STATE OF WISCONSIN CIRCUIT COURT DANE COUNTY

In the Matter of the Rehabilitation of:

Segregated Account of Ambac Assurance Corporation

Case No. 10 CV 1576

AMENDMENT NO. 2 TO DISCLOSURE STATEMENT ACCOMPANYING PLAN OF REHABILITATION

The Commissioner of Insurance of the State of Wisconsin, as the Court-Appointed Rehabilitator of the Segregated Account of Ambac Assurance Corporation

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I. ADDITIONS TO TEXT OF DISCLOSURE STATEMENT

The Rehabilitator hereby submits the following additional text to the Disclosure Statement, as filed with this Court on October 8, 2010:

1. Allocations to the Segregated Account (Section III.A.1)

In order to disclose an amendment to the Plan of Operation effective Nov. 7, 2010, the following textual additions are to be inserted immediately following the text of Section III.A.1.b ("The One State Street Lease") on page 13 of the Disclosure Statement:

c. Liabilities to AFGI.

Pursuant to Amendment No. 1 to the Plan of Operation, effective Nov. 8, 2010, AAC, in consultation with the Commissioner, allocated to the Segregated Account any and all liabilities (including contingent liabilities) it has or may have, now or in the future, to its shareholder, AFGI, or any successor to AFGI, in regard to, or respecting, tax refunds and/or the July 18, 1991 Tax Sharing Agreement, as amended, provided, that such allocation shall not include any liability to AFGI pertaining to any possible misallocation of up to $38,485,850 of tax refunds received by AAC in September 2009 and February 2010. Any such liabilities are disputed. This allocation includes, but is not limited to, any preference claim or fraudulent conveyance claim pertaining to the above-referenced subjects brought by, or on behalf of, AFGI in any bankruptcy proceeding involving AFGI by AFGI as debtor-in-possession, or a trustee or committee appointed by a bankruptcy court to pursue any such claim in regard to AFGI, or any similar state court action or claim pursued by, or on behalf of any receiver or creditor of AFGI.

Any such liabilities are disputed, and under the Plan of Rehabilitation, any claims submitted which arise from such liabilities would be treated as General Claims, and would receive Junior Surplus Notes in complete satisfaction of such Claims.

d. Liabilities to the Internal Revenue Service ("IRS") and/or the United States Department of the Treasury ("U.S. Treasury").

Pursuant to Amendment No. 1 to the Plan of Operation, effective Nov. 8, 2010, AAC, in consultation with the Commissioner, allocated to the Segregated Account (i) any and all liabilities (including contingent liabilities) it has or may have, now or in the future, to the IRS and/or the U.S. Treasury in regard to, or in respect of, taxes imposed under the Internal Revenue Code of 1986, as amended ("Federal Taxes"), for taxable periods ending on or prior to December 31, 2009; and (ii) to the extent not described in clause (i), any and all liabilities (including contingent liabilities) the Company has or may have, now or in the future, to the IRS and/or the U.S. Treasury in regard to, or respect of, any Federal Tax

refunds that were received prior to November 7, 2010 by the Company, AFGI or their affiliates.

Any such liabilities are disputed, and under the Plan of Rehabilitation, any claims submitted which arise from such liabilities would be treated as General Claims, and would receive Junior Surplus Notes in complete satisfaction of such Claims.

2. Claims Administration Responsibility (Section V.C.1)

In order to clarify the Rehabilitator's intent with respect to Section 4.01 of the Plan, the following textual addition is to be inserted immediately following the text of Section V.C.1 on page 26 of the Disclosure Statement:

> Section 4.01 of the Plan provides: "Claims under Surplus Notes or Junior Surplus Notes shall not be treated as Administrative Claims, Policy Claims or General Claims for purposes of this Plan." This statement is meant to clarify that the holder of a Surplus Note or Junior Surplus Note may not submit a Claim under the Plan relative to the obligations of the Segregated Account under such Surplus Note or Junior Surplus Note. The statement is necessary given that the broad definition of the term "Claim" in Section 1.09 of the Plan would otherwise encompass the right to payment under Surplus Notes and Junior Surplus Notes.

