

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WISCONSIN

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)	
IN THE MATTER OF THE)	Case No. 10-cv-778
REHABILITATION OF SEGREGATED)	
ACCOUNT OF AMBAC ASSURANCE)	(Dane County Circuit Court Civil Case
CORPORATION)	No.: 10 CV 1576)
_____)	
SEAN DILWEG, COMMISSIONER OF)	
INSURANCE OF THE STATE OF)	
WISCONSIN)	
)	
Petitioner)	
)	
v.)	
)	
UNITED STATES OF AMERICA,)	
)	
Respondent.)	
_____)	

**UNITED STATES’ REPLY IN SUPPORT OF ITS
MOTION TO DISSOLVE INJUNCTION**

Ambac Assurance Corporation and its affiliates may each be severally liable for \$700 million in federal taxes, the result of Ambac (as part of a consolidated tax group) claiming and receiving tentative federal tax refunds that it may not have deserved. One small part of Ambac, the “Segregated Account,” is subject to state rehabilitation proceedings and the state insolvency statutes. The rest of Ambac, referred to as the “Ambac General Account,” is not.¹

The Commissioner and Ambac spill much ink arguing that the United States should not

¹ For convenience, we will refer to “Ambac General Account” to include all Ambac affiliated companies in the Ambac consolidated tax group except the Segregated Account and the holding company AFGI, currently in Chapter 11 bankruptcy proceedings in the Southern District of New York. The potential tax liability at issue arose from the 2007 and 2008 tax years, long before Ambac created the Segregated Account. (Dkt. # 14-19, Ex. S to Comm’r Brief, Wallis Affidavit, at ¶ 13).

be permitted to interfere with the work of the rehabilitation court by levying on the Segregated Account's assets within that court's custody. But the United States is already barred from doing so under its own regulations. Thus, the United States does not "seek[] dissolution of the [Injunction] so that it can seize assets protected by the State Rehabilitation Court." (Dkt. # 20, Ambac Opp. 21 n.15). If that were the Commissioner and Ambac's concern, this dispute would never have reached this Court.

The Commissioner and Ambac's real goal in obtaining the Injunction was quite different. Simply put, they wish to have their cake (keep the Ambac *General* Account out of rehabilitation) and eat it too (consign the Ambac *General* Account's potential federal tax liability to the Segregated Account and subject the IRS to the restrictions on claimants in rehabilitation proceedings). All their arguments about preserving the integrity of the rehabilitation proceeding and ensuring that the IRS doesn't "jump" ahead of its place in the insolvency priority statutes obscure the indisputable fact that the Ambac General Account is neither under the custody of the rehabilitation court nor subject to the Wisconsin insolvency statutes (including the injunction and priority statutes). Accordingly, the Injunction purporting to prevent the United States from exercising its Constitutional prerogative to collect federal taxes from Ambac General Account or any other Ambac assets not within the Segregated Account, by levy or any other means available under the Internal Revenue Code, cannot be sustained.

As to the Segregated Account, the United States may, at the appropriate time and if it so chooses, file a claim with or move to intervene in the rehabilitation proceeding for the assets of the Segregated Account. At that time, it may assert - in federal court - its rightful priority as to

the assets in the custody of the rehabilitation court.² In the meantime, the United States has the right to assess taxes against Ambac and perfect the resulting tax liens even though those tax liens will attach to the assets of the Segregated Account, and no state law or state court can interfere with that right.

The state court had no jurisdiction to restrict the United States' tax collection powers through the Injunction; indeed no court (federal or state) has the power to do so. 26 U.S.C. § 7421(a). Accordingly, this Court should dissolve the Injunction and determine that Ambac's allocation of the potential federal tax liability to the Segregated Account does not bind the IRS.³

ARGUMENT

The United States has already explained the Constitutional basis for its power to lay and collect taxes, the inability of any state law to bar, or any state court to enjoin, the collection of federal taxes, and the inapplicability of McCarran-Ferguson to the Internal Revenue Code. (Dkt. # 23, USA Opp., at 2-8). That discussion is incorporated by this reference and the United States will not repeat it here. Nonetheless, the Constitutional prerogative to lay and collect taxes

² We have suggested that this Court, if it remands most of the rehabilitation proceeding to state court, retain jurisdiction to determine the amount and priority of any tax liability. This was the approach taken in the second *Manor Oak* receivership remand order discussed in the United States' Opposition to the Motion for Remand. That course of action would avoid a potential repeat of the current dispute about removal.

³ Once the rehabilitation proceeding was removed, all property subject to that court's custody came with that proceeding to this Court, and the state court's jurisdiction terminated. "Thus, there is no jurisdictional conflict between the state and federal courts" as to in rem jurisdiction. *Barr v. Hagan*, 322 F. Supp. 2d 1280, 1282 (M.D. Ala. 2004)(asserting federal custody over property subject to state partition suit upon removal to federal court). The Commissioner's and Ambac's argument that dissolving the Injunction or asserting federal jurisdiction over the federal tax issues herein would interfere with the jurisdiction of the rehabilitation court is nonsense, because at present this Court *is* the rehabilitation court.

undergirds the United States' position. The state court could not, as a matter of Constitutional law, federal statute, and Supreme Court and Seventh Circuit precedent, enjoin the United States from assessing taxes or levying upon the assets of Ambac. Const. art. I § 8, cl. 1 & Amend. XVI; 26 U.S.C. 7421(a); *see, e.g., United States v. Rodgers*, 461 U.S. 677, 697 (1983); *Modern Life & Acc. Ins. Co. v. Comm'r*, 420 F.2d 36, 37-38 (7th Cir. 1969). No court has jurisdiction to issue such an injunction, and this Court should dissolve the Injunction accordingly. *See, e.g., Beale v. IRS*, 256 Fed. Appx. 550, 2007 WL 4287590 (3d Cir. 2007) (taxpayer's state court injunction action should be removed to federal court and promptly dismissed by that court for lack of subject matter jurisdiction).

