

In the Matter of the Rehabilitation of:

Segregated Account of  
Ambac Assurance Corporation

Case No. 10 CV 1576

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**ORDER DENYING THE REHABILITATOR'S MOTION FOR CONFIRMATION  
OF THE PLAN OF REHABILITATION OF THE SEGREGATED  
ACCOUNT OF AMBAC ASSURANCE CORPORATION**

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This matter came before the Court on the motion (the "Motion") of the Wisconsin Office of the Commissioner of Insurance ("OCI") to confirm the Plan of Rehabilitation for the Segregated Account of Ambac Assurance Corporation (the "Plan"). Based on the Court's review of the Plan, as well as the testimony and exhibits admitted into evidence, and argument of counsel on confirmation of the Plan, and for other good cause, the Motion is hereby DENIED.

In support of this Order, the Court makes the following findings and conclusions:

1. Under Wisconsin Statute § 645.33(5), a rehabilitator may propose a rehabilitation plan, and the Court may either approve or disapprove the plan proposed, or may modify it and approve it as modified to ensure that the plan complies with applicable law.

2. The applicable law includes, among other things, the Wisconsin rehabilitation and liquidation statutes (Wis. Stat. § 645), the Wisconsin segregated account statute (Wis. Stat. § 611), the Wisconsin insurance statutes (Wis. Stat. §§ 600 to 655), and the Wisconsin and United States Constitutions.

3. The Commissioner of Insurance, acting as Rehabilitator, may not take any actions that exceed or conflict with the authority he is granted by statute and the Wisconsin Legislature. *See, e.g., State ex rel. Knudsen v. Bd. of Educ., Elmbrook Sch., Joint Common Sch. Dist. No. 21,*

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43 Wis. 2d 58, 67, 168 N.W.2d 295, 299 (Wis. 1969) (a court will set aside a regulator's exercise of power when "the power has been abused or exercised beyond the limits conferred by the legislature"); *Sheely v. Wis. Dep't of Health & Social Servs.*, 150 Wis. 2d 320, 339, 442 N.W.2d 1, 10 (Wis. 1989) (An administrative official's exercise of authority "will not be sustained if it has no basis in 'the appropriate and applicable law.'"); *cf.* Wis. Stat. § 227.57(8) (a court must reverse an agency decision if "the agency's exercise of discretion is outside the range of discretion delegated to the agency by law").

4. When revising Chapter 645 of the Wisconsin Statutes, the Wisconsin Legislature included in the enacting legislation, "not only the statutory language but also the comments of the Insurance Laws Revision Committee." Spencer L. Kimball, Introductory Comment to Wisconsin Laws of 1967, Chapter 89 (Aug. 4, 1967). As a result, the "quasi-enactment of the committee comments gave them a measure of dignity and permanence not ordinarily accorded the work of committees." *Id.*

**The Rehabilitator exceeded his authority by proposing a *de facto* liquidation.**

5. Wisconsin Statute § 645.33(5) states the permissible purposes of a plan of rehabilitation. Liquidation, or the run-off of a delinquent insurer's assets, is not among them.

6. The comments to the Rehabilitation Statutes provide that liquidation "must be used when the insurer's assets are to be distributed and the insurer dissolved" and that rehabilitation is inappropriate unless "substantial additional resources are poured into the enterprise *immediately* by contributors of capital funds." (Wis. Stat. Ann. Ch. 645, introductory cmt. to subch. III; Wis. Stat. Ann. ch. 645, introductory cmts. (emphasis in original); *see also* J. Schacht, Nov. 19, 2010 Hrg. Tr. at 83 ("Assuming that the failing company cannot get additional capital to resume its operations in some fashion, the objective then becomes

determining the best way to fairly distribute *all* of the assets of the company to *all* of the company's policyholders." (emphasis added)).

7. The Rehabilitator concedes that the rehabilitation is designed solely to run off the Segregated Account's liabilities, and that thereafter the Segregated Account will be terminated. (Plan of Rehab. at 1; S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 215.) During the hearing, the Rehabilitator testified that "we're not trying to build back a AAA company five years from now to start selling municipal bond insurance. We're just trying to take the claim's [sic] paying ability that it has and make sure the policyholders continue to have coverage as the company runs off over the next 10 to 20 years." (S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 152; *see also id.* at 215.) He admitted that "this [was] purely runoff." (S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 55-56.)

8. The Rehabilitator testified that the Segregated Account "has no assets," (S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 215), that "there are no assets in the Segregated Account, only liabilities," (S. Dilweg Nov. 16, 2010 Hrg. Tr. at 32-33), and that "[t]here are no assets in the Segregated Account. They all reside in the General Account." (S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 218.) Not only does this demonstrate that the Segregated Account was not adequately capitalized when it was established, but also that the Segregated Account will never emerge from the rehabilitation as a viable business entity capable of writing business in the future.

