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# **THE NEW WORLD ORDER: FINANCIAL GUARANTY COMPANY RESTRUCTURING AND TRADITIONAL INSURANCE INSOLVENCY PRINCIPLES**

*Bill Goddard\**

## **INTRODUCTION**

For over a century, insurance company receivership in the United States has looked much the same. The affairs of insurance companies are concluded or “wound up” in a receivership proceeding by the state insurance regulator under the supervision of a state court. The proceeding is long, cumbersome, and strictly statutory. Most celebrated insurance insolvency cases are either large life insurance company failures that burn brightly and then flame out, or property casualty failures that seemingly smolder forever in the morass of long-tailed asbestos or environmental claims. In the last two years, however, a strange breed of insurance company, the financial guaranty company, has come under attack. Huge exposures to residential mortgage-backed investments swamped their traditional business of guaranteeing the principal and interest payments on municipal bonds. These cases have changed the entire rubric of insurance insolvency. The traditional rules about the relative priorities of creditors, the benchmarking of the rehabilitation proceedings against liquidation valuations, the encroaching federal influence in a state process, and the sanctity of the aleatory contract between a carrier and its insured have all been tested. Before discussing the financial guarantors, it is helpful to first look at the historical framework of insurance insolvency.

## **I. THE HISTORICAL BACKDROP**

The insurance regulatory system in the United States is governed, almost entirely, by state law. This system developed immediately following the U.S. Civil War when the U.S. Supreme Court declared that insurance regulation was beyond the reach of Congress’ Commerce Clause powers. The Court reasoned that the sale of insurance was not “a transaction of commerce.”<sup>1</sup> In 1944, the Supreme Court reversed this decision,

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1. Paul v. Virginia, 75 U.S. 168, 183 (1868).

recognizing that insurance did, in fact, constitute interstate commerce, and could therefore be regulated by Congress.<sup>2</sup> In response, Congress rapidly passed the McCarran-Ferguson Act (McCarran-Ferguson or the Act), which codified the primacy of state insurance regulation.<sup>3</sup>

The Act recognizes the authority of state insurance laws over federal laws in most circumstances. Specifically, the Act prevents the preemption of state insurance laws by federal laws that are not specifically targeted at insurance. The Act states in pertinent part, “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, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance . . . .”<sup>4</sup>

Each state has its own system for administering an insolvent insurance company. The systems adopted by various states, however, are quite similar because they are based on model laws. Moreover, states frequently adopt the language of other states’ legislation. The model laws are promulgated by the National Association of Insurance Commissioners (NAIC),<sup>5</sup> and the National Conference of Insurance Legislators,<sup>6</sup> in an attempt to make the system more uniform. The NAIC has historically proposed, and many states have adopted, the Insurers Rehabilitation and Liquidation Model Act.<sup>7</sup> More recently, however, the NAIC has promulgated the Insurance Receivership Model Act, which has only been adopted by a few states.<sup>8</sup> While any participant in a proceeding in a particular state must be familiar with that state’s laws, the model laws may serve as a guide for what may be encountered at the state level.

There are essentially two basic types of judicial proceedings that a troubled insurer may be ordered into. The first type of proceeding is a reorganization of the company wherein it continues to operate under court supervision.<sup>9</sup> This type of proceeding is called a “rehabilitation” or “conservation,” depending on the state. While the insurer continues to operate, a receiver (generally an agent of the state insurance commissioner) displaces management. Historically, few insurers emerge from rehabilitation, despite the name of the procedure. Once an insurer loses

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2. See *United States v. Se. Underwriters Ass’n*, 322 U.S. 533, 553 (1944).

3. 15 U.S.C. §§ 1011–1015 (1945).

4. 15 U.S.C. § 1012(b) (2006).

5. See generally *Model Categories Index*, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, [http://www.naic.org/committees\\_index\\_model\\_description.htm](http://www.naic.org/committees_index_model_description.htm) (last visited Dec. 23, 2011).

6. See generally *History and Purpose*, NATIONAL CONFERENCE OF INSURANCE LEGISLATORS, <http://www.ncoil.org/ncoilinfo/about.html> (last visited Dec. 23, 2011).

7. See, e.g., CONN. GEN. STAT. § 38a-903 (2009).

8. See, e.g., TEX. INS. CODE ANN. art. 443.001 (West 2007).

9. See *Carpenter v. Pac. Mut. Life Ins. Co.*, 74 P.2d 761, 774–75 (Cal. 1937); see also *Foster v. Mut. Fire, Marine & Inland Ins. Co.*, 614 A.2d 1086, 1091 (Pa. 1992).

public confidence, it is hard to regain it.<sup>10</sup> Rehabilitation, although different in many ways, is somewhat analogous to a corporate reorganization under Chapter 11 of the U.S. Bankruptcy Code.

The second form of proceeding consists of a court-supervised winding up and liquidation of the insurer.<sup>11</sup> In a liquidation proceeding, notice is provided to policyholders that their policies will be cancelled. Then, reinsurance is collected, assets are liquidated, and creditors are paid according to specific statutory priorities. Liquidation bears some resemblance to an insurance liquidation proceeding in the United Kingdom or a proceeding under Chapter 7 of the U.S. Bankruptcy Code.<sup>12</sup> As noted below, one of the fundamental differences between these proceedings and a corporate bankruptcy is the priority given to policyholder claims over the claims of most other creditors.

Of great importance is the priority structure that governs the order in which claims are paid. One priority level must be fully discharged before the next can be paid. The system can vary from state to state, but the general structure remains the same.<sup>13</sup> Like bankruptcy, the expenses of administration are paid first and equity holders are paid last.<sup>14</sup> The similarity, however, ends there. In many states, expenses of the state guaranty fund come second, followed by policyholder claims and policyholder-related claims of the guaranty funds.<sup>15</sup> Next come the federal government claims and certain limited employee claims.<sup>16</sup> Finally, after a small number of miscellaneous government claims are paid, the general creditors are paid.<sup>17</sup> This class typically includes ceding insurance companies that were reinsured by the failed insurer.<sup>18</sup> The priority of reinsurance creditors is uniform across all states, but some states explicitly relegate reinsurance creditors to general creditor priority by statute, while others rely on the common law.<sup>19</sup> The last time a state court deviated from this principle, that court's decision was promptly reversed on appeal.<sup>20</sup>

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10. See TEX. INS. CODE ANN. art. 441.001(a) (West 2007) ("An insurer delinquency, or the state's inability to properly proceed in a threatened delinquency, directly or indirectly affects other insurers by creating a lack of public confidence in insurance and insurers.").

11. See *In re* Liquidation of Midland Ins. Co., 947 N.E.2d 1174, 1177 (N.Y. 2011) (discussing liquidation).

12. Compare 11 U.S.C. §§ 701–785 (2006), with The Insurers (Winding Up) Rules, 2001, S.I. 2001/3635 (U.K.).

13. Compare N.Y. INS. LAW § 7434 (McKinney 2005) (requiring the payment to state and local governments ahead of general creditors), with CONN. GEN. STAT. § 38a-944 (2009) (having a separate class for administrative expenses of insurance guaranty associations).

14. Compare N.Y. INS. LAW § 7434(a)(1)(i), with 11 U.S.C. § 507(a)(1)(C).

15. See N.Y. INS. LAW § 7434(a)(1)(ii).

16. See *id.* § 7434(a)(1)(iii)–(iv).

17. See *id.* § 7434(a)(1)(vi).

18. See *id.*

19. See, e.g., *Covington v. Ohio Gen. Ins. Co.*, No. 01AP-213, 2001 WL 1013126 (Ohio Ct. App. Sept. 6, 2001), *rev'd*, 99 Ohio St. 3d 117 (2003).

20. See *id.*

Finally, as noted above, equity holders come last.<sup>21</sup> The U.S. government has consistently challenged any exceptions to the Federal Priority Statute,<sup>22</sup> a statute that grants the government first priority in all insolvencies outside those governed by the U.S. Bankruptcy Code.<sup>23</sup> The U.S. Supreme Court, however, held that under certain state statutes that protect insurance policyholders, states may prioritize policyholders over the federal government.<sup>24</sup>

A common aspect of the insurance insolvency system in the United States is the supremacy of the state receivership court. State insurance statutes generally prohibit the bringing of any type of action against an insolvent insurer in any court other than the state receivership court administering the insolvency.<sup>25</sup> Removal to a federal court is generally not available because of the primacy of state regulation under McCarran-Ferguson.<sup>26</sup>

## II. THE BOND INSURERS CHANGE THE GAME

When we think about financial guaranty insurance companies, two large players come to mind: the American Municipal Bond Assurance Corporation and the Municipal Bond Insurance Association. These organizations were founded in the 1970s to provide credit enhancement for municipal bonds. These entities guaranteed the payment of interest and principal when a municipality was unable to meet the debt service on its bonds.<sup>27</sup> This development aided small or more risky public finance issuers' ability to tap the capital markets using the highest credit rating—Aaa from Moody's or AAA from Standard and Poor's (S&P).<sup>28</sup> Thus, bond liquidity increased as more buyers became eligible.<sup>29</sup> Over time, one of these two giants became Ambac Assurance Corporation. Eventually, other companies joined this business, including the Financial Guaranty Insurance Company, Financial Security Assurance (now known as Assured Guaranty Municipal Corp.), Syncora (formerly known as XL Capital Assurance, Inc.), Radian Asset Assurance Inc. (formerly part of Enhance Financial Services Group, Inc.), CIFG Assurance North America, Inc., ACA Financial Guaranty Corp., and Assured Guaranty Ltd.

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21. 11 U.S.C. § 726(a)(6) (2006).

22. 31 U.S.C. § 3713(a) (2000).

23. *Id.*

24. *U.S. Dep't of the Treasury v. Fabe*, 508 U.S. 491, 492 (1993).

25. *See Knickerbocker Agency, Inc. v. Holz*, 149 N.E.2d 885, 890 (N.Y. 1958) ("Hence other courts, except when called upon by the court of primary jurisdiction for assistance, are excluded from participation.").

26. 15 U.S.C. § 1012(b) (2006).

27. *See, e.g., N.Y. INS. LAW* § 6901 (McKinney 2005).

28. Consolidated Amended Class Action Complaint at 14, *In re Ambac Fin. Grp., Inc. Sec. Litig.*, 693 F. Supp. 2d 241 (S.D.N.Y. 2010) (No. 08-00411) [hereinafter Class Action Complaint].

29. *Id.*

The basic business of a bond insurer relies on its high credit rating.<sup>30</sup> The credit rating models, however, put significant emphasis on size and market share.<sup>31</sup> With the municipal bond business experiencing limited growth and increased competition, the financial guaranty companies looked for new ways to grow. They began to provide their guaranties to securitizations of many asset classes—most significantly, residential mortgage-backed securities (RMBS).<sup>32</sup> They also began to provide credit protection to various financial counterparties in the form of credit default swaps (CDSs).<sup>33</sup> These swaps referenced single credits or, alternatively, pools of assets, which were often synthetic and referencing RMBS.<sup>34</sup> Since insurance companies generally cannot enter into derivative transactions without hedging investment exposure,<sup>35</sup> the financial guaranty companies formed subsidiaries that entered into CDSs with sophisticated financial counterparties. The insurance entity would then provide a guaranty of its subsidiary's performance under the CDS.<sup>36</sup>

When the RMBS market began to disintegrate, the financial guaranty companies began to stumble because they were exceptionally leveraged to these securities, thereby launching a vicious cycle of credit rating downgrades. These downgrades had a number of consequences, including a loss of new business, and the establishment of requirements to post collateral in transactions that required additional collateral upon downgrade of the financial guarantor.<sup>37</sup> Moreover, sometimes CDSs came with penalties for rating downgrades and very expensive mark-to-market damages upon early termination.<sup>38</sup>

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30. *Id.* at 14–18.