The Commissioner and Ambac both make much of the fact that there is only a potential tax liability, and the IRS has yet to determine whether the tentative refund should be recaptured. That fact actually adds force to the United States' contention that the Injunction violates the Anti-Injunction Act. "[I]n the absence of a lien, an action to foreclose the Government's right to assert a lien imperils the government's tax revenues in precisely the way the Anti-Injunction Act is meant to foreclose." *S.E.C. v. Credit Bancorp, Ltd.*, 297 F.3d 127, 138-39 (2d Cir. 2002).⁴

⁴ Even while contending that the Injunction is not an action against the United States, the Commissioner simultaneously argues that the Injunction is actually a "quiet title" action against the United States as to which the United States has waived sovereign immunity under 28 U.S.C. § 2410, which (the Commissioner apparently believes) subjects the United States to a state court injunction after all. Dkt. # 21, Comm'r Opp., at 29-32. Putting aside the cognitive dissonance of the Commissioner's position, and the failure of the Injunction to meet the pleading requirements of Section 2410, *see Genger v. IRS*, 2010 WL 5463314 * 2 (E.D. Wis. 2010), if this were indeed an action under Section 2410, the United States would have the absolute right to remove it to this Court under 28 U.S.C. § 1444. Of course, it would also be premature, given that there is not as yet a federal tax lien to litigate - and the Injunction on its terms would prevent the United States from even making an assessment that would give rise to a lien. *Credit Bancorp*, 297 F.3d at 138-39; *Watson v. Chessman*, 362 F. Supp. 2d 1190, 1197-1202 (S.D. Cal. (continued...))

I. No Court Has Jurisdiction To Enjoin The Collection Of Federal Taxes From Ambac Assets Not Within The Segregated Account

The Commissioner and Ambac assert that this dispute is an “insurer rehabilitation proceeding.” As to the Ambac General Account, this is simply not true. Much as the Commissioner and Ambac attempt to blur the issue, the simple fact is that the Ambac General Account is not in a rehabilitation proceeding and is not subject to either the custody of the rehabilitation court or the state insolvency statutes on which the Commissioner and Ambac rely. *See* 26 C.F.R. § 301.6331-1(a)(3) (“Any assets which under applicable provisions of law are not under the control of the [rehabilitation] court may be levied upon.”)

Ambac, the Commissioner, and the state court have all explicitly disavowed any rehabilitation court custody of the Ambac General Account.⁵ Indeed, any assertion that the Ambac General Account is subject to the rehabilitation court’s custody may, if the Commissioner is to be believed, trigger the provisions in the Ambac General Account policies that would lead to the allegedly negative results for the Ambac General Account policyholders that the Commissioner posits. Needless to say, the Ambac General Account either is or is not in the rehabilitation court’s custody; it cannot be both, and it cannot be selectively in the court’s

⁴(...continued)

2005) (“speculation that the IRS may seek a lien against the property, some time in the future” is not grounds for an action under Section 2410 and court lacks jurisdiction to grant injunction against potential levy or lien under Anti-Injunction Act). However the Injunction is characterized, “[i]f a taxpayer tries to defeat the government's efforts at assessment or collection by filing groundless suits to prevent the government from levying on his assets to collect the taxes that he owes, the government's remedies include . . . recharacterization of the taxpayer's conduct as a de facto effort to enjoin the collection of taxes, thus bringing the anti-injunction act into play.” *Harrell v. United States*, 13 F.3d 232, 234 (7th Cir. 1993) (Posner, J.)

⁵ *See* Dkt. # 23, U.S. Opp. To Remand, at 16.

custody as to the United States but not to Ambac General Account policyholders. The Commissioner and Ambac chose to exclude the Ambac General Account from the custody of the rehabilitation court. They must be held to the consequences of that choice.⁶

The Commissioner and Ambac's reliance on the alleged preemptive effect of state insurance insolvency statutes (Chapter 645 of the Wisconsin Statutes) in their opposition briefs is particularly ironic because the Commissioner and Ambac have already successfully asserted, in this very proceeding, that those statutes do *not* apply to the Ambac General Account. As background, the Commissioner and Ambac negotiated a settlement agreement with some of the policyholders in the Ambac General Account, as referenced in the Commissioner's Motion for Remand at 15. Certain Segregated Account policyholders challenged the settlement on the ground that it did not comply with the procedures of the insolvency statutes and the state rehabilitation court had not approved the settlement, among other arguments. In response, the Commissioner asserted that because the Ambac General Account was "outside the scope of this

⁶ The only purported justification for claiming that the Ambac General Account is in the exclusive jurisdiction of the rehabilitation court is that the Segregated Account is a creditor of the Ambac General Account. (Dkt. # 20, Ambac Br., at 19 n.13). Presumably this refers to a demand note made by the Ambac General Account to the order of the Segregated Account that (along with a reinsurance agreement) is the only "asset" the Segregated Account holds. On its terms, the note does not even grant the Segregated Account a security interest over the assets of the Ambac General Account, except for premiums and recoveries that the Ambac General Account may receive "in respect of" Segregated Account policies. *See* Ex. # 10, Secured Note, at 1 (defining "Covered Policies"), 3-4 (defining "Collateral"). The Segregated Account's interest as an unsecured creditor of the Ambac General Account is a far cry from placing the Ambac General Account in the custody of the rehabilitation court for purposes of assigning exclusive jurisdiction to that court. *See Koken v. Pension Benefit Guar. Corp.*, 383 F. Supp. 2d 712, 719-20 (2005), *reconsideration denied by*, 381 F. Supp.2d 493 (E.D. Pa. 2006) (business relationship between insolvent insurance company and subsidiaries insufficient to place the subsidiaries in the exclusive jurisdiction of the rehabilitation court). Moreover, even a security interest in property in favor of a receivership or bankruptcy estate does not place the underlying property itself into the estate.