9. The evidence shows that the Segregated Account is unable to pay its obligations as they become due. Under the Plan, policyholders with permitted claims will receive 25% of their permitted claim in cash and 75% of their claim in surplus notes, which are of questionable value. (Plan of Rehab., §§ 1.08, 1.62, 4.04; *see* ¶¶ 31-38 *infra.*)

10. In addition, the evidence indicates that there are no plans to infuse capital into the Segregated Account. (S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 215.)

11. Under these circumstances, rehabilitation is inappropriate under Wisconsin law, and the Plan is unauthorized by the statutory scheme.

**In violation of Wisconsin Statute § 601.01(2), the Rehabilitator's proposed Plan does not treat Segregated Account policyholders fairly and equitably.**

12. Wisconsin Statute § 601.01(2) provides that one of the purposes of the Wisconsin Insurance Statutes is “[t]o ensure that policyholders, claimants and insurers are treated fairly and equitably.”

13. The central aspect of fairness is that similar claims are treated in the same manner. As the Supreme Court of Wisconsin has stated in an analogous context, “where equality is lacking so is equity.” *Associated Gas & Elec. Co. v. Public Serv. Comm’n*, 221 Wis. 519, 266 N.W. 205, 209 (Wis. 1936) (rejecting distressed company’s plan to restructure its debenture obligations because the plan failed to “treat[] all bondholders alike”); *see also* Wis. Stat. § 601.01(2).

14. The Plan enforces an unfair distribution. As established at the hearing, the Plan divides policies of the same priority level between the Segregated Account and the General Account of Ambac Assurance Corporation (“AAC”). Claims on policies left in the General Account will be paid in full. Claims on policies in the Segregated Account will be paid 25% in cash and 75% in surplus notes. However, the value of the surplus notes will likely be far less than 100% of the face amount of principal and interest of such notes; and, in fact, there may be no payments at all on the surplus notes. (*See* ¶¶ 31-38 *infra*.) Although the surplus notes purport to mature in June 2020, the Plan allows the Commissioner to extend the maturity date of the surplus notes without prior Court approval. (*See* Plan of Rehab., Ex. B (Form of Surplus Note) at 2, 7; Disc. St. at 39.) Moreover, the Segregated Account surplus notes are intended to have identical economic attributes to other surplus notes issued by AAC, which currently trade at only

“cents on the dollar.” (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 61.) Expert James Schacht testified that he had never seen a plan of rehabilitation that divided policyholders in such a manner. (J. Schacht, Nov. 19, 2010 Hrg. Tr. at 87.)

15. Further, AAC intends “to repurchase surplus notes at below face value” as a means of generating value for AAC’s shareholder-parent. (Complaint for Injunctive Relief and Declaratory Judgment Determining Amount of Tax Liability at ¶ 15, *In re Ambac Fin. Group, Inc.*, Case No. 10-15973 (SCC) (Bankr. S.D.N.Y. Nov. 8, 2010), Docket No. 8.)

16. As a result, the Plan enforces an unfair and inequitable result in violation of Wisconsin Statute § 601.01(2).

**In violation of Wisconsin Statute § 645.68, the Plan subordinates policyholders in the Segregated Account to AAC’s other policyholders and general creditors.**

17. Wisconsin Statute § 645.68 creates a rule of absolute priority, requiring that “every 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.” Wis. Stat. § 645.68 (assigning policyholder loss claims Class 3 priority, general creditor claims Class 5 priority, contribution notes Class 10 priority, and shareholder claims Class 11 priority, among others); *see also* Wis. Stat. Ann. § 645.01 cmt. (stating that “[t]he priority system [and especially § 645.68] has been structured to make the insurance institution do its job better and to apportion loss equitably”).

18. Wisconsin Statute § 645.68 also requires that “[n]o subclasses shall be established within any class.”

19. Although the Commissioner concedes that the policies allocated to the Segregated Account are in the same class as the policies that remain in the General Account (*see* S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 191-92 (all policies are part of AAC’s financial guaranty line of

business)), in fact the Plan effectively treats the policies allocated to the Segregated Account as a separate subclass subordinated to the policies allocated to the General Account.

20. Through the creation of the Segregated Account and by the terms of the proposed Plan, OCI and the Rehabilitator have violated the priority of claims required by statute.

21. During the hearing, the Rehabilitator testified that the creation of the Segregated Account was for the benefit of the General Account. (*See* S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 139-40, 142-43, 151; *see also* R. Peterson, Nov. 17, 2010 Hrg. Tr. at 42 (explaining that the creation of the Segregated Account had the benefit of stabilizing the municipal bond business in the General Account).) The Rehabilitator also testified that an orderly run-off of the Segregated Account would benefit the creditors of the General Account. (*See* S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 189.)

22. The Rehabilitator further concedes that one of the purposes for creating the Segregated Account was to get policyholders to commute their policies for less than full value. (*See id.* at 189-90.) This represents an improper attempt to gain leverage over the Segregated Account policyholders that is contrary to the goals and principles that must be followed in a rehabilitation. (*See* J. Schacht, Nov. 19, 2010 Hrg. Tr. at 70-71 (discussing importance of following priority scheme to ensure fair and equitable treatment of policyholders), 83 (discussing objective in rehabilitation, which is to distribute all of the company's assets to all policyholders).)

