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

UNITED STATES OF AMERICA, Plaintiff v. WISCONSIN STATE CIRCUIT COURT FOR DANE COUNTY; THEODORE K, NICKEL, COMMISSIONER OF INSURANCE OF THE STATE OF WISCONSIN, as Rehabilitator of the Segregated Account of Ambac Assurance Corporation; and AMBAC ASSURANCE CORPORATION Defendants.	Case No. 11-cv-99

UNITED STATES' MOTION FOR LEAVE TO FILE A REPLY

The United States respectfully moves for leave to file a reply brief in support of its Motion for Preliminary Injunction to address new issues raised by Ambac and the Commissioner in their opposition briefs, some of which relate to events that have occurred after the Motion was filed. While the Court's procedure for motions for injunctive relief do not permit parties to file reply briefs as of right, the United States believes that fairness dictates that it be permitted to respond to those issues. A copy of our proposed reply brief is attached as Exhibit 1.

Both Ambac and the Commissioner allege that this action is somehow barred by the terms of a stipulated temporary restraining order entered in the Chapter 11 proceeding of Ambac's parent AFGI, *In re Ambac Financial Group, Inc*., Case No. 10-4210 (SCC) (Bankr. S.D.N.Y.). Ambac has filed in this Court a copy of a motion to enforce that order that AFGI filed with the bankruptcy court on February 15, 2011. Obviously the United States could not

address this issue in its Motion, which was filed before AFGI made its motion in bankruptcy court.

The United States today filed an objection to AFGI's motion demonstrating that this action does not violate the stipulated TRO. A copy of that objection is attached to and discussed in the proposed reply. Simple fairness dictates that the United States be permitted to complete the record before this Court by filing the objection filed in bankruptcy court and by responding to Ambac and the Commissioner's argument on an issue that arose subsequent to filing the Motion.

In addition, the United States's proposed reply brief addresses two additional new arguments made by Ambac and the Commissioner, specifically: (1) whether 28 U.S.C. §§ 1331, 1340, and 1345 and 26 U.S.C. 7402(a) are reverse-preempted by operation of McCarran-Ferguson, and (2) whether this Court should abstain under the *Colorado River* doctrine. The United States did not address any of those issues in its Motion or its previously filed briefs. The United States believes that it should be given the opportunity to respond to these new arguments, and that the Court would benefit from reviewing that response.

Given the important issues of first impression and the high financial and policy interests at stake, this Court should grant leave to file the United States' reply brief.

Respectfully submitted,

February 17, 2011

UNITED STATES DEPARTMENT OF JUSTICE

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I hereby certify on this 17th day of February, 2011 that I filed a copy of this motion with the Court's electronic filing system which sent a copy to the following parties:

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

UNITED STATES OF AMERICA, Plaintiff v. WISCONSIN STATE CIRCUIT COURT FOR DANE COUNTY; THEODORE K, NICKEL, COMMISSIONER OF INSURANCE OF THE STATE OF WISCONSIN, as Rehabilitator of the Segregated Account of Ambac Assurance Corporation; and AMBAC ASSURANCE CORPORATION Defendants.	)	Case No. 11-cv-99

Exhibit
1

UNITED STATES' REPLY IN SUPPORT OF MOTION FOR PRELIMINARY INJUNCTION

We use this reply solely to address the few new issues that Ambac and the Commissioner raise that we have not previously briefed in this case or in the removal action documents, which have been incorporated into this proceeding.

I. This Suit Does Not Violate the State Court Injunction or the Bankruptcy TRO.

Ambac implies that the United States should have brought the instant suit in the New York Bankruptcy Court. *See* Dkt. #28, Ambac Opp. at 5 n.3. Ambac and the Commissioner also argue that the United States "is in a direct violation of the Supplemental Injunction" and the provisional TRO that the United States agreed to in the Bankruptcy Court. These interrelated contentions are meritless. Moreover, if the Defendants had quoted more fully what was agreed to in the Bankruptcy Court hearing, it would have revealed that counsel for the debtor, Ambac's parent company, understood that the Supplemental Injunction issued by the State Court does not

cover the instant complaint seeking to quash that very injunction.

First, while the Bankruptcy Court may have jurisdiction to determine the tax liability of the consolidated group, its subject matter jurisdiction does not extend to the issues involved with the Supplemental Injunction – *viz*, whether the tax could ultimately be collected from assets of Ambac other than the Segregated Account or from other members of the consolidated group that are not before the Bankruptcy Court. The subject matter jurisdiction statutorily conferred by 28 U.S.C. § 1334(b) is limited to civil proceedings at least "related to" the bankruptcy case, which the Supreme Court has held to mean requires an impact on a *bankruptcy estate*. *Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.6 (1995) (noting that most courts of appeals agree with the test for the outer limits of bankruptcy jurisdiction in *Pacor v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984)). As interpreted by the Seventh Circuit, for an issue to come under the "related to" jurisdiction, it must "affect[ ] the amount of property available for distribution or the allocation of property among creditors" in the bankruptcy case. *Matter of Xonics, Inc.*, 813 F.2d 127, 131-32 (7th Cir. 1987) (citing *Pacor*). For this reason, the vast majority of courts that have addressed the issue have held that 11 U.S.C. § 505(a) – the provision under which Ambac's parent has requested a determination of tax – is limited to determining the "amount or legality" of a tax liability asserted against the *debtor* and not the liability of third parties. While a proper § 505 determination in New York will nevertheless presumably bind the United States and Ambac Assurance Corporation with respect to the amount of the tax as to the debtor's non-debtor affiliates, it will not remotely address to what extent any liability that is determined may be collected from any non-debtor affiliates or from any assets of Ambac or the validity of the State Court plan to confine the IRS to the Segregated Account.