rehabilitation proceeding,”“Chapter 645 [the chapter containing the insolvency statutes] does not apply.” *See* Ex. 11, Comm’r State Brief, at 15-16. Likewise, Ambac contended that “only the activities of the Segregated Account are subject to review” by the rehabilitation court, notwithstanding the agreements between the General Account and Segregated Account. *See* Ex. 12, Ambac State Brief, at 22. The Commissioner and Ambac are bound by their position and are estopped from arguing that the insolvency statutes (including the injunction statute at 645.05 and the priority statute at 645.68) apply to the Ambac General Account.

To be sure, the rehabilitation court did issue in personam injunctions against the United States and Segregated Account policyholders preventing them from pursuing actions against the Ambac General Account. Whatever jurisdictional basis the state court may have for such injunction - and the United States contends there is none - it cannot be in the nature *in custodia legis* jurisdiction that arguably might preclude a court other than the rehabilitation court from adjudicating the merits of the injunction even after a partial remand of the rehabilitation proceeding.⁷ As a district court held in a recent insurance liquidation proceeding in Pennsylvania, a liquidation proceeding over an insurance company did not give the state court in rem jurisdiction over that company’s subsidiaries not in liquidation, even though the court had

⁷ As noted, this Court presently is the rehabilitation court and there is simply no basis to argue that an injunction against the United States, even with respect to property that is in the custody of a state court, could not be removed to this Court under 28 U.S.C. § 1442 or dissolved by the Court after removal. Additionally, the doctrine of prior exclusive *in rem* jurisdiction is one of comity evolved in suits generally not involving the United States as a plaintiff or the collection of federal tax. The United States’ position is that it can in fact invoke the jurisdiction of a federal district court, under the explicit authority of 26 U.S.C. § 7402(a), to interfere with a state court’s custody of property in an appropriate case, although we would not invoke that authority unless demonstrably necessary. Fortunately that difficult issue is not presented here.

issued orders regarding those subsidiaries. *Koken*, 383 F. Supp. 2d. at 719-20.⁸ The Seventh Circuit has held that the Anti-Injunction Act bars a bankruptcy court from enjoining the collection of taxes from persons other than the debtor, even when the debtor is severally liable for those taxes and even if the collection of tax from the non-debtor would “permanently and irreparably harm” the debtor’s prospects at a successful reorganization. *Matter of LaSalle Rolling Mills, Inc.*, 832 F.2d 390, 391-94 (7th Cir. 1987). The same reasoning applies here. It is uncontested that the Ambac General Account is itself liable for any recapture of the tentative refund at issue here, regardless of the liability of the Segregated Account. Under Seventh Circuit precedent, therefore, the United States may not be enjoined from collecting that potential tax liability from property that is not property of the rehabilitation estate.

Nor does Ambac’s allocation of the potential tax liability to the Segregated Account absolve the Ambac General Account of that liability. “It is fundamental that an agreement to which [the IRS] is not a party cannot force [it] to collect taxes from someone other than the person upon whom taxes are imposed.” *Bonner v. Comm’r*, T.C. Mem. 1979-435, 1979 WL

⁸ Should this Court remand the non-federal tax aspects of the proceeding to the state court, this Court could plainly still assert jurisdiction, or even custody, as to the Ambac General Account because it (as opposed to the Segregated Account) is not subject to the rehabilitation proceeding. The principle of exclusive *in custodia legis* jurisdiction is limited to the specific property in the court’s custody. “A judgment in an in rem proceeding is valid only against the specific property and not against a defendant or a defendant’s other assets.” *In re Return of Property in State v. Glass*, 628 N.W.2d 343, 348 & n.10 (Wis. 2001). A court’s control over a subset of a group of assets does not deprive a federal court of jurisdiction over other assets in the same group, even if both actions involve the same controversy. *Hohenberg Bros. Co. v. Anderson Logistics Serv. Corp.*, 6 F. Supp.2d 1377, 1379 (S.D. Ga. 1998) (in dispute over possession of bales of cotton produced by cotton grower, state court in rem action over the cotton stored in one specific warehouse does not deprive federal court of in rem jurisdiction in subsequent action over cotton in other warehouses, even though both actions arose from the same controversy).

3479 (Tax Ct. 1979) (contractual promise by third party to pay taxpayer's tax does not preclude IRS from collecting from taxpayer). An insurance company's "juggling acts . . . may not be legitimated with the labels 'reorganization' or 'liquidation' when those labels do not apply." *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1251 (5th Cir. 1983).

