

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WISCONSIN

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

SEAN DILWEG, COMMISSIONER OF)
INSURANCE OF THE STATE OF)
WISCONSIN,)
))
Petitioner,)
))
vs.)
))
UNITED STATES OF AMERICA,)
))
Respondent.)

Case No. 10-cv-778

AMBAC'S REPLY MEMORANDUM IN SUPPORT OF REMAND

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Ambac Assurance Corporation (“Ambac”) submits this reply memorandum in support of the Motion to Remand (the “Motion”) filed by the Wisconsin Commissioner of Insurance (the “Commissioner”) on December 17, 2010, (Docket Entry (“DE”) 12).¹ The Motion seeks remand of this proceeding to the Circuit Court for Dane County (the “Rehabilitation Court”). The Commissioner commenced this proceeding in order to rehabilitate a segregated account of Ambac (the “Segregated Account”), which Ambac created with the Commissioner’s approval pursuant to Wis. Stat. § 611.24(2).

PRELIMINARY STATEMENT

This proceeding should be remanded in its entirety as soon as possible so that the complex and vital work of the Rehabilitation Court can resume. To start with, the IRS’s removal petition is procedurally defective because the Supreme Court decided long ago that state court proceedings to resolve competing claims need not be litigated in federal court just because the federal government happens to be one of the claimants. *See United States v. Bank of New York & Trust Co.*, 296 U.S. 463 (1936). If the law were otherwise, few insurance insolvency proceedings would remain in state court due to the prominent role of the federal government in today’s economy. The existence of a protective injunction, which is akin to the automatic stay in federal bankruptcies and is a standard feature of state insurance delinquency proceedings, should not change this result.

Even ignoring the petition’s procedural defects (*i.e.*, that the IRS is not a party, much less a defendant), remand is required because the exercise of removal jurisdiction would impair Wisconsin’s comprehensive statutory regime to regulate the business of

¹ In order to avoid duplication, Ambac did not file a separate remand motion, but Ambac (also referred to as the “General Account”) has a vital interest in and supports this Motion because the IRS has made clear that it is availing itself of this Court’s jurisdiction in order to encumber and levy upon Ambac’s assets.

insurance by providing an exclusive forum to oversee the administration of insurance rehabilitation proceedings. Courts have recognized that policyholders are best served by avoiding competing actions in federal court. In this unique context of insurance insolvency proceedings, which are not permitted in federal bankruptcy court and which, with limited exception, can proceed only in state court, the McCarran-Ferguson Act provides that state statutes regulating the business of insurance trump federal statutes that would otherwise impair their operation. The only express exception to this rule of reverse-preemption exists for federal statutes that specifically relate to the business of insurance, but the federal removal statutes and other federal laws on which the IRS relies do not fit within this exception because they are statutes of general application.

The IRS's frequent references to the supremacy of the Internal Revenue Code and its arsenal of pre-judgment remedies do not change this result, for the Internal Revenue Code enjoys no exemption from McCarran-Ferguson. Instead, these statements only highlight the massive disruption that the IRS would visit upon this rehabilitation proceeding if permitted to proceed outside of the watch of the Rehabilitation Court, which has extensive experience supervising such specialized proceedings. Indeed, the IRS acknowledges that it removed this proceeding to federal court, in part, so that it may attempt to *override Wisconsin's priority statute*, which requires policyholders to be paid ahead of the federal government. This approach places the IRS squarely at odds with the Supreme Court's holding in *U.S. Department of Treasury v. Fabe*, 508 U.S. 491 (1993), that federal statutes cannot impair the operation of state priority statutes, like Wisconsin's, that were enacted to ensure payment to policyholders notwithstanding an insurer's financial difficulties.

Although the IRS's own regulations prevent it from levying upon assets under the protective jurisdiction of a state rehabilitation court, the IRS seeks to do so here because of one of the unusual -- yet essential -- features of this rehabilitation: only the Segregated Account is in rehabilitation, but the claims-paying assets are held in Ambac's General Account. In fact, this arrangement provides enormous benefits for all of Ambac's policyholders and creditors, *including the IRS*, and if the IRS were to upset it by taking steps to subject Ambac's assets to liens and levies, the Commissioner might feel compelled to plunge all of Ambac into rehabilitation to defend Wisconsin's priority statute against the IRS's effort to override it by obtaining payment ahead of policyholders. But a full rehabilitation of all of Ambac, as opposed to the more surgical Segregated Account rehabilitation chosen by the Commissioner, could dramatically reduce any chance the IRS had to recover anything from Ambac, assuming that it even has a claim, which the IRS has not yet established or even asserted, but is merely considering.

In the alternative, if the Court finds that there is federal subject matter jurisdiction, contrary to what Ambac and the Commissioner contend would be the proper application of the McCarran-Ferguson Act, it should nonetheless abstain from exercising jurisdiction because proceeding in these special circumstances would require the determination of difficult, unresolved questions of state law bearing on the largest insurance rehabilitation proceeding in Wisconsin history -- a proceeding that has been active and ongoing in state court for roughly ten months, including nearly 1,000 financial guaranty insurance policies insuring approximately \$60 billion of financial obligations, and involving more than 600 docket entries -- with ramifications far beyond the narrow

interests of the IRS. Nor would splitting the rehabilitation proceedings into two pieces, as the IRS urges, with all but the dispute with the IRS being remanded to state court, solve anything. Litigation with the IRS in federal court would be disruptive of state efforts to establish a coherent policy with respect to this very substantial insurance rehabilitation. To move forward in these circumstances would -- contrary to the McCarran-Ferguson Act and the Supreme Court's teachings in *Fabe* and *Bank of New York & Trust Co.* -- invite unseemly conflicts between state and federal courts, which would only thwart the orderly administration of justice.

