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STATE OF WISCONSIN : CIRCUIT COURT CIRCUIT COURT DANE COUNTY

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In the Matter of the Rehabilitation of:

DANE COUNTY, WI

Case No. 10-CV-1576

Segregated Account of Ambac Assurance Corporation

**BRIEF IN SUPPORT OF EMERGENCY MOTION TO ENJOIN
CONSUMMATION OF THE PROPOSED SETTLEMENT
BETWEEN AMBAC AND CERTAIN CDS COUNTERPARTIES**

Certain beneficial holders (the "LVM Bondholders")¹ of the Las Vegas Monorail Project Revenue Bonds (the "LVM Bonds"), municipal bonds which are supported by an insurance policy issued by Ambac Assurance Corporation ("Ambac"), respectfully submit this memorandum of law in support of their emergency motion to enjoin the consummation of the proposed settlement (the "CDS Settlement," or the "Settlement") between Ambac and a group of unidentified banks (the "CDS Banks") in connection with Ambac's obligations under guaranties of credit default swap agreements (the "CDS Guaranties") entered into by Ambac's subsidiary, Ambac Credit Products, LLC ("ACP"). For the reasons detailed below, the proposed Settlement could have a devastating impact on the rehabilitation of the Segregated Account of Ambac and cause irreparable harm to the rights of the LVM Bondholders and other policyholders whose policies have been allocated to the Segregated Account. The LVM Bondholders seek judicial relief on an emergency basis because the Insurance Commissioner of the State of Wisconsin (the "Commissioner"), Sean Dilweg, has indicated his intention to

¹ These holders are certain funds and accounts managed or owned by Eaton Vance Management, Nuveen Asset Management, Restoration Capital Management LLC, and Stone Lion Capital Partners L.P. The LVM Bondholders hold a majority of outstanding LVM Bonds.

authorize the implementation of the CDS Settlement immediately and without the prior approval of this Court.²

Preliminary Statement

Ambac recently announced that, with the involvement and approval of the Commissioner, it has entered into a Statement of Intent with undisclosed CDS Banks under which Ambac would immediately pay the CDS Banks \$2.6 billion in cash and issue \$2 billion in surplus notes. The full details of the transaction have not been disclosed. However, based on the Commissioner's filings in this Court and Ambac's most recent Form 10-K, as well as recent communications with the Commissioner's counsel, the LVM Bondholders believe that Ambac is currently in the final stages of the transaction and could consummate the Settlement at any time.

This Court should enjoin the consummation of the CDS Settlement until the Court has had the opportunity to review and pass on the Settlement's merits. Such an injunction is warranted for at least two independent reasons.

First, the proposed Settlement requires the approval of this Court under Wis. Stat. § 645.33(2). The Commissioner has taken the position that, because the credit default swaps that are the subject of the proposed Settlement are obligations of and supported by Ambac's General Account, which is not in rehabilitation, he has no obligation to submit the proposed CDS Settlement for review and approval by the rehabilitation court. The Commissioner is mistaken. As we show below, the Cooperation Agreement between Ambac and the Segregated Account

² On April 30, 2010, a group of holders of residential mortgage-backed securities with policies issued by Ambac (the "RMBS Policyholders") filed an Emergency Motion to Modify the Order for Temporary Injunctive Relief (the "RMBS Motion"). The LVM Bondholders join in the RMBS Motion to the extent that it seeks to enjoin Ambac from entering into the CDS Settlement, and we adopt and incorporate the arguments contained in Point I of the brief filed by the RMBS Policyholders in support of their motion. The LVM Bondholders take no position at this time with regard to the arguments contained on pages 23 through 29 of the RMBS Policyholders' brief, concerning the creation and composition of the Segregated Account. The LVM Bondholders reserve the right to file a separate motion regarding those issues.

requires the consent of the Segregated Account to the proposed CDS Settlement, and the Commissioner, as rehabilitator of the Segregated Account, lacks the authority under section 645.33(2) of the Wisconsin rehabilitation statute to consent to this extraordinary transaction on behalf of the Segregated Account without court approval.

