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

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

MEMORANDUM IN SUPPORT OF MOTION TO DISSOLVE ORDER FOR TEMPORARY SUPPLEMENTAL INJUNCTIVE RELIEF AND OBJECTIONS TO NOTICE, MOTION AND ORDER

On November 8, 2010, without prior notice to the United States, the Wisconsin Office of the Commissioner of Insurance ("Insurance Commissioner") requested, and Lafayette County Circuit Court Judge William Johnson signed, an Order for Temporary Supplemental Injunctive Relief ("Injunction") enjoining the United States from commencing any actions, claims or lawsuits relating to the potential federal tax liability of Ambac Assurance Corporation ("Ambac"). Additionally, the Injunction prohibits the United States from taking any steps to collect those potential taxes from Ambac (and dozens of its subsidiaries), and even from obtaining a tax lien against Ambac and any of its subsidiaries' assets. Finally, the Injunction ostensibly grants the State Court exclusive jurisdiction over any federal tax claims involving Ambac and its subsidiaries.

After the state court signed the Injunction, the Insurance Commissioner served the United States with a copy of the Injunction, his Motion seeking the injunction, and a "Notice of Amendment to Plan of Operation for the Segregated Account" (the "Notice").[1] The United States timely removed the State Court action to this Court. The United States now objects to the injunction and moves to dissolve it.

Section 1442 of Title 28 gives the United States and its agencies an absolute right to remove any civil action against them and relating to the collection of revenue. 28 U.S.C. § 1442. The Injunction here specifically identifies the "United States Internal Revenue Service," and the order both restrains and relates to the collection of revenue. Additionally, § 1441 of Title 28 gives a defendant the right to remove a case in which the United States District Court has original jurisdiction. *Id*. § 1441. The District Court has original jurisdiction of "all civil actions arising under the Constitution, laws, or treaties of the United States," including those laws providing for the internal revenue. 28 U.S.C. §§ 1331, 1340, 1346 (a)(1), 1346(e). To the extent that jurisdiction exists for any suit against the federal government, it would be pursuant to a law of the United States. The United States' removal of this action was proper pursuant to both §§ 1441 and 1442 of Title 28, and, as a result, this Court has jurisdiction to dissolve the Injunction and resolve the dispute between the parties.[2]

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[1] We have previously filed these documents with the Court at Docket # 2. *See* Dkt. # 2, State Court Pleadings.

[2] The Rooker-Feldman Doctrine does not bar this Court from dissolving the Injunction. *See* this Court's decision in *Simon Kent v. L. Harris*, Case No.: 3:08-cv-00141-bbc (June 13, 2008) at 2008 WL 2434122 (W.D. Wis. 2008). We understand that the Insurance Commissioner intends to file a motion to remand the entire proceeding back to the State Court. In our Opposition to that motion, we will, if necessary, address more substantively the removal issue.

After providing some factual background, the United States will explain its objections to the Notice, Motion, and Injunction and why the Injunction should be dissolved.[3]

FACTS

1. The Rehabilitation Proceeding.

Ambac Assurance Corporation ("Ambac") is an insurance company incorporated under the laws of the State of Wisconsin.[4] Ambac is a wholly-owned subsidiary of Ambac Financial Group Inc. (AFGI), a holding company headquartered in New York City.[5] At all relevant times, AFGI filed a consolidated federal income tax return on behalf of itself and all of its subsidiaries, including Ambac.[6]

While Ambac's traditional line of business was insuring municipal bonds, in the 2000s Ambac shifted away from such pedestrian pursuits to become a purveyor of sophisticated credit-default swaps for mortgage-backed securities and collateralized debt obligations.[7] Following the

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[3] Ambac's holding company, Ambac Financial Group, Inc. ("AFGI"), filed a bankruptcy petition in the United States Bankruptcy Court for the Southern District of New York on November 8, 2010. *See In re Ambac Fin. Group, Inc.*, Case No.: 10-15973 (Bank. S.D.N.Y.) In conjunction with that case, AFGI has sought injunctive relief prohibiting the United States from collecting tax from, among other entities, Ambac. *Ambac Fin. Group, Inc. v. United States*, Adversary Proc. No. 10-04210 (Bank. S.D.N.Y.) The matter has not been fully briefed and is not yet ripe for decision by the bankruptcy court. In the meantime, the United States has voluntarily agreed to provide five days notice to AFGI before taking any collection action.

[4] The Insurance Commissioner sent a letter to the SEC on November 11, 2010. This letter provides some background facts and we have attached it as exhibit 1. Ex. 1, SEC Letter, at 2. We have not taken any discovery in this case, so we do not accept, adopt or acquiesce to all of the statements in this letter.

[5] Ex. 1, SEC Letter, at 2.

[6] *See* Dkt. # 2, State Court Pleadings, at 13.