ARGUMENT

I. The Removal of this Proceeding Was Procedurally Improper

In its Memorandum of Law in Support of the Motion (the "Commissioner's Br.") (DE 15), the Commissioner explained that this action is not a civil suit against the IRS, but is instead an *in rem* proceeding to rehabilitate the Segregated Account, which is analogous to a federal bankruptcy proceeding. Commissioner's Br. at 20-26. Thus, it is incorrect to view either this rehabilitation proceeding or the injunction orders issued in aid thereof as a suit "against" the IRS any more than it is a suit "against" all persons having a potential interest in the Segregated Account, which it is not.

In his opening brief, the Commissioner stated that he had not "located any precedent for a federal court accepting removal of an underlying state insurance delinquency proceeding or finding that an insurance rehabilitation or liquidation petition constituted a 'civil action' against all potential claimants of the insurer." Commissioner's Br. at 21. Apparently, the IRS located no such authority either, for none is cited in its memorandum of law filed in response to the Motion (the "IRS Br.") (DE 23). Further, the Commissioner cited *United States v. Bank of New York & Trust Co.*, 296 U.S. 463

(1936), which explained that the status of the United States as a potential claimant in state court proceedings does not render it a “defendant.” Commissioner’s Br. at 25-26. The IRS offers no response to this seminal decision, in which there was also a “sweeping injunction” entered to protect the state court proceedings, or the line of cases following it. *Id.* at 475.

Instead, the IRS cites several cases in which federal agencies or federal officials obtained removal despite not being designated as “defendants” in state court. IRS Br. at 10-12. But each of these cases involved some mandatory process requiring a federal official or federal agency to take an affirmative action, which is not required of the IRS here.² None of these cases involved a state insurance insolvency proceeding or the injunctive relief typically provided in support of such proceedings.

If the IRS were correct in arguing that being subject to a protective injunction renders one a “defendant” for purposes of removal, nearly every insurance rehabilitation proceeding would be subject to removal to federal court because: (1) the IRS and other federal agencies are frequently creditors of insurance companies; and (2) private-sector creditors, which are also subject to broad injunctive relief, could seek removal based on diversity of citizenship. Yet there is a lack of any precedent for such removals. Moreover, the IRS’s own regulations, 26 C.F.R. § 301.6331-1(a)(3), contemplate that the

² See *Wisconsin v. Schaffer*, 565 F.2d 961 (7th Cir. 1977) (state court issued order to federal prosecutor requiring production of grand jury materials or to show cause why federal prosecutor should not be held in contempt); *Brown & Williamson Tobacco Corp. v. Williams*, 62 F.3d 408 (D.C. Cir. 1995) (state court proceeding to enforce subpoena against members of Congress); *Nationwide Investors v. Miller*, 793 F.2d 1044 (9th Cir. 1986) (proceeding that required federal employee to testify about judgment debtor’s wages). *Mason City & Ft. Dodge R.R. Co. v. Boynton*, 204 U.S. 570 (1907), recognized that a landowner whose property was taken involuntarily was properly viewed as a “defendant” even though the landowner was required to initiate judicial review. As a potential *claimant* against the Segregated Account, the IRS can hardly be viewed as a “defendant.”

IRS will participate as a creditor in state court receivership proceedings without exercising any right to levy. Thus, the IRS has failed to demonstrate that removal is procedurally proper, and this case should be remanded to the Rehabilitation Court.

II. There Is No Federal Subject Matter Jurisdiction Because the Removal Statutes Are Reverse-Preempted Under McCarran-Ferguson

Assuming, *arguendo*, that the IRS's removal petition is procedurally proper, the Commissioner argued that this Court lacks subject matter jurisdiction because the removal statutes that would otherwise apply are reverse-preempted under the McCarran-Ferguson Act, 15 U.S.C. § 1012(b). Commissioner's Br. at 26-36. Further, the Commissioner provided an analysis establishing satisfaction of the three-part test for determining when state insurance statutes can supersede conflicting federal statutes. Commissioner's Br. at 29-33. In response, the IRS essentially ignores the test for reverse-preemption, arguing instead that the McCarran-Ferguson Act cannot apply to federal jurisdictional statutes or to the Internal Revenue Code. IRS Br. at 2-9.

The starting point of this analysis must be the language of the McCarran-Ferguson Act itself: "*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 . . .*" 15 U.S.C. § 1012(b) (emphasis added). On its face, the statute says that *every* federal statute is subject to reverse-preemption, as long as the remaining requirements of the Act are satisfied. The IRS makes several arguments to avoid this result, but none is persuasive.

A. The IRS Is Not Acting Under Direct Constitutional Authority

First, the IRS tries to avoid the McCarran-Ferguson Act entirely by arguing that it is carrying out a direct “Constitutional mandate” that is not subject to reverse-preemption. IRS Br. at 2-3. This argument overstates the effect of the Constitution.

The two Constitutional provisions cited by the IRS grant taxing power to *Congress*. See U.S. Const. art. I, § 8, cl. 1 (“*The Congress shall have Power To lay and collect Taxes . . .*”) (emphasis added); U.S. Const. amend. XVI (“*The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.*”) (emphasis added). Notably, neither provision makes any reference to the Internal Revenue Service, the President or any member of the Executive Branch. The taxation power rests with Congress, meaning that the authority of the Internal Revenue Service stems from acts of Congress. As a creation of Congress, the IRS is subject to federal statutes limiting its authority, including the McCarran-Ferguson Act. See 15 U.S.C. § 1012(b) (“*No act of Congress shall . . .*”) (emphasis added). Thus, while the powers of the IRS are formidable, they are not bestowed directly by the Constitution and do not include ignoring other federal statutes that may operate to curb these powers under certain circumstances.

B. The IRS Has No Categorical Exemption from McCarran-Ferguson

In his opening brief, the Commissioner cited decisions in which other district courts found that statutes creating federal jurisdiction were reverse-preempted by state insurance insolvency statutes. Commissioner’s Br. at 28-29, 33-34. In response, the IRS attempts to distinguish some of these decisions (*see* IRS Br. at 13-15), but never

undermines the core principle for which they stand: *all* federal statutes, including those creating federal subject matter jurisdiction, are subject to McCarran-Ferguson. The only exception mentioned in the Act itself is for federal statutes that specifically relate to the business of insurance. *See* 15 U.S.C. § 1012(b).