Secondly, the Commissioner's selective quotes from the transcript of the hearing at which the government agreed to give 5 days notice of any intent to violate the State Court Injunction leave out statements of debtor's counsel and government counsel that reveal a mutual understanding that what was purportedly enjoined by the State Court, and therefore what the United States stipulated in the Bankruptcy Court it would provide five days advance notice of, included only "enforcement actions" and not actions challenging the validity of the State Court Injunction. The United States has today filed our opposition to AFGI's motion in the Bankruptcy Court for the Southern District of New York, which describes the parties' agreement. We attach that opposition as Exhibit A and incorporate it by reference.[1]

Third, any argument that the instant action violates the State Court injunction (which the United States' contends was entered in violation of its sovereign immunity and without jurisdiction) is also wrong. This action is not seeking to determine Ambac's federal tax liabilities or collect them and thus is not "in regard to [those] liabilities," as the injunction requires *See* Dkt. # 10, Injunction. It is not seeking any prejudgment attachments or to establish a lien on or otherwise exercise any purported rights in any property or assets of anyone. This case has an extremely narrow focus. It seeks merely to establish that the State Court injunction is void and prevent any attempt to enforce it. Moreover, this Court should not lightly ascribe to

[1] Also, notwithstanding lack of formal notice filed with the Bankruptcy Court, this case should come as no surprise to Ambac, AFGI, or the Commissioner. The government's Seventh Circuit filing, more then five days before this action was commenced, stated that the United States noted that it was "considering whether it should seek relief by means of a suit brought under the District Court's original jurisdiction." *See* Dkt. # 32-11, Jurisdictional Brief, at 9 and 22; *see also In re Ambac Financial Group, Inc*., Case No.: 10-15973 (Bank. S.D.N.Y.) (Noting that Peter Ivanick is counsel for debtor, AFGI); Dkt. # , USA Reply, at 7, n. 7 (noting that the United States could bring an action pursuant to I.R.C. § 7402).

the State Court the intent to enjoin the United States specifically from commencing an action in federal court to at least argue for an injunction against that State Court if the United States believes the State Court is in violation of federal law. Such a state court injunction would be virtually unprecedented (and of course any such injunction would be completely void and unenforceable). *See generally Matter of Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 140 B.R. 969, 974 (N.D. Ill. 1992) (holding that district court had authority to determine the applicability of the automatic stay stemming from a bankruptcy filing in another district).

II. MCCARRAN-FERGUSON DOES NOT REVERSE-PREEMPT THE FEDERAL JURISDICTION STATUTES

Ambac contends that McCarran-Ferguson's reach is so broad that it deprives this Court of any jurisdiction over any proceeding related to insurance, because the fundamental statutes establishing federal court jurisdiction over federal questions, federal tax actions, and actions in which the United States is the plaintiff (28 U.S.C. §§ 1331, 1340, and 1345) are reverse-preempted by Wisconsin state insurance law that supposedly vests exclusive jurisdiction in the state rehabilitation court (which the United States disputes). Ambac does not cite a single case as support for this proposition, but nonetheless claims that the United States cannot "contest these conclusions . . . in good faith." *See* Dkt. # 28, Ambac Br. at 8. Needless to say, the United States does contest Ambac's argument, which has no merit. The United States has not found any case holding that Sections 1331, 1340, or 1345 are reverse-preempted because of McCarran-Ferguson. To the contrary, it is clear that McCarran-Ferguson does not "remove federal jurisdiction over every claim that might be asserted against an insurer in state insolvency proceedings." *Gross v. Weingarten*, 217 F.3d 208, 222 (4th Cir.2000)(reversing district court's dismissal of federal indemnification action against insurer that was subject to state liquidation

proceeding and holding that McCarran-Ferguson does not reverse-preempt the diversity jurisdiction statute, 28 U.S.C. § 1332). In particular, when the action is based on exclusive federal jurisdiction, such a rule would "operate to divest exclusively federal jurisdiction as effectively as it would diversity jurisdiction, leaving many plaintiffs with no forum in which to assert their federal rights" and is therefore inconsistent with Congressional intent. *Id.; see also Hawthorne Savings FSB v. Reliance Ins. Co. Of Illinois*, 421 F.3d 835, 842-43 (9th Cir. 2005), *amended* 433 F.3d 1089 (9th Cir. 2006). By the same token, 26 U.S.C. § 7402(a), which provides that "district courts of the United States at the instance of the United States ***shall have such jurisdiction***" to issue injunctions and other orders "as may be necessary or appropriate for the enforcement of the internal revenue laws," is a broad grant of exclusive supplemental jurisdiction that is not reverse-preempted by McCarran-Ferguson, particularly given that § 7402(a) explicitly provides that the remedies described therein "are in addition to and not exclusive of any and all other remedies of the United States in such [federal] courts or otherwise to enforce such laws. *United States v. Elkbad*, 732 F.2d 562, 563 (7th Cir. 1984) (per curiam) ("Congress has vested in the district court jurisdiction over 'any case commenced by the United States' and specifically 'to render such judgments and decrees as may be necessary or appropriate for the enforcement of the Internal Revenue laws'. The United States has standing to seek relief from actual or threatened interference with the performance of its proper governmental functions.") (citing Section 1345 and Section 7402(a)); *cf. Central States v. Old Security Life Ins. Co.*, 600 F.2d 671, 676 (7th Cir. 1979)(McCarran-Ferguson "cannot be interpreted as precluding a party from pursuing a congressionally created federal claim in the only courts able to provide affirmative relief on that claim," even in the face of a state insurance

insolvency proceeding).