[7] *See In re Ambac Fin. Group, Inc. Secs. Litig.*, 693 F. Supp. 2d 241 (S.D.N.Y. 2010).

onset of the subprime mortgage crisis, those transactions were revealed to be toxic to Ambac's financial health. Ambac submitted to the Insurance Commissioner a request to establish a segregated account for the toxic policies pursuant to Wisconsin Statute § 611.24(2), which allows an insurance corporation to establish an account for "any part of its business."[8] According to the legislative comments in the Wisconsin statute, a segregated account is the equivalent of a "corporation within a corporation," with the "basic idea behind segregated accounts" being that "different operations" within the insurance company "can be kept independent without formally creating a separate corporation." Wis. Stat. § 611.24(2).[9] When properly done, some of an insurance corporation's business is placed into a separate account and insulated from the rest of the company's business. *Id*.

Ambac placed into its segregated account some of its insurance policies and some of its other potential liabilities.[10] It did not (and has not) placed *all* of its (or its subsidiaries) assets and liabilities into the Segregated Account.[11] The Segregated Account is capitalized by a secured note issued by Ambac to the Segregated Account, and an aggregate excess of loss reinsurance agreement provided by Ambac.[12] In short, in order to make funds available to pay the liabilities in the Segregated Account, Ambac lent money to the Segregated Account via a secured note and

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[8] Ex. 1, SEC Letter, at 3.

[9] We have attached Wisconsin Statute § 611.24 as Ex. 2.

[10] Ex. 1, SEC Letter, at 3.

[11] Ex. 1, SEC Letter, at 1, 3; *See* Dkt. #2, State Court Pleadings, at 1. ("A number of policies, contracts, and other assets and liabilities of Ambac Assurance Corporation have been allocated to the Segregated Account for disposition and treatment . . .); Ex. 3, Plan of Operation for Segregated Account.

[12] Ex. 3, Plan of Operation for Segregated Account, at 3-4.

agreed to reinsure the policies in the Segregated Account.[13]

On March 24, 2010, the Insurance Commissioner filed a petition in the Dane County Circuit Court to rehabilitate the Segregated Account.[14] The Segregated Account is considered a separate insurer from Ambac for purposes of the rehabilitation, so neither Ambac nor its subsidiaries (excepting only the Segregated Account) are subject to rehabilitation.[15] Shortly thereafter, the Insurance Commissioner was named rehabilitator of the segregated account.[16] The Insurance Commissioner has filed a plan of rehabilitation with the Court and intends to pay the claims in the Segregated Account with a combination of cash and notes.[17] The money to pay these claims will come from the secured note from Ambac and, if necessary, the reinsurance policy.[18]

2. Ambac's Federal Tax Issues

From 2008 through 2010, AFGI received approximately $700 million in "tentative" tax refunds pursuant to 26 U.S.C. § 6411.[19] AFGI allocated the $700 million to Ambac in

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[13] Ex. 3, Plan of Operation for Segregated Account, at 3-4.

[14] Ex. 1, SEC Letter, at 1.

[15] Ex. 1, SEC Letter, at 1 (The Rehabilitation pertains solely to the Segregated Account, which is a separate insurer from Ambac Assurance for purposes of the Rehabilitation. The Rehabilitation does not include Ambac Assurance, its general account or [its holding company].); Wis. Stat. § 611.24.

[16] Ex. 1, SEC Letter, at 1.

[17] Ex. 1, SEC Letter, at 5.

[18] Ex. 3, Plan of Operation for Segregated Account, at 3-4.

[19] Ex. 4, Wallis Affidavit ¶13. This affidavit was filed in the AFGI bankruptcy at Dkt. #2, Case No: 10-15973. The affidavit is lengthy, so we have attached as Ex. 4 only the portion (continued...)

accordance with an internal allocation agreement.[20] AFGI, Ambac, and any other entities that filed the consolidated tax return will be severally responsible for the tax liabilities and responsible for repaying the $700 million plus interest if the companies were not entitled to a refund. 26 C.F.R. §§ 1.1502-6; 1.1502-78. On October 28, 2010, the IRS sent AFGI an information document request seeking information relating to the basis for the refunds, asking among other things whether AFGI had received permission from the IRS before changing its accounting method.[21]

This mild request for information seemingly caused AFGI and Ambac to take several actions. Within a week, AFGI filed for Chapter 11 bankruptcy protection and concurrently filed an adversary proceeding in the bankruptcy court to determine its tax liability.[22] That action remains pending in the Southern District of New York bankruptcy court.

