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Wisconsin regulator's decision on Ambac illustrates key features of surplus notes as well as challenges faced by policyholders in rehabilitation proceedings.

With the news on June 1 that the Wisconsin Insurance Commissioner has blocked a surplus note payment by the segregated account of monoline insurer Ambac,¹ a brief survey of these types of instruments, as well as their particular use as a claims-paying currency in the Ambac rehabilitation, is instructive.

By way of background, surplus notes are a species of debt instrument that may be issued by insurance companies, usually pursuant to specific authorization in state insurance statutes. Surplus notes' legal characteristics vary slightly from state to state. However, in general, surplus notes are deeply subordinated instruments, senior only to equityholders in a liquidation, whose issuance is subject to regulatory approval in the insurer's domiciliary state. Proceeds of surplus notes are included in surplus of the insurer, rather than treated (as would be the case with other types of debt instruments) as a liability. In addition, each payment of interest and principal is subject to regulatory approval, often based on a finding that the insurer's surplus after the particular payment will be sufficient to support policyholder obligations. Upon an event of default under a surplus note, a holder's remedies are extremely limited, and covenants are minimal. By contrast, in a typical debt security, such as a senior note or a subordinated note, a holder can enforce various affirmative and negative covenants and, in a default situation, accelerate the debt. Because of these and various other features of surplus notes, they are regarded for some purposes as quasi-equity and are frequently well suited for mutual insurers, which by definition cannot raise capital by issuing shares.

Because interest and principal payments are expressly subject to regulatory approval under the terms of a surplus note, the noteholder bears the risk that the regulator may block any given payment as being too detrimental to surplus. Under such circumstances, interest continues to accrue, but under the note the holder has no right of action against the insurer for the missed payment *per se*. A holder's only remedy concerning the surplus-adequacy decision would be to challenge the regulator's determination. Typically, no detailed procedure is set out in the relevant surplus note statute either for the regulator's approval determination or for any challenge thereto. One potential avenue would be available under state statutes specifically authorizing challenges to decisions of state agencies, such as actions under Article 78 of New York's Civil Practice Law and Rules. Frequently such statutes require a determination that the agency's decision is arbitrary and capricious or an abuse of discretion.

¹ "Ambac barred from paying interest on surplus note", WSJ Online, June 1, 2011, available at <http://online.wsj.com/article/BT-CO-20110601-715799.html>.

By the same token, following a denial of approval for a payment, the terms of the note itself often impose an obligation on the *issuer* to obtain a reversal of such decision. In typical language, the issuing insurer agrees to

... use its best efforts to obtain the approval of the [regulator] ... for the payment by the Issuer of interest on and principal of the Notes on the scheduled payment dates or scheduled maturity dates thereof, and, in the event any such approval has not been obtained for any such payment at or prior to the scheduled payment date or scheduled maturity date thereof, as the case may be, to continue to use its best efforts to obtain such approval promptly thereafter.

Although we are not aware of any case construing such a requirement in a surplus note context, based on the language quoted above, the issuer presumably is not permitted simply to say to its investors after a disapproval of a payment, "sorry, we tried." It must continue to take active steps to obtain approval. Typically, surplus notes do not specify what specific actions this requirement may encompass, and this may raise issues. One may fairly ask whether a "best efforts" standard implies substantive, as opposed to merely procedural, efforts. If the insurer knows that it could lawfully take some affirmative step to generate additional capital, such as by releasing certain reserves within the parameters of the relevant actuarial guidance, could it be compelled to take such a step in order to change the regulator's mind? Is the insurer required to present evidence supporting its surplus adequacy? And, if it came to this, what would it take to persuade a court that a regulator's decision was an abuse of discretion?

One 2004 surplus note that has come to our attention apparently does not contain *any* efforts standard. The issuer's only significant obligation in this regard is to "seek" approval for payment in writing (and to notify holders, through the insurer's fiscal agent, of any disapproval). Such lack of an efforts standard would appear to be far more favorable to the insurer than the preponderance of notes we reviewed, in which the insurer must exercise best efforts. In the 2004 note described above, the holder would have no remedy against the insurer on the missed payment and would effectively be limited to challenging the regulator's determination.