The need for court review of the CDS Settlement could not be clearer. The proposed CDS Settlement, if approved, would deplete Ambac's assets by more than a third, thereby severely compromising Ambac's ability to make payment on its \$2 billion note (the "Secured Note") that constitutes the Segregated Account's primary asset. In so doing, the proposed Settlement would jeopardize the Segregated Account's prospects for successful rehabilitation. At the same time, the proposed CDS Settlement would turn Wisconsin's well-established priority rules on their head. It would treat the claims of the CDS Banks more favorably than those of Ambac's policyholders, despite the likelihood that full disclosure would reveal that the CDS Banks are entitled to *lower* priority than policyholders.

Second, even if judicial review of the proposed CDS Settlement were not required by the plain terms of Wisconsin's statute, this Court would still have ample grounds to enjoin consummation of the Settlement pending court review, by means of an appropriate modification of the Order for Temporary Injunctive Relief, dated March 24, 2010 (the "Temporary Injunction"). The Temporary Injunction expressly contains numerous provisions that restrain *creditors* from taking actions that would deplete the Segregated Account's assets or otherwise interfere with its rehabilitation. In its current form, however, the Temporary Injunction would permit *Ambac* to achieve the same result – a depletion of the value of the Segregated Account's principal asset (the Secured Note) through the diversion of billions of dollars to improperly preferred creditors (the CDS Banks). To protect the rehabilitation from being jeopardized in this

fashion, the Court should modify the Temporary Injunction to enjoin consummation of the proposed CDS Settlement pending judicial review.

Statement of Facts

Ambac

Ambac is a Wisconsin-domiciled financial guaranty company whose traditional business was to insure municipal bonds. Historically, Ambac had AAA financial strength ratings. (Ambac Financial Group, Inc. Form 10-K for the year ended December 31, 2009, filed Apr. 9, 2010, at 3, annexed as Exhibit A to the Affidavit of Bryan K. Nowicki in Support of Motion to Modify Order for Temporary Injunctive Relief Filed by Certain RMBS Policyholders (the “Nowicki Aff.”), dated April 30, 2010.) Recently, Ambac began to guaranty “riskier” and “more speculative” structured finance obligations, including residential mortgage-backed securities, collateralized debt obligations of asset backed securities, and credit default swaps. (Commissioner’s Brief in Support of Entry of Order for Rehabilitation (“Rehabilitation Brief”), dated Mar. 24, 2010, at 3, 15, 17.) As it did to other major financial institutions, Ambac’s investment in these riskier products has proven fatal for Ambac. In 2007 and 2008, as these investments began to implode, Ambac’s projected future liabilities grew, resulting in dangerous capital shrinkage. This peril was a principal reason for the commencement of the rehabilitation proceedings. (*Id.* at 2.)

The LVM Bondholders and the LVM Bond Policies

The LVM Bonds are municipal bonds that were issued in 2000 by the Director of the State of Nevada Department of Business and Trust to finance the construction of a four-mile monorail system in downtown Las Vegas. Ambac issued a municipal bond insurance policy (the “LVM Bond Policy”) that insures the payment of all principal and interest due and owing on the

LVM Bonds. When issued, Standard & Poors, Moody's and Fitch IBCA assigned triple-A ratings to the LVM Bonds.

Most of the LVM Bonds were purchased and are held by retail investors or mutual funds. Due to their triple-A rating, the LVM Bonds were believed to be a conservative municipal bond investment appropriate for college or retirement savings accounts and were widely held for those purposes, either directly or through mutual fund accounts. (*See* Declaration of Gavin Wilkinson in Support of Motion of Wells Fargo Bank, National Association, to Modify Temporary Injunction and to Intervene, dated Apr. 5, 2010, ¶ 7.)

Las Vegas Monorail Corporation ("LVMC"), which owns and operates the monorail, filed a voluntary petition for bankruptcy on January 13, 2010. The LVM Bonds are currently in payment default. The main source of repayment for these bonds is expected to be Ambac, through its obligations under the LVM Bond Policy.

Ambac has insured a current outstanding amount of LVM Bonds of more than \$500 million.³ Ambac estimates that its total exposure under the LVM Bond Policy is now approximately \$1,163,435,771.15, minus any payments of principal and interest made by LVMC. (*See* Declaration of Scott Zuchorski in Support of Motion of [Ambac] for Dismissal of Chapter 11 Proceeding, dated January 13, 2010, ¶ 13, annexed to the accompanying Affidavit of Noreen J. Parrett (the "Parrett Aff.") as Exhibit A.)

