but could, read literally, preclude One State Street from any recovery against AFG in its chapter 11 bankruptcy proceeding.

Again, One State Street is placed in a position different from policy holders. Policy holders do not have claims against AFG, which is not in the insurance business. Thus, these broad releases may not have much practical effect on most claimants in the rehabilitation, but must be curtailed as to One State Street.

A. Articles 8 and 9 of the Plan Proposes Extraordinarily Broad Releases, Injunctions, and Immunities.

In an apparent acknowledgment of the impropriety of the releases originally proposed, the Rehabilitator submitted a modified proposed order that purports to amend section 8.01 of the Plan. The amended section 8.01, however, continues to propose astonishingly broad releases and an injunction against numerous third-parties, providing:

[A]ll Holders of Claims are precluded from asserting against the Segregated Account, the General Account or AAC, or their respective successors or property or any of their respective current or former members, shareholders, affiliates, officers, directors, employees or agents, any Claims, obligations, rights, causes of action or liabilities, based upon any act, omission, transaction, or other activity of any kind or nature, made in connection with, or arising out of, the Segregated Account, AAC or the General Account with respect to the Segregated Account, the Proceeding, this Plan (and the Confirmation Order related thereto), the consummation of this Plan, or the administration of this Plan or the property to be distributed under this Plan, other than claims of intentional fraud or willful misconduct. Except as otherwise provided in this Plan, and except as otherwise agreed by the Rehabilitator or the Management Services Provider, all Holders of Claims shall be permanently barred and enjoined from asserting against the Segregated Account, the General Account or AAC, or their respective successors or property or any of their respective current or former members, shareholders, affiliates, officers, directors, employees or agents, any of the following actions on account of such Claim: (i) commencing or continuing in any manner any action or other proceeding on account of such Claim, or the property to be distributed under the terms of this Plan, other than to enforce any right to Distribution to such Holders under this Plan;

... and (v) acting or proceeding in any manner, in any place whatsoever, that does not conform to, or comply with, the provisions of this Plan.

Proposed Order Modifying and Confirming Plan of Rehabilitation (As Modified), With Findings of Fact and Conclusions of Law at 1-2.

Similarly, Article 9 of the Plan provides, *inter alia*, that the Segregated Account, AAC, and the General Account, and “each of their respective current and former members, shareholders affiliates, officers, directors, employees and agents” with blanket immunity from:

any act or omission made in connection with, or arising out of, the Segregated Account, AAC or the General Account with respect to the Segregated Account, the Proceeding, this Plan (and the Confirmation Order related thereto), the consummation of this Plan, or the administration of this Plan or the property to be distributed under this Plan, whether prior to or following the commencement of the Proceeding, with the sole exception of acts or omissions resulting from intentional fraud or willful misconduct

Plan §§ 9.01, 9.02 (emphasis added).

B. Amended Section 8.01 Is Ambiguous As To Whether AFG Is Released From Liability Under The Headquarters Lease.

Amended section 8.01 remains ambiguous with respect to whether the releases and injunctions apply only to actions arising in connection with the rehabilitation or are even limited to acts relating in some way to the Segregated Account. The ambiguity of section 8.01 arises from the language highlighted below:

[A]ll Holders of Claims are precluded from asserting against the Segregated Account, the General Account or AAC, or their respective successors or property or any of their respective current or former members, shareholders, affiliates, officers, directors, employees or agents, any Claims, obligations, rights, causes of action or liabilities, based upon any act, omission, transaction, or other activity of any kind or nature, made in connection with, or arising out of, the Segregated Account, AAC or the General Account with respect to the Segregated Account, the Proceeding, this Plan (and the Confirmation Order related thereto), the consummation of this Plan, or the administration of this Plan or the property to be distributed under this Plan, other than claims of intentional fraud or willful misconduct. Except as otherwise

Specifically, it is unclear whether the highlighted language applies to “any Claims, obligations, rights, causes of action or liabilities, based upon any act, omission, transaction, or other activity of any kind or nature, made in connection with, or arising out of . . . AAC” or whether the highlighted language only modifies such claims arising out of “the General Account.”