In response, the IRS argues at length regarding the importance and supremacy of the federal removal statutes and the Internal Revenue Code. *See* IRS Br. at 12-15 (section entitled, “No State Law Can Preempt the Right to Remove”) and 2-8 (section entitled, “The McCarran-Ferguson Act Does Not Apply To The Internal Revenue Code”). Thus, the IRS appears to argue that federal removal statutes and federal tax statutes are categorically exempt from reverse-preemption under McCarran-Ferguson, but there is no support for such a proposition.

1. Federal Jurisdictional Statutes Can Be Reverse-Preempted

As referenced above, the Commissioner cited decisions holding that federal jurisdictional statutes were reverse-preempted under McCarran-Ferguson. Commissioner’s Br. at 28-29, 33-34. The IRS argues for a different result, citing other cases holding, on different facts, that federal jurisdictional statutes were not reverse-preempted. IRS Br. at 13. The net result of these competing analyses is that there is no categorical rule exempting federal jurisdictional statutes, including the removal statutes at issue here, 28 U.S.C. §§ 1441 and 1442, from reverse-preemption by McCarran-Ferguson. The outcome in any particular case depends on application of the criteria for reverse-preemption.

The IRS begins its response by misstating the issue, arguing that no “state law” can restrict a federal right of removal. IRS Br. at 12-13. But the real issue here is

whether a *federal* law (McCarran-Ferguson) accomplishes this result through reverse-preemption. Next, the IRS cites decisions in which removal was upheld despite a McCarran-Ferguson argument, but these cases are just examples in which the test for reverse-preemption was not met.³ The IRS also cites *Appleton Papers, Inc. v. Home Indemnity Co.*, 2000 WI App 104, 235 Wis. 2d 39, 612 N.W.2d 760, which did not involve a rehabilitation proceeding, but which expressly noted, “[w]e do not imply that a Wisconsin court may not issue an injunction under Wis. Stat. ch. 645 dealing with rehabilitation and liquidation of insurers.” 2000 WI App 104 at ¶27 n.11.⁴

Finally, the IRS cites the unpublished decision in *Granite Reinsurance Co. v. Frohman*, No. 8:08CV410, 2009 WL 2601105 (D. Neb. Aug. 17, 2009), which permitted removal, but only after distinguishing other authorities on the basis that they did not involve “a federal agency charged with *implementing a federal insurance program*.” *Id.* at *5 (emphasis added). Thus, *Granite* fell within the express exception to McCarran-Ferguson for federal statutes relating specifically to insurance. This was the basis upon which the court distinguished its prior decision in *In re Amwest Insurance Co.*, 245 F.

³ See *Int’l Ins. Co. v. Duryee*, 96 F.3d 837 (6th Cir. 1996) (invalidating statute penalizing any foreign insurance company that sought removal of a case brought by an Ohio citizen). In *Duryee* the Ohio statute in question had no apparent relationship to ensuring that payments were made to policyholders, which is why the Sixth Circuit found that it was not within the protection of McCarran-Ferguson. *Id.* at 840. *Koken v. Pension Benefit Guaranty Corp.*, 383 F. Supp. 2d 712 (E.D. Pa. 2005), denied a motion to remand, in part, on the understanding that the dispute in federal court would not determine the priority of the government liens at issue, while the IRS has made clear that this is precisely the issue it would have this Court decide. *Id.* at 719-20; *cf.* IRS Br. at 19 n.14. Also, *Koken* involved a separate state court action filed expressly *against* a federal entity to decide an underlying federal law issue. Here, the underlying tax issue will be decided in federal bankruptcy court. To the extent *Koken* suggests that McCarran-Ferguson can never preempt a federal removal statute, it is inconsistent with other federal decisions and, Ambac respectfully submits, wrongly decided.

⁴ Similarly inapposite is the unpublished order from *Novello v. Manor Oak Skilled Nursing Facilities, Inc.*, No. 04-CV-0415E(F) (W.D.N.Y. Jun. 3, 2004), attached as Exhibit 9 to the IRS filing. See IRS Br. at 17. First, this case was not an insurance delinquency proceeding, but was a nursing home receivership not subject to McCarran-Ferguson. Second, the final paragraph of this Order indicates that it was issued before a motion to remand had been filed.

Supp. 2d 1038 (D. Neb. 2002) (finding reverse-preemption), and nothing in *Granite* undermines the principle that removal statutes are subject to reverse-preemption if the relevant test is met, which it was not in *Granite*.

2. The Internal Revenue Code Can Be Reverse-Preempted

The IRS Brief includes a lengthy discussion of various tax statutes, including the Anti-Injunction Act, the provisions governing consolidated returns, and the statutes empowering the IRS to enforce the payment of taxes (*see* IRS Br. at 3-6), the conclusion of which is an argument that McCarran-Ferguson cannot preempt “any part of the Internal Revenue Code, including either the consolidated tax provisions or the administrative collection provisions.” IRS Br. at 7. On its face, this is an extraordinary assertion, which is unsupported by any precedent. The cases cited by the IRS do not stand for a categorical rule that no provision of the Internal Revenue Code can ever be reverse-preempted. Instead, they are just individual examples in which reverse-preemption arguments regarding particular provisions of the Internal Revenue Code failed for one reason or another.