It is ironic that 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(a), which (the Commissioner apparently believes) subjects the United States to a state court injunction after all. *See* Dkt. # 31, Comm'r Opp. at 31-35. Of course, the Injunction cannot be a quiet title action. Section 2410 applies by its terms only where "the United States has or claims a mortgage or other lien." Accordingly, it contains specific pleading requirements, including requirements that the pleadings state with particularity "the nature of the interest or lien of the United States." It would be impossible for the Injunction to satisfy these requirements, because there is not as yet a federal tax lien to litigate – and the Commissioner would presumably argue that the Injunction on terms prevents the United States from even making an assessment that would give rise to such a lien. *S.E.C. v. Credit Bancorp, Ltd.*, 297 F.3d 127, 138-39 (2d Cir. 2002) (§ 2410 inapplicable to receiver's concern about a future tax assessment); *Watson v. Chessman*, 362 F. Supp. 2d 1190, 1197-1202 (S.D. Cal. 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).[2]

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[2] If the State Court action was indeed an action under Section 2410, the United States would have the absolute and unqualified substantive right to remove under 28 U.S.C. § 1444, because access to a federal forum is a necessary condition for the invocation of Section 2410's waiver of sovereign immunity. *See, e.g., Hood v. United States*, 256 F.2d 522, 525 (9th Cir.1958) ("The cardinal concern of the United States is that all cases in which the interests of the government are involved may be tried in federal fora."); *Vincent v. P.R. Matthews Co.*, 126 F.Supp. 102, 105 (N.D.N.Y. 1954)("there is no basis upon which this court can remand the case over the objection of the United States"). If McCarran-Ferguson were read as broadly as Ambac

(continued...)

Finally, the federal jurisdiction statutes do not invalidate, impair, or supersede the Wisconsin Statutes given that the State statutes do not vest exclusive jurisdiction over insurance receiverships in state court, and the State jurisdiction statutes do not regulate the business of insurance. Wis Stat. §§ 645.04 (court can transfer action to forum outside state), 645.05 (injunction action can be brought in other court), 645.45 (commissioner can commence a federal receivership); *International Ins. Co. v. Duryee*, 96 F.3d 837, 839-40 (6th Cir. 1996) .

III. THIS COURT SHOULD NOT ABSTAIN

Ambac and the Commissioner's contention that this case presents the "exceptional circumstances" that would justify *Colorado River* abstention lack merit. *See* Dkt, # 31, Comm'r Opp. at 40-42; Dkt. # 28, Ambac Opp. at 9-11. To begin with, a court may not abstain under *Colorado River* unless there is are parallel proceedings. *Tyrer v. City of South Beloit, Ill*, 456 F.3d 744, 752 (7th Cir. 2006). A "suit is parallel when substantially the same parties are ***contemporaneously litigating*** substantially the same issues in another forum." *Id*. (emphasis added). The United States is not trying to contemporaneously litigate these federal issues before the State Court. In fact, to date, only the Commissioner has asked State Court to decide the matters raised in the United States' motion to dissolve, and the United States has maintained that the State Court lacks jurisdiction. The entire purpose of this action is to ***prevent*** the possibility of contemporaneous litigation by stopping the State Court from considering the issue. As a result, this case does not involve "parallel proceedings" as that term in described in analyzing *Colorado River* abstention.

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[2](...continued)
and the Commissioner suggest, presumably also reverse-preempting Section 1444, then the waiver of sovereign immunity in 2410 would be rendered inoperative.

Even if parallel proceedings did exist, the Seventh Circuit has outlined several non-exclusive factors for courts to consider before concluding that a particular case is "exceptional" and that abstention under *Colorado River* is appropriate. *Tyrer*, 456 F.3d at 754. Taken together, these factors overwhelmingly weigh against abstention. In particular:

- The State Court has not assumed jurisdiction over Ambac, except for the Segregated Account, and has disclaimed any in rem custody over it.[3]

- The federal forum is not only convenient for the parties, but the Wisconsin insurance insolvency statute explicitly provides for proceedings in federal court and state courts other than Dane County. Wis Stat. §§ 645.04, 645.05, 645.45.[4]

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[3] 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.") . We are unaware of any case that has held that all the assets of third parties that have merely promised to pay money to cover a future shortfall in a receivership estate are *in custodia legis.* Additionally, approximately 2% of Ambac - $100 million - is not available to pay the claims in the Segregated Account, but nonetheless purported taken out of the IRS's reach by the Injunction. *See* Dkt. # 32.6, Remand Order, at 5. Ambac and the Commissioner's continued insistence that the injunction simply protects the assets subject to the "in rem" jurisdiction of the State Court is simply without merit. And, unlike the *Bank of New York* and the *Foster* cases upon which the Commissioner relies, the United States has not filed a proof of claim in the insurance rehabilitation proceeding or otherwise voluntarily subjected itself to the jurisdiction of the State Court. *See* Dkt. # 31, Comm'r Brief, at 26; *United States v. Bank of New York & Trust Co.*, 296 U.S. 463, 472 (1936); *Foster v. Mut. Fire, Marine & Inland Ins.* Co., 614 A.2d 1086, 1100-01, (Pa. 1992) .