OCI has been evasive, at best, about these provisions. It has refused to further clarify the provision – for example, to make a clear, express statement in the Plan that no liability of AFG is released. At the same time, Mr. Peterson testified that it was not OCI’s intent to release AFG from liability under the Headquarters Lease. Nov. 18, 2010 Transcript at 97:4-15 (“There was no goal in – in that respect. We have taken – OCI has taken the position that the lease is an obligation of AFG, the holding company, and that, ah, is a relation or an obligation between One State Street and AFG. There are contingencies that have been addressed in the Plan if that obligation becomes one of Ambac Assurance.”). And still, amended section 8.01 remains ambiguous regarding whether AFG is released from liability under the Headquarters Lease. Any order confirming the Plan must expressly state, in a manner that overrides any statement in the Plan, that no liability of AFG (to One State Street) is released, and that section 8.01 does not affect or impair One State Street’s claims against AFG under the Headquarters Lease.

C. There is No Basis Or Jurisdiction To Release Claims Against AFG In The Rehabilitation Of AAC.

To the extent the Rehabilitator refuses to clarify, or the Court does not clarify, the language under amended section 8.01, the Court and OCI do not have jurisdiction to provide AFG any such release. A threshold question in the approval of any release or immunity, or the granting of an injunction, is whether the Court has jurisdiction over the affected claims. *See, e.g., Johns-Manville Corp. v. Chubb Indemnity Ins. Co. (In re Johns-Manville Corp.)*, 600 F.3d 135, 146, 153 (2d Cir. N.Y. 2010) (holding that even “a [federal] bankruptcy court only has

jurisdiction to enjoin third-party non-debtor claims that directly affect the *res* of the bankruptcy estate”). If a court has jurisdiction, the question then becomes whether the scope of the requested relief is permissible. In bankruptcy proceedings, where access to broader federal power is available, numerous federal bankruptcy courts, district courts, and courts of appeal have held that releases of non-debtors from liability to creditors is only permissible, if at all, in extraordinary circumstances, where the release is narrowly tailored, and when there is substantial consideration provided by the third party. *See In re Airadigm Commc’ns*, 519 F.3d 640, 655-56 (7th Cir. 2008) (providing an overview of the various approaches to third-party releases and holding any release must be narrowly tailored); *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142 (“Courts have approved nondebtor releases when: the estate received substantial consideration . . .”). Even if the requested release is appropriate in unique cases, most jurisdictions approve third-party releases only if narrowly tailored to claims “‘arising out of or in connection with’ the reorganization itself.” *Id.*

Here, any release of AFG regarding the Headquarters Lease is unwarranted and cannot be approved. AFG is not providing any consideration to either the Segregated Account or One State Street to support its unwarranted release of a liability which the Rehabilitator admits may be in the range of \$94 million. There is no proper purpose or rational basis for the Rehabilitator to seek any release of AFG in these proceedings with respect to any claim of One State Street simply because AFG and AAC both have liability under the Headquarters Lease. There is no legitimate reason for this ambiguity to remain in the Plan. To the extent the Rehabilitator does not further modify section 8.01 of the Plan to resolve this ambiguity, this Court should amend

section 8.01 to prevent any argument that AFG is released from any liability under the Headquarters Lease.

IV. THE REHABILITATOR HAS NOT ADDRESSED SEVERAL OBJECTIONS OF ONE STATE STREET.

The Rehabilitator has not even addressed several objections that were raised in One State Street's initial objection to plan confirmation. One State Street incorporates such arguments as if set forth in full herein, and provides the following summary of such objections that have not been addressed.

A. The Rehabilitation Plan Violates The Priority Scheme Of Section 645.68 Of The Wisconsin Statutes.

Section 645.68 of the Wisconsin statutes provides a clear, mandated priority scheme by identifying eleven possible classes of claims in order of priority. The Plan largely tracks the priority statute with respect to administrative claims, which are afforded first priority and are to be paid in cash, and with respect to policy claims, which are afforded second priority and are to be paid in a combination of cash and priority surplus notes. *See* WIS. STAT. §§ 645.68(1), (3). The Plan, however, completely departs from the priority statute with respect to all claims other than administrative and policy claims.