The Creation of the Segregated Account and the Commencement of Rehabilitation Proceedings

On March 24, 2010, the Commissioner announced that Ambac, with the Commissioner's approval, had created the Segregated Account pursuant to Wis. Stat. § 611.24

³ The amount of the LVM Bonds outstanding continues to increase because approximately \$99 million of the original issuance are "capital appreciation" bonds. That is, holders of these bonds do not receive any cash interest over the life of the bonds, but rather interest continues to accrue in kind until maturity.

and had allocated to that account certain policies and other liabilities that were considered to have “material projected impairments,” such as residential mortgage-backed securities, collateralized debt obligations, and credit default swaps that are not held by the CDS Banks. (Rehabilitation Brief at 3-4.)

The LVM Bond Policy was also allocated to the Segregated Account. It appears that the LVM Bond Policy is the *only* municipal bond insurance policy that Ambac has allocated to the Segregated Account.⁴

The Segregated Account’s assets consist of (1) the \$2 billion Secured Note issued by Ambac and (2) an aggregate excess-of-loss reinsurance policy issued by Ambac to reinsure the liabilities of the Segregated Account. The reinsurance policy appears to be a “last dollars out” policy that is effectively subordinated to the other obligations of Ambac. Ambac states that the net par exposure allocated to the Segregated Account is approximately \$68 billion. (Nowicki Aff. Ex. A at 4.)

Simultaneously with the creation of the Segregated Account, the Commissioner commenced rehabilitation proceedings with regard to the Segregated Account by filing a Verified Petition for Order of Rehabilitation dated March 24, 2010 (the “Petition”). The Commissioner himself has admitted that the Segregated Account has insufficient assets to pay the claims under the policies that have been allocated to it: The Commissioner has announced that the claims allocated to the Segregated Account will be paid approximately 25% of their

⁴ On April 5, 2010, Wells Fargo Bank, N.A., as indenture trustee of the LVM Bonds, filed a motion arguing that (1) the transfer of the LVM Bond Policies to the Segregated Account without notice was an ineffective novation under Wisconsin law, (2) the Segregated Account is a nullity because it is not adequately capitalized as required by Wis. Stat. § 611.24(3), (3) the Commissioner exceeded his statutory authority by creating the Segregated Account prior to placing Ambac in rehabilitation, and (4) the Commissioner violated the United States and Wisconsin Constitutions by taking the LVM Bondholders’ property without providing just compensation or due process, and by improperly treating the LVM Bondholders differently from the other municipal bondholder insureds. The LVM Bondholders take no position at this time on these issues, and reserve the right to file a separate motion addressing these issues.

claims in cash, and may be issued “surplus notes” by Ambac for the remainder. (See Andrew Frye and Jody Shenn, *Ambac Clients May Receive 25 Cents on Dollar in Cash*, <http://www.businessweek.com/news/2010-03-25/ambac-clients-may-receive-25-cents-on-dollar-in-cash-update1-.html> (quoting a Mar. 25, 2010 telephone interview with the Commissioner).)

The Commissioner has failed to give the LVM Bondholders any information that would allow them to verify the stated value and likelihood of such recoveries.

The Plan of Operation for the Segregated Account provides that the General Account of Ambac will continue to remain closely intertwined with the affairs of the Segregated Account. (Petition, Tab 1.) Ambac is the “Management Services Provider” for the Segregated Account pursuant to a Management Services Agreement. (Petition, Tab 1, Ex. A.) In addition, Ambac and the Segregated Account have entered into a Cooperation Agreement, which “addresses, as between the General Account and Segregated Account, specified issues pertaining to decision making and shared authority, information sharing, tax compliance, allocation of expenses, confidentiality, and other specified topics.” (Petition ¶ 8(a) & Tab 1, Ex. B.) The Cooperation Agreement sets forth the parties’ intent to “consult ... and cooperate with each other in good faith, to make all determinations or decisions relating to any action vote, or grant any consent or exercise any right . . . that is reasonably likely to have a material effect upon the assets and/or liabilities of Ambac.” (Petition, Tab 1, Ex. B § 1.01.) Most important, the Cooperation Agreement requires Ambac to obtain the consent of the Segregated Account for any transaction with any third party involving consideration in excess of \$5,000,000, other than ordinary-course payments of policy claims. (*Id.* § 1.02.)