3. Submission of Policy Claims (Section V.C.3)

In order to clarify the Rehabilitator's intent with respect to Section 1.32 ("Late Claim") of the Plan to Holders of long-dated Policy Claims, the following text replaces the third paragraph of Section V.C.3 on page 27 of the Disclosure Statement:

> Other than in the case of excusable neglect, Holders of Policy Claims that arise after the Effective Date of the Plan must submit such Policy Claims within 120 days of the earliest date on which such Policy Claim, if it had been submitted, would have satisfied all of the requirements to be considered a Permitted Claim, or else such Policy Claim will be considered a Late Claim and will be denied pursuant to the terms of the Plan. However, Holders of Policy Claims are not permitted to submit such Policy Claims any earlier than permitted under the relevant Policy or other underlying instrument(s) or contract(s) giving rise to or governing the submission of such Policy Claims. This means that Holders of long-dated Policy Claims must wait to submit such Policy Claim until the relevant Policy or other underlying instrument(s) or contract(s) giving rise to or governing the submission of such Policy Claims permits the submission of such Policy Claim. However, once the submission of such Policy Claim is permitted by the relevant Policy or other underlying instrument(s) or contract(s) giving rise to or governing the submission of such Policy Claims, and such Policy Claim would satisfy all of the requirements to be

considered a Permitted Claim, such Policy Claim must be submitted within 120 days in order to avoid being considered a Late Claim and thereby disallowed pursuant to the terms of the Plan.

4. Recoveries and Reimbursements on Policy Claims; Assignment of Rights (Sections V.E and V.F)

In order to clarify the Rehabilitator's intent with respect to Sections 4.04(g) ("Recoveries and Reimbursements on Policy Claims") and 4.04(h) ("Assignment of Rights") of the Plan, the following text is added following the second paragraph of Section V.F on page 32 of the Disclosure Statement:

> In the context of policies insuring RMBS allocated to the Segregated Account, AAC and/or the Segregated Account typically benefit from any excess cash flows (i.e., cash flows in excess of current interest) generated by the RMBS trust. In the majority of transactions, the instruments or agreements (i) pursuant to which the relevant policy was issued, (ii) which govern the payment of claims under such policy, or (iii) which govern or specify the subsequent allocation, distribution or disbursement of amounts received pursuant to a policy, including but not limited to any note, indenture, certificate, servicing agreement or other similar instrument or agreement (collectively, "Transaction Documents") provide that any such excess cash flows are first applied to offset losses for the current period. In such transactions, the debt service shortfall for such period would be lower by the amount of losses offset by the excess cash flows. Section 4.04(g) of the Plan is not intended to require the payment of such excess cash flow amounts directly to AAC or the Segregated Account, but is intended to preserve the status quo with respect to any such excess cash flow.
>
> However, in a minority of transactions, the Transaction Documents do not provide for the application of excess cash flows to offset losses for the current period. In such transactions, the Segregated Account would pay the full amount of the debt service shortfall with a combination of cash and Surplus Notes, but Section 4.04(g) requires the excess cash flow to be paid to AAC in full in cash. Such transactions are informally referred to as "non-netting" transactions. The payment of claims in part with Surplus Notes in non-netting deals presents a complication, as AAC benefits from receiving 100% of the excess cash flow in cash, while the Segregated Account is paying 25% of claims in cash. Although, it is noteworthy that AAC, having paid claims in the months and years prior to the commencement of the Proceeding of over $2 billion, is entitled to recover those amounts in full under the Transaction Documents to the extent there is excess cash flow.. In addition, the excess cash flows received by AAC

typically do not exceed the 25% of the principal and interest shortfall (i.e., the claim amount) in any given month.[1]

The Rehabilitator has considered a number of alternatives to this issue, including limiting the excess cash flows payable to AAC to the Cash Percentage (e.g., 25%) under the Plan and using the remainder of the excess cash to redeem (in whole or in part) Surplus Notes received by the holders. The Rehabilitator has rejected this alternative for the following reasons, among others:

- Since the Surplus Notes received by the holders can be traded in the open market, there is no mechanism to cancel or redeem specific Surplus Notes. In fact, there is no mechanism to trace Surplus Notes to a particular transaction.

- If AAC does not exercise its contractual rights under the Transaction Documents to recover these excess cash flows for the benefit of all policyholders, in many transactions such excess cash flows could flow through the waterfall to uninsured tranches, thereby taking the cash out of the reach of AAC and the holders of insured obligations, to the detriment of all.

As a potential solution to this issue, the Rehabilitator will not object in the event that any trustees are able to apply any such excess cash flows in a given month to offset losses relating to the Ambac-insured tranche(s) for such month rather than pay such excess cash flows directly to AAC (e.g., modify the minority of transactions with the identified complication to operate in the same manner as the majority of transactions).