Ambac's experience raises other interesting issues. In 2010, the Wisconsin regulator approved the establishment by Ambac of a "segregated account" as authorized under Wisconsin insurance law. The segregated account functionally acts like a company-within-a-company for purposes of Ambac's rehabilitation proceeding, with the assets attributable to the segregated account not chargeable with liabilities arising out of Ambac's other business and *vice versa*.² On the same day that the segregated account was established, the Wisconsin Commissioner petitioned the Wisconsin Circuit Court for Dane County to place it into rehabilitation under Wisconsin insurance law.³ The Court did so and named the Commissioner as the segregated account's rehabilitator. In connection with such proceeding, the segregated account has settled or otherwise resolved certain of its policy liabilities for consideration consisting of cash and surplus notes.⁴ It was these surplus notes as to which the Commissioner blocked an interest payment on June 1.

² Wis. Stat. §611.24(3).

³ "Report on the Rehabilitation of the Segregated Account of Ambac Assurance Corporation" pp. 1-2, *In the Matter of the Rehabilitation of Segregated Account of Ambac Assurance Corp.*, Case No. 10 CV 1576 in Wisconsin Circuit Court for Dane County, June 1, 2011.

⁴ *Id.*, p. 10.

Unlike surplus notes in a capital markets context (in which terms are commercially negotiated between an issuing insurance company and a securities firm or firms underwriting the notes), the Ambac segregated account surplus notes were fashioned by the regulator as part of the rehabilitation proceeding and did not involve negotiation. As a result, the notes deviate in key respects from surplus notes negotiated between commercial parties. These surplus notes, in other words, are essentially a vehicle through which the Wisconsin regulator has arranged for Ambac to defer a portion of certain of its claims by substituting a subordinated obligation for cash. Similarly, two other anomalies are found in the Ambac segregated account surplus notes:⁵

- There is no clause providing for an efforts standard. This could be because the person with the authority to act for Ambac, *i.e.*, its rehabilitator, is the same individual as the person whose approval is required, *i.e.*, the Commissioner, albeit acting in distinct capacities, and the regulator would not want to, essentially, impose a burden on himself to seek approval. This reflects the unilateral, non-commercial nature of these notes.
- No standard is provided for determining approval. Surplus notes issued under the laws of other states contain guidelines, albeit sometimes vague ones, for approving payments. Consider, for example, surplus notes of New York-domiciled insurers, which incorporate New York Insurance Law Section 1307. Such provision prescribes that the superintendent may approve payment on a surplus note "whenever, in his judgment, the financial condition of such insurer warrants." Or consider Nebraska provisions incorporating Revised Statutes of Neb. Section 44-221, which requires that payment may be approved only when surplus is double the amount of the payment applied for and only when the director of insurance has determined surplus "adequate" pursuant to the standards of the Nebraska insurance holding company act. (These standards include, among others, a consideration of surplus in relation to the insurer's size and diversification and types of risks covered.) Wisconsin, by contrast, does not appear to have a specific surplus note statute for stock companies.

Consequently, holders of Ambac policies receiving surplus notes in partial satisfaction of their claims received, in lieu of cash, Ambac obligations ranking junior to their pre-existing obligations, *i.e.*, their policies. Such outcome was not determined in a negotiated context but rather the "rough justice" of the rehabilitation court. Because of the unilateral nature of the Ambac notes in connection with its ongoing rehabilitation, it seems unlikely that these features will have ramifications for surplus notes generally in the capital markets context, but observers of the Ambac saga will certainly be staying tuned to see how the segregated account's surplus notes fare over time.

⁵ See Exhibit D, "Form of Junior Surplus Note," to Plan of Rehabilitation of Ambac Assurance Corp., Case No. 10 CV 1576 in Wisconsin Circuit Court for Dane County, confirmed January 24, 2011.

For More Information

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