Nor does the state court's blessing of Ambac's allocation bind the IRS. See *Van Den Wymelenberg v. United States*, 397 F.2d 443, 445 (7th Cir.1968) (IRS not bound by retroactive amendment of trust to take advantage of gift tax exclusions despite state court reformation of trust; "[w]ere the law otherwise there would exist considerable opportunity for 'collusive' state court actions having the sole purpose of reducing federal tax liabilities"); see *In re Cooper*, 83 B.R. 544, 545 n. 1 (Bankr. C.D. Ill.1988)("since the IRS was not a party to the separation agreement and never agreed to look solely to Alva to recover the taxes in question, the IRS was not bound by the couple's separation agreement and was free to go after either Alva or Darlene, or both, for the unpaid taxes," even though agreement was incorporated into state divorce judgment). A taxpayer cannot, even with the approval of federal bankruptcy court, agree to divide up its assets and limit the collection of a potential tax liability to the portion of the assets given to a related entity, even where that entity is simultaneously in receivership. In *In re Indian Motorcycle Co.*, 261 B.R. 800 (1st Cir. B.A.P. 2001), the Massachusetts Bankruptcy Court estimated that the maximum gains tax on the sale of the bankrupt corporation's assets (sold in tandem with the assets of the receivership estate) was \$1.2 million. It then ordered a distribution sufficient to satisfy the bankrupt's creditors, and distributed the remaining sale proceeds to the receiver for another corporation appointed in a diversity suit in Colorado, directing that \$1.2 million be escrowed by the receiver and used first to pay any tax which the receivership court

might determine was incurred by the bankrupt corporation. The Bankruptcy Appellate Panel of the First Circuit reversed and held that the court could not limit the collection of a potential future tax assessment to a specific portion of the taxpayer's assets, and also could not cede its jurisdiction to determine the bankrupt's tax to the receivership court. *Id.* at 810.

The Ambac General Account, as a member of the consolidated tax group that claimed the \$700 million tentative refund, is severally liable for the potential tax liability that will be owed should the IRS determine that the refund was subject to recapture. 26 C.F.R. § 1.1502-6(a); *United States v. Williams*, 959 F. Supp. 210, 212 (S.D.N.Y.1997) (IRS can levy against subsidiaries in taxpayer's consolidated group to collect consolidated tax obligations). The United States is not bound by any internal allocation of tax liabilities among members of the consolidated group. It can collect the entire amount from any of the participating entities - even insurance companies - regardless of any internal agreements. 26 C.F.R. § 1.1502-6(c); *In re First Cent. Fin. Corp.*, 269 B.R. 481, 489-90 (Bankr. E.D.N.Y. 2001), *subsequently aff'd* by, 377 F.3d 209 (2nd Cir. 2004) (dispute between liquidator of subsidiary insurance company and its corporate parent regarding allocation of tax refund; “[a]s a matter of state corporation law, parties are free to allocate among themselves their ultimate tax liability by an express agreement, or by a clearly implied agreement” but such an agreement “does not alter each member's liability to the government for the entire tax”) (citations omitted); *accord Home Group, Inc. v. Comm’r*, 92 T.C. 940, 942 (Tax Ct. 1989) (“As a member of the affiliated group of corporations, Home Insurance Company is severally liable for the consolidated tax liability of the entire group. Therefore, such total consolidated tax liability, including deficiencies, may be collected from Home notwithstanding the allocation of tax liability or other intercompany agreements.”)

(citations omitted). Certainly, Ambac has not hesitated to enjoy the considerable tax benefits that come with consolidated tax treatment, and both the Ambac General Account and the Segregated Account continue to do so despite the rehabilitation proceeding, so Ambac can hardly contend that the consolidated tax rules do not apply to it, on McCarran-Ferguson or any other grounds.⁹

II. As to the Segregated Account, the Injunction Is Both Illegal And Unnecessary To Preserve The Custody Of The Rehabilitation Court.

As to the Segregated Account, the United States agrees with the Commissioner and Ambac that Treasury Regulations restrict the IRS's ability to levy against the assets actually within that account. 26 C.F.R. § 301.6331-1(a)(3). The IRS has by regulation eschewed the right to seize such assets of the Segregated Account as are in the state court's custody while the rehabilitation proceeding is pending.¹⁰ A state court injunction against doing so is thus unnecessary.

The IRS *does* retain the authority to assess taxes against Ambac, and perfect the resulting federal tax liens, even though those liens would attach to the assets of the Segregated Account.¹¹ *See Appleton v. Comm'r*, T.C. Mem. 2010-225, 2010 WL 4078192 * 3 (Tax. Ct. 2010).

⁹ *See* Ex. 13, Ambac 2009 10K, at 51 (explaining the benefits of consolidated treatment and stating that loss of consolidated tax treatment “could result in a material increase in the tax liabilities of the Company Consolidated Tax Group.”)

¹⁰ The regulations also permit, though they do not require, the IRS to levy “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).

¹¹ “Assessment” is the statutory term for the IRS “administrative determination that a certain amount is currently due and owing as a tax.” *United States v. Latham*, 754 F.2d 747, 750 (7th Cir. 1985) (citing 26 U.S.C. § 6201). If, after notice and demand, the tax is not paid, a lien immediately attaches “in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.” 26 U.S.C. § 6321.

(“Recording a Federal tax lien does not impair a receiver's right to control and access to the property that is the subject of the receivership.”); *see also Matter of Volker*, 42 F.3d 1050, 1052 (7th Cir. 1994)(federal tax lien attaches to all debtor’s property, even property exempt from levy: “A lien enables the taxpayer to maintain possession of protected property while allowing the government to preserve its claim should the status of [the] property later change” (citation omitted)). Neither the assessment of taxes nor the recording of a lien intrude on the *in custodia legis* jurisdiction of the rehabilitation court.¹² Nor, of course, does the in rem jurisdiction of the rehabilitation court oust this Court from exercising its federal jurisdiction over the assessment, collection, or priority of federal tax, assuming the Court remands the rest of the rehabilitation proceeding to state court.

