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Ambac Assurance Corporation (“Ambac”) submits this memorandum of law in opposition to the motion filed by the Internal Revenue Service (the “Motion”) to dissolve the temporary supplemental injunction (the “Supplemental Injunction”) entered on November 8, 2010 by the Circuit Court for Dane County (the “Rehabilitation Court”), which, for the past ten months, has presided over this insurance rehabilitation proceeding before it was improperly removed by the IRS. This proceeding concerns the rehabilitation of a segregated account of Ambac (the “Segregated Account”), which was created by Ambac with the approval of the Wisconsin Commissioner of Insurance (the “Commissioner”) pursuant to Wis. Stat. § 611.24(2).

### **PRELIMINARY STATEMENT**

The Supplemental Injunction entered by the Wisconsin Rehabilitation Court performs a vital function -- it prevents the IRS from gaining an unfair advantage over policyholders by encumbering and seizing Ambac’s assets, contrary to the carefully crafted priority scheme enacted by the Wisconsin Legislature. Unhappy with the Wisconsin statutory scheme, and without regard to the best interests of thousands of policyholders who that statutory scheme is designed to protect, the IRS -- on the eve of the Rehabilitation Court’s entry of an order with respect to the Commissioner’s proposed rehabilitation plan -- removed the entire rehabilitation proceeding to federal court. It did so notwithstanding federal legislation -- the McCarran-Ferguson Act -- that precluded removal of this proceeding.

Because this case belongs in state court, and removal was improper, the Commissioner has filed a motion to remand this case back to the Wisconsin Rehabilitation Court. That motion must be decided before any motion to dissolve or

modify the Supplemental Injunction is heard. Where both a motion to remand and a motion to dissolve an injunction issued by a state court have been filed, the state court injunction should not be dissolved or modified until after the motion to remand the case to state court has been resolved. For if the remand motion is granted, the proper court to decide the Motion is the court that issued the injunction in the first place -- the Rehabilitation Court. Only in the event that remand is denied, and this Court elects to exercise (rather than abstain from exercising) subject matter jurisdiction over this action, would it be appropriate for this Court to hear and decide the IRS's Motion to dissolve or modify the Supplemental Injunction.

But even if this Court were to consider the merits of the Motion after denying the Commissioner's remand motion, it should deny the Motion. The IRS has failed to articulate, much less meet, the standard for dissolution of an injunction, which is well-established in the Seventh Circuit, and requires a balancing of the irreparable harms that may occur if the injunction remains in place or is dissolved, taking into account likelihood of success on the merits.

The IRS has not come close to making the requisite showing. It makes no showing of irreparable harm, let alone harm that outweighs the very substantial harm Ambac's policyholders stand to suffer if the IRS is allowed to "jump the line" ahead of them in derogation of the priority scheme embedded in the Wisconsin rehabilitation statute. Being prevented from pursuing a potential remedy for a highly contingent claim the IRS has yet to assert, much less win, is not irreparable harm. On the other hand, ceding some \$700 million in claims-paying resources to the IRS would have a clear impact on the Commissioner's rehabilitation plan and could trigger more drastic state

regulatory action -- including potentially a full-scale rehabilitation of all of Ambac -- which could irreparably increase the claims against Ambac by far more than \$700 million, thereby decreasing the recovery for *all* creditors, including the IRS.

Nor has the IRS demonstrated a likelihood of success on the merits. On the contrary, the Supreme Court's holding in *U.S. Department of Treasury v. Fabe*, 508 U.S. 491 (1993) ("*Fabe*"), along with the McCarran-Ferguson Act, doom the IRS Motion to failure. In *Fabe*, the Supreme Court held that state insurance insolvency proceedings can and should favor administrative claimants and policyholders over all other creditors, *including the federal government*. The Wisconsin rehabilitation statute adheres to this teaching, and the Supplemental Injunction protects against efforts by others, including the IRS, to upset that carefully crafted scheme. For without the Supplemental Injunction, the IRS could attempt to bypass Wisconsin's priority statute and the entire rehabilitation process by seizing assets that are under the protection of the Rehabilitation Court and have been made available to pay policyholders and other creditors, including the IRS, in accordance with the statutory priority scheme set by the Wisconsin Legislature and rehabilitation plan that has been proposed and was on the verge of being ruled upon until the precipitous removal of the entire rehabilitation proceeding by the IRS. Not a single case cited by the IRS supports such an outcome.