The IRS begins by reading too much into *American Insurance Association v. Garamendi*, 539 U.S. 396 (2003), which addressed whether a state insurance statute could reverse-preempt U.S. foreign policy, articulated in an executive agreement entered into by the President, without Senate confirmation. It had nothing to do with the tax code and the Supreme Court questioned whether the state statute at issue, which concerned disclosure of Nazi-era insurance activities in Europe, actually related to the “business of insurance” because it was directed to events that had occurred many decades earlier

outside the country. *Id.* at 427-29. This decision certainly does not stand for a categorical restriction on reverse-preemption of the Internal Revenue Code.⁵

Next, the IRS cites several cases addressing whether an insurance company's business classification at the state level (*e.g.*, whether it is chartered as a life insurance company or a property and casualty insurer) controls how it is taxed at the federal level. IRS Br. at 7-8. Not surprisingly, these cases hold that the basis upon which the federal government taxes an insurance company does not "impair" or otherwise interfere with state regulations categorizing insurance companies for different purposes.⁶ Thus, these cases represent a failure to meet one or more of the criteria for reverse-preemption, and do not stand for a categorical exemption for the Internal Revenue Code. Additionally, they have no application here because, as explained in its opposition to the IRS's motion to dissolve the injunction (DE 10), Ambac is not seeking to have its federal tax liability determined in state court. *See* Ambac's Memorandum of Law in Opposition to IRS's Motion to Dissolve the Temporary Supplemental Injunction (DE 20) ("Ambac

⁵ Although the plain words of the McCarran-Ferguson Act begin, "[n]o Act of Congress," without qualification, the IRS argues that this statute applies only to acts of Congress enacted under the Commerce Clause. IRS Br. at 7. The primary source for this legal theory is a law review article that admits that its central thesis is not generally recognized. *See* Raymond A. Guenter, *Rediscovering the McCarran-Ferguson Act's Commerce Clause Limitation*, 6 CONN. INS. L.J. 253, 256 (2000) ("With few exceptions, [the courts] have resolved federal-state conflicts without distinguishing between federal laws that are based on the commerce clause and those that are based on other constitutional grants of authority.").

⁶ *See Modern Life & Acc. Ins. Co. v. Comm'r*, 420 F.2d 36 (7th Cir. 1969) (McCarran not triggered because there was no showing that how the IRS classifies a taxpayer interferes with state regulation of the insurer); *Allied Fed. Corp. v. Comm'r*, 572 F.2d 1190, 1192 (7th Cir. 1978) (state classification of company writing surety bail contracts is not binding on whether it is an "insurance company" for federal income tax purposes). These classification questions do not implicate the policy behind McCarran-Ferguson because, as another case cited by the IRS recognized, the power to tax an insurance company is not the same thing as the power to regulate insurance. *See Indus. Life Ins. Co. v. United States*, 344 F. Supp. 870, 874 (D.S.C. 1979) ("The plaintiff mistakes the right to tax a life insurance company with the right to regulate such company."), *aff'd*, 481 F.2d 609 (4th Cir. 1973).

Dissolution Br.”) at 3-4. 11. What, if any, tax Ambac owes will be determined in federal bankruptcy court. Finally, the IRS plucks a quote out of context from *Security Industry Insurance Co. v. United States*, 702 F.2d 1234, 1251 (5th Cir. 1983), to suggest that the Internal Revenue Code somehow overrides state court reorganization proceedings. IRS Br. at 7. In fact, this decision was not about an ongoing insurance rehabilitation proceeding, but was yet another decision involving whether a taxpayer qualified as a life insurance company under federal tax statutes after a series of corporate transactions.

In short, the IRS cites no decision that supports its astoundingly broad assertion that McCarran-Ferguson can *never* apply to either federal jurisdictional statutes (such as the removal statutes) or to the Internal Revenue Code. Like all other federal statutes, they are subject to the three-part McCarran-Ferguson test articulated in the case law, which is discussed below.

C. The Test for Reverse-Preemption Is Met Here

Having disposed of the contention that certain federal jurisdiction and tax statutes are categorically immune from reverse-preemption, the relevant question is whether McCarran-Ferguson applies on the particular facts of this case. The IRS Brief has little to say about this critical question, and does not even mention the three-part test for determining whether a state insurance statute reverse-preempts a conflicting federal statute. For the reasons articulated in the Commissioner’s opening brief and in Ambac’s Dissolution Brief,⁷ the McCarran-Ferguson Act defeats federal subject matter jurisdiction in this instance.

⁷ As Ambac argued in its Dissolution Brief, the Court should decide the Commissioner’s remand motion first and then, only if it determines it has jurisdiction and decides to exercise that jurisdiction, should the Court decide the IRS’s motion to dissolve the injunction entered by the Rehabilitation Court.

Although the IRS's brief in opposition to the Motion is nearly silent on the subject, it is undisputed that under McCarran-Ferguson, a state insurance statute can reverse-preempt a federal statute if three conditions are met: (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. *See* IRS Memorandum in Support of Motion to Dissolve Order for Temporary Supplemental Injunctive Relief and Objections to Notice, Motion and Order (the "IRS Dissolution Br.") (DE 13 at 16). Because all three conditions are met here, the removal statutes relied upon to bring this action into federal court are reverse-preempted by the Wisconsin insurance statutes enacted to provide an orderly rehabilitation of a troubled insurer in a single forum.

1. The Federal Removal Statutes Do Not "Specifically Relate" to the Business of Insurance

The Commissioner correctly argues in its opening brief that subject matter jurisdiction statutes do not specifically relate to the business of insurance, citing decisions reaching this same conclusion. Commissioner's Br. at 29. The IRS offers no direct response to this argument, but asserts in a footnote that the "Internal Revenue Code" (presumably as a whole) "specifically relates to the business of insurance" because it "provides for federal taxes on insurance companies." IRS Br. at 9 n.6 (*citing* 26 U.S.C. §§ 801-848, 1502).