23. In the months leading up to commencement of these rehabilitation proceedings, OCI determined that it needed to take regulatory action with respect to AAC because AAC was in a "financially hazardous" condition. (*See* S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 138 (Ambac became a financially hazardous company in the fall of 2009), 172 (AAC's financially hazardous

condition forced the Commissioner to take regulatory action), 222 (“[a]t this point we’re dealing with a financially hazardous company”).) OCI faced three options: a full rehabilitation of AAC, a full liquidation of AAC, or the creation and immediate rehabilitation of a segregated account of AAC. (See Disc. St. at 5; First Affidavit of Roger A. Peterson, dated May 19, 2010, at 4-7; S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 151; R. Peterson, Nov. 16, 2010 Hrg. Tr. at 160-63.) For various reasons, OCI chose the third option.

24. On March 24, 2010, AAC created the Segregated Account and allocated a subset of AAC’s policies and certain other liabilities, but not assets, to the Segregated Account, and OCI petitioned this Court for a rehabilitation order for the Segregated Account. (See Verified Petition for Order of Rehabilitation, filed Mar. 24, 2010, at 5, 13; Plan of Operation, filed as Tab 1 to Verified Petition, at 1; R. Peterson, Nov. 16, 2010 Hrg. Tr. at 160 (describing those events and noting that they occurred “in very tight sequence”); S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 215, 218 and Nov. 16, 2010 Hrg. Tr. at 32-33 (explaining that there are no assets in the Segregated Account).) From time to time since the creation of the Segregated Account, OCI has transferred other policies or liabilities of AAC to the Segregated Account. Approximately six months after the entry of the rehabilitation order, the Commissioner, as Rehabilitator, proposed the Plan of Rehabilitation. (See Plan of Rehab., filed Oct. 8, 2010.) However, the Plan and this attempt to address AAC’s “financially hazardous” condition violate Wisconsin’s statutorily directed priority of claims embodied in Wisconsin Statute § 645.68.

25. First, OCI permitted AAC to create a subclass of policyholders in violation of Wisconsin Statute § 645.68. The Plan treats policyholders in the Segregated Account as a subclass of all AAC policyholders, and treats them differently than policyholders of the same priority in the General Account. In satisfaction of permitted policy claims, policyholders in the

Segregated Account will receive 25% of their claim in cash and 75% of their claim in surplus notes, while policyholders in the General Account will receive 100% of their claim in cash on a timely basis. (See S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 187, 191, 199-200; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 59-60.) The surplus notes are worth only pennies on the dollar. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 61; *see also* ¶¶ 31-38 *infra*.)

26. Second, in the event that AAC as a whole is placed into delinquency proceedings under Chapter 645, the unsecured claims of policyholders in the Segregated Account may be subordinated to other AAC policyholder claims. The Segregated Account has no assets. Instead, to pay claims of policyholders in the Segregated Account, the Segregated Account will make demands for payment on AAC's General Account under the Secured Note and Reinsurance Agreement. (See Plan of Rehab., § 4.04(c); Secured Note, filed as Exhibit G to Plan of Operation, at 1-2; Aggregate Excess of Loss Reinsurance Agreement ("Reinsurance Agreement"), filed as Exhibit H to Plan of Operation, at 1-2.) Thus, the Plan transforms the policyholders' claims of the Segregated Account (Class 3) into unsecured contract claims by the Segregated Account against the General Account (Class 5). At the same time, loss claims of policyholders remaining in the General Account would receive Class 3 treatment.

27. Third, claims of policyholders in the Segregated Account are subordinated to claims of other AAC policyholders and creditors because of an on-going delay in payment. Because the General Account is not in delinquency proceedings, unsecured creditor and policyholder claims against the General Account may be paid on a timely basis in full whereas policyholders in the Segregated Account are to be paid in large part in surplus notes, which may or may not be paid at some point in the future. (S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 62, 83; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 68-69.)

28. Fourth, if AAC's statutory surplus falls below \$100 million, or such other amount as determined by OCI, AAC's obligations under the Secured Note and Reinsurance Agreement will effectively disappear. (Secured Note, at 3; Reinsurance Agreement, at 2.) As a result, Segregated Account policyholders would no longer have recourse to assets in the General Account even though General Account policyholders, general creditors, and AAC's shareholder could still look to AAC's remaining assets to satisfy their claims.

29. In preferring General Account policyholders and creditors over Segregated Account policyholders, the Plan is unauthorized by law.

**The Plan violates Wisconsin Statute § 645.68 by permitting AAC's shareholder to retain its equity interest and permitting AAC to transfer value to its shareholder while policyholders in the Segregated Account have impaired claims.**

30. Wisconsin Statute § 645.68 creates a rule of absolute priority, requiring that "every 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."