On Sunday, November 7, 2010, AAC allocated to its Segregated Account any liabilities it

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[19](...continued)
of the affidavit that provides background facts relevant to this case. We have not taken any discovery in this case or the New York bankruptcy matter, so we do not accept, adopt or acquiesce to all of the statements in this affidavit. Section 6411 requires the IRS to provide a "tentative" refund within 90 days of an application by a corporate taxpayer that has overpaid tax due to a net operating loss ("NOL") carryback, among other situations, after a limited examination. This refund is "tentative" because the IRS "retains the right to conduct a more thorough audit of the taxpayer's application later and recapture any funds that it has erroneously paid. . . . This treatment allows the IRS to assess the resulting increase in tax liability immediately 'without regard to whether the taxpayer has been mailed a prior notice of deficiency.'" *Coca-Cola v. United States*, 87 Fed. Cl. 253, 256-57 (Fed. Cl. 2009), citing 26 U.S.C. § 6213(b)(3) & Treas. Reg. § 301.6213-1(b)(2).

[20] *See* Dkt. # 2, State Court Pleadings, at 13.; Ex. 4, Wallis Affidavit ¶ 13.

[21] *See* Dkt. # 2, State Court Pleadings, at 14, 22.

[22] *See* ftn. # 3; *Ambac Fin. Group, Inc. v. United States*, Adversary Proc. No. 10-04210 (Bank. S.D.N.Y.); Ex. 1, SEC Letter, at 4.

has or may ever have arising from its federal taxes through December 2009 and specifically any liabilities it may have with respect to the $700 million tax refund.[23] The Insurance Commissioner approved the allocation, filed a "Notice" with the State Court, and served the United States with that Notice on or about November 8, 2010, the same day that AFGI filed for bankruptcy.[24]

Additionally, on November 8, 2010, the Insurance Commissioner sought and obtained from the State Court the Injunction, which, in pertinent part, enjoins the United States Internal Revenue Service from:

> 3. . . . commencing or prosecuting any actions, claims, lawsuits or other formal legal proceedings in regard to . . . [Ambac's potential future federal tax liabilities] in any state, federal or foreign court, administrative body or other tribunal against: (a) the Segregated Account; (b) any subsidiary of Ambac whose stock, limited liability company member interests or other forms of ownership interests were allocated to the Segregated Account . . .; (c) Ambac Assurance Corporation . . . ; (d) any subsidiary of Ambac; or (e) the Rehabilitator. This Court has exclusive jurisdiction over any such actions, claims or lawsuits.
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> 4. . . . taking any prejudgment or other steps to transfer, foreclose, sell, assign, garnish, levy, encumber, attach, dispose of, or exercise purported rights in or against any property or assets of the Segregated Account, Ambac, . . . or Ambac subsidiaries in respect of [Ambac's potential future federal tax liabilities.][25]

In paragraph 2 of the Injunction, the Wisconsin State Court noted that the "Order is made in furtherance of the allocation" of Ambac's tax liabilities "to the Segregated Account."[26]

This injunction purports to prohibit the United States from initiating any type of lawsuit

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[23] *See* Dkt. # 2, State Court Pleadings, at 4.

[24] *See* Dkt. # 2, State Court Pleadings, at 3.

[25] *See* Dkt. # 2, State Court Pleadings, at 29-32.

[26] *See* Dkt. # 2, State Court Pleadings, at 30.

at all related to Ambac's potential tax liabilities, not just against the Segregated Account in rehabilitation, but against Ambac and any of its subsidiaries (some of which remain profitable). It also purports to vest the state court with exclusive jurisdiction over any dispute over Ambac's taxes, and prohibits the United States from taking any collection action against Ambac, the Segregated Account, and/or Ambac's subsidiaries. The Injunction seems to prevent the United States from assessing any tax against Ambac because a federal tax lien would, at the time of assessment, automatically "encumber" all of Ambac's property. 26 U.S.C. §§ 6321, 6322. Finally, the State Court appears to have taken jurisdiction over what (very) few investigative and collection tools remain to the United States.

ANALYSIS

The injunctive relief obtained here by the Insurance Commissioner is extraordinary and was obtained in violation of the Anti-Injunction Act. 26 U.S.C. § 7421. Indeed, the Insurance Commissioner failed to even notify the State Court of the existence of the Act.[27] The Insurance Commissioner seeks to prohibit the United States from (1) collecting taxes, (2) filing suit regarding any disputed tax, (3) defending any challenge with respect to Ambac's federal tax liabilities in any proceeding except the state court rehabilitation action,[28] and (4) assessing any tax against Ambac. This relief is especially extraordinary given that the injunction purports to cover not just the Segregated Account in rehabilitation, but all of Ambac and its affiliates even though those entities are not in rehabilitation.

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[27] *See* Dkt. # 2, State Court Pleadings, at 5-11.

[28] In conjunction with its bankruptcy action, AFGI has brought an adversary proceeding to determine its tax liability. Because AFGI and Ambac filed a consolidated returns, the outcome of that proceeding would establish Ambac's tax liability. 26 C.F.R. § 1.1502-6.

