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HEARING DATE AND TIME:
March 13, 2012 at 11:00 a.m.

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	:	
	:	Chapter 11
AMBAC FINANCIAL GROUP, INC.,	:	Case No. 10-15973 (SCC)
	:	
Debtor.	:	

AD HOC GROUP OF EQUITY SECURITY HOLDERS' OBJECTION TO THE THIRD AMENDED PLAN OF REORGANIZATION OF AMBAC FINANCIAL GROUP, INC.

TO THE HONORABLE SHELLEY C. CHAPMAN,
UNITED STATES BANKRUPTCY JUDGE:

The informal Ad Hoc Group of Equity Security Holders (the "Equity Group")[1] of Ambac Financial Group, Inc. ("AFGI" or the "Debtor"), through its attorneys DiConza Traurig Magaliff LLP, objects to confirmation of the Third Amended Plan of Reorganization of Ambac Financial Group, Inc. (the "Plan").[2] In support of this objection, the Equity Group respectfully states:

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1 The Equity Group was formed on or about December 1, 2011 and DiConza Traurig Magaliff LLP was retained as counsel for the Equity Group on December 30, 2011. Contemporaneously with this Objection, DiConza Traurig Magaliff LLP is filing a Verified Statement Pursuant to Federal Rule of Bankruptcy Procedure 2019. On or about February 29, 2012 certain individual shareholders filed objections to confirmation of the Plan. DiConza Traurig Magaliff LLP does not represent any of the individual shareholders, although many of them are members of the Equity Group.

2 By agreement with the Debtor and the Creditors' Committee, the Equity Group's time to object was extended through March 2, 2012.

Preliminary Statement

1. The Equity Group has recently retained NHB Advisors, Inc. ("NHB") as its financial advisors to analyze the Debtor's hypothetical liquidation valuation and financial projections to determine if the Plan meets the "best interest of creditors" test and is fair and equitable. NHB has identified several critical areas of concern that call into question the validity of the financial analyses upon which the Debtor proffers confirmation. The Equity Group and NHB have requested additional information from the Debtor and the Debtor's financial advisors at Blackstone to assist in their analysis and evaluation of (a) whether the Plan improperly wipes out equity while giving billions of dollars of value to creditors and (b) whether equity would receive more in a liquidation.

2. As set forth below, based upon NHB's preliminary analysis, the Equity Group has significant concerns that the Debtor is being undervalued both on an enterprise and liquidation value basis and that the Plan is not confirmable under section 1129(b) of the Bankruptcy Code.[3] Moreover, the Plan as proposed cannot be confirmed over the objection of equity holders because the Plan contains impermissible third-party releases which members of the Equity Group have not consented to and for which they are receiving no consideration.

3. This objection by the Equity Group should not come as a shock to the Debtor or creditors because the Second Amended Disclosure Statement of Ambac Financial Group, Inc. (the "Disclosure Statement") filed with the Court on September 30, 2011 expressly stated in its discussion of risks of the Plan that "[c]ertain Holders of Equity Interests in the Debtor may express dissatisfaction with the proposed Plan and

[3] NHB has prepared its preliminary analysis based on readily available public information and in a short time period. NHB continues to review and analyze available information. Accordingly, the Equity Group reserves its right to amend this objection to reflect NHB's most current analysis.

the Options contained therein. … It is possible that such actions could lead to modifications to the Plan." Disclosure Statement at p. 124. Moreover, counsel for the Equity Group and NHB have had several discussions with counsel for the Debtor and the Creditors' Committee and their professional and financial advisors about these issues. On multiple occasions the Disclosure Statement expresses concerns that any alternative to confirmation of the Plan would result in different recoveries for Holders of Allowed Claims and Equity Interests – even though equity is being wiped out. *See, e.g.,* Disclosure Statement at pp. 3, 112.

4. The Debtor maintains that its enterprise value is not sufficient to satisfy unsecured claims and that equity would receive no distribution in liquidation. However, as of today the Debtor has not filed its SEC Form 10-k for 2011 and there is significant likelihood that the financial data set forth in the Disclosure Statement is stale. Moreover, the Debtor admits that "[d]ue to the speculative nature of the sources of value and uncertainty surrounding the outcome of certain value enhancing contingencies, the actual post-Confirmation going concern value for the Reorganized Debtor may be significantly higher or lower than the Reorganized AFG's Estimated Enterprise Value. …" Disclosure Statement at p. 95. While creditors may have voted in favor of the Plan, equity has not consented to providing unsecured creditors with all of the upside if the post-confirmation value of the Debtor is significantly higher.

