IN THE COMMONWEALTH COURT OF PENNSYLVANIA

Re: Penn Treaty Network America Insurance Company in Rehabilitation	DOCKET NO. 1 PEN 2009
In Re: American Network Insurance Company in Rehabilitation	DOCKET NO. 1 ANI 2009

JOINT MEMORANDUM OF LAW SUBMITTED BY BROADBILL AND PTAC IN FURTHER SUPPORT OF THE VERIFIED JOINT APPLICATION OF THE COMMISSIONER, PENN TREATY AMERICAN CORPORATION, EUGENE WOZNICKI, AND BROADBILL PARTNERS LP FOR APPROVAL OF SETTLEMENT AGREEMENT

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PRELIMINARY STATEMENT[1]

At stake here are not just hundreds of millions of dollars in potential tax claims that PTNA and ANIC cannot afford but also resolution of the most significant hurdle to bringing this case to an orderly conclusion after years of hard-fought litigation—including a trial, appeal, and the start of another trial. Through the Court-supervised settlement, PTNA and ANIC gain access to up to $1 billion in CNOLs as well as tax exclusions available to the consolidated tax group through a private letter ruling, without which these Companies would potentially incur more than $280 million in income tax claims and policyholders would suffer negative tax consequences. Both Special Deputy Rehabilitator Patrick Cantilo and the Rehabilitator's tax advisor Lori Jones testified at length concerning these tax risks facing the Estate and policyholders, even before the parties settled this dispute.

That alone is more than enough evidence to show that the Companies are resolving an enormous potential liability for pennies on the dollar. But the MOU speaks for itself: in consideration for $10 million, PTAC will (i) forbear from taking actions that would eliminate PTNA and ANIC's ability to use a tax shield that belongs to the consolidated tax group; and (ii) participate in seeking a PLR from the IRS that protects both the Estate and policyholders from tax liability. PTAC is essential to seeking a PLR because the IRS has made clear that it will only speak with and take direction from the head of the consolidated tax group—PTAC.

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[1] The "Rehabilitator" refers to Pennsylvania's Insurance Commissioner Teresa Miller in her capacity as statutory and court-appointed rehabilitator of Penn Treaty Network America ("PTNA") and American Network Insurance Company ("ANIC"); "CNOLs" consolidated net operating losses; "WSD" refers to worthless stock deduction; "PLR" refers to private letter ruling; "TSA" refers to the parties' June 6, 2001 Tax Sharing Agreement; "Joint Application" refers to the June 14, 2016 Verified Joint Application of the Commissioner, Penn Treaty America Corporation, Eugene Woznicki, and Broadbill Partners LP for Approval of Settlement Agreement to this Court; "MOU" refers to the June 14, 2016 Memorandum of Understanding and Settlement; and "Estate" refers to the estates of PTNA and ANIC together.

This is not the first time that distressed insurance companies have acquired through a settlement the right to use valuable tax attributes. Courts around the country—including the Commonwealth Court of Pennsylvania in the Reliance Insurance Company liquidation—have approved settlement agreements to allocate tax attributes similar to the one here. Indeed, the Reliance case specifically provided (i) for payments from the insurance estate to the parent for using CNOLs and (ii) that any such payment obligations of the Commissioner as liquidator would be entitled to an administrative priority under 40 P.S. § 221.44(a). These precedents demonstrate not only the value of the CNOLs that the MOU puts at the Companies' disposal, but the reasonableness of the price they are paying and the priority accorded thereto. On top of this, PTAC is facilitating the PLR process that is at the heart of the Commissioner's tax plan.

The Court need not pause long over the objection that the MOU improperly pays equity-holders ahead of other claimants. The Estate is not compensating PTAC for its equity but for the cost of using the valuable tax asset that PTAC controls under the parties' TSA, Internal Revenue Code, and Treasury Regulations and also for PTAC's assistance in submitting the PLR request. This deal is no different from a debtor making lease payments while in rehabilitation, even if the landlord happens also to be a shareholder of the debtor. It is fully consistent with other precedents according an administrative priority in similar circumstances.