The Petition states that the Commissioner has “met extensively over many months with Ambac and its advisors, [and] with various policyholders and groups of policyholders . . . in

regard to possible restructuring plans for the company.” (Petition ¶¶ 7-8; *see also* Press Release, Media Advisory Wisconsin Insurance Commissioner Statement Regarding Ambac Assurance Corp., available at <http://oci.wi.gov/pressrel/0310ambac.htm>, stating that the Commissioner was “work[ing] closely with all interested parties.”) Unfortunately, however, it appears that the CDS Banks were the principal – and perhaps the only – parties with whom the Commissioner conducted negotiations before the commencement of these proceedings. To date, there has been no evidence of serious discussions with the LVM Bondholders or any other party holding obligations supported by financial guaranties issued by Ambac. In their recently-filed motions in this proceeding, both Wells Fargo, as indenture trustee for the LVM Bondholders, and the RMBS Policyholders have indicated that they, too, first learned of the actions taken by Ambac and the Commissioner with respect to their policies on March 25, 2010, when the plan was announced to the public.

The Proposed CDS Settlement

Simultaneous with establishing the Segregated Account and putting it into rehabilitation, on March 24, 2010, Ambac reached a “non-binding” agreement with the CDS Banks to enter into the CDS Settlement. (Ambac Financial Group, Inc. Form 8-K dated Mar. 25, 2010, at 5 (Nowicki Aff. Ex. B).) Because Ambac, as a state-regulated insurer, would not itself have been permitted to enter into CDS Contracts,⁵ which contemplate protection in the absence of insurable interests (*see* Point I.B. below), the CDS Contracts were entered into by ACP, with Ambac guaranteeing ACP’s payments to the CDS Banks. (Petition ¶ 4(a).)

⁵ Wis. Stat. Chapter 620 does not list investments in credit default swaps as permitted investments by insurance companies authorized to do business in Wisconsin. Other states have permitted insurers to use credit default swaps only for very limited purposes, primarily in hedging programs. *See, e.g.*, N.Y. Ins. Law § 1410; Cal. Ins. Code § 1211; Tex. Ins. Code §§ 424.201-424.218.

Many of the details of the CDS Settlement – including the identity of the CDS Banks, or how large of a percentage of Ambac’s overall CDS liability the CDS Banks hold, or what other Ambac-related liabilities (*e.g.*, obligations of Ambac’s parent) the CDS Banks may hold – have not been made public by the Commissioner or by Ambac. It appears, however, from the limited public disclosures, that the CDS Settlement would seriously undermine the prospects for a successful rehabilitation of the Segregated Account. Among other things, the CDS Settlement would:

- strip Ambac of \$2.6 billion of cash up front – *almost one-third of Ambac’s assets* (*see* Ambac Annual Statement for the year ended Dec. 31, 2009, at 2-3 (Nowicki Aff. Ex. D), stating that Ambac has assets of approximately \$8.5 billion and capital and surplus of over \$800 million);
- burden Ambac with a \$2 billion surplus note payable to the CDS Banks, with current interest payments. Because it has a scheduled maturity in 2010 and current interest payments, payments on the Surplus Notes could effectively come *ahead* of payments to the Segregated Account under the Secured Note, which matures in 2050 and will not make payments if the surplus remaining in the General Account were to fall below \$100 million. (Nowicki Aff. Ex. B at 5; Petition, Tab 1 Ex. G (Secured Note).)
- allow Ambac to continue to make dividend payments to its parent, Ambac Financial Group, Inc. (“AFG”), to allow AFG to service its debt and pay its operating expenses (Nowicki Aff. Ex. B at 7), notwithstanding Ambac’s prediction that the LVM Bondholders will receive no more than 25 cents in cash on the dollar for their claims; and

- impose numerous other limitations on Ambac, and indirectly on the Segregated Account. Among other things, the CDS Settlement would severely limit the ability of Ambac to resume underwriting, limit the terms of the surplus notes that can be issued by Ambac to creditors of the Segregated Account, and require Ambac to allow the CDS Banks to participate in certain restructuring transactions. (See Nowicki Aff. Ex. A at 6-9 & Ex. B at 7.)