In the interest of avoiding repetition, Ambac incorporates by reference the arguments presented in its Dissolution Brief that the Internal Revenue Code is a statute of general application, and was not enacted to regulate the business of insurance. Ambac Dissolution Br. at 10-11. In short, taxing insurance companies is not the same thing as

regulating the business of insurance, so federal statutes imposing tax on insurance companies are not statutes “specifically relating” to the business of insurance within the meaning of McCarran-Ferguson. In any event, the statutes cited either provide for insurance companies to be taxed (Sections 801-48) or authorize consolidated returns (Section 1502) -- neither of which is at issue before the Rehabilitation Court -- but do not address any right to remove state insurance rehabilitation proceedings to federal court and are therefore not relevant to the instant Motion.⁸

2. The Wisconsin Statutes Protecting Exclusive Rehabilitation Court Jurisdiction Were Enacted for the Purpose of “Regulating the Business of Insurance”

The second prong of the test for reverse-preemption is met because the state statutes giving the Rehabilitation Court control over this proceeding, including by authorizing injunctions against actions that interfere with the rehabilitation, such as competing proceedings in other courts, regulate the business of insurance. As the IRS recognizes, 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.” IRS Dissolution Br. at 17 (*quoting Autry v. Nw. Premium Servs.*, 144 F.3d 1037, 1044 (7th Cir. 1998)).⁹ See *U.S. Dep’t of Treasury v. Fabe*, 508 U.S. 491, 505

⁸ *Hanover Insurance Co. v. C.I.R.*, 598 F.2d 1211 (1st Cir. 1979) (IRS Br. at 17), is inapposite because it concerned a McCarran-Ferguson challenge to a treasury regulation pertaining to computation of insurance company income. Ambac makes no such claim here; it is not seeking to eliminate its federal tax obligations, or even to have them determined in state court. Thus, any suggestion that this Motion is about exclusive federal jurisdiction to decide Ambac’s federal tax liability misses the point.

⁹ In *Autry*, the Seventh Circuit held that the Illinois statute governing premium finance agreements was not “enacted for the purpose of regulating the business of insurance” because that statute “addresses the relationship between a creditor and a debtor, not the relationship between an insurance company and a policyholder.” *Id.* at 1044. That is not the case here.

(1993) (describing the category of laws enacted for the purpose of regulating the business of insurance as “broad”).

The Commissioner explained in his opening brief that Wisconsin’s insurance rehabilitation statutes, which provide a single, comprehensive framework for administering claims against the estate of a delinquent insurer in accord with Wisconsin’s carefully-crafted priority scheme embodied in Wis. Stat. § 645.48 (the “Priority Statute”), were enacted for the purpose of regulating the business of insurance within the meaning of McCarran-Ferguson. Commissioner’s Br. at 29-33. Ambac provided its own analysis of these statutes in its Dissolution Brief, which is incorporated by reference in the interest of avoiding repetition. Ambac Dissolution Br. at 12-16. In summary, these state insurance statutes upholding the Rehabilitation Court’s exclusive jurisdiction over this matter (which Ambac referred to as the “Priority Statute,” the “Injunction Provision,” and the “Segregated Account Statute” in its Dissolution Brief), all regulate the business of insurance. *See id.*

The IRS does not deny that the Wisconsin insurance statutes referenced above regulate the business of insurance, and begrudgingly acknowledges that “some parts of Wisconsin’s insurance insolvency statutes may relate to the business of insurance.” IRS Br. at 13. Instead of addressing the authority cited by the Commissioner on this point (*see* Commissioner’s Br. at 29-30, 32), the IRS argues that regulating “choice of forum” is not the business of insurance, citing *International Insurance Co. v. Duryee*, 96 F.3d 837 (6th Cir. 1996). IRS Br. at 13. But this decision had nothing to do with rehabilitation proceedings, and instead concerned a general prohibition against foreign insurers filing removal petitions. Because the Ohio statute at issue there had no apparent

relationship to ensuring that payments were made to policyholders, the Sixth Circuit found that it did not regulate the business of insurance. *Id.* at 840-41. Thus, *Duryee* is simply inapposite.

Additionally, the IRS questions whether Wisconsin's rehabilitation statutes truly provide for exclusive jurisdiction, but this argument misses the point. IRS Br. at 12 n.9. The Commissioner's opening brief acknowledged that there may be "individual, ancillary adversarial disputes" litigated in other courts (Commissioner's Br. at 21), but this does not undermine the need for a single forum "to dispose equitably of the company's limited assets so as to avoid a race to the courthouse." *Grode v. Mut. Fire, Marine & Inland Ins. Co.*, 8 F.3d 953, 960 (3d Cir. 1993) (distinguishing between the main rehabilitation action and separate actions involving individual claims).¹⁰

As this Court observed in granting an abstention motion in favor of a state insurance insolvency proceeding:

Experience has demonstrated that, in order to secure an economical, efficient, and orderly liquidation and distribution of the assets of an insolvent corporation for the benefit of all creditors and stockholders, it is essential that the title, custody, and control of the assets be entrusted to a single management under the supervision of one court. Hence other courts, except when called upon by the court of primary jurisdiction for assistance, are excluded from participation. This should be particularly

¹⁰ The IRS also mentions in a footnote Wis. Stat. § 645.45, which authorizes "the commissioner" to take steps to initiate a federal receivership. IRS Br. at 12 n.9. That statute "opens up the possibility . . . even if it will rarely be used," that the Commissioner may *in its discretion* seek a federal receivership where there is difficulty in collecting out-of-state assets. Wis. Stat. Ann. § 645.45 cmt. ("[Wis. Stat. § 645.45] is an extraordinary remedy . . . and the state courts should continue to provide the forum for nearly all receiverships."). Obviously the Commissioner has not initiated a federal receivership here, but even if he had, this statute in no way authorizes multiple, competing proceedings. The decision cited in support of a federal receivership, *Inland Empire Insurance Co. v. Freed*, 239 F.2d 289 (10th Cir. 1956), involved a "very special set of circumstances" in which state officials conceded their inability to rehabilitate or to liquidate the insurer, which is plainly not the case here. *Id.* at 293. Even under these circumstances, the court cautioned against "undue conflict with the state court processes" that might arise in the future. *Id.*

true as to proceedings for the liquidation of insolvent insurance companies. . . .

Metropolitan Life Ins. Co. v. Bd. of Dirs., 572 F. Supp. 460, 470 (W.D. Wis. 1983) (Crabb, J.) (*quoting Motlow v. S. Holding & Sec. Corp.*, 95 F.2d 721, 725-26 (8th Cir. 1938)). So, too, here.

In summary, nothing cited by the IRS refutes the point that Wisconsin's statutory rehabilitation regime, including the Priority Statute, the Injunction Provision, and the Segregated Account Statute (as defined in Ambac's Dissolution Brief), regulate the business of insurance within the meaning of McCarran-Ferguson, and can thus reverse-preempt conflicting federal statutes of general application.

