UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WISCONSIN

IN THE MATTER OF THE REHABILITATION OF THE SEGREGATED ACCOUNT OF AMBAC ASSURANCE CORPORATION

Case No. 10-cv-778

(Removed From Dane Court Circuit Court – No. 10 CV 1576)

BRIEF OF WISCONSIN COMMISSIONER OF INSURANCE IN OPPOSITION TO UNITED STATES INTERNAL REVENUE SERVICE'S MOTION TO DISSOLVE ORDER FOR TEMPORARY INJUNCTIVE RELIEF

FOLEY & LARDNER LLP

Michael B. Van Sicklen, SBN 1017827
Naikang Tsao, SBN 1036747
Matthew R. Lynch, SBN 1066370

150 East Gilman Street
Madison, WI 53703
(608) 257-5035 (phone)
(608) 258-4258 (fax)

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

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES

REGULATIONS

The Wisconsin Commissioner of Insurance ("the Commissioner"), as court-appointed Rehabilitator of the Segregated Account ("the Segregated Account") of Ambac Assurance Corporation ("Ambac"), files this opposition to the motion of the United States Internal Revenue Service ("IRS") to dissolve the November 8, 2010 Order for Temporary Supplemental Injunctive Relief ("Supplemental Injunction") entered by the Dane County Circuit Court ("the State Rehabilitation Court"), which has been overseeing the rehabilitation of the Segregated Account of Ambac (the "Rehabilitation Proceeding") since March 2010.[1]

INTRODUCTION

The IRS tries to portray this action as a tax case, subject to the statutes and rules that ordinarily govern such cases. However, this is not a tax case; it is an insurance case, specifically an insurer rehabilitation proceeding, and the dispute at issue relates to the administration and equitable distribution of claims-paying resources of a financially distressed insurer to competing claimants. Rather than a disagreement over whether the IRS has the authority to investigate and make tax claims against an insurer, this is a contest over *how* any IRS claim against the insurer will be administered—through the State's comprehensive framework for insurance delinquency proceedings, or through the IRS's generalized tax collection powers. This distinction is important: because this is an insurance case, it is subject to the McCarran-Ferguson Act, which reverse-preempts—*i.e.*, *precludes the application of*—the

[1] In a December 16, 2010 letter, the State Rehabilitation Court informed the Dane County Clerk's office that: "Following the [November 15-19, and 30, 2010] hearing on the Rehabilitation Plan, I informed the parties that I would issue a decision after I reviewed the submissions that had been filed. I am now ready to issue that decision. . . . At such time as the case is remanded by the Federal District Court, I will then issue my decision." (*See* **Exhibit 1** hereto.)

generally applicable federal laws the IRS seeks to invoke, because those laws conflict with state laws regulating the business of insurance.

The present case is controlled by the Supreme Court's decision in *United States Department of Treasury v. Fabe*, 508 U.S. 491 (1993), which held that, under the McCarran-Ferguson Act, a state statute assigning priority to insurance policyholders over the government reverse-preempted the competing federal priority statute. Likewise, the Wisconsin priority statute (Wis. Stat. § 645.68) expressly prioritizes the payment of policyholder claims ahead of federal government claims. Permitting the IRS to levy or attach on assets based on a disputed tax liability would circumvent the state insurance priority statute because it would allow the United States to get paid *in full*, ahead of policyholders who are presently subject to a claims payment moratorium and will be subject to a deferred payment plan in the rehabilitation. In light of this conflict with state insurance law, the McCarran-Ferguson Act precludes the application of the federal tax collection laws cited by the IRS.

Tellingly, nowhere in its motion to dissolve the Supplemental Injunction does the IRS contest the basis for the relief sought. The IRS does not (and cannot) refute any of the grounds raised by the Commissioner in his motion seeking the Supplemental Injunction in the State Rehabilitation Court, namely: (1) the tax refunds in question "form a material part of the claims-paying resources available to satisfy claims of the Segregated Account"; (2) any IRS claims "are behind policyholder loss claims in priority" under Wisconsin's insurance priority statute, Wis. Stat. § 645.68; and (3) the IRS's seizure of these assets would "circumvent[] the priority scheme for equitable distribution established by Wisconsin insurance law." (Declaration of Michael B. Van Sicklen ("Van Sicklen Decl."), Ex. O, at ¶¶ 2, 6, 14-15 (Dkt. 14).)

Instead, the IRS argues that there are procedures in place (under federal tax law) to permit the Commissioner or others to contest an IRS tax lien or levy *after* it has occurred. However, this misunderstands the effect of reverse-preemption under the McCarran-Ferguson Act. Because the criteria for the application of McCarran-Ferguson are met in this case—*i.e.*, the laws the IRS invokes are not specific to the business of insurance; Chapter 645, Wis. Stats., plainly regulates the business of insurance; and permitting the IRS to exercise its tax collection powers would impair or supersede the state insurance statutes concerning rehabilitation—the IRS is *precluded from applying* the federal tax collection laws that would otherwise be at its disposal in the run-of-the-mill tax case. In other words, the reverse-preemption effectuated by McCarran-Ferguson prevents the IRS from imposing a "pay first, litigate later" mandate in the specific, uncommon and narrow setting of the present insurance case. Based on *Fabe*, there is no other way to reconcile the McCarran-Ferguson Act and the statutes the IRS cites. To adopt the IRS's position—that there are no constraints whatsoever on its federal authority to tax and collect—would eviscerate McCarran-Ferguson.

The IRS also argues that, irrespective of the dictates of *Fabe* and the McCarran-Ferguson Act, the Commissioner lacks a *remedy* against the IRS to prevent it from violating state insurance law because the IRS has not waived its sovereign immunity and consented to be sued. However, as explained in the Commissioner's brief in support of remand, none of the Commissioner's relevant filings in the Rehabilitation Proceeding—not the Petition for Rehabilitation, the First-Day Injunction or the Supplemental Injunction—initiated a civil action (or "suit") against the IRS. Like the thousands of other entities that have an interest in the Rehabilitation Proceeding, the IRS is a potential claimant, not a party that is being sued. As the Supreme Court has held, the United States does not become a "defendant" in a state regulatory proceeding merely because it is required to submit its claims, if at all, in that proceeding. *United States v. Bank of N.Y. & Trust Co.*, 296 U.S. 463, 478-81 (1936).

Moreover, even if the IRS were deemed to be a "party" to the Rehabilitation Proceeding and one or more of the Commissioner's court filings were deemed to initiate a civil action or suit against the IRS, Congress waived the government's sovereign immunity in 28 U.S.C. § 2410(a), which permits actions against the United States in federal or state court that seek to invalidate a lien or levy or to establish claim priority.

ARGUMENT

As a threshold matter, there are two important points. *First*, this dispute does not concern the merits of the disputed tax liability. (*See* IRS Br. at 10 (citing inapposite cases that involve "determination of whether a person owes federal income tax on money received," and "tax refund suits" and a "state law claim that effectively demanded a federal tax refund").) The Commissioner takes no position as to that merits issue, which will be resolved in a different federal forum (*e.g.*, the pending bankruptcy of Ambac Financial Group, Inc. ("AFGI"), Ambac's parent company), and the Supplemental Injunction does not constrain the IRS from litigating that merits issue.[2]

The Commissioner's position is that, to the extent the IRS determines that the tax refunds were improper and need to be repaid, the McCarran-Ferguson Act, *Fabe* and state insurance law require the IRS's claim related to that disputed tax liability to be treated under a Rehabilitation Plan, subordinate to policyholder loss claims. Thus, the IRS should be required to answer the following:

> *Is the IRS willing to refrain from exercising its tax collection powers and to submit any recovery or judgment it receives as to the disputed tax liability as a claim for payment in the Rehabilitation Proceeding, to be treated under a Rehabilitation Plan in accordance with Wis. Stat. § 645.68*(*3c*) (*or as a claim in the AFGI bankruptcy proceeding*)?

[2] The Commissioner's Motion for the Supplemental Injunction and the resulting Order entered by the State Rehabilitation Court are aimed solely at blocking enforcement actions by the IRS (including assessment, attachment or levy proceedings) related to the specific tax refunds totaling approximately $708 million. There are no other known tax issues at present. The Commissioner has consistently informed the IRS, and reiterates it here, that, to the extent any wording in the Supplemental Injunction Order could be read more broadly to theoretically constrain the IRS from auditing or investigating any past tax periods or addressing any prospective tax obligations, the Commissioner disavows that intent and stands ready to stipulate to any remedial clarification.

If the IRS is willing to formally and unequivocally answer this question in the affirmative, then the Commissioner does not need the Supplemental Injunction to protect policyholders under the Plan of Rehabilitation, and will petition the State Rehabilitation Court to dissolve it upon remand of this action to that court.

However, if the IRS is not willing to make this representation, then the IRS has conceded that the reason it wants to dissolve the Supplemental Injunction is so it can "jump the line" through its tax collection powers, to the detriment of policyholders, and in direct violation of the McCarran-Ferguson Act, *Fabe* and the state insurance priority statute.

Second, unlike most of the litigants in tax disputes with the IRS—*see*, *e.g.*, cases cited herein and in the IRS's opening brief—the Commissioner has no interest in impeding the IRS's regulatory mission, in concealing or sheltering assets from tax liability, or in preventing the IRS from ultimately recovering any tax refunds it may determine were erroneously issued. The Commissioner is instead an official acting on behalf of a co-equal sovereign, the State of Wisconsin, fulfilling a statutory role that necessarily requires more multi-faceted considerations than the IRS's mission insofar as it relates to this Rehabilitation Proceeding. As the State Rehabilitation Court reiterated in rejecting challenges by other movants seeking to avoid the First-Day Injunction in order to obtain advantages relative to other claimants:

> Interests of movants yield[] to the policy decision and business decisions of the Rehabilitator who, by statute, is the public official that is best qualified to perform the rehabilitation/liquidation process. The reason for this is that the Rehabilitator has no special interests in the outcome except to administer the matter for the maximum benefit of all interested parties[,] which the Rehabilitator has done in securing the temporary injunction in this matter.

(Van Sicklen Decl., Ex. L, at 9.) The Commissioner is merely seeking to prevent actions that would interfere with achievement of the maximum benefit for all involved under the state priority structure.

I. THE MCCARRAN-FERGUSON ACT PRECLUDES THE APPLICATION OF THE FEDERAL STATUTES CITED BY THE IRS BECAUSE THEY WOULD IMPAIR OR SUPERSEDE WISCONSIN INSURANCE LAW

A. The State Law Priority Scheme Subordinates Federal Government Claims To Those Of Policyholders.

Chapter 645 of the Wisconsin Statutes—entitled the "Insurers Rehabilitation and Liquidation Act," Wis. Stat. § 645.01(1)—relates to the rehabilitation and liquidation of insurers. In enacting Chapter 645, the Wisconsin legislature expressly noted that a key statutory purpose was to prevent claimants from attempting to use federal law to circumvent the priority structure:

> [T]his chapter is perceived by the legislature as, and in fact is, part of the regulatory structure. It is a part of the regulatory system because this chapter will have considerable effect on the way the insurance business is conducted by the reinsurers, agents, premium financers, and others. If the courts see clearly that the chapter is a part of the regulatory system, it should be possible *to overcome what would otherwise be a limiting interpretation of federal statutes. This problem is of special importance in s. 645.68, on priorities*[.]