31. ARLENE ISAACS-LOWE ET AL., MOODY'S RATING METHODOLOGY FOR THE FINANCIAL GUARANTY INSURANCE INDUSTRY REPORT NO. 98408 6–7 (Moody's Investors Service Sept. 2006).

32. See Class Action Complaint, *supra* note 28, at 3; Disclosure Statement Accompanying Plan of Rehabilitation at 3–4, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 8, 2010) [hereinafter Disclosure Statement].

33. Ambac Fin. Grp., Inc., Annual Report (Form 10-K) 35 (Feb. 29, 2008) [hereinafter Ambac 2007 10-K].

34. Class Action Complaint, *supra* note 28, at 23.

35. See N.Y. INS. LAW § 1410 (McKinney 2005).

36. Amicus Curiae Brief of the Bank Insureds at 1–3, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Mar. 24, 2010) [hereinafter Bank of Insureds Amicus Brief].

37. Brief in Opposition to RMBS Policyholders' and LVM Bondholders' Emergency Motions for Injunctive and Other Relief at 13, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. May 20, 2010); Ambac 2007 10-K, *supra* note 33, at 25, 29.

38. When a swap is terminated early, the transaction is generally termed "mark-to-market," meaning that a market valuation is made of the trade and any deficit found is payable immediately. When the RMBS crisis was at its bottom, the value of swap protection was very high because there was no market price for the underlying collateral. Even though many observers

Financial guaranty companies also had financial services businesses that provided guaranteed investment contracts or similar investment vehicles.<sup>39</sup> These services provided vehicles for municipalities to invest proceeds from bond offerings and for synthetic securitizations to place funds raised, which would be available to pay losses if these were to occur.<sup>40</sup> These contracts could also require posting of collateral in the event that the financial guaranty company providing the product experienced credit rating downgrades.<sup>41</sup>

The financial guaranty companies faced losses on guarantees of RMBS, losses on CDSs referencing RMBS, and cash crunches resulting from credit rating downgrades.<sup>42</sup> With these macro forces in mind, let us examine Wisconsin-domiciled Ambac Assurance Corporation (Ambac Assurance or together with its affiliates, Ambac).

### III. WISCONSIN DIVIDES AMBAC

Wisconsin-domiciled Ambac Assurance Corporation suffered from the decline in value of RMBS. Ambac began as part of the mortgage insurer MGIC Investment Corp. (MGIC), whose brush with the Baldwin United fiasco in the early 1980s spun it off on its own independent course. Ambac prospered over the following quarter century until 2008 brought trouble. Today, Ambac is a subsidiary of Ambac Financial Group, Inc. (Ambac Financial or AFG).<sup>43</sup>

The year 2008 was not kind to Ambac. In late 2007, both major rating agencies affirmed Ambac's AAA ratings, but both warned of future downgrades.<sup>44</sup> On June 5, 2008, S&P downgraded Ambac Assurance's financial strength rating to AA, placing it on Credit Watch Negative.<sup>45</sup> On June 19, 2008, Moody's downgraded it to Aa3 with a negative outlook.<sup>46</sup> On November 5, 2008, Moody's downgraded Ambac Assurance's financial strength rating to Baa1, and on November 19, 2008, S&P lowered its rating of Ambac Assurance to A with a negative outlook.<sup>47</sup>

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believed the market would recover before swaps expired, if a valuation was done at the bottom of the crisis, a substantial amount could be due upon termination.

39. Ambac 2007 10-K, *supra* note 33, at 27–30.

40. *Id.* at 29–30.

41. *Id.* at 25.

42. *Id.*

43. See generally *Ambac Financial Group, Inc.*, ANSWERS.COM, <http://www.answers.com/topic/ambac-financial-group-inc> (last visited Oct. 1, 2011); see also *Ambac Financial Group, Inc.*, FUNDINGUNIVERSE.COM, <http://www.fundinguniverse.com/company-histories/Ambac-Financial-Group-Inc-Company-History.html> (last visited Oct. 1, 2011) (providing a history of Ambac).

44. Ambac Fin. Grp., Inc., Annual Report (Form 10-K) 25 (Mar. 16, 2009) [hereinafter Ambac 2008 10-K].

45. *Id.*

46. *Id.*

47. *Id.*

These rating downgrades took their toll on Ambac. The December 31, 2008 Ambac Assurance statutory statements show well over \$1 billion flowing from Ambac Assurance to its affiliates, much of it to collateralize guaranteed investment contracts and other transactions requiring collateral after Ambac was downgraded.<sup>48</sup>

In order to permit Ambac's non-insurance affiliates to meet the collateral posting obligations, Ambac Assurance asked its regulator, the Wisconsin Office of the Commissioner of Insurance (OCI or the Commissioner), to permit certain "liquidity enhancing activities" between the non-insurance affiliates and the regulated insurance company. Finally, in early November 2008, the OCI granted Ambac a "non-disapproval letter" with regard to a few liquidity-transferring transactions between a number of Ambac's affiliates and the insurance company. These included:

Ambac Assurance is permitted to purchase up to \$3.0 billion of investment securities presently owned by the investment agreement business;

Ambac Assurance is permitted to provide a revolving unsecured credit facility to the investment agreement business of up to \$1.6 billion for the purpose of providing such affiliates liquidity for collateral postings or liquidation of investment agreements;

Ambac Assurance is permitted to provide a revolving unsecured credit facility to Ambac Financial Services of not more than \$750 million (subsequently increased to \$850 million through March 31, 2009) for the purpose of providing liquidity for collateral postings or liquidation of interest rate and/or currency swap arrangements; and

Under a separate non-disapproval, Ambac Assurance is permitted to lend up to \$1.3 billion to the investment agreement business on a secured basis.<sup>49</sup>

Ambac responded by discontinuing its credit derivatives business<sup>50</sup> and announcing that it would attempt to revitalize a subsidiary called "Everspan" to write municipal finance guarantees.<sup>51</sup>

Ambac tried to resuscitate itself; in 2008, Ambac Financial issued \$1.25 billion of common stock and \$250 million of hybrid securities (comprised of a commitment to purchase common stock and approximately \$240 million in 9.5 percent senior notes) and raised \$800 million from their contingent capital facilities.<sup>52</sup> They put virtually all of this capital into its subsidiaries, including Ambac Assurance.<sup>53</sup>

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48. AMBAC ASSURANCE CORP., 2008 ANNUAL STATEMENT 14.4 (2008).

49. Ambac 2008 10-K, *supra* note 44, at 56.

50. *Id.*

51. *Id.* at 57.

52. *Id.* at 93, 99.

53. *Id.* at 172.



The flow of outbound claim payments could not be staunched. Between 2003 and 2007, Ambac had only paid \$177 million in gross claims, but in 2008 alone, it paid \$638 million, and recorded loss and loss adjustment expenses totaling \$2.2 billion.<sup>54</sup> In 2009, Ambac paid \$1.7 billion, and recorded loss and loss adjustment expenses totaling \$2.8 billion (\$589 million and \$1.4 billion in 2008 and 2009, respectively, on a statutory basis).<sup>55</sup> Ambac's balance sheet crumbled. Investment losses on a statutory basis were \$3.9 billion in 2008 and another \$2.6 billion in 2009.<sup>56</sup>

In March 2010, facing continued losses and deteriorating conditions, Ambac's regulator, the OCI, responded by causing Ambac to form a "segregated account" (the Segregated Account).<sup>57</sup> Life insurance companies commonly employ "separate accounts" to separate assets (generally on a small scale) for self-managed variable annuities or similar products.<sup>58</sup> The assets in the separate account cannot be used to satisfy the general obligations of the insurer. Wisconsin's segregated account statute<sup>59</sup> was used in the final stages of the spectacular failure of Baldwin United that gave rise to the current MGIC and its former subsidiary Ambac.<sup>60</sup> Under this construct, an insurer can separate an entire part of its business, not just individual accounts as described above. This is required for certain lines of business, including mortgage guaranty and financial guaranty lines. It is optional in other circumstances:

**(2) Optional segregated accounts.** With the approval of the commissioner, a corporation may establish a segregated account for any part of its business. The commissioner shall approve unless he or she finds that the segregated account would be contrary to the law or to the interests of any class of insureds.<sup>61</sup>

When a segregated account is formed from an existing business, it must have "adequate" capital and surplus:

**(3) Special provisions for segregated accounts.** (a) *Capital and surplus.* The commissioner shall specify in the certificate of authority of a newly organized corporation the minimum capital or the minimum permanent

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54. *Id.* at 88–89.

55. Ambac Fin. Grp., Inc., Annual Report (Form 10-K) 84 (Mar. 9, 2010) [hereinafter Ambac 2009 10-K]; AMBAC ASSURANCE CO., 2009 ANNUAL STATEMENT 5 (2009) [hereinafter AMBAC 2009 ANNUAL STATEMENT].

56. AMBAC 2009 ANNUAL STATEMENT, *supra* note 55, at 4.

57. Brief in Support of Entry of Order for Rehabilitation at 3–4, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Mar. 24, 2010) [hereinafter Rehab. Brief].

58. *See, e.g.*, N.Y. INS. LAW § 4240 (McKinney 2005).

59. WIS. STAT. § 611.24(2) (2010).

60. Notice and Verified Motion for Approval of Creation of Segregated Account at 2, 6, 8, *In re* The Liquidation of WMBIC Indemnity Corp., No. 85-CV-3361 (Wis. Cir. Ct. Dane Cnty. Sept. 21, 1990).

61. WIS. STAT. § 611.24(2).

surplus and the initial expendable surplus to be provided for each segregated account. If a segregated account is established after a certificate of authority has been issued, the commissioner shall require the corporation to have and maintain an adequate amount of capital and surplus in the segregated account.<sup>62</sup>

Wisconsin treats the segregated account as an independent insurance subsidiary for the purposes of a rehabilitation proceeding under Wisconsin's insolvency statutes.

(e) *Delinquency proceedings.* Each segregated account shall be deemed an insurer within the meaning of s. 645.03(1)(f). A liquidation order under s. 645.42 for the general account or for any segregated account shall have effect as a rehabilitation order under s. 645.32 for all other accounts of the corporation. Claims remaining unpaid after completion of the liquidation under ch. 645 shall have liens on the interests of shareholders, if any, in all of the corporation's assets that are not liquidated, and the rehabilitator may transform the liens into ownership interests under s. 645.33(5).<sup>63</sup>

Ambac announced on March 24, 2010 that it had created a segregated account for a large portion of its structured finance business and a small part of its municipal business.<sup>64</sup> The OCI petitioned for an order of rehabilitation for Ambac's Segregated Account.<sup>65</sup> Then, Ambac announced that it had contributed all of its business consisting of guarantees of RMBS to the Segregated Account.<sup>66</sup> It also contributed its exposure to a failing infrastructure project (i.e., the Las Vegas Monorail), certain student loan securitizations, and all CDS creditors that had not agreed to commute their exposure.<sup>67</sup> Ambac also allocated certain liabilities, such as Ambac Assurance's exposure on the lease of its New York headquarters.<sup>68</sup>

Additionally, Ambac contributed two assets to its Segregated Account. The first was a \$2 billion note secured by the premium flows attributable to the business lines transferred to the Segregated Account.<sup>69</sup> The second was an excess of loss reinsurance agreement that obligated the remainder of Ambac (the General Account) to pay the Segregated Account's losses above the \$2 billion.<sup>70</sup> Under neither instrument, however, would the

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62. *Id.* § 611.24(3)(a).