The scant available information regarding the proposed CDS Settlement casts serious doubt on its fairness. Ambac's public filings indicate that the overwhelming bulk of the liabilities to the CDS Banks and other holders of CDS obligations are not due and payable for over twenty years. (See Parrett Aff. Ex. C at 17 (Ambac 2009 Quarterly Operating Supplement Q4).) Moreover, the reserves established by Ambac for all CDS obligations – which include obligations to parties other than the CDS Banks – reportedly total \$3.8 billion. (Nowicki Aff. Ex. D at 3, line 2302.) Yet the CDS Settlement contemplates the up-front payment of \$2.6 billion in cash, plus the issuance of \$2 billion in surplus notes. (Nowicki Aff. Ex. A at 6.) On the face of it, the Settlement with the CDS Banks would pay *more* than the reserved amount of their claims. (See Affidavit of Dan Gropper In Support of Motion to Modify Order for Temporary Injunctive Relief Filed by Certain RMBS Policyholders, dated Apr. 30, 2010, ¶ 19, estimating the value to be paid on the CDS at 67 percent of the present value of their claims.) In short, if the CDS Settlement is not enjoined, the CDS Banks would receive treatment more favorable than Ambac's policyholders are likely to receive – a reversal of Wisconsin's well-established priority rules, under which, as explained in Point I.B below, the CDS Banks are entitled to *lower* priority than Ambac's policyholders. Critically, the CDS Banks' claims, many

of which mature decades in the future, would be cashed out immediately, effectively further subordinating policy claims like the LVM Bondholders' claims, many of which mature sooner than the CDS claims.

It appears doubtful that this Court would approve the CDS Settlement as currently drafted. However, the Commissioner has stated to counsel for the LVM Bondholders that it does not intend to submit the CDS Settlement for approval to this Court.⁶ Moreover, despite repeated requests, neither Ambac nor the Commissioner will state when the CDS Settlement is to be consummated, or when the \$2.6 billion payment will be made. The LVM Bondholders therefore request that the Court act immediately to enjoin Ambac from consummating the CDS Settlement until the Court and the parties have had a full opportunity to review its terms.

Argument

THE COURT SHOULD ENJOIN CONSUMMATION OF THE PROPOSED SETTLEMENT BETWEEN AMBAC AND THE CDS BANKS

I. The Proposed Settlement Requires Court Approval Under the Cooperation Agreement and Wis. Stat. § 645.33(2)

The Segregated Account is not a party to the proposed CDS Settlement between Ambac and the CDS Banks. Nevertheless, the Settlement requires the consent of the Segregated Account under the terms of the Cooperation Agreement between the Segregated Account and Ambac. While the Commissioner, as rehabilitator of the Segregated Account, is empowered to

⁶ On March 25, 2010, in a televised broadcast with Bloomberg Business Reporting, the Commissioner stated that he intended to seek court approval of the CDS Settlement. (*Wisconsin's Dilweg Interview About Ambac Contracts*, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aMSYspxTFR.c>.) Yet his attorneys have indicated to us in two separate conversations that the CDS Settlement will *not* be submitted to the Court for review. There has been no explanation as to why the Commissioner negotiated a settlement with this group of CDS creditors and not others, nor is there any explanation for the Commissioner's change of heart with regard to seeking court approval for the CDS Settlement.

manage the affairs of the Segregated Account during the rehabilitation, his consent to this extraordinary transaction requires court approval under Wis. Stat. § 645.33(2), in light of the direct and significantly detrimental impact that the Settlement would have on the primary asset of the Segregated Account and on the Segregated Account's rehabilitation.

The Cooperation Agreement between Ambac and the Segregated Account provides, among other things, that:

Ambac shall not directly or indirectly enter into any transaction with, or use any asset or property of, any third party (including any affiliate, but excluding the Segregated Account) involving consideration or other proceeds in excess of \$5,000,000 (or such higher amount as determined by the Segregated Account) without the Segregated Account's prior written consent, which the Segregated Account may withhold or condition in its reasonable discretion; provided, however, that such consent shall in no event be required with respect to (A) the payment of policy claims in the ordinary course of business or (B) any investment made in accordance with Ambac's Investment Policy (as defined in the Secured Note).

(Petition, Tab 1 Ex. B § 1.02 (emphasis added).) Clearly, the CDS Settlement requires the Segregated Account's consent, since the Settlement involves vastly more than \$5,000,000 and is not a payment of policy claims in the ordinary course of business.