Much of the IRS's Motion addresses entirely academic concerns about the Supplemental Injunction. To be clear, Ambac is not seeking to have its federal tax liability decided in state court. Hours after the Supplemental Injunction was entered, Ambac's parent company, Ambac Financial Group, Inc. ("AFG"), commenced a suit to determine this liability in federal bankruptcy court. Thus, arguments based on sovereign

immunity and exclusive federal jurisdiction to decide federal tax claims are misplaced. Nor does Ambac contend that it is somehow exempt from federal taxation because it is an insurance company. But federal tax claims, once fixed and determined, must be presented for payment under the court-approved plan of rehabilitation to ensure that *all* claims against the Segregated Account are treated in a fair and orderly fashion.

The real controversy over the Supplemental Injunction is whether certain of Wisconsin's insurance rehabilitation statutes reverse-preempt the provisions of the Internal Revenue Code that would ordinarily empower the IRS to encumber and levy upon Ambac's assets. The McCarran-Ferguson Act provides that *no* federal statute, including the Internal Revenue Code, can impair contrary state statutes enacted to regulate the business of insurance. The three-part test for reverse-preemption under the McCarran-Ferguson Act is fully met here. The Wisconsin statutes authorizing the Supplemental Injunction "regulate the business of insurance" because they promote the payment of policyholder claims. They would plainly be "impaired" by provisions of the Internal Revenue Code allowing the IRS to turn Wisconsin's priority statute on its head, paying the IRS before policyholders. Because the Internal Revenue Code is a statute of general application, as opposed to a statute specifically enacted to regulate the business of insurance, certain provisions thereof are reverse-preempted by conflicting Wisconsin insurance statutes. Thus, the federal statutes cited by the IRS that would otherwise preclude the Supplemental Injunction do not justify dissolution of the Supplemental Injunction in the unique context of a state insurance rehabilitation proceeding.

## STATEMENT OF FACTS

In the interest of avoiding unnecessary repetition, Ambac respectfully refers the Court to the Brief In Support of Motion to Remand by the Commissioner, as Court-Appointed Rehabilitator of the Segregated Account of Ambac Assurance Corporation ("Commissioner's Remand Br.") (Docket Entry ("DE") 15 at 1-19), and the Brief of Wisconsin Commissioner of Insurance in Opposition to United States Internal Revenue Service's Motion to Dissolve Order for Temporary Injunctive Relief, filed today, for a full recitation of the relevant facts.

## ARGUMENT

### **I. The IRS's Motion Should Be Held in Abeyance Pending the Outcome of the Commissioner's Remand Motion**

On December 17, 2010, the Commissioner filed a motion to remand this case back to the Wisconsin Rehabilitation Court where it had been pending for nearly ten months. During that time, multiple motions and objections were filed (there were some 650 docket entries), which resulted in several interlocutory appeals in the Wisconsin Court of Appeals. These proceedings culminated in a week-long evidentiary hearing in which the Rehabilitation Court considered whether to approve the Commissioner's proposed rehabilitation plan. Commissioner's Remand Br. at 1. The Rehabilitation Court was on the verge of issuing its decision when the IRS, which did not participate in the confirmation hearing, filed its notice of removal. As a result, this extraordinarily active proceeding affecting nearly 1,000 policies insuring some \$68 billion in exposures came to a grinding halt.

As argued in greater detail in the Commissioner's remand motion, which Ambac joins and supports, the IRS's removal petition was procedurally defective because this

case is not a civil action against the IRS, but is instead an *in rem* insolvency proceeding analogous to a federal bankruptcy case. Commissioner's Remand Br. at 20-26. Remand is required because federal subject matter jurisdiction is defeated by operation of the McCarran-Ferguson Act, which reverse-preempts *any* federal statute that impairs a state insurance insolvency regime. Commissioner's Remand Br. at 26-36. Alternatively, *Burford* or *Colorado River* abstention is appropriate in deference to the Rehabilitation Court proceedings. Commissioner's Remand Br. at 36-44.

In light of the pendency of the remand motion, it would be both premature and improper for this Court to hear and decide the IRS's Motion to dissolve the Supplemental Injunction until after the remand motion has been decided. *See Heidel v. Voight*, 456 F. Supp. 959, 960 (E.D. Wis. 1978) (“[The Court does] not believe that the state injunction should be dissolved or modified until the plaintiff's motion to remand this case to the state court has been resolved.”). This is particularly true here, where the remand motion is based on lack of federal subject matter jurisdiction (and related abstention doctrines), which, if granted, would preclude adjudication of any motion to dissolve the state court injunction. *See* 13-65 Moore's Federal Practice – Civil § 65.05 (federal court must have subject matter jurisdiction prior to issuance of injunctive relief). Quite simply, it is the Rehabilitation Court, not this Court, that should decide the IRS's Motion if, as the Commissioner and Ambac respectfully submit, the removal of this insurance rehabilitation proceeding was improper.