63. *Id.* § 611.24(3)(e).

64. Rehab. Brief, *supra* note 57, at 3–4.

65. *Id.* at 4.

66. *Id.* at 3.

67. Verified Petition for Order of Rehabilitation, Tab 1 at 2, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Mar. 24, 2010) [hereinafter Rehab. Petition].

68. *Id.*

69. *Id.* Tab 1 at 3.

70. *Id.*

General Account be required to make payments if its surplus declined below \$100 million.<sup>71</sup>

In addition to granting the OCI's rehabilitation petition, Wisconsin's Dane County Circuit Court in Darlington, Wisconsin (the Rehabilitation Court) issued an injunction.<sup>72</sup> This injunction prohibited parties from taking any action against the Segregated Account, the General Account in respect of the Segregated Account, or the Commissioner.<sup>73</sup> In addition, the injunction barred any parties from exercising setoff and from exercising rights under their documents that the Segregated Account would have had if it were not in default.<sup>74</sup>

In early June 2010, Ambac concluded its commutation arrangement with the CDS creditors that remained in the General Account. It agreed to pay fourteen financial institutions that were counterparties on its CDS transactions (the CDS Banks) \$2.6 billion in cash and \$2 billion in surplus notes in exchange for a release from these liabilities.<sup>75</sup> Ambac also granted the commuting creditors certain releases, the terms of which were never made public.<sup>76</sup> The surplus notes have a stated maturity in 2020 and bear a coupon rate of 5.1 percent. In an apparent indication of the valuation of the surplus notes, some of the counterparties entered into call options with Ambac under which Ambac could purchase \$940 million of their surplus notes for a weighted-average call price of \$0.22 for each dollar of face amount. Ambac and the CDS Banks hired BlackRock Solutions (BlackRock) to evaluate the CDS exposure. BlackRock determined that the present value of CDS exposure to the CDS Banks on a base case was \$7.7 billion (or \$9.2 billion on a stress case).<sup>77</sup> The OCI calculated that the banks received 43.3 percent of their expected losses—24.5 percent in cash and 18.8 percent in notes—and warned that the banks were entitled to \$12.9 billion if they were able to terminate their swaps and demand a mark-to-market payment.<sup>78</sup> The OCI's calculation was incorrect as they paid the CDS Banks \$2.6 billion in cash with a present value of \$2.6 billion for \$7.7 billion of present value claims<sup>79</sup> or approximately 34 percent of their claims *plus* the notes. Meanwhile, Ambac, on its statutory books, carried only \$4.3

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71. *Id.* Tab 1 at 3–4.

72. See generally Order for Temporary Injunctive Relief, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Mar. 24, 2010) [hereinafter Temporary Injunction].

73. *Id.* at 2. The injunction prohibiting actions against the Commissioner is unqualified in every respect. The Commissioner may not be sued by anyone. *Id.* at 2–3.

74. *Id.* at 4–5. This was a truly remarkable result given that the claimants against the trusts that issued the securities were not before the Rehabilitation Court.

75. Disclosure Statement, *supra* note 32, at 21–22.

76. Ambac 2009 10-K, *supra* note 55, at 6; Ambac Fin. Grp., Inc., Annual Report (Form 10-K) 118–19 (Mar. 16, 2010) [hereinafter Ambac 2010 10-K].

77. Disclosure Statement, *supra* note 32, at 21.

78. *Id.* at 22.

79. *Id.* at 21.

billion in impairment losses on subsidiary guarantees, not all of which was for exposure to the CDS Banks.<sup>80</sup> On this basis, the banks actually received more than the carrying value of their claims.<sup>81</sup>

Multiple parties objected to the rehabilitation, and the Segregated Account and the CDS Banks settlement. The Rehabilitation Court listened to the objections and overruled each of them. The first came from the indenture trustee of the Las Vegas Monorail bonds on April 5, 2010.<sup>82</sup> Subsequent objections were made by holders of the Las Vegas Monorail bonds and by a group of investors holding RMBS and other Ambac-guaranteed exposures. The objections fall into a number of categories.

First, the RMBS holders objected to the formation of the Segregated Account, claiming that it could not meet the standard articulated in Wisconsin Statute section 611.24(3) of “adequate capital and surplus” because it could not pay holders in cash and it was placed into rehabilitation as soon as it was formed.<sup>83</sup> They also argued that the formation was an improper novation of their policies.<sup>84</sup> They asserted that the formation of the Segregated Account was a taking of private property for public use without compensation under the Fifth Amendment and a denial of due process for failure to provide notice and an opportunity to be heard before taking their rights through the rehabilitation petition.<sup>85</sup> The Rehabilitation Court heard these objections on May 25, 2010 and denied them on May 27, 2010.<sup>86</sup> The RMBS holders’ appeal is currently pending before the Wisconsin Court of Appeals.<sup>87</sup>

The RMBS investors, Freddie Mac (holder of substantial investments backed by Ambac guaranties) and the Las Vegas Monorail holders, each argued that the Wisconsin court was wrong to approve the CDS Bank settlement without a full review. These objections were heard on May 25, 2010 and denied on May 27, 2010.<sup>88</sup> The Rehabilitation Court adopted the

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80. Ambac Fin. Grp., Inc., Quarterly Report (Form 10-Q) 114 (May 17, 2010).

81. Given that \$4.3 billion is less than \$4.6 billion.

82. See Brief by Wells Fargo Bank, N.A., in its Capacity as Trustee for the Benefit and Protection of Certain Bondholders, in Support of Its Motion to Modify Temporary Injunction Order and to Intervene at Ex. A, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Apr. 5, 2010).

83. See, e.g., Brief in Support of Motion and Emergency Motion to Modify Order for Temporary Injunctive Relief Filed by Certain RMBS Policyholders and Motion Seeking Expedited Relief at 24–25, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Apr. 30, 2010).

84. *Id.* at 23–24.

85. *Id.* at 23–28.

86. Findings of Fact and Conclusions of Law Regarding Motions of Certain RMBS Policyholders and Certain LVM Bondholders at 1, 14–17, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. May 27, 2010) [hereinafter May 27th Order].

87. Notice of Appeal, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. May 28, 2010).

88. May 27th Order, *supra* note 86, at 14–17.

OCI's argument that the holders would not suffer irreparable harm if the settlement were concluded.<sup>89</sup> The OCI then argued to the Wisconsin Court of Appeals that any challenge to the settlement should be dismissed as moot.<sup>90</sup> This resulted in a sharp rebuke from the appellate court and the grant of permission for the holders to proceed with the appeal.<sup>91</sup>

Several policyholders, beneficiaries, creditors, and trustees objected to their inclusion in the Segregated Account. These objections were also denied.<sup>92</sup>

The OCI proposed a Rehabilitation Plan for the Segregated Account of Ambac Assurance (the Plan) on October 8, 2010.<sup>93</sup> The Plan proposed to continue the injunction and begin a claim adjudication procedure that would pay the claims against the Segregated Account 25 percent in cash and 75 percent in surplus notes to be issued by the Segregated Account and to be *pari passu* with the surplus notes issued to the CDS Banks by the General Account.<sup>94</sup>

Ambac's fate took a turn when its parent, Ambac Financial, filed for bankruptcy under Chapter 11 on November 8, 2010.<sup>95</sup> The holding company could not obtain funding from the insurance subsidiaries. As a result, it had \$136 million in cash and investments at the end of 2009 to support \$1.6 billion in long-term debt.<sup>96</sup> At the time of the filing, the

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89. Order, *Dilweg v. Wells Fargo Bank*, No. 2010AP1291 (Wis. App. June 18, 2010).

90. *Id.*

91. *Id.*

92. Order Denying Motions of Wells Fargo Bank and Certain LVM Bondholders and Emergency Motions to Postpone the July 9, 2010 Hearing on the Motions of Wells Fargo Bank and Certain LVM Bondholders at 8, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-576 (Wis. Cir. Ct. Dane Cnty. July 16, 2010); see also May 27th Order, *supra* note 86, at 14–17; Decision on Motions Challenging the Legality of the Establishment and Structure of The Segregated Account, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 26, 2010); Challenges to the Temporary Injunction Concerning the Exercise of Control Rights, Withholding of Premiums and Other Objections, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 26, 2010); Motions to Formally Intervene as Parties to this Rehabilitation Action, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 26, 2010).

93. See Plan of Rehabilitation, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 8, 2010).

94. Disclosure Statement, *supra* note 32, at 21. Hearings on the Plan were held by the Rehabilitation Court in Darlington, over objections to the forum and requests for better facilities in a metropolitan area. The judge went so far as to tell counsel for some of the student loan lenders to check into the Super 8 in Darlington when he could not find a room and later humorously offered to help him find a place to stay. Transcript of Hearing at 39–40, 88, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 14, 2010).

95. Voluntary Petition, *In re Ambac Fin. Grp., Inc.*, No. 10-15973 (Bankr. S.D.N.Y. Nov. 8, 2010).

96. *Ambac 2009 10-K*, *supra* note 55, at 214.

bankruptcy schedules showed only \$63 million in cash and another \$22 million in securities.<sup>97</sup>

In late 2009, nearly a year before Ambac Financial filed for bankruptcy, Ambac took a tax refund, which the Internal Revenue Service (IRS) is seeking to recapture. After Ambac Financial went into bankruptcy, the IRS could have sought recovery from Ambac's General Account because all members of a consolidated tax group are jointly and severally liable for taxes.<sup>98</sup> Anticipating IRS collection, the OCI went to the Rehabilitation Court on the eve of Ambac Financial's bankruptcy petition to gain an injunction against the IRS to prevent it from collecting taxes from the General Account or the Segregated Account.<sup>99</sup> The OCI also amended the Plan for the Segregated Account to allocate the IRS's claim to the Segregated Account.<sup>100</sup>

The IRS attempted to remove the proceedings to the Federal District Court for the Western District of Wisconsin where it sought to have the injunction dissolved.<sup>101</sup> The IRS made the somewhat revolutionary claim that laws for the collection of tax, unlike many federal statutes, such as the Bankruptcy Code, need not be reverse preempted by the Wisconsin insurance receivership statutes.<sup>102</sup> Although McCarran-Ferguson shields some parts of state receivership laws from preemption by federal statutes,<sup>103</sup> the IRS argued that McCarran-Ferguson was passed pursuant to the Commerce Clause, and thus, did not preempt tax statutes passed pursuant to the Taxation Clause.<sup>104</sup> The federal court, however, sided with the Commissioner and remanded the case to the state court based upon its interpretation of McCarran-Ferguson.<sup>105</sup>

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97. Schedule of Assets and Liabilities for Ambac Financial Group, Inc. (Schedule B), *In re* Ambac Fin. Grp., Inc., No. 10-15973 (Bankr. S.D.N.Y. Dec. 22, 2010).

98. Complaint at 14, *Ambac Fin. Grp., Inc. v. United States* (*In re* Ambac Fin. Grp., Inc.), Adv. Pro. No. 10-04210 (Nov. 9, 2010).

99. Order for Temporary Supplemental Injunctive Relief at 1–2, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Nov. 8, 2010).

100. Notice of Amendment to Plan of Operation for the Segregated Account, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Nov. 8, 2010) [hereinafter Notice of Amendment to Plan].

101. *See generally* Notice of Removal to the United States District Court for the Western District of Wisconsin, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Dec. 8, 2010); Memorandum in Support of Motion to Dissolve Order for Temporary Supplemental Injunctive Relief and Objections to Notice, Motion and Order at 2, *Dilweg v. United States*, No. 10-CV-778 (W.D. Wis. Dec. 17, 2010).