[4] Although, as the Commissioner noted, Wisconsin has a procedure for rehabilitating domestic insurance companies, that rehabilitation does not necessarily have to occur in a "special" state court proceeding. Wis. Stat. 645.45 explicitly contemplates that insurance rehabilitation proceedings may proceed in federal court, ousting the State Court from jurisdiction, and authorizing the Commissioner to request appointment as federal receiver in such an action. *See* Chapter 89, Laws of 1967, 645.45 Introductory Comment, *citing Inland Empire Insurance Company v. Freed*, 239 F.2d 289 (10th Cir. 1956) (affirming appointment of federal receiver for insolvent insurance company appointed on motion of contract creditor after liquidation proceedings had commenced in state court). Additionally, the State Injunction statute

(continued...)

- This lawsuit will not result in piecemeal litigation; in fact, as described above, the point of the lawsuit is to avoid such a result by ensuring that these federal issues are considered in one court - federal court.

- Most importantly, the governing law in this case is indisputably federal. At issue is whether the federal tax Anti-Injunction Act is reverse-preempted by operation of the federal McCarran-Ferguson Act; and whether the federal McCarran-Ferguson Act explicitly waives the sovereign immunity of the federal Government in a dispute regarding federal taxes. As this Court recognized in its remand order, those are issues of federal law, not state law. *See* Dkt. # 32.6, Remand Order, at 10.

- This action is neither vexatious nor contrived. The United States has every legal right to attack the State Court Injunction (a point which neither Ambac nor the Commissioner contest). The Complaint was forthcoming as to the procedural posture of the case and forthcoming as to our (very reasonable) desire to have a federal court review these significant federal issues (implicating the ability of the United States to be heard in federal court and to collect taxes from insurance companies) of first impression.

For these reasons, this Court should not abstain under *Colorado River*. The whole point of this action is that it is one against the State Court itself, which has violated federal sovereign immunity; this is not merely a competing action in a federal court about a substantive tax issue that is already at issue in a state court proceeding. To abstain in favor of a State Court that the United States has sued for interfering with federal sovereignty would be inconsistent with any abstention doctrine that the Supreme Court has ever endorsed.

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[4](...continued)
allows the Commissioner to seek injunctive relief in any court outside the State of Wisconsin. Wis. Stat. § 645.05.

Respectfully submitted,

February 17, 2011

UNITED STATES DEPARTMENT OF JUSTICE

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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re	:	
AMBAC FINANCIAL GROUP, INC.,	:	Chapter 11 Case 10-15973 (SCC)
Debtor.	:	
AMBAC FINANCIAL GROUP, INC.,	:	
Plaintiff,	:	Adv. Proc. No. 10-4210 (SCC)
-against-	:	
UNITED STATES OF AMERICA,	:	
Defendant.	:	

Exhibit
A

UNITED STATES' RESPONSE TO ORDER TO SHOW CAUSE AND DEBTOR'S MOTION TO ENFORCE TEMPORARY RESTRAINING ORDER PURSUANT TO SECTIONS 105 AND 362(A) OF THE BANKRUPTCY CODE AND RULE 7065 OF THE BANKRUPTCY RULES

Defendant United States of America (the "United States" or the "Government"), on behalf of the Internal Revenue Service (the "IRS"), by its attorney, Preet Bharara, United States Attorney for the Southern District of New York, objects to Debtor's Motion to Enforce

Temporary Restraining Order Pursuant to Sections 105 and 362(a) of the Bankruptcy Code and Rule 7065 of the Bankruptcy Rules ("OSC Motion"):

The United States did not violate the stipulated terms of the temporary restraining order entered into by this Court when it filed a lawsuit in the United States District Court for the Western District of Wisconsin challenging the validity of a state court injunction on the basis of sovereign immunity and other federal tax statutes and regulations. The United States never agreed to provide notice to Debtor before challenging the state court injunction's validity. Debtor's argument to the contrary ignores the agreed language of this Court's temporary restraining order, which both sides stipulated included only "enforcement actions," and the events leading up to it. The Debtor's stated purpose for seeking the TRO was to provide Debtor with notice before the IRS took administrative collection action to recover a $700 million tax refund, so that they could presumably seek judicial review before the IRS could take such unilateral action. Accordingly, the terms of the TRO were limited to "enforcement actions," which are defined as "asserting liens against and levying upon the assets of [Debtor's subsidiaries]." The filing of the district court action does not violate the TRO both because it is not an administrative action by the IRS, and because the judicial action does not seek the recovery of the tax refunds. Moreover, for two months the parties have been litigating the validity of the state court injunction – the same issue that is the subject of the new federal lawsuit – and Debtor has never claimed the ongoing litigation (which was even before the same district court, and is presently on appeal before the Seventh Circuit Court of Appeals) violated this Court's temporary restraining order. Because the United States was not required to give the Debtor notice before commencing its judicial action against a non-debtor subsidiary in federal court, the Debtor's motion should be denied.