31. Under the Plan, policyholders in the Segregated Account with permitted claims will receive 25% of their permitted claim in cash and 75% of their claim in surplus notes. (Plan of Rehab., §§ 1.08, 1.62, 4.04.) The evidence adduced in these proceedings supports a finding that the surplus notes are worth less than their full value, and there is at least a substantial likelihood that Segregated Account policyholders' claims will not be paid in full while general creditors, policyholders, and AAC's shareholder will have access to the value in the General Account.

32. First, in three of the four projected financial results submitted by the Rehabilitator, policyholders will not receive 100% recovery on their surplus notes. (Disc. St. at 66-68 (Scenario 1, 100%; Scenario 2, 85%; Scenario 3, 71%; and Scenario 4, 45%); Exs. D-G to

Disc. St.; and Amend. No. 1 to Disc. St.) In the one scenario (Scenario 1) in which policyholders may receive 100% of the value of their surplus notes, the Rehabilitator assumes the “realization of R&W Remediation recoveries in accordance with AAC’s estimates.” (Disc. St. at 66.) The Rehabilitator has expressly disavowed the accuracy and likelihood of AAC’s estimates of R&W Remediation recoveries, (S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 105-07 (OCI has always had a different opinion than AAC regarding remediation recoveries)), and has failed to submit any competent proof that such projected recoveries should be given any weight by the Court in evaluating the Plan. (S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 77 (agreeing that OCI’s financial projections are “inherently uncertain”); R. Peterson, Nov. 17, 2010 Hrg. Tr. at 56-57 (refusing to disclose OCI’s estimates).) Moreover, although the surplus notes on their face mature in June 2020, none of the four financial projection scenarios provided by OCI indicate that there will be sufficient claims paying resources to pay principal and interest due in 2020 – making it a virtual certainty that surplus noteholders will have to wait years beyond 2020 to receive even a portion of the amounts due on the surplus notes. (Disc. St. at Exs. D-G.)

33. Second, the scenarios themselves do not make allowances for payment of principal or interest on the surplus notes. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 66-67.)

34. Third, surplus notes are a subordinated loan to the General Account (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 226) and treated as equity for accounting purposes (*id.* at 212).

35. Fourth, the projected financial results are uncertain. (Disc. St. at ii; S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 77.)

36. Fifth, payments on the surplus notes are subject to approval by the Commissioner and may be extended until 2050 without Court approval. (Plan of Rehab., Ex. B (Form of

Surplus Note), at 1, 2, 7; S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 185; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 68-69.)

37. Sixth, surplus notes already issued by AAC, which OCI asserts will be *pari passu* with the surplus notes to be issued by the Segregated Account, are trading at “cents on the dollar.” (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 61.)

38. Accordingly, the Court finds that the value of the surplus notes to be issued by the Segregated Account likely will be less than 100% of the face amount of principal and interest of such surplus notes; and, in fact, there may be no payments at all on the surplus notes. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 184.)

39. Despite the fact that Segregated Account policyholders with loss claims likely will not be receiving payment in full under the Plan, the Plan permits AAC’s shareholder to retain its equity interest in AAC, and the Plan contains no provisions to prohibit AAC from transferring dividends or other valuable assets to its shareholder, Ambac Financial Group, Inc. (“AFG”), while policyholders in the Segregated Account have claims that are impaired and surplus notes that remain unpaid. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 47-48; R. Peterson, Nov. 16, 2010 Hrg. Tr. at 226.)

40. In fact, the Rehabilitator has negotiated a non-binding term sheet with an ad hoc group of AFG bondholders whereby: (1) AFG will be allowed to utilize approximately \$4 billion of net operating losses (“NOLs”) attributable to AAC’s operations without paying consideration to AAC for AFG’s use of those NOLs; and (2) AAC may be required to pay AFG for the use of up to \$3.5 billion in NOLs generated by AAC, both of which violate OCI’s principled position that fairness requires that an insurer, in this case AAC, should be paid by its parent for use of NOLs attributable to AAC. (See Terms of Transaction attached to Nov. 7, 2010

Letter from S. Dilweg to AAC Board of Directors, Obj. Ex. 38B, at 2; *see also* R. Peterson, Nov. 17, 2010 Hrg. Tr. at 48-50.)

41. In addition, documents filed by AFG in its Chapter 11 bankruptcy proceedings pending in the Southern District of New York state that “[a]lthough AAC has been unable to pay dividends to [AFG] for several years and will be unable to pay dividends in 2010 absent special approval from OCI, which is not expected, *AAC is nevertheless a valuable asset.*” (Complaint for Injunctive Relief and Declaratory Judgment Determining Amount of Tax Liability at ¶ 15, *In re Ambac Fin. Group, Inc.*, Case No. 10-15973 (SCC) (Bankr. S.D.N.Y. Nov. 8, 2010), Docket No. 8 (emphasis added).) AAC is a valuable asset only if value can be upstreamed from AAC to AFG at some point in time. (*See id.* (“[t]he future value of AAC will primarily depend upon the performance of AAC’s insured portfolio (*i.e.*, the ultimate losses there in relative to its claims paying resources), ongoing remediation efforts of AAC with respect to the Segregated Account Policies, and other factors, including AAC’s ability to repurchase surplus notes at below face value.”).)