102. *See* United States' Opposition to Motion to Remand at 7–8, *Dilweg*, No. 10-CV-778 (W.D. Wis. Dec. 30, 2010) [hereinafter IRS Remand Brief].

103. *See* U.S. Dep't of the Treasury v. Fabe, 508 U.S. 491, 500 (1993).

104. IRS Remand Brief, *supra* note 102, at 7.

105. Order and Opinion at 2, *Nickel v. United States* (*In re* The Rehab. of the Segregated Account of Ambac Assurance Corp.), No. 10-CV-778 (W.D. Wis. Jan. 14, 2011) [hereinafter Jan. 14 Order].

After the Seventh Circuit signaled it would reject its appeal of the remand order,<sup>106</sup> the IRS tried again—this time as a direct suit against the court to stay the injunction.<sup>107</sup> The district court turned the IRS away again.<sup>108</sup> As of this writing, briefing on the appeals in the Seventh Circuit is largely completed, but no decision has been reached. Meanwhile, on remand, the Wisconsin court promptly confirmed the Plan.<sup>109</sup> The IRS appealed the confirmation.<sup>110</sup> The OCI, however, persuaded the Wisconsin Court of Appeals that the IRS's appeal should be dismissed because the attorney signing it was not admitted in Wisconsin.<sup>111</sup> The IRS has appealed to the Wisconsin Supreme Court, and briefing is underway in the Wisconsin Court of Appeals on the various other objections to confirmation of the Plan.<sup>112</sup>

#### IV. CHANGES TO INSURANCE INSOLVENCY PRINCIPLES

The proceedings in relation to Ambac's distress are interesting to the insurance insolvency professional because they test four key insolvency principles: (1) the priority of claims in an insurance company insolvency, (2) the role of the best interests of creditors test in insurance rehabilitations, (3) the ability of an insurance company to divide its liabilities, and (4) the robustness of McCarran-Ferguson's reverse preemption of federal statutes. This paper will address each of these four issues in turn.

##### A. PRIORITY

Insurance receiverships have existed longer than the Bankruptcy Code or its predecessor, the Bankruptcy Act of 1898. The priority of claims in an insurance receivership is governed by state priority statutes.<sup>113</sup> As the Supreme Court recounted in *U.S. Department of the Treasury v. Fabe*, the

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106. Order, *Nickel v. United States*, No. 11-1158 (7th Cir. Jan. 20, 2011) (making a preliminary finding that the district court's order to remand the matter to the state court is not reviewable).

107. Memorandum of Law in Support of United States' Motion for Preliminary Injunction and for Expedited Ruling by February 17, 2011, *United States v. Wis. State Cir. Ct. for Dane Cnty.*, 767 F. Supp. 2d 980 (W.D. Wis. 2011) (No. 11-CV-99).

108. *United States v. Wis. State Ct. for Dane Cnty.*, 767 F. Supp. 2d 980, 981 (W.D. Wis. 2011).

109. Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation with Findings of Fact and Conclusions of Law at 1, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Jan. 24, 2011).

110. Notice of Appeal at 1, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Mar. 8, 2011).

111. Order at 10, *Dilweg v. Wells Fargo Bank*, Nos. 2010AP1291, 2010AP2022, 2010AP2835, 2010AP300, 2010AP561 (Wis. Ct. App. May 3, 2011).

112. See generally Reply Brief for United States of America Interested Party-Appellant-Petitioner, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, App. No. 2011AP987 (Wis. Nov. 3, 2011); Appellants' Consolidated Reply Brief, App. No. 2011 AP 561 (Wis. App. Aug. 29, 2011).

113. See, e.g., N.Y. INS. LAW §§ 7434–7435 (McKinney 2005) (governing property casualty companies and life insurance companies).

costs of administering the estate come first, and policyholders generally come second. Thanks to *Fabe*'s conclusion that the Federal Priority Statute, 31 U.S.C. § 3713(a), was preempted by state statute, the federal government comes after policyholders, and all other creditors follow.<sup>114</sup> Those holding claims under reinsurance policies are treated as general creditors, not policyholders, whether the statutes say so,<sup>115</sup> or not.<sup>116</sup>

The question most often asked when contemplating the insolvency of a financial guaranty company is: what is the relative priority of CDS counterparties and those holding guaranties of municipal bonds? Although discussed in some of the *Ambac* pleadings,<sup>117</sup> this issue has never been fully litigated. It can be argued that those policyholders holding direct guaranties of municipal bonds have priority over CDS counterparties because: (1) the "policies" issued to guaranty CDS payments are simply subsidiary guaranties (i.e., the insurance company is merely guaranteeing the performance of its non-insurance subsidiary that entered into the swap);<sup>118</sup> (2) CDSs are not part of the business of insurance<sup>119</sup> and therefore are not entitled to protection from the Federal Priority Statute that places the federal government first in any non-bankruptcy insolvency;<sup>120</sup> (3) holders of CDSs lack an insurable interest because most do not hold the underlying obligations against which they have purchased CDS protection, and therefore, CDSs are not insurance policies at all;<sup>121</sup> and (4) CDSs are akin to

114. U.S. Dep't of the Treasury v. *Fabe*, 508 U.S. 491, 508–09 (1993).

115. See, e.g., N.Y. INS. LAW § 7434; CAL. INS. CODE § 1033(d)(3) (West 2000).

116. See, e.g., 40 P.A. STAT. ANN. § 221.44 (West 2011); OHIO REV. CODE ANN. § 3903.42 (West 2005); see also *Covington v. Ohio Gen. Ins. Co.*, 99 Ohio St. 3d 117, 2003-Ohio-2720, 789 N.E.2d 213, at ¶ 3 (discussing reinsurance creditors).

117. See, e.g., Brief in Support of Emergency Motion to Enjoin Consummation of the Proposed Settlement between *Ambac* and Certain CDS Counterparties at 14–17, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. May 5, 2011). The circuit court's decision in the matter was based almost entirely on deference to the regulator. See May 27th Order, *supra* note 86, at 14–17.

118. If we consider an ordinary corporation that guarantees the performance of a subsidiary—for example, to obtain credit to purchase goods—an observer would not likely say that such an exchange is insurance, would they?

119. The CDS industry agrees that CDSs are not insurance:

CDSs are not insurance for numerous reasons. Most significantly, there is no requirement that the protection buyer own the asset on which it is buying protection or that it suffer any loss. Other common features of CDSs that distinguish them from insurance include: (i) the absence of a requirement that the buyer provide proof of loss as a condition to payment; (ii) payment upon settlement that may be more than the loss (if any) suffered by the buyer; (iii) the absence of rights of subrogation; and (iv) differences in accounting, tax, bankruptcy and other regulatory treatment.

Brief of Amicus Curiae in Support of the Brief of Defendant-Appellant at 7 n.2, *Aon Fin. Prod. v. Société Générale*, No. 06-1080-CV (2d Cir. May 8, 2006) (citation omitted).

120. See U.S. Dep't of the Treasury v. *Fabe*, 508 U.S. 491, 492 (1993).

121. See *Howard Fire Ins. Co. v. Chase*, 72 U.S. 509, 512–13 (1866) ("The assured must therefore have an interest in the property insured; otherwise, there is a temptation to destroy it, which sound policy condemns.").



reinsurance because they simply assume a risk voluntarily assumed by another entity.<sup>122</sup>

It can also be argued that mark-to-market damages upon swap termination are “penalties or forfeitures” which, under Wisconsin’s priority statute, are allowed as general creditors “only to the extent of the pecuniary loss sustained from the act, transaction or proceeding out of which the penalty or forfeiture arose,” with the rest being subordinated to the most junior class.<sup>123</sup> Proponents of equal priority for CDS counterparty claimants frequently say that the CDS policyholders have an interest in the financial performance of the subsidiary, and therefore, have an insurable interest.<sup>124</sup> Proponents of CDS interests may also argue that under the Wisconsin priority statute, surety bonds have policyholder priority, and that these policies are a form of municipal bond guaranty which constitute surety insurance under Wisconsin regulations.<sup>125</sup> CDS counterparties also argue that their losses are not “penalties” or “forfeitures” because those terms refer to punishments by government authorities.<sup>126</sup>

In Ambac, one can easily argue that the CDS counterparties, who got out with cash long before anyone else did and received a third of their probable claims in cash, actually enjoyed priority over the RMBS creditors who will receive 25 percent in cash and the rest in the surplus notes, the payment of which is quite uncertain (remembering the call options granted by the banks at approximately 22 percent of face value).<sup>127</sup> The CDS Banks could also enjoy priority over the municipal holders who are at the mercy of Ambac paying out all but \$100 million of the General Account’s surplus to cover RMBS losses, leaving the General Account exposed to a major municipal failure.<sup>128</sup> The CDS counterparties arguably did as well or better than the other two groups, and they certainly were paid sooner.

## B. THE BEST INTERESTS OF CREDITORS TEST

It has long been a part of the confirmation of a bankruptcy plan of reorganization under Chapter 11 that a dissenting creditor must receive as much as he would in a liquidation.<sup>129</sup> This is commonly called the “best interests of creditors test.” It has been handed down in insurance insolvency

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122. Actually, the risk is transferred twice. First, someone buys a bond, and they assume the risk of default. They then place that risk with the subsidiary of a financial guaranty company, and then the financial guaranty company guarantees the risk of its subsidiary’s nonpayment. *See supra* text accompanying note 38.

123. WIS. STAT. § 645.68 (5) (2009–2010).

124. *See* Bank of Insureds’ Amicus Brief, *supra* note 36, at 9–11.

125. WIS. STAT. § 645.03(2); WIS. ADM. CODE INS. § 3.08(1).

126. Bank of Insureds’ Amicus Brief, *supra* note 36, at 11–12.

127. Ambac Fin. Grp., Inc., Report of Unscheduled Events or Corporate Changes (Form 8-K) 2 (Oct. 12, 2010).

128. Rehab. Petition, *supra* note 67, Tab 1 at 3–4.

129. *See* 11 U.S.C. § 1129(a)(7)(A)(ii) (2006).

from two celebrated insurance rehabilitations: the Pacific Mutual Insurance Company insolvency in the 1940s in California and the National Surety Company insolvency in the 1930s in New York.<sup>130</sup>

In these two cases, a distressed insurer was divided up into separate units in order to save the successful business and liquidate the business that caused the impairment.<sup>131</sup> In *National Surety*, the rehabilitation plan contemplated three companies: one for “selected lines of preferred risks,” a second for “obligations under mortgage guaranties,” and a third to liquidate the remaining assets.<sup>132</sup> In *Carpenter v. Pacific Mutual Life Insurance Company of California*, life policyholders would be transferred to a new company and paid as before, but non-cancellable disability policyholders would receive from 20–90 percent of their claims depending on the year of issue.<sup>133</sup> The non-consenting holders would be left in the old company which would be liquidated.<sup>134</sup> In each case, the lines of business that brought about the insolvency were treated less favorably than those that did not.