I. BACKGROUND

A. Events Leading Up to the Temporary Restraining Order

1. Debtor filed an adversary proceeding against the Government on November 8, 2010. The same day, Debtor filed a Motion for Temporary Restraining Order and Preliminary Injunction Pursuant to Sections 105(a) and 362(a) of the Bankruptcy Code and Rule 7065 of the Bankruptcy Rules ("PI Motion"). Declaration of Ellen London, dated February 17, 2011, ("London Decl.") Ex. A.

2. The PI Motion requested a Temporary Restraining Order and Preliminary Injunction "ordering the Internal Revenue Service (the 'IRS') to provide five business days' prior written notice . . . before taking any Enforcement Action . . . contrary to the State Court Injunction." *Id.* at p. 2.

3. The "State Court Injunction," as that term is used in the PI Motion, refers to an injunction issued on November 8, 2010 by the Dane County Circuit Court in Wisconsin that purports "to prevent the IRS from asserting liens against and levying upon the assets of [Debtor's subsidiary] AAC and its subsidiaries." *Id.* at ¶ 3.

4. With respect to the IRS, "Enforcement Action" is defined in the PI Motion as "asserting liens against and levying upon the assets of AAC and its subsidiaries." *Id.* at ¶ 17. Thus, Debtor was concerned with non-judicial IRS collection powers including liens and levies.

5. In the PI Motion, Debtor emphasized that it sought the Temporary Restraining Order and Preliminary Injunction because it was concerned about the IRS taking immediate action to recover the tax refunds issued to Debtor, as evidenced by the following assertions made by Debtor:

> "If the Court does not grant the Debtor's request for injunctive relief and the IRS places liens upon and levies AAC's assets before AFG's tax liability is determined, the IRS will single-handedly thwart AFG's reorganization proceeding . . ." *Id.* at ¶ 4.
>
> "In addition, this Court has 'related to' jurisdiction to issue an injunction against the IRS to protect the assets of the nondebtor subsidiaries because the dispute involves tax liability of the Debtor's consolidated tax group, and seizure or encumbrance of AAC's assets threatens AFG's survival and ability to reorganize, and thus has more than a 'conceivable effect' on the Debtor's estate." *Id.* at ¶ 21.
>
> "An IRS assessment and collection effort aimed at clawing back approximately $700 million would cripple AAC and endanger AFG's ability to reorganize." *Id.* at ¶ 37.
>
> "The disastrous consequences for the Debtor's reorganization that would result from an immediate assessment and collection of the Tax Refunds far outweigh any prejudice to the IRS from a limited notice injunction . . ." *Id.* at ¶ 42.
>
> "If the injunction is not granted, the Debtor is concerned the IRS . . . may elect to ignore the State Court Injunction. The IRS can then issue an assessment and levy against the assets of AAC." *Id.* at ¶ 42.
>
> "If the IRS is permitted to encumber and/or seize AAC's assets, then AAC's rehabilitation efforts will fail, which will inexorably result in AFG's inability to reorganize and maximize value." *Id.* at ¶ 43.

6. The Declaration of David W. Wallis in Support of Debtor's Request for Declaratory Judgment and Injunctive Relief states as follows:

> "[T]he Debtor believes the IRS may elect to ignore the terms of the expanded Segregated Account Injunction and take enforcement actions to recapture the Tax Refunds. Given that such actions would seriously jeopardize or destroy its reorganization efforts, the Debtor believes this Court should enter the temporary restraining order and preliminary injunction sought in the Motion."

London Decl. Ex. B at ¶ 26.

7. Debtor's proposed Temporary Restraining Order, attached as Exhibit A to the PI Motion, states:

> "ORDERED that, pending a hearing and determination of Debtor's request for a preliminary injunction, effective immediately and subject to the terms hereof, the [IRS] shall provide at least five business days' (the "Notice Period") prior written notice (which notice shall be filed with the Court and served contemporaneously by electronic mail on Debtor's counsel) before taking any Enforcement Action (as defined in the Motion)

> contrary to the State Court Injunction (defined in the Motion), whether or not such injunction remains in effect..."

London Decl. Ex. A, sub-exhibit A at ¶¶ 3-4.

8. Debtor's proposed Preliminary Injunction Order, attached as Exhibit B to the PI Motion, states:

> "Absent a preliminary injunction, the IRS may make an assessment, issue a tax lien, and/or deplete funds from the Debtor's (or AAC's) bank accounts (or bank accounts of the Debtor's non-debtor subsidiaries), with the aim of recapturing the Tax Refunds the IRS determined to issue to Debtor, all before Debtor has had a fair opportunity to have a hearing in this Court to determine its tax liability, if any, to the IRS under section 505(a) of the Bankruptcy Code."

London Decl. Ex. A, sub-exhibit B at ¶ 4. Thus, Debtor was concerned with the IRS's ability to encumber assets of AAC.

9. On November 9, 2010, this Court held a hearing on, among other matters, the PI Motion. At the hearing, Debtor's counsel explained why it had filed the PI motion:

> "As explained in our papers, we received consensually approximately 700 million dollars of tax refunds the last three years and were just recently advised that the IRS may or may not take action to take it back. Under the IRS rules and regulations and statutes, there are various provisions entitling them to seize things in enforcement before we have notice and before there's a trial on the merits. If that happened, many of our, the contracts of AAC would go into default."

London Decl. Ex. C at 7:14-23. Thus, Debtor was concerned with the administrative seizure power of the IRS under the Internal Revenue Code.