3. The Federal Removal Statutes Would Operate to Invalidate, Impair or Supersede Key Provisions of the Wisconsin Insurance Delinquency Statutes

The final requirement for reverse-preemption is that the relevant federal statute would operate to "invalidate, impair, or supersede" the state law regulating the business of insurance. 15 U.S.C. § 1012(b). *See Humana Inc. v. Forsyth*, 525 U.S. 299, 311 (1999) ("impair" means "to frustrate a goal");¹¹ *Doe v. Mut. of Omaha Ins. Co.*, 179 F.3d 557, 563 (7th Cir. 1999) ("Direct conflict with state law is not required to trigger this [the McCarran-Ferguson] prohibition; it is enough if the interpretation would interfere with a State's administrative regime.") (citation omitted).

Here, there is a direct conflict between the federal statutes creating a right of removal to federal court and state rehabilitation statutes blocking proceedings in other

¹¹ In *Humana*, the Supreme Court held that RICO does not "impair" a state insurance law where it "proscribes the same conduct as state law, but provides materially different remedies." 525 U.S. at 305. *Humana* thus presented a very different issue.

courts. Commissioner's Br. at 30-33. The IRS never denies this glaring conflict or even addresses the third prong of the test for reverse-preemption.

To the contrary, the IRS only confirms how extensively it wishes to invalidate, impair or supersede these Wisconsin statutes regulating the business of insurance. While the IRS "urges the Court to remand the remainder of the rehabilitation proceeding," which should be done immediately regardless of the outcome of this Motion, the retention of jurisdiction that the IRS seeks would plainly impair the operation of Wisconsin's rehabilitation statutes. *See* IRS Br. at 19. The matters that the IRS proposes to litigate in federal court include "the Injunction," "the allocation of the potential tax liabilities of Ambac to the Segregated Account," and disputes over the "priority or collection" of the tax. IRS Br. at 18-19. And buried in a footnote, the IRS admits what Ambac had suspected: the IRS wants this Court to decide at some point whether its claims against the Segregated Account "would have first priority over all other claimants *despite the Wisconsin insurance liquidation priority statute.*" IRS Br. at 19 n.14 (emphasis added). The exercise of federal jurisdiction to decide these questions would directly impair Wisconsin's Injunction Provision, the Segregated Account Statute and the Priority Statute, all of which regulate the business of insurance. Additionally, the IRS is advocating a course that is squarely at odds with *U.S. Department of Treasury v. Fabe*, 508 U.S. 491 (1993), which held that 31 U.S.C. § 3713, the very federal priority statute cited by the IRS, was reverse-preempted by Ohio's insurance priority statute.¹²

¹² The IRS argues in a footnote that *Fabe* is distinguishable because it did not address a claim for unpaid federal taxes, but the statutory basis for a claim of priority would be the same as in *Fabe*, 31 U.S.C. § 3713. IRS Br. at 19 n.14. *Fabe* held that *this same federal statute* was reverse-preempted.

The IRS also asks this Court to retain jurisdiction over “the amount of federal tax” (IRS Br. at 19), but as Ambac explained in its Dissolution Brief, another federal court is to decide this question. Ambac Dissolution Br. at 3-4, 11. The IRS never addresses this bankruptcy court proceeding and never explains why this Court should decide an issue already before a different federal court.

Simply put, it would be extremely difficult for the Rehabilitation Court to supervise the administration of a rehabilitation plan with some \$700 million in claims-paying resources subject to further litigation in a different court concerning whether it is subject to a lien, and if so, what priority such lien should enjoy.¹³ Additionally, the IRS wants to challenge the Commissioner’s use of the Segregated Account statute, which has already been challenged and ruled upon by the Rehabilitation Court, and is now subject to multiple pending appeals in the state court system. These are core determinations that should be made by the Rehabilitation Court without federal interference.

D. The Segregated Account Structure Does Not Require a Different Result

If the Commissioner had taken a less measured approach to rehabilitation, *i.e.*, commencing rehabilitation as to all of Ambac instead of limiting rehabilitation to the Segregated Account, the IRS acknowledges that its own regulations would prevent it from levying against Ambac’s assets during the proceeding:

During a bankruptcy proceeding or a receivership proceeding in either a Federal or a State court, the assets of the taxpayer are in general under the control of the court in which such proceeding is pending. Taxes cannot be collected by levy upon assets in the custody of a court, whether or not

¹³ This interference with the Rehabilitation Court distinguishes what the IRS wishes to do here from the facts in *Markham v. Allen*, 326 U.S. 490 (1946) (IRS Br. at 19), in which the effect of the federal judgment was to “leave undisturbed the orderly administration” of the state court proceeding, deciding only the disposition of the “net estate” after administration in state court. *Id.* at 495.

such custody is incident to a bankruptcy or receivership proceeding, except where the proceeding has progressed to such a point that the levy would not interfere with the work of the court or where the court grants permission to levy.

26 C.F.R. § 301.6331-1(a)(3) (*see* IRS Br. at 18). In accordance with this regulation, the IRS disclaims any intent to levy upon assets allocated to the Segregated Account, which are plainly subject to the jurisdiction of the Rehabilitation Court. *See* IRS Br. at 18.