Even assuming that the Health Insurers and Agents have standing to object to this settlement, the Health Insurers' alternative (to deconsolidate the Companies from the consolidated tax group by having PTNA issue more shares) is legally impossible because PTNA's bylaws (which cannot be changed without shareholder approval) prohibit issuing more shares without PTAC's express approval. In any event, the Health Insurers are wrong about the Companies' ability to use the CNOLs under their plan, since deconsolidation would consume

much of the available CNOLs and increase the risk that the IRS will deny the PLR request. And under the Health Insurers' theory, nothing would prevent PTAC from preemptively taking a worthless stock deduction, which would preclude using CNOLs that would otherwise be available to the Estate under the settlement—and would be particularly needed if the Rehabilitator could not secure the PLR.[2]

BACKGROUND

PTAC is the head of a consolidated tax group to which PTNA and ANIC belong.

As this Court is aware, PTAC is the head of a consolidated tax group under the parties' June 6, 2001 TSA that governs the disposition and control of nearly $1 billion in CNOLs as of December 31, 2014.[3] The TSA, which was filed with the Pennsylvania Insurance Department, has governed the parties' rights for more than a decade and a half. Under the TSA and binding law, tax attributes are vested in PTAC, which, under the TSA's express terms, has exclusive discretion over their use: "***At PTA[C]'s discretion***, [PTNA and ANIC] may be entitled to calculate and receive credit for any tax benefit or expense arising as a result of inclusion in the controlled group."[4] The tax attributes here include CNOLs.

These tax attributes have economic value to PTAC that is separate and apart from PTAC's equity stake in the Companies. So regardless of the value of PTAC's equity, it would

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2 Broadbill and PTAC join in the separate brief filed by the Commissioner in support of the settlement to the extent not inconsistent with this filing and the positions taken by them in this case. Because the settlement resolves disputes among them, the Commissioner, on the one hand, and Broadbill and PTAC, on the other, do not share the same views on various disputed factual and legal points. That, of course, is the basis of any settlement.

3 *See* Ex. 1 (Tax Sharing Agreement); Ex. 2 (December 23, 2015 Deposition Tr. of Lori J. Jones) ("Jones Tr.") 275:22–276:7 ("Q: What is the amount of net operating loss carryforwards that the group has, as we're sitting here today? A: A I don't know the exact number of the—the loss carryforwards. They could be—there could be net operating losses. There could be operations losses. Those are the losses allocable to the life companies. But my understanding—my understanding is that the losses that are allocable to the life companies are, are about $1 billion.").

4 TSA (emphasis added).

have the right to take a WSD estimated at as much as $450 million of ordinary loss.[5] Under the MOU, PTAC is being compensated for the use of a valuable asset it controls, not for its equity.[6] In similar circumstances, other insurance and financial service holding companies—such as Reliance and Ambac—have structured court-approved settlements around the use of these types of tax attributes.[7]

Without the MOU, PTNA and ANIC risk a massive tax bill.

The CNOLs are valuable not just to PTAC but also to the Companies. Because it is such an important issue, at the Phase I hearing on July 14, 2015, Patrick Cantilo devoted a significant amount of time to discussing the potential adverse tax consequences facing the Companies and the policyholders.[8] Mr. Cantilo testified that for the policyholders, loss of the tax shield would result in the IRS deeming some or all of the value of the policies taxable income.[9] For the Companies, according to Mr. Cantilo, "the problem is much more material."[10] He testified that he was concerned that by avoiding more than $3 billion in obligations, the Estate would realize cancellation of indebtedness income. Assuming a 35% federal tax rate, the Companies would owe more than $1 billion in cancellation of debt income (or "CODI") under the Tax Code.[11] But

5 *See* Ex. 3 (Expert Report of Gregory Fairbanks) ("Fairbanks Report") ¶¶ 37–38.

6 The description of the MOU contained in this document is for summary purposes only. The terms of the MOU speak for themselves.

7 *See* Exs. 4–6 (Reliance Approval Order, AMBAC Mediation Agreement, and AMBAC Amended TSA).

8 *See* Ex. 7 (July 14, 2015 Phase I Hearing Tr.) ("Hearing Tr.") 8:11–38:17.

9 *See id.* 8:20–9:4.

10 *Id.* 9:5–6.