10. Debtor's counsel went on to explain that they had reached an agreement with the IRS as to this issue:

> "What we have to guard against is the possibility that a precipitous action would inadvertently create tremendous loss that would have ripples probably far beyond Ambac if other cases are a guide and might cause loss unnecessarily and we are, as I hope today's stipulation evidences, we think we're on track at least to try to resolve this with the IRS. If not, what *our stipulation provides with the IRS is the IRS agrees as requested in our papers that it will not take enforcement action* against Ambac Financial Group, Inc. or its subsidiaries or their assets, absent giving us five business days notice first."

Id. at 8:15-25 (emphasis added).

11. The Assistant United States Attorney present at the hearing stated his understanding of the agreement (the "Bankruptcy TRO"), which corresponds to the above description:

> "Yes, Your Honor, we have agreed to a stipulation and the government just having received these papers in the recent past, I just wanted to be sure that there's no misunderstanding. As I understand our agreement, that the – that *we would give five days notice before taking any enforcement action contrary to the state court injunction.*"

Id. at 10:10-15 (emphasis added).

12. This Court clarified that the agreement pertained to recovery of the tax refunds from non-debtor subsidiaries, asking whether "the state court injunction is broad enough by its terms to encompass any action that the IRS would take against a non-debtor subsidiary with respect to the tax refunds." *Id.* at 11:11-15.

13. Subsequent to entering into the stipulation described above, the IRS took steps to ensure that it would not unintentionally collect against any of Debtor's subsidiaries. Specifically, the IRS implemented litigation freeze codes for each of the relevant subsidiaries. *See* London Decl. at ¶ 5.

B. The United States' Action in Wisconsin District Court

14. The United States removed the rehabilitation proceedings in the Circuit Court for Dane County, Wisconsin ("State Court Action") to federal district court on December 8, 2010 (the "Wisconsin Removal Action"). *See* London Decl. Ex. D at ¶ 21.

15. On December 17, 2010, the United States filed a motion in the federal district court to dissolve the State Court Injunction ("Motion to Dissolve Injunction"). *Id.* at ¶ 23. The State Court Injunction provides, among other things, that the IRS is "enjoined and restrained

from commencing or prosecuting any actions, claims, lawsuits or other formal legal proceedings *in regard to the Allocated Disputed Contingent Liabilities* in any" court or tribunal. London Decl. Ex. E at ¶ 3 (emphasis added).

16. That same day, the Wisconsin Commissioner of Insurance filed a motion to remand the Wisconsin Removal Action to state court. London Decl. Ex. D at ¶ 24.

17. On January 14, 2011, the Wisconsin district court granted the motion to remand and declined to rule on the Motion to Dissolve Injunction. *Id.* at ¶ 25.

18. The United States appealed from the district court's January 14 order to the United States Court of Appeals for the Seventh Circuit, and the Seventh Circuit requested that the United States file a jurisdictional memorandum addressing jurisdiction over the appeal. *Id.* at ¶ 31. It complied and this jurisdictional memorandum "indicated that the United States was considering filing a lawsuit brought under" the original jurisdiction of the United States District Court in Wisconsin *Id.*

19. The State Court subsequently entered an order on January 21, 2011, confirming a rehabilitation plan and purporting to make the State Court Injunction permanent (the "January 21 Order"). *Id.* at ¶¶ 27, 29. The Order did not discuss the United States or any of its contentions raised in the federal district court prior to remand.

20. The United States filed another action in the United States District Court for the Western District of Wisconsin on February 9, 2011 (the "Wisconsin Action"), "in the wake of an order of [the Wisconsin district court] rejecting the United States' attempt to remove the State Court proceeding." *Id.* at p. 2 n.1. The named defendants in that action are the Wisconsin State Circuit Court for Dane County, Theodore K. Nickel, Commissioner of Insurance of the State of Wisconsin, and Ambac Assurance Corporation.

21. The Wisconsin Action seeks an order to enjoin the enforcement of the State Court Injunction and the relevant parts of the January 21 Order; to enjoin the State Court from taking any actions in violation of the Anti-Injunction Act or sovereign immunity; to determine that the State Court Injunction is null and void; and to quash the State Court Injunction and the relevant parts of the January 21 Order. *Id.* at pp. 1-2. The Wisconsin Action does *not* seek a court determination regarding the tax refunds or tax liabilities of Debtor, AAC or any affiliated company, or regarding any IRS levy, lien, or other IRS action or substantive claim relating to the tax refunds or disputed contingent liabilities.

C. The Bankruptcy TRO

22. Debtor filed its OSC Motion on February 15, 2011, claiming that the Wisconsin Action violates the Bankruptcy TRO put in place on November 9, 2010.

23. Debtor mischaracterizes the Bankruptcy TRO when it states: "[i]n summary, the IRS agreed to provide Debtor with five days notice before taking 'any action that violates the state court injunction.'" OSC Motion at ¶ 9. As described in detail above, however, this is not an accurate summary of the agreement. Rather, the agreement, as reflected in the statements of both Debtor's counsel and Government counsel, is specific to "enforcement actions." This is not to suggest that the State Court Injunction is any broader than the Bankruptcy TRO. To the contrary, it appears that Debtor's counsel interpreted the State Court Injunction itself to be concerned with actions by the IRS to collect or create liens as reflected in the many statements of Debtor's counsel in this Court, both in filings and at the hearing. But assuming *arguendo* that the State Court Injunction is broader than "enforcement actions" taken by the IRS, the Bankruptcy TRO is so limited. Indeed, we submit it does not extend to any judicial actions

whatsoever; nevertheless, the broadest conceivable interpretation of the Bankruptcy TRO is limited to judicial "enforcement actions."