Wis. Stat. Ann. § 645.01 cmt (emphasis added).

The claim priority statute, Wis. Stat. § 645.68, describes thirteen different classes of claim priorities. Consistent with *Fabe*, class 1 administrative claims and class 3 policyholder loss claims (there is no longer a class 2) come ahead of class 3c "Federal Government Claims." All ten other classes (ranging to the lowest priority reserved for the proprietary claims of shareholders) rank behind "government claims." Wis. Stat. § 645.68 (1999).

The subordination of federal government claims, including tax claims, to policyholder loss claims reflects a longstanding declared state policy in Wisconsin regarding the order of priority in insurance delinquency proceedings. As explained in the August 4, 1967 legislative comments to the original version of Section 645.68, in which federal government claims were treated as "residual" claims below administrative and policy loss claims, among others:

> In this residual classification fall most of the claims by government that are traditionally given a high priority. There is *no justification for giving a high priority to the sovereign because it is sovereign*. On the merits, indeed, there seems an unanswerable case for declining to prefer government claims, *including claims on taxes*, and giving priority to claims of greater social importance, such as . . . loss claims. The sovereign, and in particular the United States, will be able to survive without hardship, even if relegated to the priority accorded ordinary creditors. Of course, governments as insureds stand on a different footing.
>
> An insurer in liquidation is failing to perform its social role and is casting heavy burdens on segments of society that cannot afford to bear them. In such a case, the modest contribution made to the handling of a difficult situation by the government, *if its taxes are subordinated*, may have social utility vastly in excess of its costs to the public. Moreover, by undertaking to regulate insurance, government should be regarded as assuming at least to this limited extent an obligation of underwriting solvency. This is as true of the federal government as of the states, for the federal government has delegated the field to the states on the theory that the states can do it better. When they fail to do it at all, such government can not then fairly depend on sovereign powers to get a preference over other creditors. Instead they should take a subordinate position in the priority hierarchy.

Ch. 89, Laws of 1967, S.B. 303, legis. cmt. (Aug. 4, 1967) (emphasis added) (attached as **Exhibit 2** hereto).

The current version of Section 645.68, which preserves the subordination of federal government claims to policyholder loss claims, was expressly adopted in 1999 "to comply with the ruling of the U.S. [S]upreme [C]ourt in *U.S. Department of the Treasury v. Fabe*, 113 S. Ct. 2202 (1993)." Wis. Legis. Ref. Bureau, Bill Analysis, 1999 Reg. Sess. A.B. 551 (attached as **Exhibit 3** hereto). Consistent with *Fabe*, the amended Section 645.68

prioritizes federal government claims (including IRS tax claims) ahead of all other claims *except* administrative expenses and policy loss claims. *See Fabe*, 508 U.S. at 508-10.[3]

In its brief, the IRS notes that the tax refunds at issue were "tentative" in nature. (*See* IRS Br. at 5 & 5-6 n.19.) However, the state priority statute does not distinguish between different types of federal government non-policyholder claims. *See* Wis. Stat. § 645.68(3c); *see also In re Matter of Union Indem. Ins. Co. of N.Y.*, 627 N.Y.S. 2d 655 (N.Y. App. 1995) (treating claims by the IRS as general federal government claims subject to the holding of *Fabe*). Moreover, as explained in the legislative history excerpted above, the declared state policy in Wisconsin is that governmental tax claims, whatever their nature, are viewed as having less "social importance" than policyholder loss claims and, as a result, are subordinated in the priority hierarchy.[4]

B. The McCarran-Ferguson Act Reverse-Preempts Each Of The Federal Tax Statutes Cited By The IRS

As the IRS acknowledges, the Supreme Court in *Fabe* held that, under the McCarran-Ferguson Act, "a state statute assigning priority to insurance policyholders over the government [reverse-]preempted the competing federal priority statute." (IRS Br. at 9.) This is precisely what the Supplemental Injunction is intended to protect: the priority of insurance

---

[3] The 1999 amendment therefore distinguishes Section 645.68 from the Ohio priority statute at issue in *Fabe*, which was struck down on remand because the Ohio statute prioritized two other, non-administrative and non-policyholder categories of claimants ahead of federal government claims, and the district court concluded that it could not on its own amend the statute to re-shuffle priorities according to the dictates of *Fabe*. *See generally Duryee v. U.S. Dep't of Treasury*, 6 F. Supp. 2d 700 (S.D. Ohio 1995) (cited in IRS Br. at 19).

[4] Federal governmental policyholder claims, such as those of government-sponsored entities Freddie Mac and Fannie Mae, are given priority treatment as policyholder loss claims consistent with the above-cited legislative commentary establishing that "governments as insureds stand on a different footing" for purposes of the state priority structure.

policyholder claims over federal government claims (under Wis. Stat. § 645.68(3) & (3c)), which the IRS seeks to circumvent through the exercise of its federal tax collection powers.

Under McCarran-Ferguson,

> a federal statute is reverse-preempted by a state statute or law if: (1) the federal statute does not specifically relate to the business of insurance; (2) the state statute was enacted for the purpose of regulating the business of insurance; and (3) enforcing the federal statute would "invalidate, impair or supersede" the state statute.

In re Amwest Sur. Ins. Co., 245 F. Supp. 2d 1038, 1043 (D. Neb. 2002) (citing *Fabe*, 508 U.S. at 501, and *Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 595 (5th Cir. 1998)). All three elements of the McCarran-Ferguson reverse preemption test are met here.

1. The Cited Federal Statutes Do Not Specifically Relate To The Business Of Insurance

None of the internal revenue statutes cited by the IRS—and relevant to the Supplemental Injunction—specifically relate to the business of insurance, but rather apply generally to the IRS's tax collection activities. (*See* IRS Br. at 12-14 (citing 26 U.S.C. §§ 6321 (tax liens), 6331 (tax levies), and 7401-7405 (judicial enforcement actions)).)

Rather than contesting this point, the IRS asserts that because it has the authority to tax insurers under the Internal Revenue Code, 26 U.S.C. § 801 *et seq.*, the *entirety* of the Internal Revenue Code "specifically relates to the business of insurance," including the above-referenced statutes of general application. (IRS Br. at 17.) This is plainly not the case. The fact that insurers are *subject to* laws of general application does not render those laws "specifically relate[d] to the business of insurance" within the meaning of the McCarran-Ferguson Act, 16 U.S.C. § 1012(b). As the Seventh Circuit held in rejecting an analogous argument by a bank contending that its actions escaped state regulation because they were authorized by the federal Bank Act—some portions of which expressly address insurance and other portions of which do not—the proper McCarran-Ferguson analysis looks only to the provisions of the congressional act or statutory framework that are directly at issue:

> The [Supreme] Court concluded that the purpose of the [McCarran-Ferguson] Act was not to insulate state insurance regulation from the reach of all federal law, but "to protect state regulation primarily against inadvertent federal intrusion—say, through enactment of a federal statute that describes an affected activity in broad general terms, of which the insurance business happens to comprise one part." As applied to the Retirement CD [the bank's insurance-like investment product], the provisions of the Bank Act at issue are exactly the intrusion the Court warned against: they describe an affected activity (banking) in broad terms, of which the insurance business (the Retirement CD) is only a part.

Am. Deposit Corp. v. Schacht, 84 F.3d 834, 843 (7th Cir. 1996) (internal citation omitted) (material in brackets added).

2. Chapter 645, Wis. Stats., Was Enacted For The Purpose Of Regulating The Business Of Insurance

Chapter 645 clearly regulates the business of insurance. "The broad category of laws enacted 'for the purpose of regulating the business of insurance' consists of laws that possess the 'end, intention, or aim' of adjusting, managing, or controlling the business of insurance." *Fabe*, 508 U.S. at 505. The Supreme Court in *Fabe* and other courts have consistently held that state rehabilitation and liquidation statutes regulate the business of insurance within the meaning of the McCarran-Ferguson Act. *See id.* at 508-10; *Munich Am. Reinsurance Co.*, 141 F.3d at 592-93 ("[T]he specific provisions of the statute at issue here—vesting exclusive original jurisdiction of delinquency proceedings in the Oklahoma state court and authorizing the court to enjoin any action interfering with the delinquency proceedings—are laws enacted clearly for the purpose of regulating the business of insurance."); *Amwest*, 245 F. Supp. 2d at 1044-45; *Boozell v. United States*, 979 F. Supp. 670, 678 (N.D. Ill. 1997); *U.S. Fin. Corp v. Warfield*, 839 F. Supp. 684, 688-89 (D. Ariz. 1993). *See also Eden Fin.*

Group, Inc. v. Fid. Bankers Life Ins. Co., 778 F. Supp. 278, 282 (E.D. Va. 1991) (pre-*Fabe* case noting that "rehabilitation proceedings necessarily are the business of insurance" because "[a] rehabilitation proceeding modifies and monitors the operation of an insurer consistent with the interests of policyholders"); *Corcoran v. Universal Reinsurance Corp.*, 713 F. Supp. 77, 80-82 (S.D.N.Y. 1989).

The IRS's contentions to the contrary are difficult to understand. Initially, the IRS argues that the Segregated Account that the Commissioner approved pursuant to Wis. Stat. § 611.24 to avoid unnecessary harm to policyholders and the public in this rehabilitation does not "relate to the business of insurance." (IRS Br. at 19-20.) Setting aside the fact that the Supplemental Injunction the IRS seeks to dissolve was issued pursuant to a different statute (Wis. Stat. § 645.05) that is not dependent upon the Commissioner's exercise of authority under Section 611.24, the IRS ignores that this statute also regulates the business of insurance. *See* Wis. Stat. Ann. ch. 611 introductory cmt. (noting that purpose of Chapter 611 is "to strengthen the protection accorded insureds and the public in general"); Wis. Stat. § 611.24(2) (making the Commissioner's approval of a segregated account contingent upon his consideration of "the interests of [every] class of insureds"); *id*. § 611.24(3)(e) (expressly providing for the rehabilitation of segregated accounts under Chapter 645); *see also* Van Sicklen Decl. Ex. L , at 19 (State Rehabilitation Court Order, rejecting numerous policyholder arguments that the establishment of the Segregated Account under Wis. Stat. § 611.24(2) unconstitutionally altered or impaired their policies, by noting "the State's pervasive and long-standing regulation of the insurance industry" and holding that "[e]ven if the creation of the Segregated Account did impair contracts as contended by movants . . . governments can do this to protect public welfare, particularly in the area of insurance").