Both courts emphasized the need for a creative rehabilitation. The *National Surety* court stated that “numerous other creditors and those dealing with the National Surety Company will most likely be saved millions of dollars by the method of rehabilitation proposed by the superintendent of insurance.”<sup>135</sup> The *Carpenter* court stated that “[t]he public has a grave and important interest in preserving the business if that is possible.”<sup>136</sup> The court continued, “Liquidation is the last resort.”<sup>137</sup>

In order to reach these goals, the California Supreme Court found that disparate treatment was appropriate:

Moreover, the record demonstrates that under the circumstances here existing the difference in treatment was justified. The life policyholders, and the commercial health and accident policyholders were paying adequate premiums for their insurance and these phases of the old company’s business were highly profitable. The [non-cancellable] policyholders were not paying adequate premiums, and this fact was the primary cause of the difficulties of the old company. The [non-cancellable] policies were draining the old company to disaster. If any plan of rehabilitation was to succeed it was imperative that the integrity of the life business be preserved in order to earn profits for the benefit of all

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130. *Carpenter v. Pac. Mut. Life Ins. Co. of Cal.*, 74 P.2d 761, 778 (Cal. 1938), *aff’d sub nom.*, *Neblett v. Carpenter*, 305 U.S. 297 (1938); *Matter of People of the State of N.Y., by Van Schaick (In re Nat’l Sur. Co.)*, 268 N.Y.S. 88, 91 (App. Div. 1st Dep’t. 1933), *aff’d*, 191 N.E. 521 (N.Y. 1934).

131. *Carpenter*, 74 P.2d at 771–72; *In re Nat’l Sur. Co.*, 268 N.Y.S. at 91.

132. *In re Nat’l Sur. Co.*, 268 N.Y.S. at 91.

133. *Carpenter*, 74 P.2d at 768.

134. *Id.*

135. *In re Nat’l Sur. Co.*, 268 N.Y.S. at 96.

136. *Carpenter*, 74 P.2d at 775.

137. *Id.*

concerned, including the [non-cancellable] policyholders. Continued profits from the life business, and from the profitable accident and health business, furnished the only sources from which full contract benefits to [non-cancellable] policyholders could ever be resumed.<sup>138</sup>

The court concluded, however, that the dissenting holders would not be inappropriately disadvantaged as long as they received at least what they would have received in liquidation: “All the dissenter is entitled to is the equivalent of what he would receive on liquidation.”<sup>139</sup>

The Supreme Court, in affirming *Carpenter*, factored in the right to receive breach damages, and found that constitutional rights had not been abridged:

The petitioners have no constitutional right to a particular form of remedy. They are not entitled, as against their fellows who prefer to come under the plan and accept its benefits, to force, at their own wish or whim, a liquidation which under the findings will not advantage them and may seriously injure those who accept the benefit of the plan. They are not bound, as were the dissenting creditors in *Doty v. Love . . .*, to accept the obligation of the new company but are afforded an alternative whereby they will receive damages for breach of their contracts. They have failed to show that the plan takes their property without due process.<sup>140</sup>

It is important to note that in *Doty*, the bank under consideration had been in liquidation proceedings for two years. Justice Cardozo, in writing for the court, makes it clear that the creditors were better off in rehabilitation, than they would have been had the bank been liquidated.<sup>141</sup>

In the case of *Ambac*, the Commissioner expressly rejected the best interests of creditors test, concluding that “nothing in *Carpenter* suggests that it is a necessary component of all rehabilitation plans; indeed, by providing an alternative justification for the plan’s differing treatment of a certain subset of policyholders, it suggests the opposite.”<sup>142</sup>

In *Ambac*, the application of the best interests of creditors test is complex. The CDS holders were paid out right away. If they are found to be junior to other creditors, then the RMBS holders received a poor deal. If the CDS holders are found to be equal to the other creditors, then the RMBS and municipal holders could argue that the CDS holders received much better treatment since they received money right away, while the other two groups had to take the risks of a long payout and possibly huge claims. If

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138. *Id.* at 778.

139. *Id.*

140. *See* *Neblett v. Carpenter*, 305 U.S. 297, 305 (1938) (footnote omitted) (citing *Doty v. Love*, 295 U.S. 64 (1935)).

141. *See Doty*, 295 U.S. at 70–74.

142. Rehabilitator’s Brief in Support of Motion for Confirmation of the Plan of Rehabilitation at 14 n.3, *In re The Rehab. of Segregated Account Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Oct. 21, 2010) (citing *Carpenter*, 74 P.2d at 778–79).

claims on both of these groups turn out to be modest and all claimants are paid in full, then no complaint could be had, but it will be a long ride until we know the truth. If, on the other hand, creditors are not paid in full, it is entirely possible that the RMBS holders will receive less than the CDS counterparties did and will receive it much further into the future. If the surplus notes turn out to be worthless, the RMBS holders will have received 25 percent of their claims when they come due, while the CDS counterparties received a third or more of their claims at the start of the case.

Unlike the parties in *Carpenter*, none of the creditors here were offered a liquidation value alternative.<sup>143</sup> Unlike *Doty*, Ambac has not yet been involved in a liquidation proceeding.<sup>144</sup> While, like *National Surety*, Ambac placed assets in defined pools, granting creditors recourse to those defined pools, Ambac lacks the judicial findings that are emphasized by Justice Cardozo in *Doty*.<sup>145</sup> Cardozo emphasized, “The judicial power has not been delegated to nonjudicial agencies or to persons or factions interested in the event.”<sup>146</sup> The safeguard of the best interests of creditors test is absent from the Ambac proceedings.

### C. TRANSFERRING LIABILITIES

Transferring the policy liabilities of an insurance company to another entity is not a widely accepted practice in the United States, but it is in the United Kingdom under Part VII of the U.K. Financial Services and Markets Act 2000 (Part VII).<sup>147</sup>

Part VII provides “for the transfer to the transferee of the whole or any part of the undertaking concerned and of any property or liabilities of the authorised person concerned.”<sup>148</sup> Insurance business transfers are permitted under section 105.<sup>149</sup> In connection with a Part VII transfer, the liabilities of the transferor are transferred to a transferee, and the transferor is released from any further liability.<sup>150</sup> Thus, if the transferee subsequently fails, the creditors have no recourse to their original contractual obligor.<sup>151</sup>

Part VII provides for judicial review and approval of the proposed transfer after an administrative review by the U.K. market regulator, the Financial Services Authority (FSA).<sup>152</sup> The FSA engages an actuarial

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143. See *Neblett*, 305 U.S. at 305.

144. See *Doty*, 295 U.S. at 65.

145. *Id.* at 71; see generally May 27th Order, *supra* note 86.

146. *Doty*, 295 U.S. at 71.

147. Financial Services and Markets Act, 2000, c. 8, § 107 (U.K.).

148. *Id.* § 112(1)(a).

149. *Id.* § 105.

150. *Id.* § 112.

151. *Id.*

152. See *id.* § 109(3). The FSA is in the process of being abolished and replaced with prudential and consumer protection regulators, but this change has not yet taken effect. *Radical Plans to*

expert, paid by the transferor, who reviews the proposed transaction to determine whether the transferee will have the financial ability to pay the liabilities transferred.<sup>153</sup> If the report is positive and the FSA is otherwise satisfied with the proposed transfer, the transferor commences legal proceedings for sanctioning under Part VII.<sup>154</sup> Creditors whose claims are being transferred are entitled to receive notice of the proceeding. Unlike their distant cousin, schemes of arrangement, creditors are not entitled to vote, and their basis for objection is extremely limited. In addition, it appears that in practice, creditors have little or no right to receive information concerning the details behind an expert's analysis.<sup>155</sup>

A Part VII transfer differs meaningfully from U.S. law, in that U.S. law does not permit a corporation to channel liabilities to particular assets in the absence of insolvency proceedings.<sup>156</sup> While a corporation could theoretically accomplish a similar result by rearranging its assets through dividends, an insurance company is unlikely to be able to do so as a practical matter, due to dividend restrictions and capital requirements. Moreover, in a Part VII transfer, there may be no continuity between the transferor and the transferee as to management or financial strength.<sup>157</sup> While this result may be theoretically possible in a merger, the degree of separation effectuated by a Part VII transfer would be difficult to replicate.<sup>158</sup>

Opponents of a Part VII transfer will argue that the transfer effectuates a novation of a contract without the consent of the creditor. Novations without the consent of the parties are barred in most of the United States.

Under the common law of contracts, an obligor may generally delegate performance of his contractual duty to another. However, neither the fact that the obligor delegates performance of a contract, nor that fact that a person contracts with the obligor to assume the duty, will discharge any duty or liability of the original obligor, unless the obligee agrees otherwise.<sup>159</sup>

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*Replace the FSA Have Fallen Behind Schedule*, THE GUARDIAN (Feb. 2, 2011), <http://www.guardian.co.uk/business/2011/feb/02/fsa-replacement-watchdogs-delayed/print>.

153. Financial Services and Markets Act § 109.

154. *Id.* § 111–12.

155. See *In re Norwich Union Linked Life Assurance Ltd.*, [2004] EWHC (Ch) 2802 [20] (Eng.).

156. 11 U.S.C. § 524(g) (2006); *In re Johns-Manville Corp.*, 340 B.R. 49, 62–65 (Bankr. S.D.N.Y. 2006); see also *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988); *In re Congoleum Corp.*, 362 B.R. 167, 179–82 (Bankr. D.N.J. 2007).

157. See, e.g., *In re Norwich Union Linked Life Assurance Ltd.*, [2004] EWHC (Ch) 2802 [14–15] (Eng.).

158. See, e.g., *Sompo Japan Ins. Inc. v. Transfercom Ltd.*, [2007] EWHC (Ch) 146, [27] (Eng.) (confirming the Part VII scheme).

159. *Sec. Benefit Life Ins. Co. v. FDIC*, 804 F. Supp. 217, 225 (D. Kan. 1992) (citing RESTATEMENT (SECOND) OF CONTRACTS § 318(1)–(3) (1979)); see also *id.* (citing RESTATEMENT (SECOND) OF CONTRACTS § 280 cmt. d (1979) (“For a novation to take place, the

As described below, novations without consent are contrary to the well-settled law in many states, including the three largest, California, New York, and Texas.<sup>160</sup>

California law does not permit a novation without the consent of the creditor.

What appellant is really contending for is a novation. The Civil Code, section 1530, defines this as the ‘substitution of a new obligation for an existing one.’ An essential element of a novation is the agreement of all of the parties to the new contract.<sup>161</sup>

In California, this restriction on novation is codified by statute. The California Code states in pertinent part, “[t]he burden of an obligation may be transferred with the consent of the party entitled to its benefit, but not otherwise, except as provided by section 1466,” which governs real estate covenants.<sup>162</sup> Although there is a special provision for an insurer withdrawing entirely from California to transfer policies to another insurer, this section “is silent regarding the extent of any continuing liability on the part of the withdrawing insurer.”<sup>163</sup> A California appellate court ruled, “It simply is not within the power of an insurer, against the consent of the insured, to substitute another insurer in carrying out of its undertaking.”<sup>164</sup>

New York has a long tradition holding a party to its contractual duty unless the creditor consents to a novation transaction.

If the defendant chose to perform its contract through an independent contractor, it may have been within its rights. Nevertheless it could not thereby escape liability for its nonperformance through the negligence of one to whom the contract duty was assigned.<sup>165</sup>

Similarly, in Texas, novation is strictly consensual. As a Texas appellate court explained,

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obligee must assent to the discharge of the obligor’s duty in consideration for the promise of the third party to undertake that duty.”); *Henrietta D. v. Bloomberg*, 331 F.3d 261, 286 (2d Cir. 2003) (“Thus, once a party has made a promise, it is responsible to the obligee to ensure that performance will be satisfactory, even if the promising party obtains some third party to carry out its promise.”).

160. See *infra* text accompanying notes 161–66.

161. *Duncanson-Harrelson Co. v. Travelers Indem. Co.*, 25 Cal. Rptr. 718, 723 (Dist. Ct. App. 1962) (quoting 36 CAL. JUR. 2d 427, Novation § 3.).