However, the Rehabilitator recognizes that in some transactions (including, but not limited to, some transactions involving RMBS and policies which guarantee obligations collateralized by student loan receivables financed through variable rate demand obligations), such a resolution for policyholders may not be achievable. For this reason, the Rehabilitator has preserved the right to enter into Alternative Resolutions pursuant to Section 3.06 of the Plan, and encourages interested parties to contact the Management Services Provider in order to discuss such an Alternative Resolution, as appropriate.

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[1] For example, in September 2010, the total of the claim payments due on non-netting transactions was $41.5 million, and AAC received reimbursement payments totaling $7.8 million, or approximately 18.8% of the total claim amount.

5. Discharge of Claims; Permanent Injunction (Section V.I.1)

In order to clarify the Rehabilitator's intent with respect to Section 8.01 ("Discharge, Release and Injunction") of the Plan, the following text is added following the second paragraph of Section V.I.1 on page 34 of the Disclosure Statement:

> For the avoidance of doubt, the satisfaction of claims (whether in cash, surplus notes, or a combination of cash and surplus notes) operates as a release of the Segregated Account with respect to those claims and only those claims.

6. Issuance of Surplus Notes Under the Plan (Section V.K.1)

The following text is added following the first paragraph of Section V.K.1 on page 38 of the Disclosure Statement:

> The Rehabilitator will advise the Court before the hearing that, if the Court approves the terms and conditions of the Plan of Rehabilitation, its confirmation of the Plan of Rehabilitation will constitute the basis for the issuance of the Surplus Notes under the Plan of Rehabilitation without registration under the Securities Act, in reliance on the exemption from registration provided by Securities Act Section 3(a)(10).

II. LIQUIDATION ANALYSIS

This analysis provides additional detail concerning the reasons why OCI rejected liquidation of AAC as an alternative to the rehabilitation of the Segregated Account. *See also* Disclosure Statement at pages 8-9.

The entry of an Order for Liquidation of AAC on March 24, 2010, would have resulted in the following events (assuming for the purposes of this analysis that no claims are submitted late or are subordinated pursuant to Wis. Stat. § 645.68(8)):

(i) All of AAC's approximately 15,000 policies would have been terminated no later than April 8, 2010, pursuant to Wis. Stat. § 645.43 (requiring termination of all policies within fifteen days of the entry of the Order for Liquidation). The terminated policies would afford no continuing coverage for future losses.

(ii) Non-CDS policy losses incurred and unpaid by AAC on or before April 8, 2010, would have been treated as Class 3 claims ("Loss Claims") under Wis. Stat. § 645.43. The aggregate amount of these claims would have been approximately $130 million.

(iii) The treatment of claims for non-CDS policy losses projected to have been incurred by AAC after April 8, 2010 (but for the termination of such policies), is unclear. A strong argument exists under Wisconsin insurance law—which the Rehabilitator does not waive by submitting this analysis—that no amount would be due for non-yet-incurred future potential losses on the terminated policies. If,

however (likely after extensive litigation), some sort of breach of contract claims were allowed (which would require time-consuming and costly policy-by-policy damage adjudications), the highest priority that such claims could receive in liquidation is Class 5 ("Residual Classification"). For purposes of this analysis only, such claims are assumed to be treated as Class 5 claims. Using the General Account Base Case Loss Estimate and the Segregated Account Base Case Loss Estimate, the aggregate net present value of those claims would have been equal to approximately $6 billion. Using the General Account Stress Case Loss Estimate and the Segregated Account Stress Case Loss Estimate, the aggregate net present value of those claims would have been equal to approximately $9.4 billion.[2]

(iv) CDS counterparties would have submitted approximately $16.3 billion (as of March 31, 2010) in mark-to-market termination claims arising from CDS contracts, and likely would have argued that since such mark-to-market claims arose while their respective policies were still in-force (i.e., before April 8, 2010), such claims should be treated as a Class 3 claims. In response, the Rehabilitator would have argued that the CDS counterparties were not entitled to make mark-to-market termination claims, but rather that such claims should be treated as Class 5 claims in a manner consistent with the treatment of claims for policy losses projected to have been incurred by AAC after April 8, 2010. It is unclear whether such claims would have been classified as Class 3 claims or Class 5 claims; however, there exists a strong possibility that such mark-to-market early termination claims would be senior in a liquidation to any non-CDS policyholder breach of contract claims. Note that the mark-to-market termination claims discussed above do not include the effects of similar claims that might be asserted under other derivative contracts (i.e., swaps in the AFS book).

(v) AAC would lose the right to collect installment premiums due to policy cancellations, thus materially reducing overall claims-paying resources. The net present value of such installment premiums as of March 31, 2010, was approximately $1.2 billion.