Next, the IRS makes the unsupported contention that Wis. Stat. § 645.05 does not concern the business of insurance "because it is merely a procedural statute outlining generally what type of relief a receiver may request from a court." (IRS Br. at 20.) The plain language of Section 645.05 belies the IRS's characterization of it. The statute does not merely "outline" the type of relief the Commissioner may seek; it expressly authorizes the State Rehabilitation Court to *grant* such relief as is "deemed necessary and proper to prevent" several enumerated actions, including "any other threatened or contemplated action that might . . . prejudice the rights of policyholders[.]" Wis. Stat. § 645.05(1)(k).

In the absence of such injunctive relief in insurer rehabilitation proceedings, there would be:

(a) no way to prevent policyholders from exercising their contractual termination triggers and seeking "damages" in the form of increased claims payment demands;

(b) no way to prevent potential claimants from filing suits in other jurisdictions (state or federal), with the concomitant risk of inconsistent rulings and the associated delays in the rehabilitation proceeding; and

(c) no way to prevent non-policyholders (such as the IRS or unsecured creditors) from trying to "jump the line" and improperly elevate their claim priority ahead of policyholders by pursuing collection remedies outside the rehabilitation, which the Commissioner has a statutory obligation to prevent under Wis. Stat. Ch. 645.

Given that the prioritization of administrative and policyholder loss claims ahead of federal government claims constitutes the business of insurance under *Fabe*, the state injunction statute designed to protect policyholders under that very same statutory priority structure (as well as the administration of the delinquency proceeding) also constitutes the business of insurance. *See Munich Am. Reinsurance Co.*, 141 F.3d at 593 (Injunctions in insurance delinquency proceedings "eliminate[] the risk of conflicting rulings, piecemeal litigation of claims, and *unequal treatment of claimants*, all of which are of particular interest to insurance companies and policyholders, who are often relying on policies with the same or similar provisions.") (emphasis added); *Warfield*, 839 F. Supp. at 689 (statute authorizing injunctive relief in insurance delinquency proceeding "regulat[es] business of insurance within the meaning of the McCarran-Ferguson Act").

3. Enforcing The Federal Statutes Cited By The IRS Would Impair Or Supersede Chapter 645

Application of the federal statutes pertaining to the IRS collection remedies would impair or supersede the state statutes concerning rehabilitation and orders issued pursuant to those statutes. As the Supreme Court has explained, only "[w]hen federal law does not directly conflict with state regulation, *and* when application of the federal law would not frustrate any declared state policy or interfere with a State's administrative regime, [does] the McCarran-Ferguson Act . . . not preclude its application." *Humana Inc. v. Forsyth*, 525 U.S. 299, 310 (1999) (emphasis added); *Doe v. Mut. of Omaha Ins. Co.*, 179 F.3d 557, 563 (7th Cir. 1999) (McCarran-Ferguson prohibition triggered if interpretation of federal law "would interfere with a State's administrative regime"; a "[d]irect conflict with state law" is not required).

Akin to bankruptcy proceedings, which insurers are expressly prohibited from filing under both federal law, 11 U.S.C. § 109, and state law, Wis. Stat. § 645.035, Wisconsin insurer delinquency proceedings are intended to be comprehensive and provide for the orderly and equitable distribution of assets, with the rehabilitator as trustee. *See* Wis. Stat. § 645.01(4)(d) (equitable apportionment of unavoidable loss); *id*. § 645.04(3), (4) (exclusive jurisdiction and venue of the rehabilitation court); *id*. § 645.32 ("An order to rehabilitate the business of a domestic insurer . . . shall appoint the commissioner and his or her successors in office rehabilitator and shall direct the rehabilitator to take possession of the assets of the insurer and to administer them under the orders of the court."); *id*. § 645.34(1) (establishing automatic stay of pending litigation involving delinquent insurer within the state and requiring the rehabilitator to seek stays of all litigation outside the state "whenever necessary to protect the estate of the insurer"); *id*. § 645.68 (establishing priorities for the equitable distribution of assets); *see also Munich Am. Reinsurance Co.*, 141 F.3d at 593 ("Insurance companies are ineligible for the protections afforded by the federal Bankruptcy Code; such protections instead are provided by state laws, which are shielded from federal interference by the McCarran-Ferguson Act.") (internal citation omitted).

The seizure of up to $708 million in claims-paying resources, or the subjection of those resources to administrative or other process outside this comprehensive Rehabilitation Proceeding, would severely "frustrate . . . declared state policy" and "interfere with [the] State's administrative regime" described above, in contravention of the McCarran-Ferguson Act. *Humana*, 525 U.S. at 310. As the Commissioner has stated from the outset of the Rehabilitation Proceeding, Ambac's financial situation is such that policyholder claims cannot be paid in cash and in full as they arise (Van Sicklen Decl. Ex. A ¶ 12(c)); the Supplemental Injunction merely prevents the federal government from prioritizing its potential claim by collecting in full and in cash when and if it arises. As noted above, this situation is squarely addressed by *Fabe*.

The IRS does not argue otherwise. It instead argues that "[i]t may be that when a litigant brings a lawsuit, the remedy or relief sought will be [reverse-]preempted by a state insurance statute, but the litigant cannot be enjoined from simply bringing a lawsuit." (IRS Br. at 21.) The IRS suggests that it should be permitted to levy against the amount of the disputed tax liability at its discretion, and then force the Commissioner to clear administrative hurdles in federal tribunals unfamiliar with the circumstances of the Rehabilitation Proceeding in order to require the IRS to comply with the state priority statute that was adopted for the benefit of policyholders.

However, because the three elements of the McCarran-Ferguson test are met in this case, the United States is reverse-preempted from exercising its general tax levying powers with respect to the disputed tax liability in the first place. In other words, the specific federal statutes the IRS seeks to invoke with respect to the disputed tax liability are *displaced* by the applicable state insurance laws.

The IRS's "pay first, litigate later" position also ignores the real, practical impairment of Chapter 645 that results from leaving the IRS's collection powers intact as to the potential claim at issue. A levy would impede the Commissioner's ability to "carry out the plan" of rehabilitation under Wis. Stat. § 645.33(5), which necessarily calls for the deferred payment of claims over time to ensure equity among long-tail and short-tail claimants and to maximize the value of the insurer's claims-paying resources. That the IRS could impose that levy at an uncertain time, and retain control of the assets for an uncertain duration while the Commissioner wades through "the maze of statutes which govern the assessment and collection of taxes, tax liens, tax levies, refunds, and so on," *Rodriguez v. United States*, 629 F. Supp. 333, 336 (N.D. Ill. 1986), in order to recover the assets for their equitable distribution under Wisconsin's priority structure, would inject needless uncertainty and instability in a proceeding that "can only work" if it "prevents the 'run-on-the-bank' psychology." Wis. Stat. Ann. § 645.32 cmt.[5]

---

[5] In addition, the delay and administrative costs of litigating to establish the supremacy of the state priority statute over generalized federal tax laws and obtain recovery of the assets from the IRS would impose additional unnecessary losses on policyholders. *See Amwest*, 245 F. Supp. 2d at 1045 (noting public interest in "conserv[ing] resources" in litigation pertaining to insurance delinquency proceedings in order to "maximize[e] the benefits available to the company's policyholders"); *Warfield*, 839 F. Supp. at 689 (noting that state court's exclusive jurisdiction over matters relating to the insurer delinquency "serve[s] the specific purpose of
(footnote continued on following page)

C. The Anti-Injunction Act Is Inapplicable Here

The IRS also cites to the Anti-Injunction Act ("AIA"), 26 U.S.C. § 7421, but that statute is inapplicable for a number of reasons.

By its terms, the AIA does not apply to the Commissioner acting in his official capacity in this non-adversarial insurance delinquency proceeding. The AIA operates to bar "any person" from bringing a "suit for the purpose of restraining the assessment or collection" of taxes. 26 U.S.C. § 7421(a). The Commissioner here is acting in his official capacity on behalf of the State of Wisconsin, and there is "a longstanding interpretive presumption that 'person' does not include the sovereign" absent "some affirmative showing of statutory intent to the contrary." *Vt. Agency of Natural Res. v. United States ex rel. Stevens*, 529 U.S. 765, 780-81 (2000); *Virginia ex rel. Cuccinelli v. Sebelius*, 702 F. Supp. 2d 598, 604 (E.D. Va. 2010). Given that the AIA "apparently has no recorded legislative history," *Bob Jones Univ. v. Simon*, 416 U.S. 725, 736 (1974), the IRS cannot overcome this presumption here. Moreover, as noted in the Commissioner's brief in support of his motion to remand the proceedings (Dkt. 15), neither this rehabilitation proceeding nor the injunctive relief applied to the IRS (and all other potential claimants) to protect the equitable allocation of assets and the administration of the proceeding constitute a "suit" against the IRS, let alone a "suit for the purpose of restraining the assessment or collection of taxes." 26 U.S.C. § 7421(a).

Moreover, the AIA "applies to injunctions which would be grounded on disputes over the right to tax or the amount to be assessed or collected." *Rodriguez*, 629 F. Supp. at 341. As noted above, the Supplemental Injunction makes no challenge to the merits of the IRS

---

protecting receivers from having to litigate in multiple forums, which might lead to a depletion of the insurance company's assets").

evaluation of the tax issues, or the amount (if any) that the IRS may determine to be owing. It merely addresses the *manner* of collection, so as to protect the proper priorities and the administration of the rehabilitation proceeding. The "anti-injunction act is no obstacle" to such relief. *Harrell v. United States*, 13 F.3d 232, 234 (7th Cir. 1993).

In addition, even in situations where the AIA applies on its face, the Supreme Court has imposed a judicial exception to the application of the AIA when IRS action threatens irreparable injury and "it is clear that under no circumstances could the Government ultimately prevail" in the issue in dispute—here, its entitlement to avoid the state priority statute by collecting and retaining any amounts it may find to be due and owing without submitting a claim in the rehabilitation process. *Enochs v. Williams Packing & Nav. Co.*, 370 U.S. 1, 7 (1962).

Both circumstances exist here. The mere threat of a prolonged deprivation of substantial claims-paying resources of a financially distressed insurer would severely disrupt the rehabilitation effort by, among other things, potentially delaying payments to superior claimants, unsettling expectations and long-term planning efforts, and multiplying litigation costs and risks of inconsistent rulings relating not only to the IRS but also all other competing policyholders and creditors looking to "jump ahead" of other claimants by filing actions outside the rehabilitation. *See Mountain Funding, Inc. v. Frontier Ins. Co.*, 329 F. Supp. 2d 994, 999 (N.D. Ill. 2004) (holding that claimant "should not be able to jump ahead of [the insurer's[other creditors because this litigation is outside the [state] rehabilitation proceeding and must not be able to set a precedent for other claimants to do the same"); *Corcoran*, 713 F. Supp at 79 (noting risk that permitting litigation outside the delinquency proceedings would "encourage other parties to the liquidation to evade the state proceedings").