## **II. When Ripe, The IRS's Motion Should Be Denied**

As noted above, it is only in the event that the Commissioner's remand motion is denied that the Court should consider and decide the IRS's Motion. Otherwise, the IRS's Motion should be decided by the Rehabilitation Court upon remand. Either way, the

IRS's Motion should be denied because the IRS has failed to articulate, much less meet, the standard for dissolution of an injunction, which is well-established in the Seventh Circuit, and requires an answer to the following question:

Is the irreparable harm to the plaintiff [the Commissioner/Segregated Account] if the injunction is dissolved, weighted by the probability that dissolution would be a mistake because the plaintiff would go on to win at trial, greater or less than the irreparable harm to the defendant [the IRS] if the injunction is not dissolved, weighted by the probability that allowing the injunction to continue in force would be a mistake because the defendant, not the plaintiff, will win at trial?

*Milwaukee Cnty. Pavers Assn. v. Fiedler*, 710 F. Supp. 1532, 1551 (W.D. Wis. 1989) (quoting *Centurion Reinsurance Co. Ltd. v. Singer*, 810 F.2d 140, 143 (7th Cir. 1987)).

For starters, the IRS cannot show that continuation of the Supplemental Injunction would cause it irreparable harm, which is a type of injury that “cannot be repaired, retrieved, put down again, atoned for” and is not compensable in monetary terms. *Graham v. Med. Mut. of Ohio*, 130 F.3d 293, 296 (7th Cir. 1997) (citation omitted). See also *Am. Hosp. Assoc. v. Harris*, 625 F.2d 1328, 1331 (7th Cir. 1980) (“[T]o constitute irreparable harm the threatened injury must be, in some way, peculiar. Mere injuries, however substantial, [compensable] in terms of money . . . are not enough.”) (internal citation and quotation omitted). Moreover, such irreparable harm may not be contingent or perceived, but must be certain and actual. See *id.* (affirming district court’s denial of injunctive relief where alleged injury was “unduly speculative or too insubstantial to constitute threatened irreparable harm.”).

Now, all the IRS can say is that it *might* have a claim for federal taxes at some point in the future. Even if that point arrives, any harm resulting from the Supplemental Injunction would still be contingent upon the IRS prevailing in its claim (which it has yet to make). But even this harm would not be irreparable because it could be remedied by

money damages. The Motion makes no showing that funds would be unavailable to pay any sums that could potentially be owed to the IRS.

On the other hand, dissolving the Supplemental Injunction would cause concrete harm to Ambac and its creditors, including policyholders. At the very least, the Commissioner would need to amend his proposed rehabilitation plan to account for some \$700 million less in claims-paying resources. Additionally, the prospect of having \$700 million paid to the IRS instead of to Ambac's policyholders, which would violate Wisconsin's insurance delinquency priority statute, could force the Commissioner to commence a full rehabilitation, as opposed to the less disruptive segregated account rehabilitation he has chosen to date. *See* Commissioner's Remand Br. at 7-13. As explained in greater detail in the Commissioner's Remand Brief, a full rehabilitation could trigger between one and three billion dollars in additional claims, which would reduce the amount of recovery for all policyholders, even if Ambac ultimately were to recover back the \$700 million improperly seized by the IRS. *Id.*

Balancing these considerations, the harm likely to result from dissolution of the Supplemental Injunction outweighs the entirely theoretical injury to the IRS from continuing the Supplemental Injunction. When weighted by the probability (or improbability) of success on the part of the IRS, discussed below, in seeking to "jump the line" ahead of policyholders -- contrary to the carefully crafted priority scheme applicable to Wisconsin insurance rehabilitation proceedings -- the reasons to deny the IRS's Motion become clear.

**III. The Federal Statutes that Purportedly “Bar” the Supplemental Injunction are Reverse-Preempted Under the McCarran-Ferguson Act**

The IRS seeks dissolution of the Supplemental Injunction on the basis that it is prohibited by various federal statutes. These arguments fail because each federal statute that would ordinarily prevent such injunctive relief is reverse-preempted under the McCarran-Ferguson Act, which provides, “*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).

The IRS acknowledges that under the McCarran-Ferguson Act, state insurance statutes “can 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. IRS Memorandum in Support of Motion to Dissolve Order for Temporary Supplemental Injunctive Relief and Objections to Notice, Motion and Order (“IRS Br.”) at 16. Because all three conditions are met here, the federal statutes cited by the IRS are reverse-preempted by Wisconsin insurance law and provide no basis for dissolving the Supplemental Injunction, which is essential to the orderly rehabilitation of Ambac’s Segregated Account.

**A. The Federal Statutes at Issue Do Not “Specifically Relate” to the Business of Insurance**

In support of its Motion, the IRS cites a number of federal statutes that purportedly “bar the relief sought in the injunction,” but these statutes are subject to reverse-preemption because none of them specifically relates to the business of insurance. *See* IRS Br. at 12-14, 16-17.