II. THE BANKRUPTCY TRO APPLIES ONLY TO ENFORCEMENT ACTIONS AND THE WISCONSIN ACTION IS NOT AN ENFORCEMENT ACTION

24. The United States[1] did not violate the stipulated terms of the Bankruptcy TRO in filing the Wisconsin Action, which simply challenges the State Court Injunction on the basis of sovereign immunity and other federal tax statutes and regulations. The United States never agreed to provide notice to the Debtor before challenging the State Court Injunction's validity. Debtor's argument to the contrary ignores the agreed language of the Bankruptcy TRO, which both sides stipulated included only "enforcement actions," and the events leading up to it.

25. Because the Bankruptcy TRO was entered orally, the transcript of the November 9 hearing defines its terms. As described above, that transcript, read as a whole, leaves no doubt that the Bankruptcy TRO encompassed enforcement actions, *i.e.*, actions to recover the disputed tax refunds.[2]

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[1] By its terms, the Bankruptcy TRO prohibits the IRS, but not the United States, from taking certain actions. *See* London Dec. Ex. C at 8:22-25 ("[T]he IRS agrees as requested in our papers that it will not take enforcement action against Ambac Financial Group, Inc. or its subsidiaries or their assets, absent giving us five business days notice first . . ."). This is significant because, while the IRS would be the agency that could use its statutorily-provided levy or seizure powers or other powers provided by the Internal Revenue Code to take any enforcement action with respect to the recovery of the tax refunds, it is the United States that would litigate any action such as the Wisconsin Action to challenge an invalid state court order. It is black letter law that the IRS cannot sue or be sued in its own name. *See Celauro v. IRS*, 411 F. Supp. 2d 257, 267 (E.D.N.Y. 2006) ("Congress has not specifically authorized suit against the IRS. Therefore, it is not a suable entity.") (citing *Blackmar v. Guerre*, 342 U.S. 512, 515 (1952)). And 26 U.S.C. § 7402(a) specifically authorizes actions only "at the instance of the United States."

[2] It appears that Debtor is trying to hinge its expanded reading of the Bankruptcy TRO on the fact that the Court, at the hearing, did not repeat the word "enforcement" before "actions" when asking a clarifying question about whether the stipulation would cover tax refund actions against subsidiaries. It is untenable to suggest that the Court intended thereby to expand the terms of the stipulated agreement between the Government and the Debtor, without providing any notice to the parties or giving the Government an opportunity to object, to encompass not only IRS

26. Moreover, it is clear, based on Debtor's counsel's representations, that what Debtor was seeking was protection against IRS administrative enforcement actions. *See* London Dec. Ex. C at 8:22-25 ("[T]he IRS agrees as requested in our papers that it will not take enforcement action against Ambac Financial Group, Inc. or its subsidiaries or their assets, absent giving us five business days notice first . . ."). All of the motion papers leading to the TRO hearing also made clear that Debtor was concerned with IRS liens or levies.

27. Accordingly, any assessment of whether the IRS violated the TRO must begin with a determination of whether the IRS undertook any enforcement action.

28. The Wisconsin Action filed by the United States is not an enforcement action. The IRS has not issued any levies with respect to Debtor. It has made no attempt to recover the $700 million refund. It has not seized, or attempted to seize, Debtor's assets. Nor does the Wisconsin Action seek to accomplish any of these things.

29. Rather, as described above, the Wisconsin Action is merely a challenge to the propriety of the State Court's orders against the United States, on the grounds that the State Court lacked the authority to issue such orders. In it, the United States requested relief of an injunctive nature and alternatively sought at least a determination that the injunction was void and unenforceable. Obviously, this is not an action seeking to recover the tax refunds in dispute.

30. Debtor's rationale for the injunctive relief sought in the PI Motion was that if IRS took immediate unilateral administrative actions to recover or encumber the assets of Debtor or its subsidiaries without judicial review, such actions would be detrimental to Debtor's ability to reorganize. *See supra* ¶ 5; Adversary Proceeding Complaint ¶ 34 ("[T]he IRS may make an immediate assessment of tax liability without issuing a prior notice and enforce a collection

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enforcement actions, and not only judicial enforcement actions by the United States, but any kind of civil action whatsoever. Debtor should be held to its own articulation of the stipulation.

action without affording a prior judicial review."). Debtor needs no notice of a district court lawsuit in order to obtain judicial review in a federal court – the court itself is the safeguard as it can deny the relief requested by the United States.

31. Whether or not the United States is successful in obtaining a judgment that the State Court Injunction is invalid has no bearing on whether it violated the Bankruptcy TRO. That is because the parties explicitly agreed that the Bankruptcy TRO would remain in place "whether or not [the State Court Injunction is] in effect." London Decl. Ex. C at 11:6-7.

III. THE BANKRUPTCY TRO DOES NOT PROHIBIT A CHALLENGE TO THE STATE COURT INJUNCTION ITSELF

32. Debtor contends that the Bankruptcy TRO is much broader than an injunction against IRS enforcement actions, and should be read to bar any actions the United States may bring with respect to Debtor or its subsidiaries, including actions brought by the United States to determine the validity or invalidity of the State Court Injunction itself.