Any claim of One State Street would be classified under the statute as a class 5 claim. *See* WIS. STAT. §§ 645.68(5) (defining class 5 as all claims not falling within other classes). Pursuant to the statute, each of the claims that would fall within the statutorily mandated classes 6 through 11 are junior in priority to class 5 claims. WIS. STAT. §§ 645.68 (“[E]very claim in each class shall be paid in full or adequate funds retained for the payment before the members of the next class receive any payment.”). The Plan, however, impermissibly classifies all claims in classes 5 through 11 as the same class, called “General Claims.” Plan § 1.28 (defining General Claims as “[a]ll Claims which are not Administrative Claims or Policy Claims, and are not

otherwise entitled to priority under the Act or an order of the Court”). As a result, the Plan contemplates that all claims junior to class 5 claims will be treated *pari passu* with class 5 claims. The statute expressly forbids such a result by mandating that class 5 claims be paid in full prior to any recovery to classes 6 through 11.

B. The Plan Does Not Address AAC’s Obligations To Enter Into A New Lease Upon Rejection Of The Headquarters Lease By AFG.

Pursuant to the express terms of the Headquarters Lease, AAC is obligated to enter into a new lease on comparable terms upon any rejection of the lease by AFG in a bankruptcy proceeding. To the extent that such an obligation falls within the “contingent liability, if any” under the Headquarters Lease that was allocated to the Segregate Account, the Plan does not address this obligation.

In the event that AFG rejects the Headquarters Lease in its chapter 11 bankruptcy case, AAC has a specific, negotiated-for contractual obligation to enter into a new lease, and that obligation will have arisen after the commencement of the rehabilitation proceeding. If such obligation has somehow been allocated to the Segregated Account, One State Street has, at a minimum, an administrative claim against the Segregated Account for this specific obligation.

“General Claims,” however, are defined as:

All Claims which are not Administrative Claims or Policy Claims, and are not otherwise entitled to priority under the Act or an order of the Court, including, but not limited to, (i) any Claim submitted by One State Street, LLC or its successor or assignee arising from the disputed contingent liability of the Segregated Account, if any, under the [Headquarters Lease] . . .

Plan § 1.28 (emphasis added). As applied to One State Street, it is ambiguous whether the definition precludes One State Street from filing an Administrative Claim. The Plan should be modified to expressly provide that the Plan, or the treatment or classification of any claim of One

State Street thereunder, has no prejudicial effect on One State Street's ability to seek allowance of an administrative claim.

Should OCI or the Rehabilitator take the position that AAC's contractual obligation to sign a new lease is part of a General Claim of One State Street and precludes the allowance of an Administrative Claim, the allocation of this obligation and the absence of any prospect of recovery on this claim constitute a taking in violation of the Fifth and Fourteenth Amendments to the United States Constitution, and Section 13 of Article I of the Wisconsin Constitution. *See, e.g., Kelo v. City of New London*, 545 U.S. 469, 477-78 (2005).

C. Section 4.06 Of The Plan Violates The Statutorily Mandated Claims Process.

After proposing to trample various constitutional and statutory substantive rights, the Rehabilitator also proposes, for good measure, to alter the procedural rights of claimants to contest what the Rehabilitator hopes will be unilateral claims determinations. Section 645.65 of the Wisconsin Statutes provides a clear process for the resolution of disputed claims.

Specifically, the statute provides

NOTICE OF REJECTION AND REQUEST FOR HEARING. When a claim is denied in whole or in part by the liquidator, written notice of the determination and of the right to object shall be given promptly to the claimant and the claimant's attorney by first class mail at the address shown in the proof of claim. Within 60 days from the mailing of the notice, the claimant may file objections with the court. If objections are not filed within that period, the claimant may not further object to the determination.

WIS. STAT. § 645.65(1) (emphasis added).

In the Plan, however, the Rehabilitator provides for a claims resolution process contrary to the plain language of the statute. Section 645.65 of the statute requires the Rehabilitator to provide written claims determinations, and a claimant is required to file an objection to the determination with the Court within sixty days. In contrast, section 4.06 of the Plan provides

that the Rehabilitator will provide written objections to claims, and any claimant who receives such a written notice must, within sixty days, respond to the Rehabilitator in writing setting forth all factual and legal bases for the claim. The Rehabilitator is then provided a further undefined time to reassess the claim and submit a further notice of denial to the claimant. A claimant is only afforded the opportunity to seek judicial relief by filing a motion after this protracted process is complete.