The IRS argues, first, that “the *Internal Revenue Code* specifically relates to the business of insurance.” IRS Br. at 17 (emphasis added).<sup>1</sup> But the Internal Revenue Code is plainly a statute of “general applicability,” which is subject to reverse-preemption under the McCarran-Ferguson Act. *See Autry v. Nw. Premium Servs., Inc.*, 144 F.3d 1037, 1040 (7th Cir. 1998) (the purpose of the McCarran-Ferguson Act is “to allow the states to regulate the business of insurance free from inadvertent preemption by federal statutes of general applicability”) (internal quotation omitted). The same is true of the particular provisions of the Internal Revenue Code that are directly implicated by the Supplemental Injunction, including the Anti-Injunction Act, 26 U.S.C. § 7421(a), which is a general prohibition against suits to restrain the collection of tax, and the other statutes authorizing the IRS to enforce tax liabilities.<sup>2</sup> None of these statutes specifically mentions, targets or relates to the insurance industry.

The IRS cites only two sections of the Internal Revenue Code that even mention insurance -- 26 U.S.C. §§ 801 (tax imposed on life insurance companies) and 831 (tax imposed on other insurance companies). Ambac is not a life insurance company, so only Section 831 can be relevant here. As one of the cases cited by the IRS notes, 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) (“[t]he plaintiff mistakes the right to tax a life insurance company with the right to regulate such

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<sup>1</sup> While the IRS argues that it is necessary to “parse the statutes” in applying McCarran-Ferguson (IRS Br. at 17), it fails to follow this approach in applying this first element of the test for reverse-preemption.

<sup>2</sup> *See* 26 U.S.C. §§ 6201 (authorizing the IRS to make inquiries, determinations, and assessments of taxes generally); 6203 (providing for the method of tax assessments); 6213 (setting forth the general procedure for petitioning the Secretary for a redetermination of tax deficiency); 6301 (authorizing IRS to collect taxes); 6321-22 (providing for a lien following an “assessment”); 6330 (providing for notice and opportunity for a hearing prior to a tax levy); 7401-05 (setting forth judicial and administrative procedural rules concerning collecting taxes generally); 7422 (providing for civil actions for a tax refund).

company”), *aff’d*, 481 F.2d 609 (4th Cir. 1973). Thus, not even Section 831 is exempt from reverse-preemption.

But even assuming, *arguendo*, that Section 831 could be viewed as a separate statute that “specifically relates” to the business of insurance (which is denied), it provides no basis to dissolve the Supplemental Injunction. Instead, Section 831 permits the imposition of federal income tax on insurance companies, assuming that certain conditions are met. Ambac does not contend that the Supplemental Injunction immunizes it from federal taxation.<sup>3</sup> Instead, Ambac relies on the Supplemental Injunction to prevent the IRS from encumbering or seizing its assets, outside of the rehabilitation process and in derogation of the statutory priority scheme enacted by the Wisconsin Legislature. Sections 801 and 831 do not address this subject at all, and are not pertinent to whether the Supplemental Injunction can protect Ambac’s assets.

Contrary to the IRS’s supposition, Ambac is not seeking to eliminate its federal tax obligations, or even to have them determined in state court. Ambac is a member of a consolidated tax group. Its parent company, AFG, is the taxpayer that is responsible for determining the federal tax liability of the consolidated tax group. AFG, which is a chapter 11 debtor, has commenced an adversary proceeding in federal bankruptcy court to decide whether and how much tax is owed by its joint tax group. The IRS acknowledges that the result of this federal litigation commenced by AFG “would establish Ambac’s tax liability.” IRS Br. at 8 n.28. For this reason, any suggestion that this case is about exclusive federal jurisdiction to decide Ambac’s federal tax liability is

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<sup>3</sup> To the extent the Supplemental Injunction could be read this broadly, the Commissioner has clarified that this was not his intent. To the extent amendment of the Supplemental Injunction is necessary, the Commissioner is empowered to agree to such limiting amendments. *See, e.g.*, the Rehabilitation Court’s March 24, 2010 Injunction (“March 24 Injunction”) at ¶¶ 15, 16.

both wrong and misses the point.<sup>4</sup> The issue before this Court is not whether Ambac is subject to federal tax, but whether the state Rehabilitation Court can prevent the IRS from taking certain steps that would “automatically ‘encumber’ all of Ambac’s property” contrary to the priority provisions in the Wisconsin rehabilitation statute. IRS Br. at 8. The provisions of the Internal Revenue Code authorizing the IRS to obtain and enforce such liens are included in statutes of general application that do not specifically relate to the business of insurance. They are, accordingly, subject to reverse-preemption if the remaining two McCarran-Ferguson elements are satisfied.