42. The failure of the Plan to preclude any payments or other transfers of value to the shareholder until policyholders and creditors are paid in full violates Wisconsin Statute § 645.68, which embodies the absolute priority rule and requires that no junior class of claims shall receive any payment before every claim in each senior class of claims is paid in full. The Plan is therefore unauthorized by law.

**The Plan violates Wisconsin Statute § 601.01(2) and the Wisconsin and United States Constitutions by failing to provide policyholders with at least liquidation value.**

43. Wisconsin Statute § 601.01(2) provides that one of the purposes of the Wisconsin Insurance Statutes is “[t]o ensure that policyholders, claimants and insurers are treated fairly and equitably.”

44. As this Court previously held, the phrase “fairly and equitably” means, among other things, “that policyholders must receive at least the liquidation value of their claims from a plan of rehabilitation.” Wis. Cir. Ct. Oct. 26, 2010 Decision, Dkt. 489, 10 CV 1576, at 14 (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) (policyholders must receive at least the liquidation value of their claims in a plan of rehabilitation)); *see also In re Executive Life Ins. Co.*, 38 Cal. Rptr. 2d 453, 480 (Cal. Ct. App. 1995) (“Indeed the modified plan here includes, as would any other rehabilitation plan, the mechanism by which a policyholder may account for his, her or its own peculiar circumstances. After weighing the benefits and risks, the policyholder may opt-out. In that event the policyholder receives the liquidated value of his, her or its contract rights without unreasonable delay, a process expressly validated by *Carpenter*.”); *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1093-94 (Pa. 1992) (“Under [*Carpenter*], creditors must fare at least as well under a rehabilitation plan as they would under a liquidation[.]”); *Grode v. Mut. Fire, Marine & Inland Ins Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990); (a rehabilitation plan must be viewed in light of the *Carpenter* rule that such plan may not give parties worse treatment than they would receive in liquidation); *Koken v. Fidelity Mut. Life Ins. Co.*, 907 A.2d 1149 (Pa. Commw. Ct. 2006) (court approved proposed rehabilitation plan after finding, among other things, that the plan gave policyholders at least as much as they would have received under a forced liquidation); NAIC, *Receivers Handbook for Insurance Company Insolvencies*, at 5, 448 (2009) (noting that a rehabilitation plan should not give policyholders and creditors worse treatment than they would receive in liquidation); 1 COUCH ON INS. § 5:29 (one who objects to a rehabilitation plan must receive “the liquidated value of his contract rights without any unreasonable delay”).

45. The Rehabilitator has failed to submit competent proof that, under the Plan, Segregated Account policyholders will receive at least a liquidation value. In violation of basic fairness and due process, the Rehabilitator failed to offer any liquidation analysis until after the close of business on the Friday immediately preceding the beginning of these Plan confirmation hearings. (See Amend. No. 2 to the Disc. St., filed Nov. 12, 2010.) The evidence demonstrates that the liquidation analysis beginning on page 6 of the Rehabilitator's Amendment No. 2 to the Disclosure Statement was prepared within the last couple of weeks before the commencement of the confirmation hearing by the Rehabilitator's unnamed financial advisors and legal staff, none of whom testified at the hearing. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 74-75.) The document was not even submitted by OCI—it was submitted by counsel—and no OCI witness was able to testify as to its detail. (See S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 241-42; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 74-75.) Mr. Peterson, who did testify, admitted that he did not work directly on the liquidation analysis. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 75.) The Rehabilitator's tardiness in providing the analysis and lack of detailed back-up information constitutes unfair surprise, and the Rehabilitator failed to introduce the appropriate foundation for the liquidation analysis. Accordingly, the liquidation analysis is stricken.

46. Moreover, and in the alternative, the Rehabilitator's liquidation analysis chart, which was prepared shortly before the confirmation hearing commenced, is insufficient and faulty in at least the following respects. (See J. Schacht, Nov. 19, 2010 Hrg. Tr. at 92.)

47. First, the liquidation analysis uses the wrong liquidation date. The appropriate liquidation valuation date is as of the Plan effective date. *Commercial Nat'l Bank in Shreveport v. Superior Court*, 17 Cal. Rptr. 2d 884, 900 (Cal. Ct. App. 1993) (reversing trial court order approving rehabilitation plan on the ground, among others, that liquidation value must be

determined as of plan effective date, rather than petition date); *see also* 11 U.S.C. § 1129(a)(7) (requiring that creditors receive as much under a Chapter 11 reorganization plan as of the plan effective date as such creditors would if the debtor were liquidated on such date); *In re PMP II, LLC*, No. 10-30252-HDH-11, 2010 WL 3291838, at \*4 (Bankr. N.D. Tex. Aug. 17, 2010); *In re CIT Group Inc.*, No. 09-16565 (ALG), 2009 WL 4824498, at \*9 (Bankr. S.D.N.Y. Dec. 8, 2009); *In re SAI Holdings Ltd.*, No. 06-33227, 2007 WL 927936, at \*8 (Bankr. N.D. Ohio Mar. 26, 2007) (“the date on which the court determines the best interests of creditors is the effective date of the plan”).