162. CAL. CIV. CODE §§ 1457, 1466 (West 2011).

163. *Baer v. Associated Life Ins. Co.*, 248 Cal. Rptr. 236, 239 (App. Dep’t Super. Ct. 1988); see also CAL. INS. CODE § 1071.5 (West 2000).

164. *Baer*, 248 Cal. Rptr. at 239 (citing *Am. Nat’l Ins. Co. v. Briggs*, 70 S.W.2d 491, 494 (Tex. Civ. App. 1934)).

165. *Davidson v. Madison Corp.*, 177 N.E. 393, 394 (N.Y. 1931); see also N.Y. Dep’t of Ins., Gen. Counsel, Op. No. 08-07-15 (2008) (“New York common law requires an insured’s consent to effectuate a transfer of his insurance contract to another insurer that is assuming all the rights, responsibilities and functions of the original underwriting insurer.”).

To constitute novation of an original contract, an agreement made thereunder must have fully extinguished the same . . . .

The essential elements of a novation are: (1) a previous, valid obligation, (2) an agreement of the parties to a new contract, (3) the extinguishment of the old contract and, (4) the validity of the new contract.<sup>166</sup>

This is also the law in other states.<sup>167</sup>

Proponents of a Part VII transfer could potentially argue in response that assumption reinsurance transactions effectuate novations without creditor consent.<sup>168</sup> An assumption reinsurance transaction transfers policies and their liabilities to a new insurance company.<sup>169</sup> Only seventeen states, however, have statutes that authorize these transactions. Most of those statutes, as well as the NAIC Assumption Reinsurance Model Act, provide that assumption cannot occur unless the policyholder consents or the insurer is in a hazardous financial condition.<sup>170</sup>

Ambac did not pursue an assumption reinsurance transaction. Ambac used the segregated account machinery to put liabilities into another separate structure, the Segregated Account.<sup>171</sup> Although there are no readily

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166. *Siegler v. Telco Leasing, Inc.*, 593 S.W.2d 850, 851–52 (Tex. Civ. App. 1980).

167. *See, e.g., Pagounis v. Pendleton*, 753 N.E.2d 808, 811 (Mass. App. Ct. 2001) (“Without the agreement of the parties to an extinguishment of the prior contract and to a substitution of the new contract, there can be no novation.”).

168. *See, e.g., N.C. GEN. STAT. § 58-10-45* (2010) (providing that the regulator may approve a transfer by assumption reinsurance if the insurer is in hazardous condition notwithstanding any requirement of policyholder consent and describing that the regulator may find that there is “implied” consent to the transfer).

169. *See, e.g., GA. CODE ANN. § 33-52-2* (West 2011) (defining an “assumption reinsurance agreement” as a contract which, “(A) Transfers insurance obligations or risks of existing or in-force contracts of insurance from a transferring insurer to an assuming insurer; and (B) Is intended to effect a novation of the transferred contract of insurance with the result that the assuming insurer becomes directly liable to the policyholders of the transferring insurer and the transferring insurer’s insurance obligations or risks under such contracts are extinguished”).

170. Ten states have adopted the Model Act. *See GA. CODE ANN. § 33-52-4* (West 2011); *COLO. CODE REGS. § 3-3-1* (1994); *MO. REV. STAT. §§ 375.1290, 375.1294*; *N.C. GEN. STAT. §§ 58-10-35, 58-10-45*. Another seven have adopted their own versions, including Arizona, Pennsylvania, Washington, Arkansas, and West Virginia. Arizona prohibits assumption of policies “unless the affected contract holder or policyholder consents to or fails to reject the transfer or assignment . . . or unless the director approves the transfer or assignment pursuant to this section.” *ARIZ. REV. STAT. § 20-736* (2011) (West). The Pennsylvania regulation makes no mention of property-casualty insurance and provides no procedure to obtain approval for a transaction. *31 PA. CODE §§ 90i.1–90i.3* (2011). The Washington regulation requires the affirmative consent of each policyholder. *WASH. ADMIN. CODE § 284-95-030(2)* (2011). Arkansas provides for policyholder notice, but not consent. *54 ARK. CODE R. § 55* (LexisNexis 2011). West Virginia provides for advance filing and approval, which can be waived by the Commissioner for companies in hazardous financial conditions. *W. VA. CODE § 33-4-15(e)* (2010). Alaska and Iowa have adopted statutes limiting assumption reinsurance with non-admitted insurers to those with regulatory approval, but have not adopted other provisions. *AK. STAT. § 21.12.025* (2005); *IOWA CODE. § 515-68A* (2009).

171. *See generally* Rehab. Petition, *supra* note 67.

identifiable transactions that affect a transfer of an active book of business into an envelope that is unlikely to have the resources to pay those liabilities, the use of a separation in Ambac looks very much like a Part VII transfer.<sup>172</sup> The primary difference is that the Segregated Account has access to most of the capital of the General Account through the Secured Note and the Excess of Loss Reinsurance Agreement.<sup>173</sup> After the General Account falls to \$100 million in surplus, the Segregated Account creditors may no longer look to the General Account for payment.<sup>174</sup>

#### D. THE MCCARRAN-FERGUSON DILEMMA

McCarran-Ferguson<sup>175</sup> has faced its greatest test to date in the dispute between the IRS and the Ambac Rehabilitator. This dispute centers on Ambac Financial's change in its accounting method for CDSs. Prior to 2005, Ambac Financial filed consolidated returns on behalf of itself and the members of its corporate group including Ambac Assurance, recognizing any gain or loss at the time a credit derivative position was closed out.<sup>176</sup> In early 2008, Ambac changed its accounting method to one that recognizes gain or loss on a mark-to-market basis.<sup>177</sup> Ambac claimed that this accounting change was related to its change in the form it used for credit derivative transactions from a physical settlement form to a cash settlement form in 2005. In 2005 and 2006, however, Ambac filed its returns without recognizing any gain or loss on the post-2005 contracts unless the trades had been closed out.<sup>178</sup>

When Ambac adopted a mark-to-market approach, it recognized a small loss in 2008 for the year ending December 31, 2007 and a huge loss in 2009 for 2008, resulting in over \$700 million of tax refunds.<sup>179</sup> According to the IRS, it had no choice but to give Ambac the refund and analyze it later.<sup>180</sup> Ambac placed its Segregated Account into rehabilitation proceedings on

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172. See *supra* text accompanying notes 148–55.

173. See Rehab. Petition, *supra* note 67, Tab 1 at 3–4.

174. See *id.* Tab 1 at 3.

175. 15 U.S.C. §§ 1011–1015 (2006).

176. See Complaint for Injunctive Relief and Declaratory Judgment Determining Amount of Tax Liability at 6–7, *Ambac Fin. Grp., Inc. v. United States (In re Ambac Fin. Grp., Inc.)*, Adv. No. 10-04210 (Bankr. S.D.N.Y. Nov. 9, 2010) [hereinafter *Ambac IRS Bankruptcy Complaint*].

177. *Id.* at 9–10.

178. *Id.* at 8–9.

179. *Id.* at 11; see also Affidavit of David W. Wallis in Support of Debtor's Chapter 11 Petition and First Day Motions and Pursuant to Local Rule 1007-2 at 8, *In re Ambac Fin. Grp., Inc.*, No. 10-15973 (Bankr. S.D.N.Y. Nov. 8, 2010).

180. Memorandum in Support of Motion to Dissolve Order for Temporary Supplemental Injunctive Relief and Objections to Notice, Motion and Order at 6 n.19, *Dilweg v. United States*, No. 10-CV-778 (W.D. Wis. Dec. 17, 2010) [hereinafter *IRS Inj. Brief*] (citing *Coca-Cola v. United States*, 87 Fed. Cl. 253, 256–57 (Fed. 2009), to support the proposition that pursuant to 26 U.S.C. § 6213(b)(3) (2006) & Treas. Reg. § 301.6213-1(b)(2), the IRS has the authority to grant a “tentative refund”).



March 24, 2010, less than two months after receiving its last refund of approximately \$444 million.<sup>181</sup>

When the IRS came calling on October 28, 2010, they asked if Ambac had received permission from the IRS to change its accounting methods.<sup>182</sup> Ambac Financial responded on November 8, 2010 by filing for bankruptcy protection under Chapter 11 of the Bankruptcy Code.<sup>183</sup> The IRS responded that members of a group filing a consolidated return are jointly and severally liable for tax liabilities, pursuant to 26 C.F.R. §§ 1.1502-6, 1.1502-78.<sup>184</sup> This exposed the General Account to the liability to repay the disputed refund.

The day before Ambac Financial's bankruptcy petition was filed, however, the Wisconsin Commissioner in his role as Rehabilitator of Ambac's Segregated Account, amended the Segregated Account's Operating Plan to channel the IRS's claims to the Segregated Account, which was in rehabilitation and subject to a judicial stay.<sup>185</sup> The Commissioner also persuaded the Rehabilitation Court, *ex parte*, to enter an injunction barring the IRS from collecting against either the General Account or Segregated Account of Ambac Assurance.<sup>186</sup> This remarkable series of events left the refund dispute subject to the rehabilitation injunction and the IRS with no way to reclaim the refund, even if the IRS is successful in demonstrating that Ambac Financial was not entitled to the refund.<sup>187</sup>

The IRS responded by filing a notice of removal to send its portion of the rehabilitation case to the Federal District Court for the Western District of Wisconsin.<sup>188</sup> Once in federal court the Commissioner petitioned the court to remand the proceeding to state court, and the IRS filed a motion to dissolve the state court injunction.<sup>189</sup>

In his motion to remand the proceeding to state court, the Commissioner argued that the federal court had no jurisdiction to hear the

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181. Ambac IRS Bankruptcy Complaint, *supra* note 176, at 11.

182. *Id.* at 12.

183. IRS Inj. Brief, *supra* note 180, at 6-7.

184. *Id.*

185. Notice of Amendment to Plan, *supra* note 100.

186. Motion for Temporary Supplemental Injunctive Relief and Order for Temporary Supplemental Injunctive Relief at 9-11, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Nov. 8, 2010) [hereinafter Temporary Supplemental Injunction].

187. Without the ability to challenge the injunction, the IRS cannot collect from the General Account. The IRS cannot collect from the Segregated Account while it is in receivership. *See* United States Reply in Support of its Motion to Dissolve Injunction at 9, *Dilweg v. United States*, No. 10-CV-778 (W.D. Wis. Jan 1, 2011). The IRS cannot collect from the bankrupt holding company while it is in proceedings. *See* 11 U.S.C. § 362 (2006).

188. Notice of Removal to the United States District Court for the Western District of Wisconsin, *Dilweg*, No 10-CV-778 (W.D. Wis. Dec. 8, 2010).