Equally clearly, the Commissioner, as rehabilitator of the Segregated Account, cannot give his contractually required consent to the Settlement without first seeking and obtaining the approval of the rehabilitation court. Wisconsin's rehabilitation statute expressly provides that the Commissioner's power to rehabilitate an insurer is subject to the Court's review and approval: "*Subject to court approval*, the rehabilitator may take the action he or she deems necessary or expedient to reform and revitalize the insurer." Wis. Stat. § 645.33(2) (emphasis added); *see also* Wis. Stat. § 645.32 (rehabilitation order "shall direct the rehabilitator to take

possession of the assets of the insurer and to administer them *under orders of the court*") (emphasis added).

Court supervision of a rehabilitator's actions is not a mere formality. To the contrary, it is a statutorily mandated check that ensures that the purposes of rehabilitation are served. Jurisdictions across the country agree that, "[d]espite the broad discretion generally afforded conservators, the powers which they exercise in the rehabilitation of insurance companies are subject to the control of the courts." 1 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 5:23 (3d ed. 2000); see also *Grode v. Mutual Fire, Marine & Inland Ins. Co.*, 572 A.2d 798, 804 (Pa. Commw. Ct. 1990) ("[T]he Rehabilitator's broad powers in these proceedings are circumscribed by this Court's mandate to act as a check on potential discretionary abuse and to insure equitable apportionment of loss."), *aff'd in part sub nom, Foster v. Mutual Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086 (Pa. 1992); *In re People ex rel Van Schaick*, 239 A.D. 490, 496, 268 N.Y.S. 88, 95 (1st Dep't 1933) ("The Legislature had the power to permit the superintendent of insurance to liquidate or rehabilitate such companies, but the extent to which that power shall be used must be supervised by the courts."), *aff'd*, 264 N.Y. 473 (1934).

To be sure, not every single action taken by a rehabilitator requires judicial review and approval. But the mandate of Wis. Stat. § 645.33(2) that a rehabilitator obtain "court approval" for "action he or she deems necessary or expedient to reform and revitalize the insurer" surely requires judicial approval for actions that go to the heart of a rehabilitation case – actions that potentially deplete an insurer's principal asset or imperil its prospects for a successful rehabilitation, or that determine the priority of payment among principal creditor

groups. Looked at from either perspective, it is hard to imagine a transaction that more clearly warrants judicial review than does the Commissioner's consent to the CDS Settlement.

A. The Proposed Settlement Would Jeopardize the Prospects for a Successful Rehabilitation

As discussed above, the CDS Settlement would have a potentially devastating impact on the Segregated Account. The primary asset of the Segregated Account is the \$2 billion Secured Note from Ambac. In a host of ways, the CDS Settlement would jeopardize the Segregated Account's ability to collect on that note: The Settlement would strip Ambac of \$2.6 billion of cash (almost one-third of its capital); it would burden Ambac with a \$2 billion surplus note payable to the CDS Banks, with current interest payments that might come ahead of payments to the Segregated Account under its own Secured Note; it would allow Ambac to continue to make dividend payments to its parent; and it would impose numerous other limitations on Ambac. (See pp. 9-10 above.) The Settlement would also increase the likelihood that Ambac's surplus capital would be reduced below \$100 million, thereby vitiating the value of the reinsurance agreement by Ambac in favor of the Segregated Account. In each of these ways, the CDS Settlement would diminish the value of the Segregated Account's assets and would imperil its prospects for a successful rehabilitation.

B. The Proposed Settlement Would Turn Wisconsin's Priority Scheme on its Head

There are, at a minimum, serious questions as to whether the claims of the CDS Banks should be subordinated to the claims of Ambac's policyholders. Depending on the underlying facts, the CDS Banks may not be entitled to policyholder priority under Wis. Stat. §

645.68(3) (“claims under policies for losses incurred”), but instead may only be general creditors under Wis. Stat. § 645.68(5).⁷

The CDS transactions were structured as credit default swaps entered into between the CDS Banks and ACP, a wholly owned subsidiary of Ambac. Ambac then issued a financial guaranty of these CDS transactions. If ACP did not have any substantial assets or financial viability, then these transactions were nothing more than disguised CDS with Ambac. Such transactions are not “insurance” and would clearly not be entitled to policyholder priority:

CDSs are not insurance for numerous reasons. Most significantly, there is no requirement that the protection buyer own the asset on which it is buying protection or that it suffer any loss. Other common features of CDSs that distinguish them from insurance include: (i) the absence of a requirement that the buyer provide proof of loss as a condition to payment; (ii) payment upon settlement that may be more than the loss (if any) suffered by the buyer; (iii) the absence of rights of subrogation; and (iv) differences in accounting, tax, bankruptcy and other regulatory treatment.