In this case, however, the IRS seeks to avoid the result typically required by its own regulations because of the unusual nature of this rehabilitation, where the insurer in rehabilitation is the Segregated Account, as opposed to the whole company, and the claims-paying assets remain allocated to the General Account, which is not in rehabilitation. The IRS's position ignores the economic reality of this rehabilitation proceeding: although the Segregated Account is deemed to be a separate insurer, it is not technically a separate corporation from Ambac. Commissioner's Br. at 9-10. Moreover, the primary assets of the Segregated Account are two legal instruments, a Secured Note and a Reinsurance Agreement, that allow it to call upon the General Account to pay the claims allocated to the Segregated Account to the extent such claims are payable under the terms of a court-approved plan of rehabilitation. *Id.* Thus, any plan to rehabilitate the Segregated Account will depend in large part on the assets of the General Account. Because of this interdependence, although the assets allocated to the General Account are not in the custody of the Commissioner or the Rehabilitation Court,¹⁴ they are protected

¹⁴ The Commissioner had good reasons for approving this arrangement. One of the primary reasons for limiting this rehabilitation to the Segregated Account, as opposed to all of Ambac, was to avoid triggering unnecessary defaults in performing policies allocated to the General Account. Commissioner's Br. at 7-13. Additionally, many of these policies contain contractual provisions resulting in termination upon a material transfer of assets from the insurer. In order to avoid triggering such defaults, Ambac's assets were not allocated from the General Account to the Segregated Account. *Id.* at 9-10.

pursuant to a first-day injunction order from creditors of the Segregated Account. This injunction order is subject to the judicial oversight of the Rehabilitation Court and the General Account is subject to the regulatory oversight of the Commissioner. Under these unusual circumstances, the Rehabilitation Court must be empowered to enjoin claims against the assets of Ambac's General Account when asserted in relation to liabilities allocated to the Segregated Account, in order to be effective.

This Court abstained from exercising jurisdiction when faced with analogous facts in *Metropolitan Life*, 572 F. Supp. at 470. In that case, the plaintiffs challenged the operation of a security fund used to pay claims against the delinquent insurer, arguing that their "*in personam*" action may proceed "because it will have no effect upon the liquidation itself." *Id.* The Court saw through this argument, recognizing that an action against the funding source for the liquidation was an attack upon the liquidation itself:

Not only do the plaintiffs' challenges actually go "to the heart of the actual liquidation process," but the assessment process they challenge in their *in personam* suit against the directors is at the heart of the ability of the Board to carry out its statutory obligations with respect to liquidation.

Although plaintiffs' complaint is brought *in personam*, rather than *in rem*, and is directed to the [General Account],¹⁵ the consequences of this filing are no different. Whether plaintiffs' suit is essentially against the [General Account] (because the obvious result of a ruling in plaintiffs' favor will be to reduce the amounts in the [General Account] available for use for the payment of disability insurance claims), and thus an *in rem* proceeding, or whether the suit is viewed as an *in personam* action which interferes with the state court's *in rem* liquidation proceedings, the result is the same: this court must defer to the state court proceedings to avoid the "unseemly and disastrous conflicts" that would arise if this court were to issue rulings that reduced the funding in the account and thereby defeated that part of the

¹⁵ In quoting from *Metropolitan Life*, Ambac has substituted the "the General Account" for "the Reliable Segregated Account" because these are the entities providing funding for the delinquency proceedings without being the subject of the proceedings themselves. Ambac has substituted "the Segregated Account" for "the Liquidation Account" because these entities are the estates in either rehabilitation or liquidation. To be clear, the Reliable Segregated Account was not part of the insurance company, as is the case here.

state's liquidation efforts which involves the provision of continuing coverage to holders of Reliable disability insurance policies.

Despite plaintiffs' efforts to distinguish the management of the [Segregated Account] (essentially the marshalling of assets) from the management of the [General Account] (essentially imposing and collecting assessments from Wisconsin disability insurance carriers), the fact is that in both instances the state is managing a fund whose integrity and viability would be jeopardized by the possibility of conflicting adjudications in different forums.

Id. at 471. Although the *Metropolitan Life* decision did not address McCarran-Ferguson, these observations, made in support of a finding that equitable abstention was appropriate, demonstrate how the exercise of federal jurisdiction here would impair the operation of state statutes enacted for the purpose of regulating the business of insurance. There would be direct interference with payment to Segregated Account policyholders, which is why reverse-preemption is warranted.

Ambac is concerned that if the IRS prevails because of the unusual nature of this segregated account rehabilitation, the Commissioner may decide that he has little choice but to subject all of Ambac to rehabilitation. This would likely be disastrous for policyholders, creditors, the public at large, and Ambac itself.¹⁶ As explained in greater detail in the Commissioner's Brief, it has been estimated that a full rehabilitation could trigger in excess of one billion dollars in additional claims against performing policies that are currently allocated to the General Account because they are not in need of rehabilitation. Commissioner's Br. at 7-13. Subjecting the same pool of assets to substantially greater claims would reduce the recovery for all creditors, *including the IRS*,

¹⁶ Under these circumstances, the Commissioner would need to choose between two bad alternatives: (1) a full rehabilitation, with its attendant damage; and (2) allowing the IRS to deprive policyholders of approximately \$700 million.

which would surely rank junior to policyholders in a full rehabilitation.¹⁷ Ironically, the IRS is advocating a course that, if adopted, could reduce the chances of it ever receiving payment. Ambac is at a loss to understand this strategy or what the IRS hopes to accomplish by forcing the Commissioner to consider a highly destructive course in order to defend Wisconsin's Priority Statute from a blatant attempt by the IRS to "jump the line," contrary to Wisconsin insurance law and the Supreme Court's holding in *Fabe*.

III. In the Alternative, Even If There Is Federal Jurisdiction, the Court Should Abstain from Exercising Jurisdiction

In the alternative, to the extent the Court finds it has subject matter jurisdiction over this action (a finding that Ambac opposes), it should nevertheless decline to exercise that jurisdiction based on the equitable abstention principles set forth in *Burford v. Sun Oil Co.*, 319 U.S. 315 (1943) and *Colorado River Water Conservation District v. United States*, 424 U.S. 800 (1976).

The IRS begins its response by incorrectly describing the circumstances under which *Burford* abstention is appropriate. IRS Br. at 20. As set forth in *International College of Surgeons v. City of Chicago*, 153 F.3d 356, 362 (7th Cir. 1998), there are two circumstances under which *Burford* abstention is appropriate, but it is not necessary to satisfy both conditions, as is implied by the IRS's use of the word "and" in describing the standard. *College of Surgeons* makes clear that the presence of either condition is a sufficient reason for abstention. *Id.*; see also *Hartford Cas. Ins. Co. v. Borg-Warner Corp.*, 913 F.2d 419, 425 (7th Cir. 1990) ("In two circumstances, *Burford* abstention is appropriate. First, we should abstain from deciding difficult questions of state law

¹⁷ The IRS disputes this in a footnote (see IRS Br. at 19 n.14), but Ambac submits that the IRS simply fails to come to grips with the *Fabe* decision.

bearing on policy problems of substantial public import whose importance transcends the result in the present case. Second, we should abstain from the exercise of federal review that would be disruptive of state efforts to establish a coherent policy with respect to a matter of substantial public concern.”) (citations omitted).