Furthermore, there is no circumstance under which the United States will ultimately prevail on the priority issue. Specifically, even if a court determined that the tax refunds had to be repaid, the IRS would still be required to submit a claim either in the AFGI bankruptcy proceeding or in the rehabilitation proceeding for equitable distribution in light of *Fabe*, the Wisconsin priority statute's preference of policyholder loss claims over federal government claims, and the IRS's own regulations barring levies on assets subject to the control of a receivership court. *See Fla. ex rel Lewis v. United States*, No. 89-6143-CIV-HOEVELER, 1989 WL 91135, at *3-*4 (S.D. Fla. June 28, 1989) (abating levy against assets under control of state receiver and subject to a plan of distribution because the IRS's levy operated to "prevent the funds in the constructive trust from being disbursed to those for whose benefit it was established" in violation of 26 C.F.R. § 301.6331-1). Simply put, there is no conceivable ground on which the IRS could seize and permanently retain claims-paying resources outside the rehabilitation proceeding without running afoul of McCarran-Ferguson and Wisconsin law governing insurer delinquency proceedings, and there is no reason why any futile yet irreparably harmful attempts at such unlawful action should not be enjoined.

Finally, even if the AIA were otherwise applicable to this action, it is reverse-preempted by Wisconsin law regulating the business of insurance—namely, Wis. Stat. § 645.05, which authorizes injunctive relief to protect policyholders and the administration of the delinquency proceeding.

The three elements of the McCarran-Ferguson analysis are met. *First*, the AIA is unquestionably a law of general application; it broadly bars any "suit for the purpose of restraining the assessment or collection of any tax . . . in any court by any person." 26 U.S.C. 7421(a). No part of the statute specifically relates to insurance.

Second, as noted above, Section 645.05 regulates the business of insurance within the meaning of McCarran-Ferguson.

Third, there is a direct conflict between the AIA and Section 645.05. The latter expressly permits the State Rehabilitation Court to enjoin *any* threatened or contemplated action that might prejudice policyholders or the administration of the proceeding; the AIA would supersede that statute to the extent it protected policyholders or the proceeding from threatened or contemplated actions by the IRS, including threatened or contemplated action that would on its face violate the priority structure of Wisconsin insurance law—and thereby violate the McCarran-Ferguson Act as interpreted in *Fabe*.

D. The IRS's Case Authority Reflects Its Misunderstanding Of The Effect Of Reverse-Preemption Under McCarran-Ferguson

As the Supreme Court explained in *Humana*, when the three-part test for applying the McCarran-Ferguson Act is met—as is the case here—the effect is to *preclude the application* of the federal law that directly conflicts with state law. *Humana*, 525 U.S. at 310.

The cases the IRS cites show its misunderstanding of the effect of reverse-preemption. For example, the IRS cites *Appleton Papers, Inc. v. Home Indem. Co.*, 2000 WI App 104, ¶ 29, 235 Wis. 2d 39, 612 N.W.2d 760 for the proposition that: "Nor does any state court have the power to limit, modify, or control the power of the federal courts by enjoining a litigant from pursuing federal remedies in federal court." (IRS Br. at 10.) The point here is that, based on the application of McCarran-Ferguson, the specific federal remedies themselves have been reverse-preempted; the IRS cannot pursue the "federal remedies" it would otherwise have in the absence of such reverse-preemption.[6]

[6] Moreover, the *Appleton Papers* holding is limited to injunctive relief granted by state courts under authority other than Wis. Stat. § 645.05, and the opinion expressly disavows any

(footnote continued on following page)

Similarly, the IRS cites *Kaucky v. Southwest Airlines Co.*, 109 F.3d 349 (7th Cir. 1997), for the proposition:

> When federal law creates an exclusive remedy for some wrong, displacing any remedy that the states may have created for it, a suit to redress that wrong necessarily arises under federal law. There is no state law for it to arise under because the state law that the plaintiff thought he was suing to enforce has been pushed to one side, and replaced, by the federal law.

(IRS Br. at 10-11 (citing *Kaucky*, 109 F.3d at 351).) Again, in light of the reverse-preemption effected by McCarran-Ferguson in this case, the above-quoted language from *Kaucky* may more properly be construed to support the following proposition:

> When [state insurance] law creates an exclusive remedy for some wrong, displacing any remedy that the [United States] may have created for it, a suit to redress that wrong necessarily arises under [state] law. There is no [federal] law for it to arise under because the [federal] law . . . has been pushed to one side [by virtue of McCarran-Ferguson reverse-preemption], and replaced, by the [state] law.

In sum, none of the cases cited by the IRS support its position that it is entitled to pursue federal remedies that have been reverse-preempted by McCarran-Ferguson. *See Fabe*, discussed *supra*.

---

interference with the authority of state courts to grant injunctive relief under Chapter 645. *See id.* ¶ 27 n.11 ("We do not imply that a Wisconsin court may not issue an injunction under Wis. Stat. ch. 645 dealing with rehabilitation and liquidation of insurers. . . . If the injunction is honored by federal courts, it is honored on either the grounds of comity or because there is no available federal remedy.").

II. THE IRS'S ARGUMENTS BASED ON SOVEREIGN IMMUNITY SHOULD BE REJECTED

As discussed above, the federal statutes the IRS cites as authority to permit it to circumvent the state priority statute are reverse-preempted under McCarran-Ferguson. Thus, as a matter of law, in the narrow and specific context of the present insurance case, the IRS is *precluded from applying* the federal collection statutes with respect to the disputed tax liability. Nevertheless, the IRS argues that the Commissioner lacks a *remedy* to prevent the IRS from violating federal law (the McCarran-Ferguson Act) and state law (Wis. Stat. § 645.68(3) & (3c)) because the United States has not waived its sovereign immunity and consented to be sued. (IRS Br. at 9-12.)

A. Neither The Rehabilitation Proceeding Nor The Supplemental Injunction, Which Protect The Commissioner's Constructive Possession Of The Res Subject To Distribution, Is A Suit Against The United States That Implicates Sovereign Immunity

As explained in the Commissioner's brief in support of his motion to remand this action to the State Rehabilitation Court, the Commissioner has not "sued" the United States (or any other claimant) in the Rehabilitation Proceeding. For the reasons that follow, the government's position would require an expansive view of sovereign immunity that is inconsistent with both precedent and practice.

1. The Rehabilitation Proceeding Is Not Barred By Sovereign Immunity

The commencement of the Rehabilitation Proceeding was not a suit against the IRS, any more than it was against any of the thousands of other potential claimants. Like a voluntary petition for relief under the Bankruptcy Code, the petition for rehabilitation was not "against" any person or entity[7]; it instead initiated a formal remedial procedure to "rehabilitate the business of a domestic insurer," Wis. Stat. § 645.32(1), and to facilitate the "[e]quitable apportionment of any unavoidable loss," *id.* § 645.01(4)(d).

There are no formal "defendants" or "parties" to the rehabilitation. As a result, the State Rehabilitation Court has denied multiple motions to intervene as inappropriate and unnecessary, because all interested persons and entities have an ongoing right to be heard in the proceeding. (*See* Van Sicklen Decl., Ex. I at 6-7.) The Commissioner's Petition for Rehabilitation seeks no judgment against a defendant and requires no answers or other pleadings from third parties. The Rehabilitation Proceeding will conclude only when the Commissioner petitions the State Rehabilitation Court to either terminate the Proceeding or to transform it into a liquidation proceeding. Wis. Stat. § 645.35. As the State Rehabilitation Court has noted, it is not an adversarial proceeding; it is a structure for management of the operation of the insurer while financially hazardous conditions exist. (Van Sicklen Decl., Ex. I at 6-7.)

If the Rehabilitation Proceeding were construed to be a suit against all potential claimants including the IRS, then sovereign immunity would operate to bar *any* state insurance rehabilitation that implicated the interests of the federal government at its outset, at least to the extent that the rehabilitation sought to comprehensively administer assets and make distributions to claimants competing with the federal government. *See United States v. Rural Elec. Convenience Coop. Co.*, 922 F.2d 429, 435 (7th Cir. 1991) (noting the "troubling . . . prospect that the government and private parties aligned with it could deploy sovereign immunity . . . to federalize state proceedings" or to extinguish state rights altogether). There is no precedent to

[7] Here, the Ambac Board of Directors formally consented to the Commissioner's Verified Petition for Rehabilitation consistent with Wis. Stat. § 645.31(14). (*See* Van Sicklen Decl., Ex. A, ¶ 9.)

support such a result, which would render the Supreme Court's ruling in *Fabe* essentially meaningless.

Indeed, the IRS's own rules and regulations anticipate the practical necessities of large insolvency proceedings, and recognize that a levy under these circumstances would impede the orderly management of this proceeding:

> During a bankruptcy proceeding or a receivership proceeding in either a Federal or a State court, the assets of the taxpayer are in general under the control of the court in which such proceeding is pending. Taxes cannot be collected by levy upon assets in the custody of a court, whether or not such custody is incident to a bankruptcy or receivership proceeding, except where the proceeding has progressed to such a point that the levy would not interfere with the work of the court or where the court grants permission to levy.

26 C.F.R. § 301.6331-1(a)(3). *See also* Internal Revenue Manual § 5.17.13.7 (Oct. 16, 2007) ("The IRS may file a proof of claim to collect any tax liability from the assets in a judicial insolvency proceeding. The IRS generally may not levy on assets in the custody of a court."), *available at* http://www.irs.gov/irm/part5/irm_05-017-013.html#d0e342; *id.* (listing alternatives to filing a proof of claim, none of which involve levying or asserting sovereign immunity to avoid orders of the receivership court).

2. The Supplemental Injunction Is Not Barred By Sovereign Immunity

The November 8 Supplemental Injunction also did not constitute a suit against the IRS. In order to effectuate any insurance rehabilitation proceeding, temporary injunctive relief against all potential claimants is necessary to ensure that the rehabilitation takes place in an orderly fashion and that the state law priority rules (*i.e.*, who gets paid in what order) are observed. Because insurers are not entitled to protection under federal bankruptcy law, the First-Day Injunction (and the Supplemental Injunction) entered in the Rehabilitation Proceeding are analogous to, and have the same effect as, the automatic stay that is triggered at the outset of a bankruptcy proceeding.

As the Supplemental Injunction makes clear, it merely continues the First-Day Injunction and supplements that order to ensure its applicability to the newly allocated contingent liabilities. (Van Sicklen Decl., Ex. R ("Supplemental Injunction") ¶¶ 1-2.) Had the potential IRS liability been known and allocated to the Segregated Account at the time the Rehabilitation Proceeding commenced, the First-Day Injunction would have had the same effect on the IRS as the Supplemental Injunction. Indeed, the First-Day Injunction *did* enjoin the IRS, at least to the extent that it had any interest in the policies, contracts, and liabilities allocated to the Segregated Account at that time.