Brief of Amicus Curiae International Swaps and Derivatives Ass’n in Support of the Brief of Defendant-Appellant, 2006 WL 1517230, *Aon Financial Products v. Societe Generale*, 476 F.3d 90 (2d Cir. 2006) (internal citations omitted).

Even if Ambac’s subsidiary, ACP, did have financial viability of its own, it appears that the policies issued by Ambac were nothing more than guaranties of affiliate obligations (as opposed to insurance underwritten for independent parties), which would, ordinarily, not be entitled to policyholder priority either. It is unknown whether Ambac received a premium for its guaranty, or if it did, whether it was a market rate premium.

⁷ This debate concerns only actual pecuniary losses sustained by the CDS Banks. It is clear that any “mark-to-market” termination damages claimed by the CDS Banks beyond actual pecuniary losses would fall below even the general creditor priority level. See Wis. Stat. § 645.68(5) (“Claims, including those of any state or local governmental body, for a penalty or forfeiture, shall be allowed in this class only to the extent of the pecuniary loss sustained from the act, transaction or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby. The remainder of such claims shall be postponed to the class of claims under sub. (8).”).

Further, there is real doubt as to whether Ambac's guaranties of CDS contracts should be treated as policies under the receivership statute when the CDS Banks did not own the securities covered by the guaranteed CDS. Basic tenets of Wisconsin insurance law require the holder of an insurance policy to have an insurable interest in the property insured. Wis. Stat. § 631.07(1) ("No insurer may knowingly issue a policy to a person without an insurable interest in the subject of the insurance."). In the absence of such an interest, the insurance contract would not likely be entitled to policyholder priority.⁸ Moreover, Wis. Stat. § 645.68(3) grants priority status only to "claims under policies for *losses incurred*" – and a CDS Bank that does not own the security covered by the guaranteed CDS will not have suffered any actual loss. For both of these reasons, without review as to the CDS Banks' actual ownership of the underlying obligations, it will remain unknown whether their claims are entitled to policyholder priority.

If the CDS Banks do not have an insurable interest or do not have a loss within the meaning of the Wisconsin statute, they would not be entitled to the priority status accorded to policyholders. Instead, they would be entitled only to the lesser status accorded to general unsecured creditors – with the result that, if Ambac has insufficient assets to pay its policyholders in full, they would be entitled to no recovery at all in a rehabilitation or liquidation proceeding. *See* Wis. Stat. § 645.68 ("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.").

Consequently, the CDS Banks may very well be entitled to *less* favorable treatment than are the LVM Bondholders and other policyholders. Yet if the CDS Settlement is approved, the CDS Banks not only will escape their likely subordinate status but will be given

⁸ The Wisconsin statute does not declare the obligation invalid for lack of an insurable interest, but allows the court to redirect payments, *see* Wis. Stat. 631.07(4), clearly suggesting the subordination of such claims to policyholder claims.

superior treatment to the claims under the LVM Bond Policy. Such a result should not be permitted. At minimum, close judicial scrutiny, after full disclosure of all pertinent facts, is necessary.

II. The CDS Settlement Would Frustrate the Purpose of the Temporary Injunction under Wis. Stat. § 645.05(k)

The Temporary Injunction that was entered by the Court at the request of the Commissioner was based on the provisions of Wis. Stat. § 645.05(1), which empowers the Court to grant a temporary injunction in order to prevent “[a]ny . . . threatened or contemplated action that might lessen the value of the insurer’s assets or prejudice the rights of policyholders, creditors, or shareholders, or the administration of the proceeding.” Wis. Stat. § 645.05(1)(k). As the Commissioner explained, the Temporary Injunction is needed “to preserve the status quo, . . . to prevent catastrophic destruction of policyholder value and to provide the Commissioner adequate time to transition this troubled insurer to the stability of a court-approved rehabilitation plan.” (Brief in Support of Motion for Temporary Injunctive Relief, dated Mar. 24, 2010, at 1.)