(vi) Policyholders would have had claims against AAC for any unearned premium received by AAC. Such claims would arise only from policyholders that prepaid their premium. Only 4% of the $2.3 billion of unearned premiums as of March 31, 2010, relates to individual policies allocated to the Segregated Account. Such claims for unearned premium would have been classified as Class 4 claims ("Unearned Premiums and Small Loss Claims"). The value of these claims would have been equal to approximately $2.3 billion as of March 31, 2010.

[2] Note that the Base Case Loss Estimate and Stress Case Loss Estimate summarized above have been adjusted to reflect the reduction of $130 million in Class 3 claims and do not reflect commutations that have occurred subsequent to April 8, 2010.

(vii) AAC would have continued to incur administrative expenses in light of the business and legal issues raised by the uncertainty of the priority status of (i) claims for non-CDS policy losses that would have been incurred by AAC after April 8, 2010, and (ii) mark-to-market termination claims arising from CDS contracts. The Rehabilitator estimates the present value of such administrative expenses would have been at least $250 million.

AAC's claims-paying resources as of March 31, 2010, after deducting the net present value of future installment premiums, consisted of the following: $7.7 billion in investment assets, $172 million in investment in Everspan, and $396 million in intercompany loans for total claims-paying resources of approximately $8.2 billion.[3]

Based on the foregoing, in a hypothetical liquidation of AAC as of March 24, 2010, the recovery analysis is as follows:

Recovery Analysis under Liquidation Scenarios

	Scenario 1: Mark-to-Market Termination Payments are Class 5 Claims			**Scenario 2: Mark-to-Market Termination Payments are Class 3 Claims**		
	Estimated Claim (In millions)	**Distribution** (In millions)	**Recovery Percentage**	**Estimated Claim** (In millions)	**Distribution** (In millions)	**Recovery Percentage**
Classes						
(1) Administrative Expenses	$ 250	$ 250	100%	$ 250	$ 250	100%
(3) Loss Claims	130	130	100%	16,444	7,908	48%
(4) UPR	2,311	2,311	100%	2,311	0	0%
(5) Residual Classification						
Present Value of Adjusted Base Case Losses	22,353	5,555	25%	6,040	0	0%
Present Value of Adjusted Stress Case Losses	25,673	5,555	22%	9,360	0	0%

The foregoing demonstrates the severe drawbacks of liquidation of AAC, as the Rehabilitator's estimates show that the vast majority of non-CDS policyholders would have received a recovery of between 22% and 25% in the event that mark-to-market termination claims arising from CDS contracts are treated as Class 5 claims, or no recovery at all in the event that such mark-to-market CDS termination claims are treated as Class 3 claims. In either case, the recovery of such policyholders is significantly lower than their assumed recovery under any of Scenarios 1 through 4.

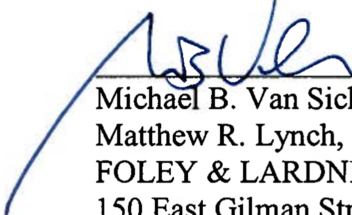
[3] Assumes optimistically for ease of presentation that no diminution in value of investment assets or AAC's investment in Everspan will result from a liquidation proceeding. Assumes diminution of $350 in value of intercompany loans will result from a liquidation proceeding as a result of additional losses suffered by the affiliated borrowers.

In addition to the foregoing considerations, OCI also took into account important policy reasons in rejecting the liquidation approach. Foremost among such reasons was (and is) OCI's mandate to "protect the interests of insureds, creditors, and the public generally, with minimum interference with the normal prerogatives of proprietors ...." Wis. Stat. § 645.01(4). Subjecting AAC's entire book of business to a liquidation proceeding would cause undue harm and hardship to the vast majority of AAC's policies (which are currently in the General Account) by terminating their coverage. In addition, OCI was (and remains) concerned with the effect that an AAC liquidation, and in particular the termination of policies in AAC's public finance book, could have on the broader economy.

OCI also considered other more difficult to quantify intangible value losses that would occur in a liquidation, including but not limited to: (i) the lost future potential value of AAC's solvent, but dormant insurance subsidiary, Everspan; (ii) loss of key employees at AAC with valuable institutional knowledge that OCI would need under some form of management services agreement to assist it with effecting an orderly liquidation of such complexity; and (iii) the insurance systems, surveillance and servicing in place at AAC.

Dated this 12th day of November, 2010.

FOLEY & LARDNER LLP



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