**B. The Wisconsin Statutes Authorizing the Supplemental Injunction Were Enacted for the Purpose of “Regulating the Business of Insurance”**

The second prong of the test for reverse-preemption is also met because the state statutes authorizing the Supplemental Injunction 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 Br. at 17 (*quoting Autry*, 144 F.3d at 1044).<sup>5</sup> See *Fabe*, 508 U.S. at 505 (1993) (describing the category of laws enacted for the purpose of regulating the business of insurance as “broad”).

The Supplemental Injunction was entered pursuant to the Wisconsin Insurers Rehabilitation and Liquidation Act (the “Rehabilitation Act”), which governs the

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<sup>4</sup> *Hanover Insurance Co. v. C.I.R.*, 598 F.2d 1211 (1st Cir. 1979), is inapposite because it concerned a McCarran-Ferguson challenge to a treasury regulation pertaining to computation of insurance company income. IRS Br. at 17. Ambac makes no such claim here.

<sup>5</sup> 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.

relationship between an insurer and its policyholders in several key respects directly relevant to the Supplemental Injunction. *See* Wis. Stat. § 645 *et seq.* At the heart of the Rehabilitation Act is Wis. Stat. § 645.68 (the “Priority Statute”), which establishes the priority of distribution for claims against the insurer. In *Fabe*, the Supreme Court held that a similar state priority statute regulated the business of insurance within the meaning of McCarran-Ferguson because it was designed to ensure the payment of policyholder claims despite an insurer’s insolvency:

The primary purpose of a statute that *distributes the insolvent insurer’s assets to policyholders in preference to other creditors* is identical to the primary purpose of the insurance company itself: the payment of claims made against policies. And “mere matters of form need not detain us.” The Ohio statute is enacted “for the purpose of regulating the business of insurance” to the extent that it serves to ensure that, if possible, *policyholders ultimately will receive payment on their claims.*

508 U.S. at 505-06 (emphasis added) (citation omitted).<sup>6</sup> The same is true here.

The Supplemental Injunction was entered in order to prevent the IRS from evading the Priority Statute. For example, if the Supplemental Injunction is dissolved, the IRS could impose a federal tax lien that would “automatically ‘encumber’ all of Ambac’s property.” IRS Br. at 8. By doing so, the IRS would obtain the right to be paid first in violation of the Priority Statute, which requires that administrative and policyholder claims be paid first.

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<sup>6</sup> The IRS in its brief discusses the *Fabe* decision after remand from the Supreme Court in which Ohio’s priority statute (which differs from Wisconsin’s current statute) was found unconstitutional because the valid provisions (those ranking administrative expenses and policyholder claims senior to federal government claims) were not severable under Ohio law from the remainder of the statute (which ranked additional claims senior to federal government claims). *See* IRS Br. at 19 (*citing Duryee v. Dep’t of Treasury*, 6 F. Supp. 2d 700 (S.D. Ohio 1995)). Wisconsin’s Priority Statute does not suffer from this infirmity because it ranks claims of the federal government immediately after administrative costs and policyholder claims, but ahead of all others. *See* Wis. Stat. § 645.68. Indeed, the legislative history for Wis. Stat. § 645.68 indicates that the claim priorities were reset to their current form to comply with *Fabe*.

The Wisconsin statute expressly authorizing an injunction of this nature, Wis. Stat. § 645.05(1) (the “Injunction Provision”), also regulates the business of insurance within the meaning of McCarran-Ferguson. The purpose of the Injunction Provision, which is part of the Rehabilitation Act, is to protect the rehabilitation process by preventing creditors from engaging in self-help. For example, the Injunction Provision authorizes injunctive relief to prevent “the institution or further prosecution of any actions or proceedings” and “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.” Wis. Stat. §§ 645.05(1)(f), (k).<sup>7</sup> Wisconsin’s Injunction Provision is critical to ensuring that the Priority Statute is given full effect. Without the Injunction Provision, any creditor could interfere with the orderly administration and adjudication of claims by taking steps outside the rehabilitation court to be paid ahead of other creditors in violation of the Priority Statute.