5. The Debtor represented that the Reorganized Debtor's enterprise value would be "between $145 million to $225 million … as of December 31, 2011 … based on information available to, and analyses undertaken by, Blackstone as of August 21, 2011" and that "[i]t should be understood that, although subsequent developments may affect Blackstone's conclusions, Blackstone does not have any obligation to update, revise or reaffirm its estimate." Disclosure Statement at pp. 94-95. While Blackstone

may have performed its analysis after reviewing, among other things, historical financial and current operational data for AFGI, the conclusions drawn by Blackstone in its valuation ultimately are premised on information provided by third parties. Indeed, the Disclosure Statement states that "[n]o independent evaluations or appraisals of the Debtor's assets were sought or were obtained" in connection with Blackstone's preparation of the Reorganized Debtor's estimated enterprise value. *Id.* at 95. The Equity Group is filing this objection because it is concerned that the underlying fundamentals and assumptions that led to Blackstone's conclusions may not have been properly updated or reflective of actual risks or asset values.

6. Similarly, the liquidation analysis filed as Exhibit D to the Disclosure Statement ("Liquidation Analysis") reflects no recovery from the Debtor's investment in subsidiaries. Footnote J to the Liquidation Analysis represents that the analysis includes the equity value of Ambac Assurance Corporation ("AAC") and Ambac Bermuda Ltd. in accordance with GAAP. No valuation date is provided for the determination of AAC's equity value under the Liquidation Analysis. This is important because the Debtor's Liquidation Analysis is in part based upon the value of AFGI's 100% equity interest in its primary subsidiary, AAC.

7. There is no question that the credit freeze that started in 2007 and the subsequent global economic meltdown that began in 2008 resulted in significant losses by various entities involved in the residential mortgage-backed securities market. However, the extent of the ultimate exposure of AAC and its subsidiaries and affiliates remains unknown. An increase in the value of underlying collateral or reduction in liabilities would reduce the ultimate exposure of the Debtor's affiliates and could lead to the payment of significant dividends to AFGI that could be made available for distribution to creditors and then equity.

Argument

A. The Plan Contains Impermissible Releases

8. Article VIII, section E of the Plan provides that the holder of Equity Interests in the Debtor shall be deemed to release the "Released Parties" from any and all Claims and Causes of Action. This is an impermissible third-party release. Third-party releases are extraordinary, and while they may be granted in limited circumstances, they are only permitted in those rare circumstances when the parties releasing the claims consent and receive a distribution. *See In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-142 (2d Cir. 2005) (holding that non-debtor releases are proper only in rare cases and may be "tolerated if the affected creditors consent"); *In re Spansion, Inc.*, 426 B.R. 114, 145 (Bankr. D. Del. 2010) (proposed plan could not include non-consensual third-party releases that applied to holders of claims or interests where the objecting parties were to receive nothing under the plan).

9. The Debtor' plan provides no distribution – not even warrants – to holders of the Debtor's equity. As such, the proposed releases are improper and the Plan cannot be confirmed.

B. The Plan Does Not Satisfy the Requirements of Section 1129(b) With Respect to the Class of Equity Interests

10. The proponent of confirmation of a plan of reorganization bears the burden of proof by a preponderance of the evidence. *In re Quigley Co.*, 437 B.R. 102, 147 (Bankr. S.D.N.Y. 2010). Under section 1129(a)(8) of the Bankruptcy Code, a plan may only be confirmed if each class of claims or interests is unimpaired or has accepted the plan. A plan may be "crammed down" and confirmed despite its failure to satisfy section 1129(a)(8) if, under section 1129(b)(1) of the Bankruptcy Code, "all the applicable requirements of subsection (a) of this section other than paragraph (8) are met with re-

spect to a plan." However, a cram-down plan requires that the "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted the plan." 11 U.S.C. § 1129(b)(1).

11. The Plan fails to satisfy section 1129(b)(1) with respect to the Debtor's class of equity holders because (a) it does *not* satisfy all the applicable requirements of Bankruptcy Code section 1129(a) other than paragraph (8), and (b) it is not fair and equitable.