The Temporary Injunction contains numerous provisions to restrain creditors from taking any steps that would deplete the Segregated Account’s assets or interfere with the rehabilitation of the Segregated Account. (*See, e.g.*, Temporary Injunction ¶¶ 4, 5, 7.) However, the Temporary Injunction, as currently drafted, imposes no reciprocal restraint on the actions of Ambac, even when, as here, its actions would have a direct and very substantial adverse impact on the value of the Segregated Account’s assets and its prospects for a successful rehabilitation. In these circumstances, the status quo that the Court sought to preserve by means of the Temporary Injunction will be frustrated unless the Temporary Injunction is modified to prohibit Ambac’s proposed Settlement with the CDS Banks – until such time as there has been adequate disclosure of the details of the transaction and the Court has had an opportunity to consider the

fairness of the Settlement to Ambac's policyholders and its impact on the rehabilitation of the Segregated Account.

III. The LVM Bondholders Are Entitled to Intervene in This Proceeding Under Wis. Stat. § 803.09(1)

The LVM Bondholders do not believe that their formal intervention in this proceeding is required. The present motion merely asks the Court to direct the Commissioner to comply with his statutory obligation to seek court approval of the CDS Settlement (Point I above) or, alternatively, requests a modification of the Temporary Injunction as expressly contemplated by paragraph 12 of that Order (Point II).

Nevertheless, if the Court were to determine that intervention is required, the LVM Bondholders request that they be permitted to intervene as of right under Wis. Stat. § 803.09(1). That statute provides that, "upon timely motion, anyone shall be permitted to intervene in an action when [A] the movant claims an interest relating to the property or transaction which is the subject of the action and [B] the movant is so situated that the disposition of the action may as a practical matter impair or impede the movant's ability to protect that interest, unless [C] the movant's interest is adequately represented by existing parties."

Each of these requirements is satisfied here. By virtue of their beneficial ownership of the LVM Bonds, the LVM Bondholders plainly have an "interest relating to the property or transaction which is the subject of the [proceeding]." Wis. Stat. § 803.09(1) (1994). Moreover, in light of the allocation of the LVM Bond Policy to the Segregated Account and the immediate threat that is posed by the CDS Settlement, it is clear that a "disposition of the [proceeding] may as a practical matter impair or impede [the LVM Bondholders'] ability to

protect that interest.” *Id.* Finally, in light of the Commissioner’s determination to proceed with the CDS Settlement despite the request of the LVM Bondholders that it be deferred pending court review, it appears that the LVM Bondholders’ interest is not “adequately represented” by the Commissioner. *Id.* The LVM Bondholders are therefore entitled to intervene as of right in this proceeding. *See M&I Marshall & Ilsley Bank v. Urquhart Cos.*, 287 Wis. 2d 623, 635 (Ct. App. 2005) (permitting creditor to intervene as of right in receivership proceeding where creditor had “an interest in ensuring that the receiver carries out his court-ordered and statutory obligations”).

Conclusion

For the reasons set forth above, the LVM Bondholders respectfully request entry of an Order:

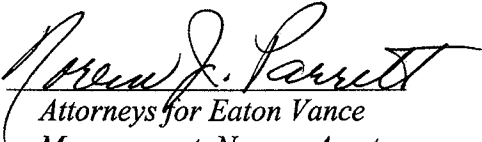
1. Pending the Court’s hearing on this emergency motion, immediately restraining and enjoining consummation of the proposed CDS Settlement;
2. Scheduling an emergency hearing at the soonest possible date to rule upon the relief requested herein;
3. Directing the Commissioner to submit the proposed CDS Settlement to the Court for review and approval, and restraining and enjoining consummation of that Settlement unless and until it is approved by the Court;
4. Alternatively, modifying the Order for Temporary Injunctive Relief dated March 24, 2010, to prohibit consummation of the proposed CDS Settlement unless and until it is approved by the Court;

5. If the Court deems it necessary, authorizing the LVM Bondholders' intervention as of right in these proceedings;
6. Granting expedited discovery concerning the proposed CDS Settlement, including the priority that would be given to the CDS Guaranties under Wis. Stat. § 645.68 (absent the Settlement); and
7. Granting such other and further relief as is just and proper.

Dated this 5th day of May, 2010.

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