The McCarran-Ferguson Act permits state laws to preempt federal laws under certain circumstances. 15 U.S.C. § 1012(b). In 1993, the Supreme Court held that a state statute assigning priority to insurance policyholders over the government preempted the competing federal priority statute. *United States Dep't of Treasury v. Fabe*, 508 U.S. 491 (1993). But Ambac's case, however, is not about whether a state priority statute regulating the business of insurance can, in certain circumstances, enjoy supremacy over a federal priority statute. This case is about (I) whether the state court can deprive the United States of the exclusive federal jurisdiction Congress has granted over the administration of the federal tax laws and (II) whether the Wisconsin injunction statute (the authority cited by the State Court for entering the Injunction) and the Wisconsin Segregated Account statute (although not directly mentioned, this was indirectly referenced by the State Court in paragraph 2 of the Injunction) preempt federal tax law.

I. THE INJUNCTION SHOULD BE DISSOLVED BECAUSE THE STATE COURT IMPROPERLY USURPED THE EXCLUSIVE FEDERAL JURISDICTION OVER FEDERAL TAX DISPUTES.

It is axiomatic that the United States, as sovereign, may not be sued without its consent and the terms of its consent define a Court's jurisdiction. *United States v. Dalm*, 494 U.S. 596, 608 (1990); *Balistrieri v. United States*, 303 F.2d 617, 619 (7th Cir. 1962). Further, the party bringing suit (in this case the Insurance Commissioner) bears the burden of proving that sovereign immunity has been waived. *Muscarello v. Ogle County Bd. Of Com'rs*, 610 F.3d 416, 425 (7th Cir. 2010). The Insurance Commissioner cannot demonstrate that the United States has consented to be sued in state court regarding the administration of federal tax laws. To the contrary, to the extent that the United States consents to be sued at all in tax matters, Congress

has determined that the federal courts have exclusive jurisdiction over those actions. 28 U.S.C. § 1340, 1346; *Balistrieri*, 303 F.2d at 619. Simply put, "[t]he determination of whether a person owes federal income tax on money received does not occur in the . . .state courts." *In re Estate of Tizzard*, 708 N.W.2d 277, 284 (Neb. App. 2005).

Because the United States has not consented to be sued in, or be bound by, the Wisconsin state court, that state court may not unilaterally assert "exclusive" jurisdiction over all federal tax disputes involving a taxpayer. *See Wolff v. United States*, 76 Fed. Appx. 867, *2 (10th Cir. 2003) ("Unequivocally, sovereign immunity shields the federal government from suit in state court."); *Gross v. Weingarten*, 217 F.3d 208, 221(4th Cir. 2000) ("An attempt to restrain the exercise of federal jurisdiction is no more effective when made by a court in the form of an injunction."). Nor does any state court have the power to limit, modify, or control the power of the federal courts by enjoining a litigant from pursuing federal remedies in federal court. *see Appleton Papers, Inc. v. Home Indem. Co.*, 612 N.W.2d 760, 767 (Wis. App. 2000); *See also General Atomic Co. v. Felter*, 434 U.S. 12, 17-19 (1977) (noting that the right to pursue federal remedies and take advantage of federal procedures and defenses in federal actions may not be restricted by a state court).

Congress has given the exclusive federal jurisdiction to the determination and collection of federal taxes to the federal courts. For instance, "[i]t is well established that the IRC provides the exclusive remedy in tax refund suits and thus preempts state-law claims that seek tax refunds." *Brennan v. Southwest Airlines Co.*, 134 F.3d 1405, 1409, amended by 140 F.3d 849 (9th Cir. 1998) (citations omitted); accord *Kauky v. Southwest Airlines Co.*, 109 F.3d 349, 351 (7th Cir. 1997)(Posner,. J.) (As to state law claim that effectively demanded a federal tax refund, "[w]hen

federal law creates an exclusive remedy for some wrong, displacing any remedy that the states may have created for it, a suit to redress that wrong necessarily arises under federal law. There is no state law for it to arise under because the state law that the plaintiff thought he was suing to enforce has been pushed to one side, and replaced, by the federal law."). The Insurance Commissioner's justification for the injunction was concern that the IRS might "impose a levy on the tax refund proceeds."[29] The Internal Revenue Code does in fact permit the IRS, in the case of a tentative refund, to assess a tax liability without notice (which automatically imposes a lien) and then utilize the Code's collection tools to recapture the tentative refunds. 26 U.S.C. § 6213(b)(3); 26 C.F.R. § 301.6213-1(b)(2). In that event, Ambac's remedy is to contest the collection action when allowed by the Code or file an administrative claim before the IRS, followed by a refund suit in federal court.