That a later-discovered potential liability was subsequently allocated to the Segregated Account without judicial involvement does not transform an existing injunction that is clarified to apply to this recent allocation into a new "suit" against the IRS specifically. Both the Supplemental Injunction and the First-Day Injunction are merely generalized, prophylactic injunctions to protect against "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(k).

In proceedings such as this one, "where suits are brought to marshal assets, administer trusts, or liquidate estates, and in suits of a similar nature" and the Commissioner is using "a sweeping injunction" in regard to the administration of the assets, the Supreme Court has long held that the mere fact that the United States is one of a number of claimants with a potential interest in the property does not make the suit one against the United States and does not entitle the United States to a federal forum for the adjudication of its particular interest. *Bank of N.Y. & Trust Co.*, 296 U.S. at 475-79. As the Supreme Court explained:

> The adverse claimants are parties to the respective proceedings in the state court and from every point of view the principles governing the convenient and orderly administration of justice require that the jurisdiction of the state court should be respected.
>
> There is no merit in the suggestion that the United States, in presenting its claim in the state proceedings, would be compelled to take the position of a defendant—being sued without its consent. In intervening for the presentation of its claim, the United States would be an actor—voluntarily asserting what it deemed to be its rights—and not a defendant. We cannot see that there would be an impairment of any rights the United States may possess, or any sacrifice of its proper dignity as a sovereign, if it prosecuted its claim in the appropriate forum where the funds are held.

Id. at 480-81; *see also id.* at 478 (rejecting assertion that claims involving government were *in personam* rather than *in rem* because "the object of the [government's attempted federal claims] is to take the property from the depositaries and from the control of the state court, and to vest the property in the United States to the exclusion of all those whose claims are being adjudicated in the state proceedings"); *United States v. $79,123.49 in U.S. Cash and Currency*, 830 F.2d 94, 97 (7th Cir. 1987) (recognizing *Bank of N.Y. & Trust Co.*'s "modern-day vitality").[8]

The Commissioner has not located any precedent where a federal court held that an injunction entered in an insurance delinquency proceeding to prevent potential claimants from

[8] In instances where the federal government is merely one of a large number of potential claimants against the limited assets of an insurer, it has participated in the state proceedings, argued any objections in state court, and received its distribution under a plan of rehabilitation, no differently than all other claimants in the rehabilitation proceeding. *See Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 572 A.2d 798, 801 n.2, 807-08 (Pa. Commw. Ct. 1990) (pre-Fabe case in which United States contested priority of contingent claims under rehabilitation plan in state court, and was subject to consequences of injunction against disposing assets of insurer), aff'd in all relevant respects, *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1100-01 (Pa. 1992).

taking adverse collection actions—similar to the automatic stay imposed in bankruptcy court[9]—constituted a "suit" barred by the sovereign immunity of any potential government claimants, as opposed to being a measure to ensure the orderly rehabilitation of the insurer.[10]

Furthermore, the IRS's case authority either is inapposite or supports the Commissioner's position. For example, the IRS cites *Central States, Southeast & Southwest Areas Health & Welfare Fund v. Old Security Life Ins. Co.*, 600 F.2d 671, 676 (7th Cir. 1979), for the proposition that a state court injunction has no effect on a federal action involving a suit under a statute (in that case, ERISA) that vested exclusive jurisdiction in the federal courts. (IRS Br. at 11-12.) However, *Central States* is readily distinguishable. Contrary to the IRS's

---

[9] *See Munich Am. Reinsurance Co.*, 141 F.3d at 593, 595 (Through the exclusion of insurers from bankruptcy proceedings, combined with the enactment of the McCarran-Ferguson Act, "Congress has evinced a strong federal policy in favor of deferring to state regulation of insolvent insurance companies."); *Baldwin-United Corp. v. Garner*, 678 S.W.2d 754, 758 (Ark. 1984) ("If any meaning is to be given to the congressional exclusion of insurance companies from the Bankruptcy Act and the mandate of the McCarran-Ferguson Act, it must be that the determination of rights among an insurance company's creditors must be left to state proceedings.").

[10] Courts have rejected IRS efforts to deploy sovereign immunity in a manner that would interfere with the orderly distribution of assets in bankruptcy proceedings. *See United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208-09, 212 (1983) (Pre-bankruptcy seizure of assets by IRS violates automatic stay because the commencement of bankruptcy proceedings "requires the Service to seek protection of its interest according to the congressionally established bankruptcy procedures, rather than by withholding the seized property from the debtor's efforts to reorganize"); *Price v. United States*, 42 F.3d 1068, 1070-72 (7th Cir. 1994) (IRS's notice of an intent to levy on the assets of debtor violates the automatic stay and subjects the IRS to damages, notwithstanding statutes otherwise authorizing the IRS's general use of broad collection powers); *McKenzie v. United States*, 536 F.2d 726, 728-29 (7th Cir. 1976) (noting that "it is axiomatic that the sovereign immunity of the United States can be waived impliedly, as well as explicitly, by statute[,]" and holding that statute permitting bankruptcy debtor to file an application for the discharge of "any debt" impliedly waived the sovereign immunity of the United States with regard to determination of tax indebtedness because "we cannot believe that Congress gave the bankruptcy court jurisdiction to determine the dischargeability of tax debts . . . and then intended that such determination should be prohibited" for lack of an express waiver of sovereign immunity regarding tax claims) (internal citation omitted).

suggestion (*id.* at 11), *Central States* was not decided on McCarran-Ferguson reverse-preemption grounds. *See Central States*, 600 F.2d at 677 & n.11 (passing discussion of McCarran-Ferguson for proposition that defendant was an insurance company subject to state regulation under that statute).

Moreover, the Seventh Circuit in *Central States* expressly noted that:

> If this federal action were in rem, it would present a very different situation. *Blackhawk Heating & Plumbing Co., Inc. v. Geeslin*, 530 F.2d 154 (7th Cir. 1976) involved state and federal proceedings, both in rem. An Illinois court placed a domestic insurance company in liquidation. Blackhawk petitioned the federal court to turn over certain securities. This court held that "since the Illinois had already acquired control over the securities . . . at the time Blackhawk filed its turn-over petition, the federal court lacked power to exercise control over that property. That property had been removed from the *in rem* jurisdiction of all other courts." *Id*. at 159. A federal court which first acquires in rem jurisdiction of a suit to liquidate is obliged to relinquish jurisdiction to permit administration of the affairs of the insolvent under the state's statutory receivership plan.

Central States, 600 F.2d at 676; *see also Blackhawk Heating & Plumbing Co. v. Geeslin*, 530 F.2d 154, 158 (7th Cir. 1976) ("The appointment of a receiver and institution of liquidation proceedings in the Illinois court against [the insurer] constitutes an action *in rem*. The fact that the Illinois court does not have actual physical possession of all of [the insurer's] assets is of no consequence. The constructive possession by [the insurer's] liquidator is sufficient; his possession is the court's possession.") (internal citations omitted).[11]

---

[11] The IRS's arguments in this respect are puzzling. If this Court were to conclude that the IRS's removal was not improper (as it must in order to reach this issue), then even the IRS's flawed reading of *Central States* would not preclude the injunctive relief entered here altogether. It would merely require that such relief be entered by this Court following removal, rather than the State Rehabilitation Court. As noted in the Introduction, the IRS does not challenge the underlying grounds for injunctive relief under Wis. Stat. § 645.05.

The IRS also cites *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), but that case involved a dispute regarding the "existence and amount of a claim against the debtor." *Id.* at 221. As the Fourth Circuit noted,

> Here, the defendants seek only to establish their rights to exoneration, contribution, or indemnification. If they are permitted to proceed in federal court and they succeed on those claims, they would *still be required to present their judgments to the Virginia Commission*. The Commission would then direct the deputy receiver to *pay those judgments in accordance with the rehabilitation plan and Virginia's statutes governing the priority of claims*.

Id. at 221-22 (emphasis added). This is the Commissioner's point here: if and when the IRS receives a judgment as to the disputed tax liability, it should "be required" to comply with state law and submit a claim in the Rehabilitation Proceeding and have its claim treated under the statute governing the priority of claims.

In sum, in this insurance case, the United States is merely one of many claimants as to assets over which the Commissioner has constructive possession by virtue of the initiation of the Rehabilitation Proceeding. It is not a defendant, and there has been no suit against it which would implicate its sovereign immunity.

B. Even If The United States' Sovereign Immunity Were Implicated, It Has Waived That Immunity In The Context Of This Dispute.

Even assuming *arguendo* that the Commissioner's actions in the Rehabilitation Proceeding were deemed to initiate a "suit" against the United States, sovereign immunity has been waived.

Under 28 U.S.C. § 2410(a)(1), "the United States may be named a party in any civil action or suit in any district court, or in any State court having jurisdiction of the subject matter to quiet title to . . . real or personal property on which the United States has or claims a mortgage or other lien."

"The Supreme Court has held that § 2410 is indeed a waiver of sovereign immunity for those situations which it covers." *Rodriguez*, 629 F. Supp. at 338-39 (citing *United States v. John Hancock Mut. Life Ins. Co.*, 364 U.S. 301 (1960)). The "situations which it covers" are wide-ranging, and encompass suits relating to IRS tax claims that are "akin to an action to quiet title brought by a third party," including actions to "clarify or determine the relative rights of the parties in the property, presumably as a matter of the interaction of state and federal priority laws." *Estate of Johnson v. Engel*, 836 F.2d 940, 945 (5th Cir. 1988). *See also Progressive Consumers Fed. Credit Union v. United States*, 79 F.3d 1228, 1232, 1233 (1st Cir. 1996) (Section 2410's quiet title provision receives "a broad construction," extending its waiver of sovereign immunity to all cases in which a plaintiff seeks "a determination of priority between competing liens"); *ContiMortgage Corp. v. United States*, 109 F. Supp. 2d 1038, 1041 (D. Minn. 2000) (noting that "2410(a) has been recognized as a vehicle for determining lien priority" regarding IRS tax claims); *McEndree v. Wilson*, 774 F. Supp. 1292, 1297 (D. Colo. 1991) (claims of priority over federal tax liens are "within the scope of a quiet title action under 28 U.S.C. § 2410(a)(1)"). "Although § 2410(a)(1) speaks only of liens, liens and levies have been treated as essentially interchangeable for purposes of finding an action covered by § 2410," *Jacobson v. Commissioner*, No. 05-C-134-C, 2005 WL 674917, at *2 (W.D. Wis. Mar. 16, 2005) (internal quotation omitted), and levies on cash fall within the scope of Section 2410, *Harrell*, 13 F.3d at 234; *Rodriguez*, 629 F. Supp. at 339.