III. McCarran-Ferguson Does Not Preclude the Application of the Federal Tax Statutes.

A. The McCarran-Ferguson Act Does Not Apply To The Internal Revenue Code And Does Not Allow State Statutes To Preempt The Constitutional Prerogative To Lay And Collect Federal Taxes

The Commissioner and Ambac contend that the state insurance statutes reverse-preempt the Anti-Injunction Act and the provisions of the Internal Revenue Code relating to the

¹² In his Motion for Remand, the Commissioner disclaimed any right he may have to enforce the Injunction against any IRS action with respect to the potential recapture of the tax refund save actual seizure of assets by levy or other attachment proceedings, thus waiving any argument that an assessment of tax or perfection of the resulting tax lien would violate the Injunction even if left in place. (Dkt. # 15, Remand Brief, at 4-5). But now, the Commissioner contends that the Injunction precludes IRS assessment of the tax liability and, presumably, the perfection of a resulting federal tax lien, even though neither of those actions effect a “seizure” of assets. (Dkt. # 21, Comm’r Opp., at 5 n.2). Even if the Commissioner could renege on his waiver, and he cannot, the Commissioner’s inconsistent interpretation of the Injunction he obtained is yet another reason to dissolve the Injunction. The Constitutional prerogative of the United States to lay and collect taxes should not be left to the caprice of a state regulator, no matter how well intentioned.

collection of federal taxes by lien or levy because of the McCarran-Ferguson Act, 15 U.S.C. § 1012(b). As we explained in our Opposition to Remand, while the McCarran-Ferguson Act permits reverse-preemption of federal laws enacted under the Commerce Power, it does not permit reverse-preemption of statutes enacted under the separately- enumerated Taxing Power, and courts have on that basis consistently rejected applying McCarran-Ferguson reverse-preemption to the Internal Revenue Code. *E.g.*, *Modern Life*, 420 F.2d at 37-38. Nor does McCarran-Ferguson constitute a waiver of the federal government’s sovereign immunity as to insurance insolvency proceedings. *See In re Application of Lewis*, 512 F. Supp. 1146, 1149-50 (S.D.N.Y. 1981) (dissolving TRO issued by state insurance rehabilitation court against federal agency and holding that McCarran-Ferguson did not waive sovereign immunity: “The Supremacy Clause alone seems sufficient support for the proposition that a federal regulator may not be enjoined from performing his regulatory duties solely by reason of a state rehabilitator’s hopes to achieve a successful rehabilitation”) ¹³

B. By Its Terms, The Internal Revenue Code Specifically Relates To Insurance.

At any rate, McCarran-Ferguson preempts federal statutes *only* if (1) the federal statute does not specifically relate to the business of insurance; (2) the state law was enacted for the “purpose of regulating the business of insurance;” and (3) the federal statute operates to “invalidate, impair, or supersede” the state law. *Autry v. Northwest Premium Serv., Inc.*, 144 F.3d 1037, 1040-41 (7th Cir. 1998). The Internal Revenue Code specifically relates to the business of insurance. *Hanover Ins. Co. v. C.I.R.*, 598 F.2d 1211, 1218 (1st Cir. 1979). In

¹³ In lieu of repeating the arguments here, we incorporate by reference pages 2 through 8 of our opposition and refer the Court to the discussion in our opening brief on page 17.

addition to the sections of the Code that deal explicitly with taxation of insurance companies, see 26 U.S.C. 801 *et seq.*, the Code specifically provides that the terms “corporation,” “person,” and “taxpayer,” when used throughout the Code, are defined to include “insurance companies.” *Id.* §§ 7701(a)(3) (defining “corporation” to include “insurance companies”); (a)(1)(defining “person” to include “corporation”), &(a)(14)(defining “taxpayer” to include any “person” subject to any internal revenue tax). *UNUM Corp. v. United States*, 130 F.3d 501, 508 (1st Cir. 1997) (“ While Subchapter L [Sections 801 et seq.] applies specifically to life insurance companies, the existence of Subchapter L does not exempt insurance companies from the application of the rest of the Code.”)¹⁴ The plain text of the Internal Revenue Code indicates that the Anti-Injunction Act (which applies to “any person”) the lien and levy statutes (“any person”), and the consolidated tax statute (“affiliate group of corporations”) specifically relate to insurance companies, and no state statute can reverse-preempt those provisions.¹⁵ As the Seventh Circuit noted, nothing in the text of either McCarran-Ferguson or the Internal Revenue Code states or

¹⁴ Section 7701(a)(3), which explicitly includes “insurance companies” in the definition of “corporation,” derives from the Revenue Act of 1918, § 1, and was retained and renumbered by Congress in the 1954 Internal Revenue Act as § 7701(a)(3), where it remains today. Clearly, had Congress intended the Internal Revenue Code not to apply to insurance companies except as to those sections that explicitly include the word “insurance” in contemplation of reverse-preemption under the (1945) McCarran-Ferguson Act, it would have removed the term “insurance companies” from the definition of “corporation” in 1954. It did not.

¹⁵ The fact that these tax provisions apply to non-insurance -company taxpayers as well does not affect this conclusion. As the Supreme Court has held, “a statute may specifically relate to more than one thing,” as “[n]either the McCarran-Ferguson Act’s language, nor its purpose, requires the Federal Statute to relate *predominately* to insurance.” *Barnett Bank of Marion Co. v. Nelson*, 517 U.S. 25, 41 (1996) (emphasis in original); *accord Patton v. Triad Guar. Ins. Corp.*, 277 F.3d 1294, 1297 (11th Cir. 2002) (“the McCarran-Ferguson Act does not require avoiding federal pre-emption by future federal statutes that indicate, through their specific relation to insurance, that Congress had focused upon the insurance industry”)(quoting *Barnett Bank*, 517 U.S. at 40) (internal quotations omitted).

implies otherwise. *Modern Life*, 420 F.2d at 37-38.