No state court can usurp this exclusive federal jurisdiction. The Seventh Circuit has long recognized that "[e]xclusive federal jurisdiction being present, only the federal courts have power to provide that affirmative relief," even in the face of McCarran-Ferguson. *Central States v. Old Security Life Ins. Co.*, 600 F.2d 671, 676 (7th Cir. 1979). In *Central States*, the Missouri Director of Insurance placed an insurance company (Old Security) into rehabilitation proceedings and obtained a state court order enjoining all actions against it. Plaintiffs filed an ERISA suit against Old Security in federal district court, and Old Security moved to dismiss, alleging that the state court injunction and McCarran-Ferguson preemption barred the suit. The Seventh Circuit held that, because the suit was under a statute (ERISA) that vested exclusive jurisdiction in the federal courts, the federal action could not be enjoined. *Id*. at 675-77. The state court injunction should

[29] Dkt. # 2, State Court Pleadings, at 14.

be dissolved on that ground alone.

II. NO COURT HAS JURISDICTION TO ISSUE THE INJUNCTION.

The McCarran-Ferguson Act states that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such act specifically relates to the business of insurance." 15 U.S.C. § 1012(b). A state law can preempt a federal statute 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). To the extent that any one of the three factors listed above is not met, then the federal statute has supremacy over that of the state. *Id*. at 1043. As demonstrated below, Wisconsin state law does not preempt the federal tax laws.

1. **Numerous Federal Laws Bar the Relief Sought In the Injunction.**

The Injunction improperly upsets and preempts the United States' rights, responsibilities, and obligations under to the Internal Revenue Code. For instance, the Internal Revenue Code expressly imposes a federal income tax on insurance companies and directs the Secretary of Treasury to make an assessment[30] of that tax. 26 U.S.C. §§ 801, 831, 6201. Additionally, the Secretary is authorized to "collect the taxes imposed by the internal revenue laws" and there exists a wide array of administrative and judicial tools to assist the Secretary's collection efforts. *See e.g., id.* §§ 6301, 6321, 6330, 7401-7405. None of these laws permit a taxpayer to do what

[30] An "assessment" is made by recording a taxpayer's liability in the office of the Secretary in accordance with the rules and regulations prescribed the Secretary. 26 U.S.C. § 6203.

Ambac ostensibly did and isolate its potential federal tax liabilities in a separate account, thereby prohibiting the United States from potentially collecting from any available assets to which any future tax lien will attach. *Id.* § 6321 ("If any person liable to pay any tax neglects or refuses to pay same . . ., the amount . . . shall be a lien in favor of the United States upon all property and rights to property. . . "). Of course, there also exists a comprehensive set of statutes and regulations allowing a taxpayer to challenge the Secretary's actions. *See e.g., id.* §§ 6213, 7422, 7425, 7429.

The Injunction restrains the United States from collecting and, possibly, assessing taxes both administratively and by bringing a lawsuit. This type of relief is expressly prohibited by the Anti-Injunction Act, which divests *all* courts of subject-matter jurisdiction to enter an order restraining the Internal Revenue Service from assessing and collecting federal taxes. *Rappaport v. United States*, 583 F.2d 298, 301 (7th Cir. 1978); *Shrock v. United States*, 92 F.3d 1187, 1996 WL 414177 *1 (7th Cir. 1996) . Subject to certain exceptions not relevant here, the Anti-Injunction Act provides that "no suit for the purpose of restraining the assessment or collection of any tax shall be maintained *in any court* by any person."[31] 26 U.S.C. § 7421(a) (emphasis added);

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[31] There are judicial exceptions to the Anti-Injunction Act as articulated by the Supreme Court in *South Carolina v. Regan*, 465 U.S. 367, 373 (1984) and *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1, 6-7 (1962). None of those exception apply here.

In *Regan*, the Supreme Court stated that the Anti-Injunction Act will not bar relief if Congress has not provided a plaintiff with an alternative legal way to challenge a tax. *Regan*, 465 U.S. at 378. The Internal Revenue Code provides Ambac with many potential ways to challenge a tax assessment or otherwise contest a levy or jeopardy assessment, so the *Regan* exception does not apply. *See e.g.*, 26 U.S.C. §§ 7433, 7429(b), 6330(d).

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 ultimately prevail and that irreparable injury would occur without the requested relief. *Williams Packing*, 370 U.S. at 6-7; *Rappaport*, 583 F.2d at 301-02; *Educo, Inc. v. Alexander*, 557 F.2d 617, 622-21

(continued...)

United States v. First Family Mortg. Corp., 739 F.2d 1275, 1278 (7th Cir. 1984). "The Act has been broadly construed to prohibit courts from granting equitable relief that would have the effect of enjoining the assessment or collection of taxes. . . and to prevent judicial intermeddling in the tax collection process." *First Family*, 739 F.2d at 1278.