11 *Id.* 9:12–10:4.

as Mr. Cantilo said, the Companies cannot "pay more than $800 million because that's all the assets they have."[12]

To avoid a massive tax liability, Mr. Cantilo proposed that the Rehabilitator request a PLR from the IRS holding that the restructuring will not create adverse tax consequences for the policyholders and the Companies.[13] But the record shows that the IRS will not even talk to Mr. Cantilo or his advisors without PTAC's consent—because PTAC is the tax-filer for the Consolidated Group.[14] Absent the PLR, the Companies would carry forward a tax liability in excess of their current assets, due until paid.[15]

As part of its tax strategy, the Estate endeavored to pursue a PLR that included a request that the Estate be granted relief under the "insolvency" exception from cancellation of debt income. But the IRS will not discuss that (or any) tax strategy without PTAC's agreement, since it is the "taxpayer." Such consent is required because pursuing the insolvency exception would need to be taken by the head of the tax group and would affect that company's rights. As Mr. Cantilo added, and as has happened in the past, "because it is allowing [the Companies] to walk away from all this tax liability," the IRS might require the Companies to surrender accrued CNOLs.[16] But the CNOLs are not the Companies' to surrender because PTAC controls them.

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[12] *Id.* 9:9–11.

[13] *Id.* 16:13–17:2.

[14] *See* Jones Tr. 148:10–17; "Consolidated Group" includes PTAC, its subsidiary corporations PTNA and ANIC, and other signatories to the TSA.

[15] Hearing Tr. 36:3–37:7.

[16] Hearing Tr. 18:23–19:5.

With each passing day, the estate—and its ability to pay policyholders—shrinks.

This Court entered a Rehabilitation Order on January 6, 2009, governing PTNA and ANIC.[17] The ensuing litigation has lasted for over seven years, including a full trial and appeal, depleting the Companies' assets with each billable hour.[18] After the appeal, a second confirmation trial began, followed by a round of discovery, including expert depositions attended by roomfuls of lawyers. Throughout, the parties conducted document discovery, while briefing and litigating a host of issues.

The Court personally mediated a resolution to this litigation.

Through the fall of 2015 to the spring of 2016, the Court was personally involved in mediating a resolution to this case. The Court held a total of six sessions in both Harrisburg and Philadelphia to bring the parties together. The parties also met countless times to discuss settlement, both in person and by telephone. The meetings were at times contentious, as parties and counsel vigorously advocated for their respective positions. To say that the discussions were arm's-length would be an understatement—they were closer to sword's-length.

Eventually, the parties reached a deal in June of 2016. It then took many weeks to document that deal. Throughout, all the parties were represented by experienced and sophisticated counsel.

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[17] *See* Ex. 8 (January 6, 2009 Rehabilitation Order).

[18] *See* Exs. 9–12 (June 20, 2016 Order) (granting Intervenors' application to recover $153,267.70 in professional fees, costs, and other expenses), (March 1, 2016 Order) (totaling $229,118.79), (December 3, 2015 Order) (totaling $201,663.97), (September 9, 2015 Order) (totaling $101,820.09).

The MOU would remove the most significant hurdle to resolving this contentious and protracted rehabilitation.

On June 14, 2016, the Rehabilitator and the PTAC Intervenors filed the Joint Application to approve the settlement.[19] The MOU will resolve several crucial aspects of this rehabilitation, allowing the Rehabilitator to perform her statutory obligations:

- **Preserve Tax Benefits.** Over $1 billion in CNOLs are potentially made available to the Companies in the course of their respective rehabilitation or liquidation, thereby shielding Estate assets from hundreds of millions of dollars in federal income taxes. This shield remains in place if the PLR is rejected. Thus, the Estate is protected whether or not the PLR is granted. PTAC gets access to the applicable CNOLs only (i) when the PLR is granted or (ii) subject to use by the Companies as provided in the MOU if the PLR is rejected.[20]
- **Joint PLR Submission.** The IRS has said that it will not entertain a PLR submission without PTAC's cooperation because PTAC is the Companies' common parent and head of the Consolidated Group.[21] The MOU would allow the Commissioner to seek the favorable tax treatment she needs to preserve the Estate's and policyholders' assets.[22]
- **Protect Companies from WSD.** Under the MOU, PTAC agrees not to take a WSD (except as provided therein), which would have the effect of depriving the Companies of any tax shield.
- **Protect Companies from Deconsolidation.** Deconsolidation would enable PTAC to use the tax attributes but would impair the Companies' tax position.
- **Protect Companies from Adverse Actions.** PTAC has agreed to forbear from taking specified actions before receiving the PLR that would put the tax shield at risk.

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19 *See* Ex. 13 (MOU); Ex. 14 (Joint Application).