C. The Relevant State Statutes Do Not Conflict With Federal Tax Law And Do Not Regulate The Business Of Insurance.

The Commissioner appears to contend that if any part of the Wisconsin insolvency statute has reverse-preemptive power over any federal statute, then the whole of Chapter 645 automatically has the same power. (Dkt. # 21, Commissioner Brief at 11-14). This directly conflicts with *Fabe*, which explicitly refused to swallow *whole* a state insolvency statute in this way. *United States Dept. Of Treasury v. Fabe*, 508 U.S. 491, 508-9 (1993) (parsing subsections of a single statute); *see also Garcia v. Island Program Designer, Inc.*, 4 F.3d 57, 61-62 (1st Cir. 1993) (Breyer, J.) (holding that claims-bar-date portion of statute does not regulate the business of insurance). Thus, the Commissioner must defend each statute on its own merits. The Commissioner and Ambac have identified three particular statutes: the State Priority Statute (Wis. Stat. § 645.68), the Injunction Statute (Wis. Stat. § 645.05) and the Segregated Account Statute (Wis. Stat. § 611.24).

Both Ambac and the Commissioner insist on categorizing the facts of this case as identical to those in *Fabe*. In *Fabe*, the Supreme Court determined whether, pursuant to the McCarran-Ferguson Act, the state priority statute preempted the federal insolvency priority statute in conjunction with the liquidation of an insurance company. Although *Fabe* involved a claim of the United States, it did not involve federal taxes. *Fabe*, 508 U.S. at 495.

In the pending case, this Court need not decide at this time whether the state priority statute trumps the federal insolvency statute. Simply put, that issue is not ripe. The United States has not asserted a claim against the Segregated Account, seized any Segregated Account assets or otherwise implicated the state priority statute by taking any action against the Segregated

Account. In fact, this issue is all the more speculative because the IRS had not even determined that any tax is due. As we noted in footnote 14 of our opposition brief, we are content to argue the merits of that issue, in federal court, when, and if, the situation presents itself.

To be sure, we moved to dissolve the State Court injunction only, which was not issued pursuant to the state priority statute. Instead, the State Court issued its injunction in accordance with Wis Stat. § 645.05 (state injunction statute) and Wis. Stat. § 611.24 (Segregated Account Statute). We know this because the State Court specifically referenced the Injunction Statute - Wis. Stat. § 645.05(1) - and indicated that its “Order [was] made in furtherance of the allocation of [Ambac’s potential, future tax liabilities] to the Segregated Account. . .”¹⁶ Ambac and the Commissioner purportedly allocated the potential federal tax liability to the Segregated Account pursuant to the Segregated Account Statute, Wis. Stat. § 611.24(2).

Following *Autry*, in order to preempt federal law, the Segregated Account Statute and the Injunction Statute must have been enacted for the purpose of regulating the business of insurance, and the competing federal statute must invalidate, impair, or supersede these state statutes. *Autry*, 144 F.3d at 1040. A statute is enacted for the purpose of regulating the business of insurance when it affects the relation of insured to insurer, prescribes the terms of an insurance contract, sets the rates charged by an insurance company, and/or regulates the actual performance of an insurance contract. *Fabe*, 508 U.S. at 504-5 (laws must possess the end, intention, or aim of adjusting, managing, or controlling the business of insurance); *Barnett*

¹⁶ This is in furtherance of the State Court’s intention to rehabilitate only the Segregated Account. To that end, the State Court specifically noted in his first day injunction order that it did “not apply to policies or other contracts which remain in the Ambac General Account.” See Dkt. # 14-4, Ex. D to the Commissioner’s Remand Brief, Order for Temporary Injunctive Relief.

Bank, 517 U.S. at 39. Further, state statutes that affect “ancillary activities that do not affect performance of the insurance contract or enforcement of contractual obligations do not regulate the business of insurance.” *Fabe*, 508 U.S. at 503 (citing *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 134 n.8 (1982)).

A federal statute invalidates a state statute when it renders it ineffective, generally without providing a replacement rule or law. A federal statute supersedes a state statute when it displaces it (and thus renders it ineffective) while providing a substitute rule. *Humana Inc. v. Forsyth*, 525 U.S. 299, 307 (1999). A federal statute impairs a state statute “when application of the federal law would . . . frustrate any declared state policy or interfere with a State’s administrative regime.” *Id.* at 310. In this circumstance, neither Wisconsin state statute was enacted for the purpose of regulating the business of insurance. Nor do the federal tax laws invalidate, impair, or supersede either statute.

The Segregated Account Statute is not part of Chapter 645 - the Insurance Rehabilitation and Liquidation Act - and is instead in a subchapter titled “Organization of Corporations.” (Dkt. # 13-2, Ex. 2 to Memo. In Support of Motion to Dissolve; Segregated Account Statute.) Even if this provision relates to the business of insurance, it does not conflict with the federal tax statutes at issue. The state statute’s text and legislative commentary do not suggest any intent to use the Segregated Account scheme to frustrate federal tax collection or absolve insurance companies of liability by the expedient of shifting those liabilities to a segregated account. To the contrary, the statute is designed to allow an insurance company to separate riskier types of policies from less risky ones in order to protect the latter from the risks of the former. *Id.* To be sure, Ambac (with the Commissioner’s blessing) endeavored to use the Segregated Account statute in order to

avoid its potential tax liability. McCarran-Ferguson grants reverse-preemptive power, if at all, to state statutes, not to internal machinations of insurance company executives (even if approved by state regulators). If, as we contend it should, this Court concludes that the segregated account statute will not in any event trump federal tax law, the injunction must be dissolved. The IRS's ability to collect this potential tax liability from any member of the consolidated tax group cannot be impaired.