The Injunction here also improperly purports to prohibit the United States from bringing an action in federal court pursuant to this Court's jurisdiction and the Internal Revenue Code. 28 U.S.C. § 1340 (federal court has exclusive jurisdiction over tax matters); 26 U.S.C. §§ 7402 (district courts at the United States' request can issue injunctions, and render judgments to enforce the internal revenue laws), 7403 (action to enforce lien), 7405 (action to recover erroneous refund),7604 (summons enforcement action).

The Injunction should be dissolved because it is expressly prohibited by the Anti-Injunction Act and no court has subject-matter jurisdiction to issue such an order. Additionally, the Injunction prohibits the United States from assessing and collecting tax in accordance with the Internal Revenue Code, and prohibits the government from filing a lawsuit in accordance with federal statutes that authorize such suits. McCarran-Ferguson does not permit a state statute to preempt these federal laws.

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[31](...continued)
(7th Cir. 1977). This exception would not apply because there is no evidence of and otherwise no reason to believe that the United States could not prevail by sustaining a possible, future tax assessment against Ambac. Additionally, Ambac will not be irreparably harmed by an IRS assessment or collection action because it can always contest those actions when they occur. *Rappaport*, 583 F.2d at 301-02.

2. No State Statute Preempts The Federal Laws to Permit A Court to Issue The Injunction.

The Insurance Commissioner apparently will rely on the McCarran-Ferguson Act to justify the state court's unlawful injunction. That argument has no merit. As the Supreme Court has held, "[w]e reject any suggestion that Congress intended to cede the field of insurance regulation to the States, saving only instances in which Congress expressly orders otherwise." *Humana Inc. v. Forsyth*, 525 U.S. 299, 308 (1999). The McCarran-Ferguson Act does not permit every state law (or even every portion of every state law) to preempt federal law simply because the state law references insurance. *Fabe*, 508 U.S. at 509 n.8. In issuing the Injunction, the State Court specifically referenced Wis. Stat. § 645.05(1)(d, f, g, h, and k), which is titled "Injunctions and Orders" and states that an insurance receiver may apply for an injunction or temporary restraining order to prevent, among other things, "(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." In this case, because the Segregated Account is an insurer separate from Ambac and only the Segregated Account is in rehabilitation the references to "insurer" in the statute refer to the Segregated Account. In paragraph 2 of the Injunction, the State Court indicated that the "Order [was] made in furtherance of the allocation of [Ambac's potential, future tax liabilities] to the Segregated Account. . . " Ambac, with the Insurance Commissioner's approval, allocated its potential future federal tax liability to the

Segregated Account and served the United States with a "Notice" of that allocation along with the Injunction. A Segregated Account is authorized pursuant to Wisconsin Statute § 611.24(2).

The issue before the Court is whether the McCarran-Ferguson Act authorizes the Wisconsin Injunction and Segregated Account statutes to preempt federal law. Generally, the Injunction enjoins (a) the United States from initiating a lawsuit in any court (including, presumably, the state court) against Ambac, the Segregated Account, or any of Ambac's subsidiaries regarding Ambac's potential tax liabilities, and grants the State Court jurisdiction over any such cause of action (presumably because the United States cannot initiate the action, it would be forced to defend a case only in state court) and (b) from taking any action to collect or, potentially, assess a tax liability against Ambac, the Segregated Account, or any of Ambac's Subsidiaries.

Assuming, *arguendo*, that the Wisconsin Injunction and Segregated Account statutes authorize the Injunction, those state laws can preempt a federal statute only if (a) the federal statute does not specifically relate to the business of insurance; (b) the state law was enacted for the "purpose of regulating the business of insurance;" and (c) the federal statute operates to "invalidate, impair, or supersede" the state law. *Autry*, 144 F.3d at 1040. None of those tests are met in this case.

a. *The federal tax statutes relate to the business of insurance and will not prohibit the United States from taxing insurance companies.*

"Congress did not give up the right to tax insurance companies by passing the McCarran Act." *Industrial Life Ins. Co. v. United States*, 344 F. Supp. 870, 874 (D. S.C. 1979), *aff'd*, 481 F.2d 609 (4th Cir. 1973) ("The plaintiff mistakes the right to tax a life insurance company with the right to regulate such company."). The Tax Code specifically authorizes and establishes

procedures for taxing insurance companies and collecting those taxes. 26 U.S.C. § 801. Thus, the Internal Revenue Code specifically relates to the business of insurance, making the McCarran-Ferguson Act inapplicable by its own terms. *Hanover Ins. Co. v. C.I.R.*, 598 F.2d 1211, 1218 (1st Cir. 1979).