48. Here, the Rehabilitator submitted a liquidation analysis as of March 24, 2010—the commencement date of these rehabilitation proceedings. (Amend. No. 2 to Disc. St. at 8; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 75-76.) However, since that date, the Bank Group Settlement was finalized and consummated, which resolved the single largest exposure facing AAC. (*See* First Affidavit of Roger A. Peterson, dated May 19, 2010, at 19 (explaining that the ABS CDO exposures were likely to experience the greatest losses of all Ambac exposures).) The liquidation analysis does not reflect the economics of the bank settlement. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 81.) The Rehabilitator has taken the position that the Bank Group Settlement cannot be unwound (*see* Rehabilitator’s Supplementations to October 8, 2010 Disclosure Statement in Support of Confirmation of the Rehabilitator’s Plan of Reorganization (Written Responses to Written Questions), filed Nov. 12, 2010, at 19); therefore, any valid liquidation analysis must take into account the economics of the settlement—both as to decreased liabilities (at least \$12.9 billion) and decreased claims paying resources (\$2.6 billion in cash paid pursuant to the settlement). In addition, the amount of loss claims from policies in the Segregated Account increased. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 207-08.) The

Rehabilitator simply has failed to present any valid liquidation analysis as of the Plan effective date and taking these significant developments into account. Indeed, OCI's own witness admitted that OCI had not prepared a liquidation analysis as of any point in time after March 24, 2010. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 76.)

49. Second, the claims paying resources used for the liquidation analysis fail to include more than \$3 billion of potential assets. The liquidation analysis does not include recoveries from remediation claims relating to RMBS policies, which AFG has recently estimated at \$2.3955 billion. (Amend. No. 2 to Disc. St. at 6-8; AFG Q3 2010 Quarterly Operating Supplement, at 4.) The liquidation analysis also does not include Ambac UK's claims paying resources of \$1 billion, "which will be available to AAC only to the extent Ambac UK receives approval from its regulator to dividend monies to AAC." (Amend. No. 2 to Disc. St. at 6-8; AFG Q3 2010 Quarterly Operating Supplement, at 5; *see also* R. Peterson, Nov. 17, 2010 Hrg. Tr. at 218-19 (agreeing that OCI did not attribute any value to AAC's ownership of Ambac UK in the Disclosure Statement).) The Rehabilitator's deficient and untimely liquidation analysis failed to take into account these clearly material claims paying resources.

50. In addition, the Rehabilitator has failed to submit sufficient credible evidence regarding what policyholders and creditors in the Segregated Account will receive under the Plan. When asked whether he was directly involved in working on the creation of the projected financial recoveries, the only witness offered by the Rehabilitator for the values in the projected financial recoveries stated only that he was involved with the initial development of the models and was consulted periodically as the models evolved over time. (S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 217-18; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 65-66.) Mr. Peterson failed to establish sufficient knowledge of the projections submitted by OCI to lay a foundation or to establish any

credibility for these projections. The Rehabilitator's projected financial recoveries also do not make adjustments for base case or stress case impacts on AAC's claims paying resources. (R. Peterson, Nov. 17, 2010 Hrg. Tr. at 136; S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 77 (agreeing that OCI's financial projections are "inherently uncertain"); *see also* S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 106 (remediation recoveries could be anywhere from \$60 million to \$2 billion).)

51. Moreover, the value of the surplus notes will likely be far less than 100% of the face amount of principal and interest of such notes; and, in fact, there may be no payments at all on the surplus notes. (*See* ¶¶ 31-38 *supra*.)

52. Because there has been no showing that Segregated Account policyholders will receive at least their liquidation value under the Plan, the Plan is unlawful. Moreover, the Plan fails to provide that policyholders may opt out of the Plan and receive the liquidation value of their claims, which might cure this infirmity.

**The Plan allocates assets to AAC's General Account without fair consideration in violation of Wisconsin Statute § 611.24(3)(h).**

53. Wisconsin Statute § 611.24(3)(h) requires that an insurer provide fair consideration when it transfers assets from a segregated account to other accounts within the corporation.

54. Section 4.04(g) of the Plan permits the Rehabilitator to divert to AAC all recoveries, reimbursements and other payments, and any assets to which the Segregated Account is entitled in its capacity as insurer of the underlying policies. (Plan of Rehab., § 4.04(g); *see also* R. Peterson, Nov. 17, 2010 Hrg. Tr. at 232.)