Courts have recognized that this provision can be a source of waiver of sovereign immunity if a taxpayer is contesting the validity of a tax lien and sale on the ground that the government has failed to comply with applicable law. *Harrell*, 13 F.3d at 233-34 (holding that "insofar as [the plaintiff's] concern is with the levy itself, that is, with the deducting of money from his paycheck for payment over to the IRS, he has not misconceived his remedy" in suing under Section 2410); *Robinson v. United States*, 920 F.2d 1157, 1161 (3d Cir. 1990) (taxpayer could challenge tax lien allegedly imposed without IRS sending notice of deficiency under Section 2410); *Pollack v. United States*, 819 F.2d 144, 145 (6th Cir. 1987) (Section 2410 can be used to contest procedural irregularity of tax lien); *Viva Ltd. v. United States,* 490 F. Supp. 1002, 1007 (D. Colo. 1980); *Aqua Bar & Lounge, Inc. v. U.S. Dep't of Treasury I.R.S.*, 539 F.2d 935, 938 (3d Cir. 1976).[12]

For example, in *Estate of Johnson*, the executor of an estate sought "a determination that the estate's administrative and funeral expenses take priority over the Government's [tax] lien, and a distribution of the assets pursuant to that determination." 836 F.2d at 945. In permitting the challenge, the Fifth Circuit noted:

> While it is true that the executor fails to present the typical section 2410(a) challenge to a federal tax lien by a third party purchaser or mortgagee holding an allegedly superior lien, we see no logical distinction between the instant case and that which the district court termed "the classic § 2410 situation." Both seek relief which would seem to fit within our earlier definition of a section 2410 quiet title action, to wit: "a determination that a tax lien does not exist, has been extinguished, *or is inferior in rank*." Therefore, given that the executor is seeking to clarify or determine the relative rights of the parties in the property, presumably as a matter of the interaction of state and federal priority laws, his suit would seem the proper method for removing the clouds on title cast by the federal tax liens.

[12] Although Section 2410 cannot be used to challenge the validity of the underlying tax assessment, *see Koehler v. United States,* 153 F.3d 263, 266 (5th Cir. 1998); *Progressive*, 79 F.3d at 1233; *Harrell,* 13 F.3d at 235; *Johnson v. United States*, 990 F.2d 41, 42 (2d Cir. 1993); *Guthrie v. Sawyer,* 970 F.2d 733, 735 (10th Cir. 1992); *Falik v. United States,* 343 F.2d 38 (2d Cir. 1965), this exclusion is inapplicable here, as the Commissioner takes no position as to the merits of the underlying tax dispute.

Id. at 946 (internal citations omitted, emphasis added). *See In re Matter of All-Star Ins. Corp.*, 484 F. Supp. 623, 625 (E.D. Wis. 1980) (analogizing probate matters and insurance delinquency proceedings and observing that, like probate matters, the Seventh Circuit has noted that insurance rehabilitations and liquidations are "best left to a proceeding which will settle all of its affairs and dispose of all of its property").

Likewise, the First Circuit has observed:

> If, in substance, the relief the plaintiff sought here—a declaration of the priority of Progressive's mortgage over the government's tax lien—is congruent with the relief available in a quiet title suit, it would frustrate congressional intent to block plaintiff's access to relief. Congress, after all, was concerned not with the niceties of common law pleading, but with practical problems facing owners whose property was encumbered by government liens.

Progressive, 79 F.3d at 1231-32*; see also id*. at 1231-33 (discussing types of cases permitted under Section 2410).

Here, Section 2410 waives the United States' sovereign immunity as to whether the federal laws that the IRS seeks to invoke are reverse-preempted by the McCarran-Ferguson Act and, if so, whether the Commissioner can prevent the IRS from violating the state insurance priority statute. *See*, *e.g.*, *Rodriguez,* 629 F. Supp. at 339-41. The IRS argues that this Court should dissolve the Supplemental Injunction and then, if the IRS does in fact levy or attach the amount of the disputed tax liability, the Commissioner can pursue post-levy remedies under federal law. However, this argument has it backwards. If reverse-preemption has been triggered, then it would violate federal and state law to permit the IRS to exercise its collection powers in the first place, to the prejudice of policyholders that the Commissioner is required by state law to protect.

CONCLUSION

For the reasons stated above, the IRS's motion to dissolve the November 8, 2010 Supplemental Injunction should be denied.

Dated this 30th day of December, 2010.

FOLEY & LARDNER LLP

/s/ Michael B. Van Sicklen
Michael B. Van Sicklen, SBN 1017827
Naikang Tsao, SBN 1036747
Matthew R. Lynch, SBN 1066370

150 East Gilman Street
Madison, WI 53703
(608) 257-5035 (phone)
(608) 258-4258 (fax)

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

EXHIBIT 1

626 MAIN STREET
P.O. BOX 40
DARLINGTON, WISCONSIN 53530
PHONE: 608-776-4811

LAURETTA F. LADE
JUDICIAL ASSISTANT
REGISTER IN PROBATE
BRIAN J. WHALEN
COURT REPORTER
LAURIE A. NEIS
JUVENILE INTAKE
PHONE: 608-776-4875

Lafayette County Circuit Court

WILLIAM D. JOHNSTON
Circuit Judge

December 15, 2010

FILED
DEC 16 2010
STATE OF WISCONSIN
CIRCUIT COURT FOR DANE COUNTY

RECEIVED
10 DEC 16 PM 2:06
CIRCUIT COURT
DANE CO., WI

Jody Baux
Dane Co. Clerk of Courts Office
215 S Hamilton St. Rm. 1000
Madison WI 53703

Re: In the Matter of the Rehabilitation of Segregated Account Of Ambac Assurance Corporation
Dane Co. Case No. 10CV1576 Q8

Dear Ms. Baux:

Following the hearing on the Rehabilitation Plan, I informed the parties that I would issue a decision after I reviewed the submissions that had been filed. I am now ready to issue that decision. However, on December 8, 2010 the United States filed a 28 U.S.C. sec. 1446(a) Notice of Removal to the United States District Court For the Western District of Wisconsin in this case. This case has now been removed to the federal court in Madison. Under 28 U.S.C. sec. 1446(d), the State Court "…shall proceed no further unless or until the case is remanded."

At such time as the case is remanded by the Federal District Court, I w ill then issue my decision. Please copy this letter to counsel and others on the service list.

Very truly yours,

William D. Johnston
Circuit Court Judge

WDJ/ll

CC: To All Parties

EXHIBIT 2

* * *

645.68 *Introductory comment:* When an insurer must be liquidated, the outcome is often tragic. While many of the losers will merely be inconvenienced, others may suffer losses or delays in receiving payment that will subject them at least to hardship and may even deprive them of the necessities of life. It becomes apparent that claims that are socially more important need to be paid ahead of those that are less important. Recognition of such social equities is commonplace in the law relating to insolvency and bankruptcy.

In an effort to minimize the harm done by liquidation, and especially to lessen it for those persons least able to bear it, much thought and consultation went into the structuring of the priority system. The outcome is the classification that follows. Because of the novelty of certain parts of the system, a full explanation for the placement of each category is provided. The basic nature of the system is explained briefly in the following outline, however, to provide an overview.

The order of distribution is:

(1) *Cost of administration.* Without this, the liquidation could not proceed and no distribution could be made. These costs generally come first in all priority systems.

(2) *Wages, in limited amounts.* This is traditionally a high priority and seems obviously meritorious in a society where the majority of people are dependent for a livelihood upon regular receipt of wages.

(3) *Loss claims.* This is limited to large claims, the cases where the most hardship will result if full payment is not made reasonably promptly.

(4) *Unearned premium reserve and small loss claims.* If this priority can be reached and these claims paid in full, the enterprise will have carried out the social function of insurance in a reasonably adequate way.

(5) *Residual classification.* This includes ordinary commercial debts and debts owing to governments, such as taxes. It is likely to be small in amount relative to the total of all claims.

(6) *Claims based solely on judgments.* Those judgments that cannot otherwise be avoided for constitutional reasons are postponed to this class to protect other claimants against inflated claims that are not properly defended because of the deterioration of the company in its last days. If the claim is meritorious, the judgment creditor can elevate his claim to the priority it would otherwise have by proving it in the liquidation on its merits and not on the basis of the judgment. The judgment may, of course, be a very persuasive fact.

(7) *Interest* on claims paid in the classes of higher priority.

(8) *Miscellaneous subordinated claims.* These are left to the last because of their minimal social importance or because of the necessities of administration. The category includes late claims and claims where the claimant is compensated in other ways, among others.

This section is designed to establish a complete system of priorities among unsecured creditors, based on the relative social and economic importance of the claims likely to be asserted against an insurer. The system is more intricate than any list of priorities provided elsewhere. It would be possible to simplify the system by having fewer categories. This is what the traditional priority system does, for it generally gives priority only to a few kinds of claims—indeed, the traditional pattern is no system at all. Its crude simplicity does crude injustice and fails to carry out sound public policy by minimizing the damage done to the insured community when an insurer fails. The insurance enterprise should be made to do its proper job in the social organism, so far as that is possible with the limited assets that remain in a liquidation.

645.68 ORDER OF DISTRIBUTION. The order of distribution of claims from the insurer's estate shall be as stated in this section. The first $50 of the amount allowed on each claim in the classes under subs. (2) to (6) shall be deducted from the claim and included in the class under sub. (8). Claims may not be cumulated by assignment to avoid application of the $50 deductible provision. Subject to the $50 deductible provision, 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. No subclasses shall be established within any class.

(1) ADMINISTRATION COSTS. The costs and expenses of administration, including but not limited to the following: the actual and necessary costs of preserving or recovering the assets of the insurer; compensation for all services rendered in the liquidation; any necessary filing fees; the fees and mileage payable to witnesses; and reasonable attorney's fees.
Comment on sub. (1): This is freely adapted from the first priority provision in Federal Bankruptcy Act s. 64a. See also s. 645.06, on defense costs, for a special provision for payment of certain litigation expenses.

(2) WAGES. (a) Debts due to employes for services performed, not to exceed $1,000 to each employe which have been earned within one year before the filing of the petition for liquidation. Officers shall not be entitled to the benefit of this priority.
Comment on sub. (2) (a): The usual wage priority is $600 (see e.g. Federal Bankruptcy Act s. 64a). It seems unrealistically low. The $1,000 provided here may still be low but is more realistic and equitable. The period covered is extended from the 3 months of the traditional statute to one year. Obviously the $1,000 limit would be reached much earlier than a year, if a full salary for even the lowliest employe were in question. The one year limit will be relevant only in unusual cases. Priority is denied to officers (which term includes directors), on the grounds that they are in a position to protect their own interests, and that those directly involved in what is likely to have been mismanagement leading to liquidation should not be accorded special privileges in a financial debacle of their own making.

(b) Such priority shall be in lieu of any other similar priority authorized by law as to wages or compensation of employes.
Comment on sub. (2) (b): This is necessary to supersede such provisions as ss. 180.40 (6) and 268.17. For analogous legislation to this paragraph, see Arizona s. 20-637B; Hawaii s. 181-678 (b); Kentucky s. 304.978 (2); North Carolina s. 558-155.27 (b); Washington s. 48.31.280 (2).