The Commissioner has emphatically asserted that because the Ambac General Account was "outside the scope of this rehabilitation proceeding," "Chapter 645 [the chapter containing the insolvency statutes] does not apply." *See* Ex. # 11, Comm'r State Brief, at 15-16. Nonetheless, the Commissioner and Ambac devote most of their energies to arguing that Chapter 645's injunction statute properly allowed the state court to enjoin the United States from collecting from the Ambac General Account, and that the Injunction serves to preserve the State priority scheme. They make this argument notwithstanding the fact that the General Account is not subject to the rehabilitation order and, therefore, its assets need not be distributed in conjunction with a state liquidation priority statute. The State Court Injunction Order specifically refers to sections d, f, g, h, and k of the State Injunction statute, but only the catch-all provision in section k could potentially allow a court to enjoin a creditor from collecting its debt from a company not in rehabilitation.¹⁷ Section k allows a receiver to obtain an injunction to

¹⁷ These sections include: "(d) waste of insurer's assets;" (f) "the institution of further prosecution of any actions or proceedings" "(g) the obtaining of preferences, judgments, attachments, garnishments or liens against the insurer or its assets;" (h) "the levying of execution against the insurer of its assets;" and "(k) any other 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." Here, the insurer is the Segregated
(continued...)

prevent “any other threatened or contemplated action that might . . . prejudice the rights of policyholders, creditors or shareholders.” Wis. Stat. § 645.05(1)(k).¹⁸

On its face, this section is vague and incredibly broad. Taken to its logical conclusion, this portion of the statute authorizes a receiver to seek, and a court to enjoin, virtually any action by any person against any other person, even if neither person is within the ambit of the rehabilitation court, as long as the court could articulate some tangential benefit to the policyholders, creditors, or shareholders of the rehabilitated company. As the Supreme Court stated in *Fabe*, not everything that arguably benefits policyholders relates to the business of insurance. *Fabe*, 508 U.S. at 508-08; *Greene v. United States*, 440 F.3d 1304, 1314-16 (Fed. Cir. 2006) (retroactive application of state priority statute did not constitute business of insurance); *Autry*, 144 F.3d at 1044-45 (statute governing premium finance agreements was not enacted for the purpose of regulating the business of insurance because that statute addressed the relationship between a creditor and a debtor, not the relationship between an insurance company and a policyholder). It also does not simply protect policyholders, but also protects creditors and shareholders. Section k, therefore, does not regulate the business of insurance because it does not regulate the actual performance of an insurance contract, and could not preempt federal tax law in any event. *See Fabe*, 508 U.S. at 508-9 (wage claims could not be paid ahead of the

¹⁷(...continued)
Account. Wis. Stat. § 645.05.

¹⁸ The cases cited by both Ambac and the Commissioner are easily distinguishable because neither involved a “catch-all” provision in an injunction statute or, for that matter, an injunction order that prohibited a creditor from collecting from an entity not in receivership. *See Munich American Reinsurance Co. v. Crawford*, 141 F.3d 585, 591 (5th Cir. 1998); *U.S. Fin. Corp. v. Warfield*, 839 F. Supp. 684 (D. Ariz. 1993).

government).

IV. The Remaining Arguments in the Opposition Briefs Lack Merit.

Without regard to McCarran-Ferguson, the Commissioner argues that the Anti-Injunction Act, 26 U.S.C. § 7421, is not applicable because the Act only prevents “persons” from bringing a suit for the purpose of restraining the assessment or collection of federal tax. (Dkt. # 21, Comm’r Brief at 17). The Commissioner apparently takes the position that he, as rehabilitator, is acting “in his official capacity on behalf of the State of Wisconsin” and is therefore immune from the Anti-Injunction Act because that statute applies to “any person” and the State is not, he alleges, a “person.” This argument lacks merit because the Anti-Injunction Act will apply to States and, in any event, the Commissioner himself is not a sovereign.

Despite the Commissioner’s protestations to the contrary, he did not seek injunctive relief in the name of or on behalf of the State of Wisconsin. Upon his appointment as the rehabilitator of the Segregated Account, the Commissioner stepped into the shoes of the insurer (in this case the Segregated Account). *See Texas Commerce Bank v. Garamendi*, 34 Cal. Rptr. 2d 155, 161-62 (Cal. App. 1994) (“... the commissioner is a public official acting on behalf of the state when dealing with insolvent insurers in general, but once appointed conservator of a particular insolvent insurer, the commissioner steps into the shoes of that insured,” and therefore is not immune from paying attorneys fees to creditors who priority status). Unquestionably, the Segregated Account is a “person” under the Code, and the Anti-Injunction Act applies to it. 26 U.S.C. § 7701(a)(1), (a)(3).¹⁹

¹⁹ The Commissioner argues that the state court injunction “merely addresses the manner of collection,” so the Anti-Injunction action is “no obstacle” to that relief. (Commissioner (continued...))