The Injunction prevents the United States from making a tax assessment against Ambac (and its subsidiaries), commencing an action to determine Ambac's tax liability, defending in Tax Court any action brought by Ambac to contest a potential liability, and collecting on a tax owed. The Injunction impermissibly interferes with the United States' right to tax an insurance company and this power was not delegated to the states through McCarran-Ferguson. *Id*; *Industrial Life Ins. Co. v. United States*, 481 F.2d 609 (4th Cir. 1973). Because the federal tax statutes specifically deal with insurance companies and because Congress did not delegate its power to tax to the states, McCarran-Ferguson is inapplicable and the federal tax statutes are supreme.

b. *The state laws were not enacted for the purpose of regulating the business of insurance.*

"[A] state statute regulating the liquidation of insolvent insurance companies need not be treated as a package which stands or falls in its entirety." *Fabe*, 508 U.S. at 510 n.8. Under *Fabe*, we have to parse the statutes to determine whether they regulate the business of insurance. "[A] statute is 'enacted ... for the purpose of regulating the business of insurance' if it possesses the end, intention, or aim of adjusting, managing, or controlling the relationship between the insurance company and the policyholder, directly or indirectly." *Autry*, 144 F.3d at 1044.

In *Fabe*, the Supreme Court addressed an Ohio insurance insolvency in which the United States as obligee on various immigration, appearance, performance, and payment bonds issued by the insolvent insurer had filed claims in excess of $10.7 million in the state liquidation

proceedings. *Id*. at 494-95. The liquidator **brought suit against the government in federal court**[32] to determine whether the Ohio priority statute (ranking administrative expenses, policyholders, employee wages and a few other items ahead of government claims) would trump the federal priority statute (ranking the government first). *Id.* at 495-97.

The Supreme Court framed the issue as follows: "In order to resolve this case, we must decide whether a state statute establishing the priority of creditors' claims in a proceeding to liquidate an insolvent insurance company is a law enacted 'for the purpose of regulating the business of insurance,' withing the meaning of § 2(b) of the McCarran-Ferguson Act." *Id.* at 494.

In a 5-4 decision, the Court found that, where there is a direct conflict between a federal statute and state insurance law, "[F]ederal law must yield to the extent the Ohio statute furthers the interests of policyholders." *Id*. at 502. The Court decided that the Ohio priority statute was enacted for the purpose of regulating the business of insurance to the extent that it served to ensure that, if possible, policyholders ultimately will receive payment on their claims. *Id.* at 507. The Court went on to find that the federal statute must also yield to the extent the Ohio statute accorded preference to the administrative expenses of administering an insolvency proceeding because, "Without payment of administrative costs, liquidation could not even commence." *Id.* at 509. However, the Court limited its holding by finding that the Ohio statute's provisions elevating employee claims and general creditor claims above claims of the United States did not escape preemption "because their connection to the ultimate aim of insurance is too tenuous." *Id*. It summarized its holding as follows:

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[32] The *Fabe* Court did not address the forum in which a claim against the Government claim could be litigated. Indeed, unlike the present case, in *Fabe*, the liquidator filed its action in federal court to determine the priority of the Government's claims.

> We hold that the Ohio priority statute escapes preemption to the extent that it protects policyholders. Accordingly, Ohio may effectively afford priority, over claims of the United States, to the insurance claims of policyholders and to the costs and expenses of administering the liquidation. **But when Ohio attempts to rank other categories of claims above those pressed by the United States, it is not free from federal pre-emption under the McCarran-Ferguson Act.**

Id. at 493-94 (bold emphasis added).

The Court then remanded the matter to address the severability of the statute. *Id*. at 509-10. On remand, the Ohio District Court resolved the severability issue in favor of the government. *Duryee v. United States Dep't of the Treasury*, 6 F.Supp.2d 700 (S.D. Ohio 1995). The court found the preempted provisions were not severable from the remainder of the statute, thereby invalidating the state statute and allowing the federal statute to dictate the priority of claims. *Id*. at 706.

The Wisconsin Statute authorizing the creation of Segregated Accounts permits a corporation to "establish a segregated account for any part of its business." Wis. Stat. 611.24. As a preliminary matter, a potential federal tax liability is not a severable "part of [an insurance company's] business." Nonetheless, Ambac, with the Insurance Commissioner's approval, allocated its potential future tax liability to its Segregated Account.[33] This ostensibly made the tax liability part of the rehabilitation proceeding and paved the way for the State Court to issue the Injunction "in furtherance" of that allocation.