1. <u>The Plan Violates the "Best Interests" Test</u>

12. Section 1129(a)(7) of the Bankruptcy Code, which is commonly referred to as the "best interests of creditors" test, "requires that each holder of a claim or interest either accept the plan or receive or retain property having a present value, as of the effective date of the plan, not less than the amount such holder would receive or retain if the debtor were liquidated in a hypothetical liquidation under chapter 7 of the Bankruptcy Code." *In re Leslie Fay Cos., Inc.*, 207 B.R. 764, 787 (Bankr. S.D.N.Y. 1997); *In re Stone & Webster, Inc.*, 286 B.R. 532, 544-45 (Bankr. D. Del. 2002) ("A liquidation and distribution analysis is performed to see whether each holder of a claim or interest in each impaired class, as such classes are defined in the subject plan, receive not less than the holders would receive in a 'hypothetical Chapter 7 distribution' to those classes.") (internal citation omitted). This test is a guarantee to individual creditors and interest holders that they will receive at least as much under a plan as they would in a chapter 7 liquidation. *Leslie Fay*, 207 B.R. at 787. This provision provides "perhaps the strongest protection creditors have in Chapter 11." *In re Crowthers McCall Pattern, Inc.*, 120 B.R. 279, 297 (Bankr. S.D.N.Y. 1990).

13. The Debtor's Liquidation Analysis assigns a zero recovery in liquidation based upon a book value of *negative* $1,053,668,100 to AFGI's interest in its sub-

sidiaries – primarily AAC. After reviewing the assumptions underlying the valuation of AAC to assess the validity of a negative book value and zero recovery in the Liquidation Analysis, NHB advises that:

a. The Rehabilitator of the AAC Segregated Account asserts that, before the accrual of paid-in-kind ("PIK") interest on the Surplus Notes, the assumed losses under the Base Case Loss Estimate and Stress Case Loss Estimate will be $5.6 billion and $9.3 billion, respectively (the "Asserted Segregated Account Losses").[4]

b. The Asserted Segregated Account Losses must stem primarily from two asset classes insured by AAC. The first are insured portfolios of Residential Mortgage-Backed Securities ("RMBS"), which represents approximately 63% of AAC's total insured exposure ("Net Par Outstanding"). The second is Student Loan securitizations, which represent 24% of Net Par Outstanding.[5]

c. Of the total Net Par Outstanding for RMBS and Student Loan securitizations, 85% and 100% respectively are adversely classified with credit classifications of 1-A through IV. These adverse classifications represent 96% of all adverse classifications within the Segregated Account.

d. The foregoing leads NHB to believe that the Asserted Segregated Account Losses are largely derived from insured portfolios of RMBS and Student Loan securitizations (*i.e.* more than 90% of Asserted Segregated Account Losses).

e. Current market analysis supports the conclusion that such losses are not likely because, for example:

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4 *See* page 62 of the Rehabilitation Disclosure Statement. NHB notes that while the Rehabilitation Disclosure Statement references that the Stress Case Loss Estimates are only $8.0 billion, its independent assessment has determined that this figure is $9.3 billion.

5 *See* page 60 of the Rehabilitation Disclosure Statement.

(i) Credit Suisse and Goldman recently bought distressed assets, at prices that suggest that the fair value for subprime/Alt-A debt is at least 50% of par.

(ii) Default rates suggest that pricing could be at least 65% of par.

(iii) Analysis of historical default rates and issuance of RMBS suggest that peak defaults (and therefore losses) for older vintage RMBS have already occurred.

(iv) Improved economic and housing market conditions should further curtail future defaults on RMBS as well as related losses.

(v) Recent data from the United States Department of Education indicates that recoveries on defaulted Student Loans exceed par value on average due to financing costs and fees associated with these obligations.

f. None of the Rehabilitator's projected Scenarios reflect the potential for several billion dollars worth of NOLs that may be realized and used by AAC. Now that there appears to be a settlement with the IRS, this is an important component of the analysis.

14. All of these factors indicate there are several billion dollars of accretive value that should be taken into account in the Liquidation Analysis, but there is no evidence that Blackstone or the Rehabilitator have considered any of this.

15. Within the General Account of AAC, NHB notes that AAC may have excessively reserved for losses associated with its U.S. Public Finance accounts. Page 58 of the Rehabilitation Disclosure Statement indicates that AAC adversely classi-

fies approximately 1% of its Net Par Outstanding for U.S. Public Finance. This classification is significantly higher than the market average and suggests that significantly higher loss reserves have been taken.

16. The Debtor's value also will increase if AAC and its affiliates are successful in litigation they have brought against various banks for breach of representations and warranties concerning the underlying collateral. There have been significant changes since October 2010 in the attitude toward banks that misrepresented or otherwise harmed investors and homebuyers. For instance, in March 2010 a New York State Supreme Court decision dismissed a lawsuit seeking more than $1 billion commenced by Ambac Assurance UK Ltd. against JP Morgan Investment Management, Inc. (Index No. 650259/2009) (the "Ambac UK Dismissal") based on allegations that the defendant failed to manage accounts in which Ambac UK invested.[6] As such, it would have been natural for the Rehabilitator to be overly conservative in placing a low value even on successful litigations. Similarly, it would have been natural that the value placed on AAC by the Debtor would have reflected a very conservative assumption of litigation recoveries.