(3) LOSS CLAIMS. All claims under policies for losses incurred including third party claims, and all claims against the insurer for liability for bodily injury or for injury to or destruction of tangible property which are not under policies, except the first $200 of losses otherwise payable to any claimant under this subsection. All claims under life insurance and annuity policies, whether for death proceeds, annuity proceeds or investment values, shall be treated as loss claims. Claims may not be cumulated by assignment to avoid application of the $200 deductible provision. That portion of any loss for which indemnification is provided by other benefits or advantages recovered or recoverable by the claimant shall not be included in this class, other than benefits or advantages recovered or recoverable in discharge of familial obligations of support or by way of succession at death or as proceeds of life insurance, or as gratuities. No payment made by an employer to his employe shall be treated as a gratuity. *Comment on sub. (3):* This class contains the claims central to the social role of insurance. The typical policy is not an ordinary mercantile contract, but one of great public importance. In the usual case, if a policyholder loses a premium, he is not seriously harmed, but if a loss goes unpaid, or even unpaid in substantial measure, great harm is likely to be done. Large claims deserve a higher priority than unearned premiums, and this system has so provided.

Small loss claims are subordinated to large claims and put on a par with unearned premiums, in order to increase the likelihood of full payment of disaster-type claims. This is the point of the $200 deduction. In the usual case, a small loss may be absorbed by the claimant without serious hardship, and therefore does not deserve or need priority above unearned premiums. The larger the claim the more likely it is that substantial payment to the claimant is urgently needed.

The investment element of life insurance and annuity contracts is here treated as a loss claim. Life insurance and annuity policies present a complex array of investment and insurance mixtures which would often be difficult to classify as either loss claims or claims for investment values. Furthermore, the economic function and social importance of these investment values closely parallel those of loss claims in general. To avoid administrative difficulty and to give proper recognition to the social values in question, all claims under life and annuity policies are placed in this priority and are given loss claim status.

The 2nd group of claims against the insurer, for "liability for bodily injury or for injury to or destruction of tangible property which are not under policies," avoids the anomaly of giving insured liability claimants a high priority while subordinating other identically situated claimants who are unprotected by the benefits of liability insurance. This might happen, for example, if the insurer were self-insured (or *not* insured) for its own public liability. The words "bodily injury" rather than "personal injury" are used in the definition of this group to elminate from this priority uninsured claims for libel, slander, invasion of privacy, false imprisonment, etc., which are less likely to generate actual out-of-pocket economic losses. The words "injury to or destruction of tangible property" are used in order to eliminate from this priority uninsured claims for intangible property losses (e.g. invasion of copyright) which are also less likely to generate out-of-pocket economic losses. These excluded claims would fall into the residual classification in sub. (5).

Under prior practice, it was possible for a claimant to be compensated legitimately more than once for certain kinds of losses. Because of their lesser social importance, this section subordinates any portion of a claim, the payment of which would result in double compensation.

(4) UNEARNED PREMIUMS AND SMALL LOSS CLAIMS. Claims under non-assessable policies for unearned premiums or other premium refunds and the first $200 of loss excepted by the deductible provision in sub. (3).

Comment on sub. (4): Unearned premium claimants are placed in line after loss claimants, to help ensure the continuity of insurance protection, and the performance of insurer functions. The holders of assessable policies are not granted any such priority since traditionally their payments are regarded as partially in the nature of capital contributions. With unearned premiums is included the "deductible" portion of loss claims from sub. (3).

(5) RESIDUAL CLASSIFICATION. All other claims including claims of the federal or any state or local government, not falling within other classes under this section. Claims, including those of any 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).

Comment on sub. (5): This is the residual classification, and includes a great variety of claims, though in aggregate amount, it will usually be unimportant. This priority and all below it are of relatively lesser social importance. They are just debts, having no significant relationship to the important role insurance plays in our society.

The last 2 sentences are similar to Federal Bankruptcy Act s. 57j. It is sound policy to disallow or subordinate such claims. The Bankruptcy Act provision does for governmental claims what general contract law does for similar claims of private parties. See MacLachlan, *Bankruptcy* 140 (1956). Here, as a precaution, the rule is made clearly applicable to private penalties and forfeitures as well. Whether the claims of the federal government can be placed this far down on the priority list depends on the following analysis justifying subordination of other governmental claims to this class.

In this residual classification fall most of the claims by government that are traditionally given a high priority. There is no justification for giving a high priority to the sovereign because it is sovereign. On the merits, indeed, there seems an unanswerable case for declining to prefer government claims, including claims on taxes, and giving priority to claims of greater social importance, such as the unearned premium reserve and, *a fortiori*, loss claims. The sovereign, and in particular the United States, will be able to survive without hardship even if relegated to the priority accorded ordinary creditors. Of course, governments as insureds stand on a different footing.

An insurer in liquidation is failing to perform its social role and is casting heavy burdens on segments of society that cannot afford to bear them. In such a case, the modest contribution made to the handling of a difficult situation by the government, if its taxes are subordinated, may have social utility vastly in excess of its costs to the public. Moreover, by undertaking to regulate insurance, government should be regarded as assuming at least to this limited extent an obligation of underwriting solvency. This is as true of the federal government as of the states, for the federal government has delegated the field to the states on the theory that the states can do it better. When they fail to do it at all, such government can not then fairly depend on sovereign powers to get a preference over other creditors. Instead they should take a subordinate position in the priority hierarchy.

A problem is created by the Federal Insolvency Act, 31 U.S.C. s. 191, which provides in part: "Whenever any person indebted to the United States is insolvent. . .the debts due to the United States shall be first satisfied. . ." If in a case that Act were held to override a priority system for insurance liquidation that subordinates government claims, it would then be possible and desirable to seek Congressional amendment of that act.

There is considerable reason to think that the Federal Act would not override this priority system. There are 2 alternative and independent arguments, either of which is enough, if successful, to subordinate the federal government claim.

The first is based on restrictive interpretations of the section by the United States Supreme Court that may prevent its application to insurance. This argument is simple. The Federal Insolvency Act has been held by the United States Supreme Court to apply, despite its broad language, in only 4 cases: the decedent's estate, voluntary assignment for benefit of creditors, attachment of the estate of an absent debtor, and the commission of an act of bankruptcy. Kennedy, "The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien," 63 *Yale Law Journal* 905, 906, n. 6 (1954). None of these 4 cases seem to comprehend an insurance liquidation. Moreover, it applies only on insolvency of the insurer, which may not have been shown. *United States v. Oklahoma,* 261 U.S. 253 (1923). See comment on s. 645.42 (4).

The 2nd argument is based on Public Law 15, s. 2 (b), which provides that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, unless such Act specifically relates to the business of insurance. . ." This precludes application of 31 U.S.C. s. 191, which does not specifically relate to the business of insurance and therefore can not "invalidate, impair, or supersede" any state law regulating insurance. The priority system created by this section is a state law regulating insurance for it is part of a complex statute all of which regulates insurance. In fact, Congress exempted insurance companies from the operation of the Federal Bankruptcy Act in recognition of the fact that they are subject to a complete system of state regulation, which extends to the rules governing insolvency. A federal court (*In Re Supreme Lodge of the Masons Annuity,* 285 Fed. 180 (N.D. Ga. 1923)) in discussing the bankruptcy exemption of insurance, notes that:

"No reasons for making these exceptions were assigned by the committees of Congress, but they may be surmised to lie in the public or quasi-public nature of the business, involving other interests than those of creditors, in the desirability of unarrested operation, the completeness of state regulation, including provisions for insolvency, and the inappropriateness of bankruptcy machinery to their affairs."

The rationale of the bankruptcy exemption, as stated by the federal court, is affirmed in s. 645.01 (4) (f). That paragraph indicates that the purposes of this chapter include "Regulation of the insurance business by the impact of the law relating to delinquency procedures and substantive rules on the entire insurance business." The statement of purpose is not a mere assertion, for it is clear that insurance regulation in general, and this chapter in particular, including the section on priorities, is part and parcel of the regulatory structure, and has a real impact on the ongoing insurance operation. It follows, therefore, that the Federal Insolvency Act cannot "invalidate, impair, or supersede" the priority system of this section.

It is true that *Langdeau v. United States*, 363 S.W. 2d 327 (Tex. Civ. App. 1962), which on its facts is on all fours with the situation contemplated in this subsection, holds that the state may not subordinate federal tax claims even to wage claims. The case is thus a clear—but not high—authority. At best it would be only persuasive authority, but it is not in the least persuasive. The court seems to rest its position on 2 points, neither of which is clearly articulated or persuasively put. First, the court seems to rely heavily on *United States v. Emory*, 314 U.S. 423 (1941) as making clear that 31 U.S.C. s. 191 applies to the case and establishes the federal tax priority. But unfortunately for that argument, the *Emory* case was not an insurance case and it was one in which an act of bankruptcy had been committed, thus bringing it within one of the classes of cases to which s. 191 has been held to apply. The court's 2nd point was that the Texas statute subordinating the federal tax was not a regulatory statute, but merely a priority established for creditors. The Texas court seems simply wrong on this point. *A fortiori* it would be wrong under this subsection, which is designed to have a regulatory impact. This chapter as a whole, and even this single subsection, is an integral part of the regulatory pattern. In fact, the supervision of the ailing insurance enterprise is not only regulation, but regulation of the greatest intensity. The obvious regulatory impact of this chapter is not limited to sick and dying insurers, either, but influences the entire operation of the industry.

For example, it seems very clear that the preference of loss claims to unearned premium claims will have a bearing on the way the business is conducted, and particularly on the way premiums are financed. Premium financing agencies would avoid financing premiums for shaky companies, thus changing their operating patterns. This is important and fruitful regulation. Every part of the priorities section has regulatory impact, and is designed to make the insurance institution work better. This priorities section thus gives the liquidator the statutory basis for contesting the federal priority. If despite the case outlined here, the U.S. Supreme Court decided otherwise, the federal statute should then be amended if possible. But there is little point in proposing amendment until its meaning as applied to this situation is tested in an authoritative tribunal. Designing the subsection as it is designed is in effect inviting a test case the first time enough money is involved to justify it.

This comment does not purport to be a brief for the test case, if one develops. But the chances of achieving the goal are excellent and it should be tried. Acquiescence in an unfair federal priority in liquidation cases would be anticipatory capitulation. Acquiescence by the federal government in this reasonable state priority system is possible, though perhaps not to be relied upon; it would eliminate the need for a test case.

(6) JUDGMENTS. Claims based solely on judgments. If a claimant files a claim and bases it both on the judgment and on the underlying facts, the claim shall be considered by the liquidator who shall give the judgment such weight as he deems appropriate. The claim as allowed shall receive the priority it would receive in the absence of the judgment. If the judgment is larger than the allowance on the underlying claim, the remaining portion of the judgment shall be treated as if it were a claim based solely on a judgment.