33. The United States never stipulated to the entry of such an overbroad injunction. This overbroad interpretation of the Bankruptcy TRO is inconsistent with the terms of the agreement itself, which enjoin "enforcement actions" with respect to the disputed tax refunds, *see supra* ¶¶ 9-12. It is also at odds with the reasoning presented by Debtor in the PI Motion and in its argument to the Court, *see supra* ¶¶ 2-6, as well as the relief requested in Debtor's proposed temporary restraining order and preliminary injunction, *see supra* ¶¶ 7-8.

34. Even assuming *arguendo* that the Debtor is correct that the Bankruptcy TRO imposed a notice obligation with respect to any action taken in violation of the State Court Injunction – which it plainly did not – the filing of the Wisconsin Action still would not run afoul of this requirement. The United States' Wisconsin Action *challenges* the State Court Injunction – it does not *violate* it. To say otherwise would mean that there is no way to challenge the very

validity of the State Court Injunction without being in violation of its terms, except if the United States is willing to submit to the jurisdiction of a court in which it maintains it is completely immune from suit and does not have to appear. In essence, it would be a self-proclaimed declaration that it is the supreme law of the land that cannot be challenged, even by the United States in federal court. Such a radical view could be easily drafted in absolute terms, whereas, instead, the State Court Injunction confined its injunction to "commencing or prosecuting any actions, claims, lawsuits or other formal legal proceedings *in regard to the Allocated Disputed Contingent Liabilities*." London Decl. Ex. E at ¶ 3 (emphasis added). In *Matter of Mahurkar Double Lumen Hemodialysis Catheter Patent Litig.*, 140 B.R. 969, 974 (N.D. Ill. 1992), Seventh Circuit Court of Appeals Judge Easterbrook, sitting by designation in the district court, held in an analogous case that "litigation to determine the extent of the automatic stay" is not a violation of the automatic stay, and was critical of a Delaware bankruptcy judge's order trying to assert exclusive jurisdiction to determine whether a hearing set before Judge Easterbrook would in fact violate the stay and enjoining the parties from attending that hearing. Judge Easterbrook suspended the enforcement of the bankruptcy court's TRO and explained that "[f]or one federal court to issue an injunction forbidding litigation in another is extraordinary, given principles of comity among coordinate tribunals;" and found "[t]his unseemly war between two federal courts was occasioned by an unnecessary, incomplete, and deceptive filing by [a party] in the bankruptcy case." *Id.* at 974-75. He cautioned that "[l]awyers who make *ex parte* applications have a special duty of candor in light of the one-sided nature of the presentation." *Id.* at 975.

35. The Government could not and did not intend its agreement in the Bankruptcy TRO to elevate the State Court Injunction to be an order that cannot be challenged without violating the order itself, save by submitting unwillingly to the State Court's jurisdiction and

asking that court to interpret all the federal laws that govern the issue. The Government stipulated only to provide five days' notice of any IRS "enforcement action," as reflected in the language of the Government's attorney (and Debtor's), *see supra* ¶¶ 10, 11. The broader injunction that Debtor now claims was entered by the Court would have exceeded the Court's subject matter jurisdiction. There is no source of authority under 28 U.S.C. § 1334(b), or any other statute, for a bankruptcy court to issue such an injunction in abrogation of the Government's sovereign immunity at least where, as here, the injunction is not directed at protecting property of the estate or even property of the debtor's subsidiaries that is not property of the estate. *See Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.6 (1995) (approving of the test for the outer limits of bankruptcy jurisdiction in *Pacor v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984)). And neither Debtor's OSC nor TRO Motion suggested subject matter jurisdiction exists for such an injunction; indeed, the TRO Motion did not seek the relief Debtor now contends the Bankruptcy TRO provides, *see supra* ¶¶ 5, 7, 8.

36. The fact that the parties have been litigating the validity of the State Court Injunction since December 2010 – when the Government first removed the Wisconsin state court proceeding to federal district court and sought to dissolve the State Court Injunction, *see supra* ¶¶ 14-20 – without Debtor ever suggesting, either in its pleadings in Wisconsin federal court, its discussions with Government counsel, or with this Court, that this litigation somehow violated the Bankruptcy TRO, further highlights that Debtor itself never understood the TRO to be implicated by the Wisconsin litigation. The point of filing the separate civil action against the state court, the Wisconsin Commissioner, and AAC was simply to lay an alternative procedural path for obtaining one of the primary aspects of the relief that the government was already seeking in the same federal district court through removal – that is, the lifting of the State Court

Injunction – and which it is continuing to seek through its appeal of the remand order to the Seventh Circuit.

37. Not only did the prior Wisconsin Removal Action litigation raise the same issue, but it even was before the same district court, and is presently on appeal before the Seventh Circuit Court of Appeals. For Debtor to have litigated the validity of the State Court Injunction for two months in federal court, without ever once broaching the issue of the Bankruptcy TRO, and then rush to hold the United States in contempt of the Bankruptcy TRO by Order to Show Cause, with merely a few days' notice, is highly disingenuous at best. This further supports the fact that a challenge to the State Court Injunction is not a violation of the Bankruptcy TRO.

WHEREFORE the United States prays that this Court deny the relief request in Debtor's OSC Motion.

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