The alteration of the claims objection process proposed in the Plan will result in a legal conundrum. Are objecting claimants required to follow the Plan, and file objections with the Rehabilitator within sixty days of receiving the Rehabilitator's claim objection? Or are claimants required to follow the statute, and file the objection with the Court? Either course will provide the Rehabilitator with the argument that the objecting claimants waived their rights by failing to comply with either the Plan or the statute. The Rehabilitator is afforded no discretion to re-write the statute, and the disputed claims process in section 4.06 of the Plan should not be approved.

D. Section 7.02 of the Plan Purports to Provide the Rehabilitator With Discretion to Inequitably Alter The Plan to the Detriment of General Claims.

Section 7.02 of the Plan provides that the Rehabilitator can petition the Court to amend the Plan if "the Rehabilitator has determined, in his sole and absolute discretion, that such an amendment is equitable to the interests of the Holder of Policy Claims generally." Plan § 7.02 (emphasis added). Such language remarkably omits Holders of General Claims. The rehabilitation statute expressly provides that the purpose of rehabilitation is for the "protection of the interests of insureds, creditors, and the public generally" through the "[e]quitable apportionment of any unavoidable loss." WIS. STAT. § 645.01. Accordingly, the statute

expressly requires that the Rehabilitator act in the protection of the interests of not only Policy Claims, but also in the protection of the interests of General Claims.

E. Section 8.01 of the Plan Should Be Amended To Provide That Claims Are Only Discharged Following Payment In Full.

Section 8.01 of the Plan provides that upon “Distribution,” defined to include the distribution of the Junior Surplus Notes, the claims are to be full and unconditionally settled, satisfied, discharged, and released. While a distribution under a properly approved Plan may discharge a claim as to the entity in rehabilitation, there is no basis or rationale to deem the claim as paid in full. Determining a claim to be full and unconditionally settled upon distribution may have unintended consequences beyond this case.

F. One State Street Incorporates All Arguments Made In Its Motion For Dissolution Or Modification Of The Temporary Injunction.

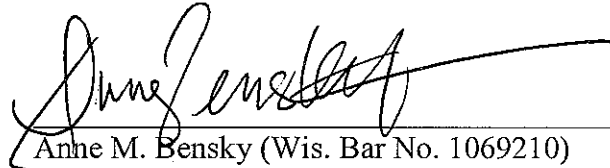
The Plan purports to make permanent the prior temporary injunction and finalize the creation of the Segregated Account. One State Street filed a motion on June 22, 2010 (the “Motion to Dissolve”), to dissolve the temporary injunction issued by this Court on March 24, 2010. In summary, the Motion to Dissolve raised several arguments, including without limitation, that: (i) the Wisconsin statute governing segregated accounts does not permit allocation of AAC’s liability under the Headquarters Lease to the Segregated Account; (ii) the attempt to separate the benefits and liabilities of the Headquarters Lease violates the Wisconsin statutes; (iii) the segregated account is not adequately capitalized as to the Headquarters Lease; (iv) the allocation of liability under the Headquarters Lease to the Segregated Account is not justified; (v) the allocation of the liability under the Headquarters Lease to the Segregated Account violated fraudulent transfer law; and (vi) the allocation of liability under the Headquarters Lease violates the Wisconsin and United States Constitutions, including the equal protection and takings clauses thereunder.

At the hearing on the Motion to Dissolve, OCI attempted to justify the allocation of liability under the Headquarters Lease to the Segregated Account on the basis that the secured note and reinsurance agreement backstopped the obligations of the Segregated Account. On October 26, 2010, the Court issued an order denying the Motion to Dissolve, but did not address the basis for the decision with respect to most of the arguments raised by One State Street in the Motion to Dissolve. Now, after obtaining a favorable decision on the Motion to Dissolve, OCI substantially changes the facts by proposing (via the Junior Surplus Note) to relegate One State Street to the very back of the line with respect to such backstop obligations and reserving the ability to place future claims ahead of any recovery by One State Street.

To the extent the Plan proposes to make permanent the prior temporary injunction and finalize the creation of the Segregated Account, One State Street incorporates by reference all arguments made by One State Street in the Motion to Dissolve, the memorandum in support of the Motion to Dissolve, the memorandum in reply to the Rehabilitator's opposition to the Motion to Dissolve, and on the record at the hearing conducted on the Motion to Dissolve, all as if set forth in full herein.

Respectfully submitted this twenty-ninth day of November, 2010

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