Even if the Commissioner could cloak himself in the mantle of the sovereign State of Wisconsin after having stepped into the shoes of the Segregated Account, “[i]n interpreting federal revenue measures expressed in terms of general application, [the Supreme] Court has ordinarily found them operative in the case of state activities even though States were not expressly indicated as subjects of tax.” *Sims v. United States*, 359 U.S. 108, 112 (1959), quoting *Wilmette Park Dist. v. Campbell*, 338 U.S. 411, 416 (1949). Thus, the term “any person” in the statute imposing liability for failure to honor IRS levies, 26 U.S.C. § 6332, includes “States or any sovereign or political entity or their officers.” *Id.* at 112; accord *Comm. of Mass. v. United States*, 296 F.2d 336 (1st Cir. 1961). Likewise, the Anti-Injunction Act is a “federal revenue measure expressed in terms of general application” and it applies to states and state officials as well.

Finally, the Commissioner argues that the *Williams Packing* exception to the Anti-Injunction Act applies. *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1, 6-7 (1962). In *Williams Packing*, the Supreme Court held that the Anti-Injunction Act does not apply when it is clear that the Government under the most liberal view of the law could not possibly prevail and that irreparable injury would occur without the requested relief. *Williams Packing*, 370 U.S. at 6-8; *Rappaport v. United States*, 583 F.2d 298, 301-02 (7th Cir. 1978); *Educo, Inc. v.*

¹⁹(...continued)

Opposition at 25). By its terms, the Anti-Injunction act prohibits a court from issuing an injunction that restrains the collection of tax. 26 U.S.C. § 7421. The Injunction restrains the collection of tax in that it prohibits the IRS from levying or encumbering Ambac’s assets. Nonetheless, the Commissioner relies on the Seventh Circuit’s decision in *Harrell v. United States*, 13 F.3d 232 (7th Cir. 1993). *Harrell* merely states that the Anti-Injunction Act was “no obstacle” to a quiet title action that satisfies the conditions set forth in 28 U.S.C. § 2410. 13 F.3d at 234. As explained in footnote 4 above, this is not a quiet title action to which § 2410 applies.

Alexander, 557 F.2d 617, 619-21 (7th Cir. 1977).

A. The Commissioner And Ambac Have Not Shown That It Is Impossible For The Government To Prevail On The Merits Of The Tax Issue, So The Exception Does Not Apply.

The first factor - whether it is impossible that the government could ultimately prevail - relates to the merits of the underlying tax issue (*i.e.*, whether the tentative refund was erroneous). *Williams Packing*, 370 U.S. at 8 (noting that the government's claim of liability was not without foundation). Neither the Commissioner nor Ambac address, much less meet, the burden of showing that it is *inconceivable* that the United States could prevail on this substantive tax issue. Instead, the Commissioner focuses on whether the United States would prevail in a priority contest over the Segregated Account's assets. That issue is not ripe because no tax has been assessed. It is also irrelevant to the *Williams Packing* analysis, because a levy "does not determine whether the Government's rights to the seized property are superior to those of other claimants." *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 721 (1985) (citations and quotations omitted); *see also United States v. Third Nat.'l Bank of Nashville, Tenn.*, 589 F. Supp. 155, 157 (M.D. Tenn. 1984)("A claim of lien priority is not a defense to a federal tax levy.").

B. Neither the Commissioner Nor Ambac Will Be Irreparably Harmed.

The Commissioner argues that it will be irreparably injured if the IRS is allowed to levy because the levy will deprive the rehabilitation of claims-paying resources, delay payment to superior creditors, "unsettle" expectations, and multiply litigation costs. (Dkt. # 21, Comm'r Opp., at 21). Unsettled expectations, additional litigation costs, and delays are not irreparable injury. *Williams Packing*, 370 U.S. at 7 (ruination of a business is not "irreparable injury"). Neither Ambac nor the Insurance Commissioner will be irreparably harmed by an IRS collection

action because they can always contest those actions when they occur. *See Alexander v. Americans United, Inc.*, 416 U.S. 752, 761-63 n.13 (1974); *Rappaport*, 583 F.2d at 301-02. Additionally, far from the picture that the Commissioner paints of a “prolonged deprivation of substantial claims-paying resources,” the Internal Revenue Code generally requires that the IRS notify a taxpayer in advance of a levy. 26 U.S.C. §§ 6330, 6331. With prior notice, Ambac and the Insurance Commissioner are free to bring whatever action they believe is appropriate and authorized before the levy. An exception to the “notice” requirement is the jeopardy levy, which allows the IRS to seize assets without prior notice. If the IRS makes a jeopardy levy, the Code permits a taxpayer to contest that in federal court less than a month after the levy and requires the Court to decide the matter within 20 days of filing. *Id.* § 6331(a); 7429. Assuming the Commissioner is correct and a Court would require the IRS to return the jeopardy-levied assets, there would not be a “prolonged deprivation” of claims paying resources.²⁰

²⁰ Ambac argues that the United States must show “irreparable harm” before the Injunction may be dissolved. That standard only applies to the dissolution of an injunction that the enjoining court had jurisdiction to issue in the first place, not to the dissolution of an injunction that the court had no jurisdiction to issue at all. Here, Congress has deprived any court - including the rehabilitation court - of jurisdiction to enjoin tax collection. It is Ambac and the Commissioner who bear the burden of showing *both* that dissolving the injunction would suffer irreparable injury *and* that it is inconceivable that the United States could prevail on the merits of the underlying tax dispute. Ambac and the Commissioner have met neither burden, and this Court should dissolve the Injunction on jurisdictional grounds as a matter of law.

CONCLUSION

For the reasons described above and in our opening brief, the United States respectfully requests that this Court deny the Insurance Commissioner's motion to remand and grant the United States' motion to dissolve.

Respectfully submitted,

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CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing Reply Brief and Declaration have been made by First Class Mail, postage prepaid, upon the following this 7th day of January, 2011:

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