Given the close relationship between the Priority Statute, a variation of which was held to regulate the business of insurance in *Fabe*, and the Injunction Provision, other courts have found that similar injunction provisions reverse-preempt inconsistent federal statutes. *See, e.g., Munich Am. Reinsurance Co. v. Crawford*, 141 F.3d 585, 593 (5th Cir. 1998). The *Munich* court recognized that injunctions in aid of delinquency proceedings prevent “unnecessary and wasteful dissipation of the insolvent company’s funds that

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<sup>7</sup> The Rehabilitation Court availed itself of the Injunction Provision on March 24, 2010 by temporarily enjoining, *inter alia*, all interested parties from bringing any action in any court with respect to liabilities allocated to the Segregated Account. March 24 Injunction ¶1. The Rehabilitation Court further found that it “had exclusive jurisdiction over any such actions, claims or lawsuits.” *Id.* ¶3. The effect of the Supplemental Injunction was to enjoin the IRS from “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” and certain subsidiaries. Supplemental Injunction ¶4. It merely made more explicit what was implicit (if not explicit) in its first-day injunction.

would occur if the receiver had to defend unconnected suits in different forums across the country” and “eliminate[] the risk of conflicting rulings, piecemeal litigation of claims, and *unequal treatment of claimants*, all of which are of particular interest to insurance companies and policyholders, who are often relying on policies with the same or similar provisions.” *Id.* (emphasis added).

Other courts have held that statutes granting state courts broad injunctive powers in insurance delinquency proceedings “regulate the business of insurance.” For example, in *U.S. Fin. Corp. v. Warfield*, 839 F. Supp. 684, 689 (D. Ariz. 1993), the district court held that Ariz. Rev. Stat. § 20-614, which is substantially the same as the Injunction Provision, had “been enacted to serve the interests of promoting the performance of insurance contracts during insolvency and, therefore, are statutes regulating the business of insurance within the meaning of the McCarran-Ferguson Act.”<sup>8</sup>

Finally, another Wisconsin statute being used to protect policyholders in this case is Wis. Stat. § 611.24(2) (the “Segregated Account Statute”), which authorizes an insurer, with the Commissioner’s approval, to establish a “segregated account for any part of its business.” This segregated account can then be placed into rehabilitation without plunging the entire company into delinquency proceedings. *See* Wis. Stat. § 611.24(3)(e). As the IRS observes, the Segregated Account Statute permits certain aspects of an insurance business to be “insulated from the rest of the company’s business.” *See* IRS Br. at 4 (*citing* Wis. Stat. § 611.24(2)). This insulating feature of the

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<sup>8</sup> Despite this authority, some of which is cited in the IRS brief, the IRS asserts that the Injunction Provision is “merely a procedural statute” that is not closely related to the actual distribution of an insurance company’s assets. IRS Br. at 20. The IRS cites *International Insurance Co. v. Duryee*, 96 F.3d 837 (6th Cir. 1996), but that case is inapposite. In *Duryee*, the state statute penalized any foreign insurance company that sought removal of a case brought by an Ohio citizen. This Ohio statute had nothing to do with rehabilitation proceedings and had no apparent relationship to ensuring that payments were made to policyholders.

Segregated Account Statute allows for the rehabilitation of Ambac's impaired policies and other material liabilities "while avoiding the dangerous contractual pitfalls of a formal, full rehabilitation," including "trigger-related claims for loss," which would needlessly increase the amount of claims asserted against Ambac, thus diminishing recovery by policyholders. Commissioner's Remand Br. at 12.<sup>9</sup> By enabling the Commissioner to "increase[] the amount of the likely recovery for all claimants with policies, contracts, or liabilities allocated to the Segregated Account," *id.*, the Segregated Account Statute serves "to ensure that, if possible, policyholders ultimately will receive payment on their claims," which is the business of insurance under McCarran-Ferguson.<sup>10</sup> *Fabe*, 508 U.S. at 506.

In short, all three state statutory provisions discussed above, the Priority Statute, the Injunction Provision, and the Segregated Account Statute, regulate the business of insurance within the meaning of McCarran-Ferguson, and can thus reverse-preempt inconsistent federal statutes of general application.

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<sup>9</sup> For a more detailed explanation of how the Segregated Account benefits policyholders, see Commissioner's Remand Br. at 11-13.

<sup>10</sup> The IRS suggests that the Segregated Account is being used to elevate "the claims of non-policyholders (*i.e.*, general creditors of Ambac) ahead of the IRS." IRS Br. at 20. This assertion is incorrect. As the Commissioner has explained, he attempted to have every "known, potentially material non-policy liability of the General Account" allocated to the Segregated Account when it was created. Commissioner's Remand Br. at 10. In order to avoid paying "general" creditors of the General Account before paying policyholders allocated to the Segregated Account, the Commissioner has pledged continued vigilance to consider whether liabilities material to the General Account should be allocated to the Segregated Account as they come to light. Indeed, that was the primary reason for allocating the contingent claims of the IRS to the Segregated Account once they became known. As long as the Commissioner continues this approach, it is unlikely that there would be material "general creditor" liabilities in the General Account, aside from the necessary, ordinary-course costs of running Ambac, which would qualify as first priority administrative expenses under the Priority Statute.

**C. The Federal Statutes that the IRS Claims “Bar”  
Application of the Supplemental Injunction 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.”);<sup>11</sup> *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).