189. *See generally* IRS Inj. Brief, *supra* note 180.

dispute.<sup>190</sup> He maintained that the removal to federal court was precluded by McCarran-Ferguson.<sup>191</sup>

(a) State regulation – The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) Federal regulation – 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, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance[.]<sup>192</sup>

The Commissioner insisted that chapter 645 of the Wisconsin statutes gives the Rehabilitation Court exclusive jurisdiction over proceedings and that it can enforce remedies that protect those proceedings.<sup>193</sup> He further argued that a grant of jurisdiction to the federal court would “impair and supersede” the proceeding under chapter 645,<sup>194</sup> which regulates the business of insurance.<sup>195</sup> Furthermore, the segregated account statute allowed him to assign the IRS’s claims to the Segregated Account.<sup>196</sup> The Commissioner claimed that the federal jurisdiction statutes do not specifically relate to the business of insurance,<sup>197</sup> and that the IRS’s rights could be preserved in state court.<sup>198</sup>

In addition, the Commissioner encouraged the federal court to abstain from exercising its jurisdiction because any federal action would interfere with a state regulatory scheme.<sup>199</sup> The Commissioner correctly referred to many cases in which federal courts have refused to exercise jurisdiction over the matter.<sup>200</sup>

The IRS responded with the following arguments. First, McCarran-Ferguson does not apply to the federal government’s powers to tax. It maintained that the U.S. Constitution’s Taxation Clause, prevents the states from restraining that power.<sup>201</sup> Second, the IRS argued that the Anti-Injunction Act, 26 U.S.C. § 7421(a), prevents state courts from issuing

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190. Brief in Support of Motion to Remand by the Wisconsin Commissioner of Insurance, as Court-Appointed Rehabilitator of the Segregated Account of Ambac Assurance Corporation at 26–27, *Dilweg*, No. 10-CV-778 (W.D. Wis. Dec. 17, 2010) [hereinafter OCI Remand Brief].

191. *Id.* at 29–33.

192. *Id.* at 26–27 (quoting 15 U.S.C. § 1012 (2006)).

193. *Id.* at 26–29.

194. *Id.* at 30–31.

195. *Id.* at 29–30.

196. *Id.* at 28 n.12.

197. *Id.* at 29.

198. *Id.* at 35.

199. *See id.* at 36–41.

200. *Id.* at 37.

201. IRS Remand Brief, *supra* note 102, at 2–3 (citing U.S. Const. art.1, § 8 cl. 1).

injunctions that interfere with federal taxation.<sup>202</sup> Third, Ambac took advantage of the ability to file a consolidated return and must therefore abide by the rules regarding returns.<sup>203</sup> Fourth, the IRS's ability to recapture tentative refunds is an important part of the taxing power.<sup>204</sup> The IRS insisted that McCarran-Ferguson could not abridge the taxing power because the Act was enacted under Congress' Commerce Clause powers, not its taxing powers,<sup>205</sup> an argument developed in a law journal article.<sup>206</sup> Fifth, as a question of federal power, the IRS claimed it had the right to remove the action to federal court.<sup>207</sup> They argued that nothing should restrict a federal government agency from having a question of its powers reviewed by a federal court.<sup>208</sup> Sixth, the IRS maintained that the state court does not have jurisdiction over parts of Ambac other than the Segregated Account,<sup>209</sup> and therefore, could not have jurisdiction over the IRS's tax claims against the General Account. Seventh, the IRS argued against a *Burford* abstention,<sup>210</sup> claiming that federal courts should decide questions of the government's constitutional prerogatives.<sup>211</sup> Eighth, they disputed the Rehabilitation Court's exclusive jurisdiction, maintaining that rehabilitation can continue in federal court, pursuant to Wisconsin Statute section 645.45 and Wisconsin Statute section 645.82(4).<sup>212</sup> The IRS encouraged the federal court to look beyond the company's status as an insurance company and acknowledge that the fundamental nature of the action related to the power to tax, as the IRS believed.<sup>213</sup>

The Commissioner replied that the IRS had "misunderst[ood] Wisconsin law and the relationship between the [General and] Segregated Accounts."<sup>214</sup> The Commissioner claimed that the IRS just wanted to seize \$700 million "in violation" of McCarran-Ferguson;<sup>215</sup> and that there was a

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202. *Id.* at 3–4.

203. *Id.* at 4.

204. *Id.* at 6.

205. *Id.* at 7.

206. Raymond A. Guenter, Rediscovering the McCarran-Ferguson Act's Commerce Clause Limitation, 6 CONN. INS. L.J. 253, 316–17 (2000).

207. IRS Remand Brief, *supra* note 102, at 9–10.

208. *Id.* at 12–15.

209. *Id.* at 15–17.

210. *Quackenbush v. Allstate Ins. Co.*, 517 U.S. 706, 726–27 (1996) (citing *Colo. River Water Conservation Dist. v. U.S.*, 424 U.S. 800, 814 (1976)). *Burford* allows a federal court to dismiss a case only if it presents "difficult questions of state law bearing on policy problems of substantial public import whose importance transcends the result in the case then at bar," or if its adjudication in a federal forum "would be disruptive of state efforts to establish a coherent policy with respect to a matter of substantial public concern." *Id.*

211. IRS Remand Brief, *supra* note 102, at 20–23.

212. *Id.* at 23 n.15.

213. *Id.* at 10–12.

214. Reply Brief in Support of Motion to Remand by the Wisconsin Commissioner of Insurance at 1, *Dilweg v. United States*, No. 10-CV-778 (W.D. Wis. Jan. 1, 2011) [hereinafter OCI Remand Reply].

215. *Id.* at 6.

“legal nexus” between the General and Segregated Account because they were one entity prior to the rehabilitation petition, and because the General Account provides the funding for the Segregated Account.<sup>216</sup> The Commissioner maintained that no constitutional issue was present; and that the dispute was a conflict between a federal law passed by Congress and a Wisconsin state law.<sup>217</sup> The Commissioner reasoned that since the language of McCarran-Ferguson begins with, “*No Act of Congress shall be construed,*” and tax legislation is enacted by Congress, the tax collection legislation must yield to state law.<sup>218</sup>

The IRS also petitioned the federal court to dissolve the state court injunction that prevented it from collecting from the General Account.<sup>219</sup> The IRS claimed that the General Account exists outside the insurance regulatory framework and McCarran-Ferguson. First, it claimed that the Internal Revenue Code (IRC) specifically relates to the business of insurance because the IRC imposes tax on insurance companies.<sup>220</sup> It posited that when Congress legislates in the area of insurance, the McCarran-Ferguson preemption is eviscerated.<sup>221</sup> The IRS also argued that the revised injunction was a violation of the Anti-Injunction Act, 26 U.S.C. § 7421.<sup>222</sup> The IRS contended that the Anti-Injunction Act prohibits any court from taking subject matter jurisdiction to enter an order restraining the IRS from collecting taxes. It claimed that the IRC establishes “exclusive federal jurisdiction.”<sup>223</sup> The IRS also questioned the use of the Wisconsin segregated account statute to justify the allocation of tax liability as a part of the insurance company’s “business.”<sup>224</sup>

The Commissioner’s response to the IRS’s motion stayed close to his McCarran-Ferguson arguments, saying that “this is not a tax case; it is an insurance case.”<sup>225</sup> The Commissioner claimed that the IRS was trying to subvert the *Fabe* holding, which prioritizes policyholder’s claims over the federal government’s claims.<sup>226</sup> He argued that the Wisconsin priority statute<sup>227</sup> regulates the business of insurance along with the rest of chapter

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216. *See id.* at 3, 5.

217. *Id.* at 25–29.

218. *Id.*

219. IRS Inj. Brief, *supra* note 180, at 1–2.

220. *See, e.g.*, 26 U.S.C. §§ 801, 831, 6201 (2006); *Hanover Ins. Co. v. C.I.R.*, 598 F.2d 1211, 1218 (1st Cir. 1979); IRS Inj. Brief, *supra* note 180, at 12, 17.

221. *See* 15 U.S.C. § 1012(b) (2000).

222. IRS Inj. Brief, *supra* note 180, at 8.

223. *Id.* at 11.

224. *Id.* at 19.

225. Brief of Wisconsin Commissioner of Insurance in Opposition to United States Internal Revenue Service’s Motion to Dissolve Order for Temporary Injunctive Relief at 1, *Dilweg v. United States*, No. 10-CV-778 (W.D. Wis. Dec. 30. 2010) [hereinafter OCI Inj. Brief].

226. *Id.* at 2.

227. WIS. STAT. § 645.68 (2009–2010).

645. The Commissioner distinguished the statutes taxing insurance<sup>228</sup> from the tax collection statutes,<sup>229</sup> arguing that the latter are not specifically targeted at insurance.<sup>230</sup> The Commissioner challenged the IRS's assertion that the Wisconsin injunction statute does not regulate the business of insurance by pointing out that it is part of chapter 645 and specifically references insurance liquidation proceedings.<sup>231</sup> He alleged the third prong of the McCarran-Ferguson analysis by saying that the IRS attempts to take \$700 million in "claims-paying resources" would impair the rehabilitation proceeding.<sup>232</sup> He also claimed that the Anti-Injunction Act is reverse preempted by McCarran-Ferguson because it does not specifically relate to insurance.<sup>233</sup>

When Federal District Court Judge Crabb for the Western District of Wisconsin rendered her decision, she declined to address the injunction motions, deciding only that McCarran-Ferguson divested the court of jurisdiction.<sup>234</sup> The judge agreed with the Commissioner that the powers to tax "belong to the Congress; the IRS derives its authority from Congress."<sup>235</sup> The court found that the Commissioner was not challenging the power to tax, but only that McCarran-Ferguson requires the United States to conform to state laws.<sup>236</sup> Judge Crabb found that chapter 645 regulates the business of insurance, and that the application of the removal statute would disrupt chapter 645's "comprehensive rehabilitation structure" and, therefore, "invalidate[], impair[], or supersede[]" Wisconsin law.<sup>237</sup> As a result, federal tax laws are not exempt from McCarran-Ferguson. She adopted the Commissioner's argument that the rehabilitation proceeding extends to the General Account to the extent it is a lender or insurer of the Segregated Account. She stated that the Segregated Account is not a separate corporation, concluding that "the whole point of the rehabilitation is to rehabilitate Ambac Assurance Corporation."<sup>238</sup> In addition, she elected to abstain under *Burford* because "Wisconsin has a great interest in maintaining a uniform insurance rehabilitation process that provides strong protection to policyholders."<sup>239</sup> Judge Crabb added that "[f]ederal court review of the United States' claims would be disruptive of

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228. See, e.g., 26 U.S.C. § 801 (2006).

229. See, e.g., *id.* § 6331.

230. OCI Inj. Brief, *supra* note 225, at 10.

231. OCI Remand Brief, *supra* note 190, at 29.

232. OCI Inj. Brief, *supra* note 225, at 15.

233. *Id.* at 19.

234. Jan. 14 Order, *supra* note 105, at 2.

235. *Id.* at 9.

236. *Id.* at 11.

237. *Id.* at 12 (alteration in original) (citing *Hudson v. Supreme Enters., Inc.*, No. 2:06-cv-795, 2007 WL 2323380, at \*7 (S.D. Ohio Aug. 9, 2007)).

238. *Id.* at 13.

239. *Id.* at 17 (citing *Prop. & Cas. Ins. Ltd. v. Cent. Nat'l Ins. Co. of Omaha*, 936 F.2d 319, 323 (7th Cir. 1991)).

the state's rehabilitation goals and procedures."<sup>240</sup> She concluded that the injunction is like a bankruptcy stay for insurance companies and that the state rehabilitation court is "uniquely qualified to hear these claims."<sup>241</sup>

Once the remand order was submitted, the Rehabilitation Court wasted no time in confirming the Plan.<sup>242</sup> The IRS attempted to appeal the remand order to the U.S. Court of Appeals for the Seventh Circuit, but the Seventh Circuit was quick to point out that its own rules prohibit the appeal of a remand for lack of subject matter jurisdiction, saying:<sup>243</sup>

This court has consistently reminded litigants that an order remanding a case to state court based on a lack of subject matter jurisdiction or a defect in the removal procedure is not reviewable on appeal, whether or not the decision is correct.<sup>244</sup>

The IRS filed a jurisdictional memorandum, claiming that this case "implicates significant issues of federal statutory interpretation, federalism, and the sovereign prerogatives of the United States."<sup>245</sup> The IRS maintained that the remand was beyond the district court's authority because of the unique federal issues.<sup>246</sup> The Commissioner argued that this was nonsense; this appeal is a review of a federal court finding that it had no subject matter jurisdiction.<sup>247</sup>

The IRS was not content to sit still with the remand ruling and sued in federal court to enjoin the state court from enforcing the November 8, 2010 injunction, to enjoin the enforcement of the confirmation of the Plan, and to void the November 8, 2010 injunction in so far as it affects the IRS.<sup>248</sup> The parties made similar arguments to those made in the previous federal court proceeding. Judge Crabb was no more receptive to these arguments than she had been previously. She dismissed the IRS's complaint within ten days of its filing, explaining that even though the posture had changed from a removal to a claim for injunctive relief, "this distinction does not change my earlier conclusions regarding jurisdiction."<sup>249</sup> The IRS has appealed to

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240. *Id.* at 18.