Comment on sub. (6): Whether or not recent judgments can be rendered invalid under other provisions of this chapter, they should always be suspect because of the likelihood of inadequate defense in the last days of the insurer. This priority is an effort to provide additional protection to the estate of the insurer against unwarranted depletion by such inadequately defended suits. Such judgments are questionable enough that they should not be given parity of treatment with better proved claims. If the claimant proves his claim in the statutory way he gets his normal priority.

(7) INTEREST ON CLAIMS ALREADY PAID. Interest at the legal rate compounded annually on all claims in the classes under subs. (1) to (6) from the date of the petition for liquidation or the date on which the claim becomes due, whichever is later, until the date on which the dividend is declared. The liquidator, with the approval of the court, may make reasonable classifications of claims for purposes of computing interest, may make approximate computations and may ignore certain classifications and time periods as de minimis.

Comment on sub. (7): Interest might well receive the priority given the underlying claim. Practical considerations urge postponement. At some point, however, interest should be allowed before paying the remaining funds to ownership claimants. Interest should also rank ahead of the very low priority claims that fall in the next class. Interest does present special problems unless the liquidator is using automated equipment. These problems necessitate separate treatment. Moreover, the liquidator has wide discretion, controlled by the court, to pay or ignore interest, or to estimate it.

(8) MISCELLANEOUS SUBORDINATED CLAIMS. The remaining claims or portions of claims not already paid, with interest as in sub. (7):

(a) The first $50 of each claim in the classes under subs. (2) to (6) subordinated under this section;

(b) Claims under s. 645.63 (2);

(c) Claims subordinated by s. 645.90;

(d) Claims filed late;

(e) Portions of claims subordinated under sub. (5); and

(f) Claims or portions of claims payment of which is provided by other benefits or advantages recovered or recoverable by the claimant.

Comment on sub. (8): It will be a rare liquidation that will pay anything to the last few priorities, but only claims of little merit have been relegated to this class. Still they should rank above ownership claims.

(9) PREFERRED OWNERSHIP CLAIMS. Surplus or contribution notes, or similar obligations, and premium refunds on assessable policies. Payments to members of domestic mutual insurance companies shall be limited in accordance with s. 201.13. Interest at the legal rate shall be added to each claim, as in subs. (7) and (8).

Comment on sub. (9): These claims are quasi-ownership claims, and rank close to the bottom by their own terms.

(10) PROPRIETARY CLAIMS. The claims of shareholders or other owners.

645.71 Introductory comment: This section prescribes a procedure to assure proper court records and the submission of lists of recommended claims to the court. Special treatment is accorded to claimants of investment values under life and annuity contracts, and to unearned premium claimants, since the insurer's records should make their submission of claims unnecessary.

The former Wisconsin insurance liquidation law, s. 200.08, prescribed no appropriate procedures. Especially in view of the fact that liquidation is not frequent enough to generate detailed case law, it is useful to spell out basic procedures in the statute rather than rely on sketchy and inadequate tradition.

EXHIBIT 3

Wisconsin Bill Analysis, 1999 Regular Session, **Assembly Bill 551**
1999

Wisconsin Legislative Reference Bureau

94th Regular Session, 1999

Insurer liquidation and the security fund

Current law classifies claims and sets out the priority in which the claim classes are paid when an insolvent insurer is liquidated. This bill makes some minor remedial changes in those liquidation priorities to comply with the ruling of the U.S. supreme court in *U.S. Department of the Treasury v. Fabe*, 113 S. Ct. 2202 (1993).

Under current law, a $50 deductible applies to all claims except those that are for administration of the liquidation process. The bill provides that this deductible does not apply to any claims of the federal government.

Under current law, wage claims of employes of the insurer have second priority of payment, immediately after administration claims. The bill places these claims fifth but provides that, if there are no claims of the federal government, these claims are paid immediately after administration claims, as under current law.

Under current law, claims under policies for losses incurred, as well as claims that are not under policies and that are against the insurer for bodily injury or destruction of property, are paid third. Claims under this class are reduced by the first $200 of losses. The bill places loss claims under policies second in priority of payment and specifies that any loss claims of the federal government under policies are not subject to the $200 reduction. The bill also establishes at a third priority of payment any claims of the federal government that are not loss claims under policies. In addition, the bill separates out claims that are not under policies and that are against the insurer for bodily injury or destruction of property and places them fourth in priority of payment.

Finally, under current law, interest on claims has its own class of priority of payment that is generally lower than the priority of payment that the claim has. The bill provides that interest on all claims of the federal government, however, has the same priority of payment as claims of the federal government that are not loss claims under policies.

In current law, the insurance security fund, which is funded through assessments paid by insurers, pays claims on behalf of insurers in liquidation. The fund is administered by a board of directors made up of the commissioner of insurance, the attorney general, the state treasurer and representatives of insurers. The board stands in the position of an insurer in liquidation for purposes of not only paying claims but also investigating, settling and denying claims and defending third party claims against insureds. The bill makes a number of changes, many of which are technical in nature, to the provisions relating to the fund and the board.

Under current law, the board of directors of the insurance security fund has no duty or liability with respect to any claim that is filed with the liquidator after the date for filing specified by the liquidator in the notice of the liquidation unless, for reasons specified in the statutes, the late filing is excused. The bill adds that, except for excused late filings and claims under life insurance policies, annuities and noncancelable or guaranteed renewable disability insurance policies, the board has no duty or liability with respect to claims that are filed after the earlier of the date for filing specified by the liquidator or 18 months after the order of liquidation is entered. The effect of the change is to place a maximum time on filing extensions that may be granted by the liquidator or a court.

Among the powers that the board of directors has under current law are the power to review settlements and judgments to which an insurer or its insureds were parties to determine whether they should be contested and the power to appear in any liquidation proceeding in this state involving an insurer in liquidation. The bill adds the power to pursue salvage or subrogation with respect to paid covered claim obligations and to retain any amounts recovered and the power to appoint and direct legal counsel for the defense of covered claims under insurance policies.

The bill provides that the duty of the board to defend an insured ceases upon the board's payment of an amount equal to its covered claim obligation limit or the applicable policy limit. In addition to the requirements in current law related to whether a claim is eligible for payment, the bill adds that, except for claims under life insurance policies, annuities and noncancelable or guaranteed renewable disability insurance policies, a claim must have arisen within 30 days after the liquidation order was entered or before the policy expires or is replaced or canceled by the insured, if the policy expires or is replaced or canceled less than 30 days after the liquidation order was entered. The bill also provides that an insurer's obligation to pay assessments to the insurance security fund terminates if the insurer's license or certificate of authority to do business in this state terminates or expires. Such an insurer remains liable, however, to pay assessments that were made or called before the insurer's license or certificate terminated or expired and assessments that were made or called after the insurer's license or certificate of authority terminated or expired but that relate to a liquidation order entered before the license or certificate of authority terminated or expired.

Mutual insurance holding company provisions

Current law specifies procedures for a mutual insurance company to restructure by forming a mutual insurance holding company and becoming a stock insurance company that is owned by the mutual insurance holding company. The statutes also set out various requirements related to the structure and operation of the mutual insurance holding company that is formed in the restructuring. Because many of these requirements are identical with the requirements in the statutes for nonstock corporations, there are many cross-references to the chapter governing nonstock corporations in the chapter governing the formation of mutual insurance holding companies.

The act that created the chapter in the statutes that governs the formation of mutual insurance holding companies was passed in the 1997-98 session of the legislature. During that same session, the chapter governing nonstock corporations was completely revised. As a consequence, the cross-references in the chapter governing the formation of mutual insurance holding companies are no longer valid. This bill changes those cross-references to conform to the changes that were made in the chapter governing nonstock corporations, sometimes incorporating substantive changes that were made in the law governing nonstock corporations. For example, a provision in current law that governs the bylaws of a mutual insurance holding company specifies that the statutory provision governing the bylaws of a nonstock corporation applies to the bylaws of a mutual insurance holding company. When the chapter governing nonstock corporations was revised, provisions governing bylaws were created to include not only the former provision, which addressed adoption of bylaws, but also provisions on contents of bylaws, adopting emergency bylaws and amendment of bylaws by a corporation's board of directors and members. In changing the cross-references to conform to the current law on nonstock corporations, the bill applies the additional provisions on contents of bylaws, adopting emergency bylaws and amendment of bylaws by the board of directors and members to mutual insurance holding companies.

In addition, the bill makes a technical correction to a provision in the statutes related to a mutual insurance company. The statutes make a distinction between the way in which a sale, lease or exchange of less than all of the property and assets of a mutual may be authorized and the way in which a sale, lease or exchange of all or substantially all of the property and assets may be authorized, but incorrectly attribute both ways to the sale, lease or exchange of less than all of the property and assets. The bill specifies that the methods for authorizing the sale, lease or exchange of all or substantially all of the property and assets of a mutual apply to the sale, lease or exchange of all or substantially all of the property and assets.

Miscellaneous changes to insurance statutes

The bill makes a number of miscellaneous changes to the insurance statutes. Under current law, a group life insurance policy may be issued only to a group that is formed for purposes other than to obtain insurance. The bill eliminates this provision. Current law places no such limitation on any other type of group insurance.

Under current law, an insurer may change its registered agent for service of process no more than once per year, and any change takes effect on January 1 of the year following the delivery to the commissioner of insurance (commissioner) of the statement changing the registered agent. The bill still limits a change of registered agent to once per year, but any change takes effect immediately with the delivery of the statement.

The bill authorizes the commissioner to employ experts to assist the commissioner with examinations and reviews of insurers and insurance transactions, and provides that the subject of an examination or a person involved in a transaction under review will be responsible for the costs of the expert and related expenses.

Under current law, a life insurer is prohibited from providing any bonus, prize, award or similar additional compensation on insurance business in this state as a result of a competition among insurance intermediaries. Awards may be given as recognition of merit, however, as long as the cost of any such award does not exceed $150 and the aggregate cost of such awards in a calendar year does not exceed 1.5% of the insurer's total first year life insurance premium income derived from sales in this state. The bill eliminates this provision related to bonuses and awards.

Certified capital investment credit

Under current law, rather than pay an income tax or a franchise tax, certain insurers pay a license fee that is based on a percentage of an insurer's gross premiums. Such an insurer, however, may claim as a credit against the license fee an amount that is based on the amount the insurer paid as an investment in a capital company that is certified as a capital company by the department of commerce.

Under current law, if an in-state insurer is licensed to conduct business in another state, this state may not require a similar insurer from the other state who is licensed to conduct business in this state to pay more in license fees to this state than the in-state insurer pays to the other state. Under this bill, this state may not require a similar insurer from the other state who is licensed to conduct business in this state to pay to this state a greater amount for license fees than the amount which an in-state insurer pays to the other state, less the amount of the credits it receives from this state for investments in capital companies.

For further information see the ***state and local*** fiscal estimate, which will be printed as an appendix to this bill.

WI B. An., 1999 Reg. Sess. A.B. 551
END OF DOCUMENT