Next, although the existence of a state insurance rehabilitation proceeding does not automatically result in *Burford* abstention, federal courts routinely abstain where, as here, injunctive or declaratory relief is sought in federal court. Thus, the IRS’s assertion that courts “frequently decline to abstain from asserting federal jurisdiction in the face of an insurance insolvency proceeding” is wrong in the present context. IRS Br. at 20. The cases the IRS cites for this proposition involved claims for money damages, which do not provide a basis for equitable abstention in light of *Quackenbush v. Allstate Insurance Co.*, 517 U.S. 706 (1996). *See id.* at 731. (“[F]ederal courts have the power to dismiss or remand cases based on abstention principles only where the relief being sought is equitable or otherwise discretionary. Because this was a damages action, we conclude that the District Court’s remand order was an unwarranted application of the *Burford* doctrine.”).¹⁸ As the IRS acknowledges on the next page of its brief, it invoked this Court’s jurisdiction for a determination that it is “entitled to be free of the state court’s injunction.” IRS Br. at 21. This is a request for equitable relief (*i.e.*, modification or

¹⁸ Two of the other cases cited by the IRS for this proposition involve applications of the *Quackenbush* rule in federal suits seeking money damages. *See Gross v. Weingarten*, 217 F.3d 208, 223 (4th Cir. 2000) (In light of *Quackenbush*, “legal claims for money damages cannot be dismissed under the equitable doctrine of abstention.”); *Webb v. B.C. Rogers Poultry, Inc.*, 174 F.3d 697, 705 (2d Cir. 1999) (“Sitting at law, without discretion to deny relief, a court cannot remand a *quantum meruit* claim under *Quackenbush*.”). In *Riley v. Simmons*, 45 F.3d 764 (3d Cir. 1995), abstention was denied because there was no court that could hear the underlying claim. There was a similar issue in *Gross v. Weingarten*, but that is not a problem here because an adversary proceeding has already been commenced in federal bankruptcy court to decide Ambac’s federal tax liability, if any. All other questions, including allocations to the Segregated Account and the priority of claims, can be decided in the Rehabilitation Court.

dissolution of an injunction), which is subject to equitable abstention, notwithstanding the IRS's argument that such relief is not "discretionary." *Id.*

The IRS also argues that *Burford* abstention is inapplicable because Ambac's General Account is not in rehabilitation, but this contention cannot be reconciled with the Court's decision in *Metropolitan Life*, discussed above, which abstained from hearing a challenge to a fund that was not the subject of the underlying liquidation proceeding. 572 F. Supp. at 471. The IRS attempts to distinguish *Metropolitan Life* by arguing that the instant proceeding raises no unsettled state law questions and is unlikely to disrupt the Wisconsin regulatory scheme. But the IRS acknowledges that it intends to litigate, *inter alia*, whether the potential tax liabilities of Ambac can be allocated the Segregated Account. *See* IRS Br. at 18. This is a question of state law (*i.e.*, the proper construction of Wis. Stat. § 611.24(2), which allows for the creation of a segregated account for "any part" of an insurer's business) and it is unsettled because there are no appellate decisions interpreting this statute. Indeed, arguments concerning whether the Commissioner properly approved Ambac's Segregated Account are presently before the Wisconsin Court of Appeals, which is proceeding despite the removal of this action from the Rehabilitation Court. The possibility of inconsistent determinations would disrupt Wisconsin's regulatory regime as would the possibility of having some \$700 million unavailable to fund any rehabilitation plan approved by the Rehabilitation Court.¹⁹

¹⁹ In a footnote, the IRS contends that the Rehabilitation Court has no "specialized relationship of technical oversight or concentrated review." IRS Br. at 23 n.15. This argument ignores that fact that this action was being presided over by Judge Johnston, who not only had this case pending before him for the past ten months, but who has also overseen every insurance delinquency case brought in the State of Wisconsin for the past twenty years. *See* Declaration of Michael B. Van Sicklen, dated December 17, 2010, Ex. B (Noting a Standing Insurance Cases Order directing that insurance delinquency proceedings be assigned to Judge Johnston and explaining that "[b]ecause of the specialized nature and complexity of delinquency proceedings

Finally, the IRS argues that *Colorado River* abstention is inapplicable because it “requires simultaneous pending federal and state suits,” which are said to be absent here. IRS Br. at 23. This argument ignores both: (1) the fact that the IRS, in the same brief, “urges the Court to remand the remainder of the rehabilitation proceeding” (IRS. Br. at 19), which would create simultaneous federal and state suits if the IRS prevails in its arguments; and (2) the pending state court appeals, which are simultaneously addressing whether the Commissioner properly applied Wisconsin’s Segregated Account Statute in commencing this rehabilitation. Thus, this Court’s conclusion in *Metropolitan Life* applies with equal force here:

I conclude that as in *Colorado River*, exceptional circumstances exist in this case. The orderly administration of justice and the prevention of unseemly conflicts between courts require this court to defer to the state courts in the determination of the constitutional and statutory claims raised by plaintiffs.

572 F. Supp. at 472.

under Chapter 645, and because of the extraordinary amount of court time and specialized expertise needed to efficiently administer such proceedings, the Dane County Circuit Court has a longstanding practice of assigning such specialized proceedings to Judge Johnston. As a consequence, Judge Johnston has developed great expertise and efficiency in handling delinquency proceedings under Chapter 645.”).

CONCLUSION

For all of the foregoing reasons, the Commissioner's Motion to remand this action should be granted.

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