241. *Id.* at 20.

242. See Decision and Final Order Confirming the Rehabilitator's Plan of Rehabilitation, with Findings of Fact and Conclusions of Law at 1, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Jan. 24, 2011).

243. Order, *Nickel v. United States*, No. 11-1158 (7th Cir. Jan. 20, 2011).

244. *Id.* (citing *Rubel v. Pfizer, Inc.*, 361 F.3d 1016 (7th Cir. 2004); *Phoenix Container, L.P. v. Sokoloff*, 235 F.3d 352, 354-55 (7th Cir. 2000); *In re Continental Casualty Co.*, 29 F.3d 292, 293 (7th Cir. 1994)).

245. IRS Jurisdictional Memorandum at 8, *Nickel*, No. 11-1158 (7th Cir. Feb. 1, 2011).

246. *Id.* at 8, 17, 20.

247. Wisconsin Commissioner of Insurance's Response to United States' Jurisdictional Memorandum at 2, *Nickel*, No. 11-1158 (7th Cir. Feb. 1, 2011).

248. Amended Complaint at 1-2, *United States v. Wis. State Cir. Ct. for Dane Cnty.*, 767 F. Supp. 2d 980 (W.D. Wis. 2011) (No. 11-CV-99).

249. *United States v. Wis. State Cir. Ct. for Dane Cnty.*, 767 F. Supp. 2d 980, 981 (W.D. Wis. 2011).

the Seventh Circuit—this time hoping that it will not run aground on the Seventh Circuit’s rules concerning appeals of remand orders. As of this writing, briefing on the appeals in the Seventh Circuit is largely completed, but no decision has been reached. .

The IRS returned to the state court, where it filed an appeal of the confirmation of the Plan to the Wisconsin Court of Appeals.<sup>250</sup> Unfortunately for the IRS, the attorney who signed the notice of appeal was not admitted in Wisconsin, and the Commissioner moved to dismiss its appeal.<sup>251</sup> The Wisconsin Court of Appeals granted the Commissioner’s motion and dismissed the IRS’s appeal on May 3, 2011.<sup>252</sup> The IRS has petitioned the Wisconsin Supreme Court for review.<sup>253</sup>

If the Seventh Circuit turns the IRS away, this will have been a great victory for McCarran-Ferguson. Ambac was able to draw an enormous refund from the federal government on only its say-so. The federal government, having provided the refund, must wait in line to get it back after policyholders have been paid, with considerable doubt as to whether the government will be paid at all. In the process, the Commissioner will have successfully argued that the Rehabilitation Court had enough jurisdiction over the General Account to stop the IRS, but not enough jurisdiction over the General Account to stop the settlement with the CDS Banks.<sup>254</sup> The rehabilitator and Ambac Financial, along with various other parties, have reached a settlement resulting in a new Plan of Reorganization for Ambac Financial.<sup>255</sup> This settlement involves, among other things, the payment by Ambac Assurance to Ambac Financial for the use of net operating losses.<sup>256</sup> Nevertheless, if the parties cannot settle with the IRS,

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250. Notice of Appeal at 1, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Mar. 8, 2011).

251. Wisconsin Commissioner of Insurance’s Motion to Dismiss United States Appeal at 1, 10, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, App. No. 2011AP561 (Wis. App. Mar. 25, 2011).

252. Opinion and Order at 5, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, App. No. 2011AP987 (Wis. App. May 3, 2011).

253. Petition for Review at 1, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, App. No. 2011AP987 (Wis. Jun. 1, 2011).

254. Compare OCI Remand Brief, *supra* note 190, at 13 (arguing that the Rehabilitation Court had jurisdiction to enjoin claims on the General Account), with Ambac Assurance Corporation’s Brief in Opposition to (i) Certain RMBS Investors’ Motion Seeking Expedited Relief and to Modify Order for Temporary Injunctive Relief; and (ii) LVM Bondholders’ Emergency Motion to Enjoin Consummation of the Proposed Settlement Between Ambac and Certain CDS Counterparties at 22, *In re The Rehab. of Segregated Account of Ambac Assurance Corp.*, No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. May 20, 2010) (arguing that the Rehabilitation Court had no jurisdiction over the General Account).

255. See Debtor’s Motion for an Order Further Extending Its Exclusive Period for Soliciting Votes to Accept or Reject a Chapter 11 Plan at 3, *In re Ambac Fin. Grp., Inc.*, No. 10-15973 (Bankr. S.D.N.Y. Jan. 4, 2012) [hereinafter Debtor’s Motion].

256. See First Amended Disclosure Statement of Ambac Financial Group, Inc. at 41–54, *In re Ambac Fin. Grp., Inc.*, No. 10-15973 (Bankr. S.D.N.Y. Sept. 21, 2011).

nothing will be accomplished.<sup>257</sup> While Ambac Financial has made a proposal to the Department of Justice to settle its disputes with the IRS, at the time of this writing, no settlement had been reached.<sup>258</sup> The proposed settlement includes, among other things, a payment by Ambac Assurance to the IRS of \$100 million.<sup>259</sup>

This drama is by no means over. The Commissioner is now grappling with two new threats. First, Ambac Financial, in its public filings, has raised the specter that the issuance of the surplus notes by the Segregated Account might cause the deconsolidation for tax purposes of the various Ambac entities, or, second, the surplus notes may be deemed equity, causing a change of control, which might severely restrict the use of Ambac's net operating losses.<sup>260</sup> This leads to the sobering realization that the "rehabilitator is considering substantial amendments to the rehabilitation plan and/or the initiation of rehabilitation proceedings with respect to Ambac Assurance."<sup>261</sup> It appears that the IRS may have found another way to fight back.

Meanwhile, Ambac Financial has asked the bankruptcy court to adjudicate the merits of the disputed refund.<sup>262</sup> The complaint was sent to mediation, and there has been no result reached as of yet. Ambac Financial has also filed a plan of reorganization with the bankruptcy court.<sup>263</sup> This plan threatens the Commissioner with the deconsolidation of the holding company with the insurance subsidiaries if the holding company cannot reach a settlement with the Commissioner.<sup>264</sup> This would be accomplished by converting the Chapter 11 proceeding to a Chapter 7 liquidation, or by causing a change of control of Ambac Assurance by transferring its stock to different entities.<sup>265</sup> The Commissioner responded that "[t]he [Ambac Financial] plan proposes to employ litigation to try to divert value from the Segregated Account. The Rehabilitator will vigorously contest that litigation."<sup>266</sup>

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257. Debtor's Motion, *supra* note 255, at 3.

258. *Id.* at 4 n.1 ("[T]here can be no assurance that the IRS Dispute will be settled on the terms described above, if at all, or as to the timing of any such settlement.").

259. *Id.*

260. Ambac Fin. Grp., Inc., Quarterly Report (Form 10-Q) 126-30 (May 10, 2011).

261. *Id.* at 11, 127, 130.

262. See Ambac IRS Bankruptcy Complaint, *supra* note 176, at 30.

263. Plan of Reorganization of Ambac Financial Group, Inc. at 26-27, *In re* Ambac Fin. Grp., Inc., No. 10-15973 (Bankr. S.D.N.Y. July 6, 2011).

264. *Id.*

265. *Id.*

266. Press Release, Rehabilitator Comments on AFGI Proposed Plan of Reorganization (July 7, 2011), available at <http://ambacpolicyholders.com/>. Subsequently, the OCI and Ambac Financial settled their differences in exchange for a payment to the holding company. See Order, *In re* The Rehab. of Segregated Account of Ambac Assurance Corp., No. 10-CV-1576 (Wis. Cir. Ct. Dane Cnty. Nov. 10, 2011).



The Ambac Assurance rehabilitation is testing the McCarran-Ferguson Act as never before since the authority of the bankruptcy court has been posed against the authority of the Rehabilitation Court. The Commissioner has been fighting the IRS and Ambac Financial for control of the rehabilitation process. If these disputes with the IRS and Ambac Financial can be resolved by settlements, prolonged litigation could potentially be avoided; but if the disputes cannot be settled, the Commissioner may put the entirety of Ambac Assurance into liquidation proceedings, permanently subordinating any claims of the holding company or the IRS to claims of policyholders.

### V. WOULD DODD-FRANK MAKE A DIFFERENCE?

The Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>267</sup> (Dodd-Frank) sets up a new Orderly Liquidation Authority.<sup>268</sup> Dodd-Frank allows insurance companies and a group whose largest subsidiary is an insurance company to be designated for the new liquidation regime under § 203(a)(1)(C) of the statute.<sup>269</sup> This regime may affect the non-insurance entities that are part of insurance holding company families resulting in the Federal Deposit Insurance Corporation (FDIC) serving as receiver; however, regulated insurance entities may only be taken into proceedings under state law pursuant to § 203(e).<sup>270</sup> The FDIC has backup authority to take an insurance company into proceedings if a state regulator fails to do so within sixty days, but Dodd-Frank is unclear as to whether the FDIC or the state regulator would be the receiver in such proceedings.<sup>271</sup> It says that the receivership will be “under the laws and requirements of the State,”<sup>272</sup> most of which require the state insurance regulator to be the receiver.<sup>273</sup> Since the bulk of the activity in Ambac took place in regulated insurance companies, there would likely be little difference. It is an interesting question whether the federal government could have used its new powers to force the General Account of Ambac into proceedings, but the Wisconsin Commissioner would likely have full control over it once it got there.

### CONCLUSION

Ambac poses some amazing challenges to the way we have traditionally thought about insurance insolvency in this country. This case is not only massive in size but also deals with a company that wrote highly

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267. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

268. *Id.* §§ 201–217.

269. *Id.* § 203.

270. *Id.* § 203(e).

271. *Id.*

272. *Id.*

273. *See, e.g.*, N.Y. INS. LAW § 7405 (McKinney 2005).

specialized products that are more similar to those written by commercial and investment banks. The Commissioner in Wisconsin used means to tackle these gigantic crises that are different from traditional insurance insolvency procedures. First, these proceedings have challenged the way we think about priority, choosing to place some policyholders ahead of others. Second, they have changed the way we view the rights of creditors to take the value they would have received in liquidation. Third, they have adopted an English-style model, previously unknown in this country, to transfer policy liabilities. Fourth, the Ambac case has supercharged the force behind McCarran-Ferguson's reverse preemption of federal law.

Only time will tell if there will be enough claims-paying resources in the Ambac entities to discharge its policy liabilities. Many of Ambac's exposures extend for decades. Uncertainty reigns in the market for municipal credit, and everyone's crystal ball is especially cloudy on the future of residential real estate values.

The battle for control of Ambac is raging. The world will be watching to see if the parties have made the right choices.