17. On July 14, 2011, the Supreme Court, Appellate Division, First Department reversed the Ambac UK Dismissal and reinstated Ambac UK's lawsuit in its entirety. Thus, to the extent that this and other litigations were booked or analyzed by the Debtor's financial advisors prior to Blackstone's Liquidation Analysis and not adequately updated, those recoveries may be significantly underestimated. With com-

[6] As this Court is aware, a Plan of Rehabilitation was filed by the Commissioner of Insurance of the State of Wisconsin, as the Court-Appointed Rehabilitator of the Segregated Account of Ambac Assurance Corporation (the "Rehabilitation Plan"). In support of the Rehabilitation Plan, the Rehabilitator filed a Disclosure Statement, dated October 8, 2010 (the "Rehabilitation disclosure Statement"), that attached four scenarios of Projected Financial and Operating Results. Notably, at the time the Rehabilitator's financial projections were prepared, the Debtor's affiliates were facing significant difficulty with litigation against the banks for breaches of representations and warranties in connection with the origination of mortgage loans.

plaints filed by Ambac entities seeking recoveries of billions of dollars, there is significant upside potential from the pending litigation.

18. Under the Plan, the Debtor is seeking to extinguish equity without even the chance for warrants if it turns out that the value of the Debtor's investments in its subsidiaries is positive and exceeds the value of unsecured claims. Accordingly, the class of equity interests would be better off in a chapter 7 case where there would be a potential for positive recoveries, as opposed to the Plan which takes away any potential for recovery. The Debtor has failed to meet its burden under section 1129(a)(7) of showing that the Plan satisfies the "best interests" test with respect to equity holders.

2. The Plan is Not Fair and Equitable

19. Section 1129(b)(1) of the Bankruptcy Code protects equity as a dissenting class by requiring that a plan be "fair and equitable." As set forth above, the Debtor bears the burden of proof by a preponderance of the evidence.

> It's undisputed that the "fair and equitable" requirement encompasses a rule that a senior class cannot receive more than full compensation for its claims. Courts will deny confirmation if a plan undervalues a debtor and therefore would have resulted in paying senior creditors more than full compensation for their allowed claims.

In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D.N.Y. 2010).

20. Market parameters have changed substantially since the Debtor's enterprise value was prepared in connection with the Disclosure Statement. The Equity Group and NHB believe that there are many factors that have changed which necessitate a new calculation of enterprise value for the Debtor to determine if the Plan allocates value in a fair and equitable manner. These factors include:

a. Stronger gross domestic product, which as of the fourth quarter of 2011 is growing at a rate that is twice as high as forecasts for the same period that were compiled as of September 2011 (*i.e.*, when enterprise value was last determined), and which promotes strength in housing and suggests lower loan defaults;

b. A rate of unemployment that is 0.7% lower than twelve months ago and which is at a 36-month low (high unemployment has been partially blamed for the prolonged housing malaise);

c. Reduced risk of a systemic shock from Europe to United States markets (which in turn reduces the risk profile of certain AAC asset classes and supports stronger economic growth in the United States);

d. Recent highs in the stock market and approximately 14% gains in the S&P 500 from September 1, 2011 to March 1, 2012 (which drive comparable valuations); and

e. Reduced market concerns about sharp, exogenous shocks to asset valuations (as demonstrated by the VIX index's low level, and which are a reinforcement for reduced concerns about uncertainty with the economy and/or markets).

21. These factors are all drivers of a determination of enterprise value. Stock prices drive comparable valuations, as does strong GDP growth (which can be associated with more robust M&A markets). General wealth creation through higher rates of employment as well as through higher investment portfolios drive consumer confidence and subsequently home sales (which is in part tied to consumer confidence). All of these factors influence both the projected cash flows of AAC as well as the discount rates in a manner that is accretive (*i.e.* leading to higher valuations).

<u>Conclusion</u>

22. The Equity Group submits that unless the Debtor is able to demonstrate that (a) it has appropriately considered and accounted for the various factors described in this objection that impact valuation, and that as a result the enterprise value

and liquidation value should not be revised, and (b) that the scope of the releases is appropriate, the Plan should not be confirmed.

23. Alternatively, the Equity Group submits that the Court should adjourn confirmation for 60 days so that Blackstone can update the Liquidation Analysis.

WHEREFORE, for the reasons set forth above, the Equity Group respectfully requests that this Court decline to confirm the Plan, and grant such other and further relief as the Court deems just.

Dated: New York, New York
March 2, 2012

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