55. Section 4.04(h) of the Plan permits the Rehabilitator to divert to AAC all subrogation rights of policyholders in the Segregated Account upon receipt of any payment with

respect to a Permitted Policy. (Plan of Rehab., § 4.04(h); see also R. Peterson, Nov. 17, 2010 Hrg. Tr. at 62.)

56. No evidence has been offered to demonstrate that the Segregated Account has received or will receive any consideration in exchange for the transfers permitted under Sections 4.04(g) and 4.04(h) of the Plan.

57. In addition, under Section 4.04(h), the assignment of subrogation rights to AAC will permit AAC to recover 100% of the cash due from the primary obligor even if the Segregated Account policyholder does not receive 100% of its recovery in cash. (See R. Peterson, Nov. 17, 2010 Hrg. Tr. at 62-64.)

58. Section 4.04(h) therefore also violates the “made whole” doctrine because it permits AAC to exercise subrogation rights before Segregated Account policyholders have been made whole. See *Ruckel v. Gassner*, 2002 WI 67, ¶ 4, 253 Wis. 2d 280, 646 N.W.2d 11.

59. Sections 4.04(g) and 4.04(h) of the Plan are therefore unlawful.

**The Plan strips valuable assets from the Segregated Account in violation of Wisconsin Statute § 611.24(3)(b).**

60. Wisconsin Statute § 611.24(3)(b) requires that income and assets attributable to a segregated account must remain identifiable with the particular account and “[t]he income, gains and losses, whether or not realized, from assets attributable to a segregated account shall be credited to or charged against the account without regard to other income, gains or losses of the corporation.”

61. Under the Plan, all remediation *claims* related to policies in the Segregated Account were allocated to the Segregated Account. (Plan of Operation, § IV; Plan of Rehab., § 4.04(h).)

62. At the same time, all *recoveries* from the remediation claims and insurance premiums are credited to the General Account. (S. Dilweg, Nov. 15, 2010 Hrg. Tr. at 211; R. Peterson, Nov. 17, 2010 Hrg. Tr. at 54; Plan of Operation, § V; Plan of Rehab., § 4.04(h).)

63. The rehabilitation and Plan are therefore unlawful in that they separate remediation gains and insurance premiums associated with policies in the Segregated Account from the policies themselves, thereby failing to keep income and assets identifiable with the Segregated Account.

**In violation of Wisconsin Statute § 645.68, the Plan discriminates among policyholders in the Segregated Account by failing to provide for treatment of policyholder claims that arise after June 1, 2020.**

64. A rehabilitation plan may not create a sub-class of policyholders. *See* Wis. Stat. § 645.68.

65. The Plan does not address the treatment of permitted policy claims expected to arise after June 1, 2020 that cannot be paid in full. (Amend. No. 1 to Disc. St. at 1; R. Peterson, Nov. 16, 2010 Hrg. Tr. at 209-10 (admitting that “some revision to the Plan would be necessary” in order to account for claims arising after 2020); R. Peterson, Nov. 18, 2010 Hrg. Tr. at 21-22.)

66. In failing to provide for policyholders with claims expected to arise after June 1, 2020, the Plan violates Wisconsin Statute § 645.68 by creating a sub-class of policyholders in the Segregated Account.

**In the event of a liquidation, the Plan treats holders of Surplus Notes differently from other policyholders, in violation of Wisconsin Statute § 645.68.**

67. The form Surplus Note provides: “In a proceeding commenced under Chapter 645 of the Wisconsin Statutes, claims for interest on, principal of, or any redemption payment with respect to, the Notes constitute Class 10 claims under Section 645.48, as currently in effect.” (Plan of Rehab., Ex. B (Form of Surplus Note) at 11, ¶10(b).) Thus, in the event of any

liquidation of the Segregated Account, the basis for asserting a claim under a Surplus Note would be as a Surplus Note holder and not as a policyholder.

68. This potential subordination of a policyholder's payment priority from Class 3 (loss claims) to Class 10 (contribution notes) in the event of a liquidation of the Segregated Account violates Wisconsin Statute § 645.68 by creating a subclass of policyholders in the Segregated Account.

**The Plan contains overly broad and impermissible release, injunction, immunity, and indemnification provisions.**

69. Wisconsin Statute § 645.08(2) identifies the type and scope of releases that the Rehabilitator may grant, and he may not grant broader releases than provided for in that provision.

70. Under Wisconsin Statute § 645.05, any injunctive relief entered in connection with a rehabilitation must be "necessary and proper" for an appropriate and enumerated rehabilitative purpose.

71. Wisconsin Statute § 645.05 also limits this Court's ability to impose injunctive relief outside the borders of the State of Wisconsin.

72. Sections 8.01, 9.01, and 9.02 of the Plan contain broad release, injunction, immunity, and indemnification provisions that, among other things, prohibit suit against AAC's shareholder, AFG, enjoin policyholders outside of Wisconsin, and grant immunity and indemnification to a wide variety of individuals and entities, many of which are only peripherally related to these proceedings and are not subject to the jurisdiction of this Court.