20 *See* MOU § I.D.3-4.

21 *See* Jones Tr. 148:10–17 ("Q: Is it your opinion that you could continue to seek a PLR request from the IRS in the event that PTAC were to object to your doing so? A: At this point after this meeting, the IRS indicated that we would need a power of attorney form and a penalties of perjury statement signed by PTAC, as well as the rehabilitator, should we go forward with the PLR request.").

22 *See* Joint Application ¶ 5.

Additionally, the MOU would resolve all of the PTAC Intervenors' formal objections to the Second Amended Plan, which is still pending before this Court.[23] Aside from avoiding further litigation costs, the Companies would cease paying both agent commissions and premium taxes (totaling over $14 million annually) were this Court to enter a liquidation order.[24] Similarly, the result would expedite liquidation, and the release of funds to the state Guaranty Associations, reducing their burden of covering benefit costs.[25]

ARGUMENT

I. PTAC IS BEING COMPENSATED FOR USE OF ITS CNOLS AND TAX SERVICES, NOT FOR ITS EQUITY STAKE IN THE COMPANIES.

A. PTAC controls the Consolidated Group's tax attributes under statute, regulation, and contract.

PTAC controls the CNOLs under statute, regulation, and contract.[26] The Internal Revenue Code and Treasury Regulations permit parent companies and subsidiaries to file consolidated income tax returns, and the TSA requires it.[27] Here, the consolidated tax group includes PTAC and its subsidiary corporations PTNA and ANIC, all of which agreed to use tax attributes—such as the CNOLs—as a group subject to the terms of the TSA.[28] No objector disputes that the TSA—which the Rehabilitator once sued to enforce—is a binding agreement.[29]

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[23] *See id.*

[24] *See id.*

[25] *See id.*

[26] *See* TSA.

[27] *See* Fairbanks Report ¶¶ 19–25.

[28] *See* TSA; Fairbanks Report ¶¶ 20–25; 26 CFR§§ 1.1502-21(b),(e), 1.1502-91 *et seq.*

[29] *See* TSA; Ex. 15 (*Pratter v. Penn Treaty American Corp.*, Civ.A. No. 451 M.D. 2010 Complaint). Broadbill and PTAC assert that any positions the Rehabilitator might otherwise have taken regarding taxes were released in that settlement and/or would be barred by Pa.R.C.P. 1020(d) and the rule against claim splitting. *See Hillgartner v. Port Auth.*, 936 A.2d 131, 141 (Pa. Commw. Ct. 2007) ("A plaintiff must recover all damages from given operative facts in a single action when the first forum has the ability to give the relief sought in the second forum."). While the Commissioner contests this point and the Court need not reach the question, it presented an additional risk for the Estate had it not reached the settlement with Broadbill and PTAC under the MOU.

Absent the CNOLs, the Companies face an enormous potential tax liability. As Mr. Cantilo testified in Court, any confirmable plan would give rise to significant CODI.[30] If PTNA and ANIC were to incur CODI without any CNOLs to offset that income or access to the insolvency exception sought in the PLR, the potential tax consequence to those Companies and policyholders would far exceed the consideration due to PTAC under the MOU or the $20 million that the Health Insurers envision.[31] Mr. Cantilo testified that CODI taxation could result in an enormous tax bill to the Companies, which "can't pay more than $800 million [in taxes] because that's all the assets they have."[32] Assuming $800 million CODI, the Rehabilitator's tax advisor Lori Jones estimated that the cost would be close to $300 million.[33] If her estimate is correct (and it may be low), a tax bill of that magnitude would leave the Estate in a significantly worse position.

To make certain to avoid these tax consequences, the Rehabilitator needs PTAC both to seek a PLR from the IRS and to agree to not take adverse actions before receiving the PLR.[34] In fact, in August 2015, Alexis MacIvor, Branch Chief at the IRS' Office of Chief Counsel, expressly told Ms. Jones (tax counsel to the Commissioner) in a voicemail about the Penn Treaty pre-submission conference that "[t]o move forward, we're being a little more diligent with our powers of attorneys and we will need one from the parent company, which I believe is PTAC,

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[30] *See* Hearing Tr. 9:9–10:4

[31] Health Insurers' Obj. at 9–10.

[32] Hearing Tr. at 9:5–11; *see also supra* pp. 4–5.