The Wisconsin statutes discussed in the preceding section (the Priority Statute, the Injunction Provision and the Segregated Account Statute) function to maximize payment to policyholders by protecting claims-paying assets from levy or seizure, particularly by junior creditors such as the federal government. Simply put, the portions of the Internal Revenue Code that permit the IRS to encumber and to levy against assets would impair these state statutes by permitting the IRS to be paid ahead of policyholders. Indeed, the IRS effectively admits that the relevant federal statutes would impair Wisconsin’s statutes authorizing the Supplemental Injunction because it argues that these federal and state provisions are directly in conflict. *See, e.g.*, IRS Br. at 12-14 (identifying federal statutes said to “bar” application of the Supplemental Injunction). Notably, the IRS argues that the Supplemental Injunction, which would prevent it from “automatically

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<sup>11</sup> 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.

‘encumber[ing]’ all of Ambac’s property,” should yield to conflicting federal statutes. *See* IRS Br. at 8.

The IRS describes Ambac’s tax refunds as “tentative.” *See, e.g.*, IRS Br. at 5. Regardless of this characterization, the IRS never denies that the approximately \$700 million refund is currently an unencumbered asset of Ambac subject to distribution pursuant to the Commissioner’s plan of rehabilitation in accord with the Priority Statute. Indeed, that is why the IRS is moving to dissolve the Supplemental Injunction, which preserves this *status quo*.

The IRS argues that federal jurisdiction statutes do not impair conflicting state statutes. IRS Br. at 20-21.<sup>12</sup> But, as discussed above, Ambac is not relying on the Supplemental Injunction to litigate substantive tax issues in state court. All it is trying to do is preserve the *status quo* to protect policyholders by preventing the IRS from “jumping the line” in contravention of the Priority Statute. Furthermore, the cases cited by the IRS on this point actually demonstrate why the Supplemental Injunction should not be dissolved. For example, although *Gross v. Weingarten*, 217 F.3d 208 (4th Cir. 2000), found there was federal subject matter jurisdiction over a suit to establish “the existence and amount of a claim against the debtor,” the Fourth Circuit made a point of emphasizing that the action before it “in no way disturbs the possession of the liquidation court, in no way affects title to the property, and does not necessarily involve a determination of what priority the claim should have.” *Id.* at 221 (citations omitted). Dissolving the Supplemental Injunction would permit what the Fourth Circuit sought to avoid. As that court observed:

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<sup>12</sup> In fact, the Commissioner’s Remand Brief cited a number of cases finding federal jurisdiction statutes reverse preempted under McCarran-Ferguson. *See* Commissioner’s Remand Br. at 28-29.

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

*Id.* at 221-22 (emphasis added). The same process should be followed here, with the IRS litigating the merits of the tax issue first in the federal court overseeing AFG's chapter 11 case and then, if it prevails, presenting the judgment to the rehabilitation court for treatment in accord with the rehabilitation plan and the Priority Statute.

The IRS also cites *Munich American Reinsurance Co. v. Crawford*, 141 F.3d 585 (5th Cir. 1998), but this decision found that a federal suit to compel arbitration was properly dismissed because the McCarran-Ferguson Act reverse-preempted the Federal Arbitration Act. Recognizing the "strong federal policy in favor of deferring to state regulation of insolvent insurance companies," the Fifth Circuit found that state laws regulating the business of insurance, including statutes authorizing broad injunctions against suits interfering with the delinquency proceedings, "may suspend federal remedies based on conflicting federal statutes." *Id.* at 595-96.<sup>13</sup>

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<sup>13</sup> *Munich* recognized the "well established rule" that "if two competing actions are *in rem* or *quasi in rem*, the court first assuming jurisdiction over the property in question exercises that jurisdiction to the exclusion of the other. 141 F.3d at 594 n.6 (citing *Penn Gen. Gas Co. v. Pennsylvania*, 294 U.S. 189, 195 (1935)). Here, assets of the General Account (*i.e.*, Ambac) are available to fund the rehabilitation plan for the Segregated Account. Accordingly, these assets are subject to a Cooperation Agreement and other agreements giving the Commissioner approval rights over transactions with consideration exceeding \$5 million in value (less than 0.1% of Ambac's assets) and are protected by the March 24 Injunction issued by the state Rehabilitation Court. Although the Segregated Account is deemed a separate insurer, the Commissioner has negotiated substantial contractual rights and protections on behalf of the Segregated Account, as a creditor, in regard to assets of the General Account. The IRS also cites *General Atomic Co. v. Felter*, 434 U.S. 12 (1977) (IRS Br. at 10), but *Munich* pointed out that *General Atomic* did not consider "the effect of the McCarran-Ferguson Act or the broad power bestowed on States when acting, as here, pursuant to a law enacted for the purpose of regulating the business of insurance." *Munich*, 141 F.3d at 597.