Not all of Ambac's assets and liabilities have been allocated to the Segregated Account, subjected to the receivership process, or constrained by the proposed Rehabilitation Plan. By

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[33] Additionally, no federal tax law actually impedes or impairs the Segregated Account statute because the Segregated Account Statute involves severing types of insurance policies and not parsing tax obligations.

placing the possible tax debt in the Segregated Account and leaving other claims and assets in Ambac, Ambac and the Insurance Commissioner have elevated the claims of non-policyholders (*i.e.*, the general creditors of Ambac) ahead of the IRS. This is prohibited by *Fabe* because non-policyholder claimants have too tenuous a connection to the ultimate aim of insurance. 508 U.S. at 509. Also, on its face, the statute itself does not regulate the business of insurance because it does not control the relationship between the insurance company and the policyholder. Instead, the statute simply deals with the organization of an insurance corporation and its accounting. Wis. Stat. 611.24 (subchapter II "Organization of Corporations"). Ambac and the Insurance Commissioner cannot put the federal tax claims into a special account, sever the government's ability to collect from all of the taxpayer's assets, and then get an Injunction to further their improper action.

The Wisconsin injunction statute also does not regulate "the business of insurance" for purposes of McCarran-Ferguson because it is merely a procedural statute outlining generally what type of relief a receiver may request from a court. As such, it is not analogous to a statute dealing with the actual distribution of an insurance company's assets in a priority contest between the Government and policyholders. *See generally Int'l Ins. Co. v. Duryee*, 96 F.3d 837, 839-840 (6th Cir. 1996) (statute forbidding foreign insurance companies from removing actions to federal court does not regulate the business of insurance). These state laws were not enacted for the business of insurance, so they will not preempt federal law.

c. The federal statutes do not "impair" the competing state statutes.

In order for a state statute to reverse preempt a federal statute, a federal statute, must, among other things "impair" a state law. *Autry*, 144 F.3d at 1040 (7th Cir. 1998). Federal

statutes providing for federal jurisdiction or authorizing a litigant to file suit, do not "impair" conflicting state statutes and are, therefore not reverse preempted by McCarran-Ferguson Act. *Gross*, 217 F.3d at 222 (internal citation omitted).

McCarran-Ferguson will not allow a state statute to preempt the various federal jurisdictional statutes by prohibiting a litigant from bringing a federal lawsuit. *Appleton Papers, Inc.*, 612 N.W.2d at 764-67. It may be that when a litigant brings a lawsuit, the remedy or relief sought will be preempted by a state insurance statute, but the litigant cannot be enjoined from simply bringing a lawsuit. *Id.*; *Munich Amer. Reinsur. Co. v. Crawford*, 141 F.3d 585, 595-96 (5th Cir. 1998).

III. ADDITIONAL OBJECTIONS TO THE MOTION, NOTICE, AND INJUNCTION.

We have outlined above why the Injunction should be dissolved, why we object to the injunction, and why we oppose the Insurance Commissioner's motion seeking the injunctive relief. In addition to the Motion and Injunction, the Insurance Commissioner also served the United States with a "Notice of Amendment To Plan Of Operation For the Segregated Account."[34] This "Notice" informed the United States that Ambac had allocated, and the Insurance Commissioner had approved, all of Ambac's potential, future tax liabilities to the Segregated Account. We object to that allocation.

For the reasons described in the sections above, neither the Internal Revenue Code, the McCarran-Ferguson Act, nor any state law permit a taxpayer (not a troubled Insurance Company, or an individual 1040EZ filer) to unilaterally limit the reach of a prospective tax lien or otherwise limit the United States' ability to collect from any of a taxpayer's assets. Liens attach by

[34] Dkt. # 2, State Court Pleadings, at 3-4.

operation of law to any and all assets of taxpayers, not just those assets the taxpayer wishes to have the lien reach. 26 U.S.C. § 6321. A taxpayer simply cannot isolate a potential tax liability from a taxpayer's other assets (by forcing the United States to collect only from those certain assets that a taxpayer chooses to devote to a segregated account). Nor does the Wisconsin Segregated Account statute itself authorize Ambac and the Insurance Commissioner to take the tax liabilities of Ambac as a whole, shift them to a segregated account consisting largely of a portfolio of toxic policies, and then limit the IRS's ability to collect taxes to that account. *See* Wis. Stat. § 611.24(3)(c). The Segregated Account statute is not to be used to isolate an entire insurance company's tax liabilities, thereby insulating the company from paying tax. *Id.*

CONCLUSION

The State Court did not have jurisdiction to enter the Injunction prohibiting the Internal Revenue from assessing or collecting tax or from filing a lawsuit. The United States respectfully requests that this Court dissolve the Injunction and void any attempt by Ambac to limit the reach of future federal liens. If, in the future, the United States takes some collection action, files a proof of claim in the rehabilitation, or files a lawsuit, this Court or another federal district court can determine whether some state statute preempts the action.

Respectfully submitted,

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CERTIFICATE OF SERVICE

IT IS HEREBY CERTIFIED that service of the foregoing Memorandum In Support has been made by First Class Mail, postage prepaid, upon the following this 17th day of December, 2010:

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And by service through the Court's e-filing system to all parties registered with that system, including Counsel for the Commissioner.

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