73. No evidence has been offered to demonstrate that such broad releases, injunctive relief, and immunity and indemnification comply with the Wisconsin statutes and applicable law. OCI's witnesses were unable to address the release provisions. (*See* S. Dilweg, Nov. 15, 2010

Hrg. Tr. at 236-37 (stating he has not spent time on the issue of the releases and referring those questions to Roger Peterson); R. Peterson, Nov. 17, 2010 Hrg. Tr. at 72 (explaining that OCI relied on counsel to develop the language for the releases.)

74. Because the Rehabilitator does not have the authority to grant such broad releases, injunctive relief, and immunity and indemnification, those provisions are unlawful.

**The Plan proposes to treat creditors with claims under credit default swaps as policyholders in violation of Wisconsin Statute § 645.68.**

75. Under Wisconsin Statute § 645.68, claims for losses under insurance policies are entitled to Class 3 priority status, while claims of general creditors fall within Class 5.

76. The evidence is insufficient to show that, under Section 1.48 of the Plan, guarantees that AAC made on behalf of its non-insurance, non-regulated subsidiary (Ambac Credit Products) in connection with certain credit default swap agreements are to be treated as insurance policies subject to Class 3.

77. Moreover, insufficient proof has been offered to show that each credit default swap counterparty owns the security covered by each of its swaps, such that each counterparty would have an insurable interest under each of its swaps.

78. Thus, the Plan violates Wisconsin law by automatically affording credit default swap counterparties Class 3 priority status when they may be entitled only to Class 5 status.

**In contravention of the express intent of the Wisconsin Legislature, the Plan leaves management in control of the insurer.**

79. The Wisconsin Legislature has made clear that rehabilitation requires the replacement of a delinquent insurer's management with new decision-makers who have "the capacity to see what is wrong and the power to correct it." Wis. Stat. Ann. ch. 645, introductory cmts.

80. The Segregated Account has no employees of its own; instead, all employees who perform services for the Segregated Account are employed by the General Account. (*See* C. Matanle, Nov. 19, 2010 Hrg. Tr. at 25; S. Dilweg, Nov. 16, 2010 Hrg. Tr. at 37 (Segregated Account “uses the same officers [as AAC]”); R. Peterson, Nov. 18, 2010 Hrg. Tr. at 56 (“The Segregated Account doesn’t have employees directly”).)

81. The Plan provides for the retention of AAC’s management and the delegation to those officials of significant authority to implement the Plan. (Plan of Rehab., §§ 1.35, 3.04; Management Services Agr., § 1.01.) While the retention of individuals with institutional knowledge may be useful, those individuals should not be left in control of AAC management but rather under the control of the rehabilitator. (*See* J. Schacht, Nov. 19, 2010 Hrg. Tr. at 167-168.) The Plan here does not provide for OCI or the Rehabilitator to retain sufficient control over those responsible for implementing the Plan at AAC. (*See* R. Peterson, Nov. 17, 2010 Hrg. Tr. at 223-224; J. Schacht, Nov. 19, 2010 Hrg. Tr. at 199-200.)

82. The Plan is contrary to the Wisconsin rehabilitation statutes in that it retains those who contributed to AAC’s delinquency and charges them with implementing the Plan without sufficient control by the Rehabilitator and OCI.

**The Plan violates Wisconsin law by giving the Rehabilitator more discretion than granted by the Wisconsin Legislature.**

83. Wisconsin Statute § 645.33(5) requires that this Court approve any proposed rehabilitation plans.

84. The Plan nevertheless delegates to the Rehabilitator the “sole and absolute” discretion to do at least the following:

- determine whether indemnification agreements are commercially reasonable, so as to qualify as administrative claims (§ 1.04);

- determine whether an increase in the Cash Percentage and corresponding decrease in the Surplus Note Percentage of the cash/note split to be provided to Holders of Permitted Claims is equitable (§ 7.02);
- change the Determination Date (§ 1.16) and Payment Date (§ 1.40) on which Claims are evaluated and paid, respectively;
- determine Duplicate Claims (§ 1.21);
- determine whether a party filed a claim late due to excusable neglect (§ 1.32);
- amend proof of policy claim forms (§ 1.51);
- issue guidelines or further directions as may be necessary or appropriate to carry out the purposes and effects of the Plan (§ 3.02);
- determine whether alternative methods of claim resolution are equitable to the interests of policyholders (§ 3.06(a));
- determine whether administrative claims will be permitted (§ 4.03(b));
- determine the terms and conditions of the Surplus Notes (§ 5.01(a));
- determine whether conditions precedent to the Plan's effectiveness have been satisfied (§ 5.01(e)); and
- amend, alter, or modify the Plan until the confirmation date (§ 10.04).

85. The Plan is therefore unlawful in that it strips this Court of ability to provide the oversight and approval function required by Wisconsin Statute § 645.33(5).

Dated: \_\_\_\_\_

BY THE COURT

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