Finally, the IRS cites *Appleton Paper, Inc. v. Home Indemnity Co.*, 2000 WI App 104, ¶27 n.11, 235 Wis. 2d 39, 612 N.W.2d 760, but that decision 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.” The court observed that, as a practical matter, it may be up to a federal court to honor such injunction. This Court should do so here by not dissolving the Supplemental Injunction.

**IV. Alternatively, This Court Should Abstain from Dissolving the Supplemental Injunction**

To the extent the Court finds it has subject matter jurisdiction over this action, it should nevertheless decline to grant the equitable relief sought by the IRS -- dissolution of the Supplemental Injunction -- under 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). Ambac hereby incorporates by reference the arguments in favor of abstention set forth in the Commissioner’s Remand Br. at 36-44.

**V. Arguments about Sovereign Immunity are Misplaced**

The IRS raises a number of arguments about sovereign immunity, but they are misdirected. *See* IRS Br. at 9-12. Neither the Commissioner nor Ambac has sued the IRS in state court, and the IRS is not a party to the rehabilitation proceeding.<sup>14</sup> The only suit against the IRS is AFG’s adversary proceeding filed in federal bankruptcy court, but the IRS never argues that AFG’s federal suit about the merits of the tax dispute violates principles of sovereign immunity. Now that the federal adversary proceeding has been

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<sup>14</sup> These facts demonstrate why remand is proper. If the federal government had the right to remove an action whenever it is subject to an order issued by a state rehabilitation court, very few insurance rehabilitation proceedings would remain in state court, which would eviscerate the McCarran-Ferguson Act.

commenced, the tax liability of both Ambac and its parent company will be determined there. Regardless of any suggestion to the contrary by the IRS, both the Commissioner and Ambac have disavowed the right to adjudicate this tax liability in state court. Ambac incorporates by reference the discussion of sovereign immunity contained in the Commissioner's brief filed in opposition to the IRS's Motion.

Neither the Commissioner nor Ambac is asking the state Rehabilitation Court to make any determination or to enter any judgment against the IRS *in personam*.<sup>15</sup> The effect of the Supplemental Injunction is to ensure that, like all other current and potential creditors of Ambac's Segregated Account, the IRS cannot seize the assets designated by the Commissioner to fund payments to policyholders under the rehabilitation plan to be entered by the Rehabilitation Court. The IRS is free to conduct an audit, to determine what Ambac's tax liability should be, and to litigate the existence of tax liability in a federal court. The only steps that the Commissioner and Ambac seek to prevent through the Supplemental Injunction are efforts to encumber or levy upon Ambac's assets in direct contravention of the rehabilitation plan and the Priority Statute. The Supplemental Injunction was necessary because the Internal Revenue Code, a statute of general application, permits the IRS to do so without affording the taxpayer prior notice or opportunity to prevent it.

Finally, while the Supplemental Injunction prohibits the IRS from commencing another action outside the Rehabilitation Court, nothing has actually stopped the IRS

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<sup>15</sup> Thus, *Central States v. Old Security Life Ins. Co.*, 600 F.2d 671 (7th Cir. 1979), is inapposite. To start, much of this decision is *dictum* because the appeal was dismissed for lack of jurisdiction. *Id.* at 673. Additionally, *Central States* involved an *in personam* suit, which the Seventh Circuit was careful to distinguish from an *in rem* proceeding. *Id.* at 674, 675 n.7 (distinguishing *Blackhawk Heating & Plumbing Co. v. Geeslin*, 530 F.2d 154 (7th Cir. 1976) (dismissing federal action to turn over assets under control of state insurance rehabilitation court)). Here, the IRS seeks dissolution of the Supplemental Injunction so that it can seize assets protected by the state Rehabilitation Court.

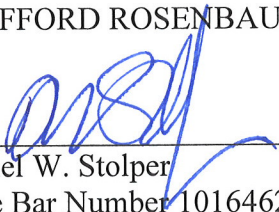
from filing the subject removal petition. The IRS having done so, however, it is appropriate for this Court to remand the case back to state court for the reasons articulated in the Commissioner's motion to remand. No case cited by the IRS supports the removal of a state insurance insolvency proceeding. Nor does the IRS cite any case that supports the right of a federal agency to seize claims-paying assets that are protected by an injunction issued in an insurance rehabilitation proceeding. To the contrary, such proceedings have long been recognized to be within the exclusive jurisdiction of state courts.

**CONCLUSION**

For all of the foregoing reasons, the IRS's Motion should be denied, assuming that the Court exercises subject matter jurisdiction.

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