[33] Jones Tr. at 130:14–19, 180:13–182:1.

[34] Hearing Tr. 16:13–17:2.

who is the parent company of the Consolidated Group."[35] As far as the IRS is concerned, PTAC is the indispensable party and taxpayer for any group tax position, including any PLR.[36]

If the PLR were to fail, the Companies would all the more need access to the CNOLs to absorb the multi-hundred-million-dollar tax liability.[37] And Section I.D.4 of the MOU allows the Companies to use the CNOLs ***even if*** the PLR is denied.[38] So the Health Insurers are wrong that the Estate would receive "no tax benefit whatsoever" from the MOU if the PLR were to fail.[39] The Companies get access to the CNOLs in any case. Indeed, the settlement is at least as valuable to the Companies if the IRS rejects the PLR request because the group tax attributes will remain available to them.

Under the MOU, PTAC also agrees not to take a WSD or deconsolidate, even though it is entitled to do that, which would wipe out the Companies' ability to avail themselves of any tax shield. Under the unified loss rules and IRC Section 382, a WSD would effectively use up the CNOLs, thus making them unusable to the Companies—as Ms. Jones agrees.[40] A similar result would follow if PTAC were to deconsolidate from the Consolidated Group for any reason at all, in which case a substantial amount of the CNOLs would be consumed. The MOU avoids this disastrous situation for the Companies and policyholders.

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[35] *See* Ex. 16 (MacIvor voicemail to Jones); Jones Tr. 234:5–235:14.

[36] *See* Jones Tr. 46:21–47:6; 26 CFR § 1.1502-77(a).

[37] *See* Jones Tr. 184:20–185:4, 188:23–189:5.

[38] *See* MOU § I.D.4 ("In the event that the PLR is not granted, the Commissioner shall have access to and free use of all CNOLs generated by the operations of ANIC and PTNA to the extent necessary to offset PTNA and ANIC's taxable income.").

[39] *See* Health Insurers' Obj. at 9–10 ("[T]he settlement payment is payable whether or not the PLR actually is successful—resulting in the possibility that the estate pays up to $15 million . . . for no tax benefit whatsoever.").

[40] Jones Tr. at 178:25–180:12.

Under Pennsylvania law, the costs and expenses of administration include "the actual and necessary costs of ***preserving . . . the assets of the insurer***" and are given first priority.[41] In *Illinois Insurance Guarantee Fund v. Reliance Ins. Co.*, this Court noted the Insurance Commissioner continued to pay, among other things, rent, utility bills, employee salaries and computer expenses as administrative expenses at the top priority level.[42] Here, consideration paid to PTAC under the MOU constitutes an administrative cost because it will allow the Companies to use the CNOLs to reduce taxes that would deplete the Estate.[43] This savings is of great value to the Companies. [44]

B. PTNA and ANIC are paying to use PTAC-controlled valuable tax assets.

The Estate's payment under the MOU compensates PTAC for the Companies' use of the CNOLs and tax services, not for its equity stake in PTNA. Much like payments due under a lease, the settlement captures the cost associated with using an asset that another entity owns in order to continue operations.[45] The law prohibits the Rehabilitator from commandeering

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41 40 P.S. § 221.44 (emphasis added).

42 *See Ill. Ins. Guar. Fund v. Reliance Ins. Co.*, 88 A.3d 313, 315–16 (Pa. Commw. Ct. 2014).

43 Hearing Tr. 37:2–7 ("The Court: So, in other words, the choice is wiping out all the liabilities and creating a tax liability approximately equal to the assets that the company holds? The Witness [Mr. Cantilo]: Well, right."); Fairbanks Report ¶¶ 29–33.

44 *See, e.g.*, *State of North Carolina v. United States*, 139 F.3d 892 (4th Cir. 1998) (unpublished table decision), *aff'g* 92-2 U.S.T.C. ¶ 50, 811, 80 A.F.T.R.2d 5825, 1997 WL 792548 (E.D.N.C. July 21, 1997); *see also* 52 TAX LAW 1115, 1117 (1999); *Kirk v. Kirk*, 243 Cal. App. 2d 580, 583 (1966); *see* 11 U.S.C. § 365(d); *Strauss v. W. H. Strauss & Co.*, 328 Pa. 72, 78 (1937).

45 *See American Anthracite & Bituminous Coal Corp. v. Leonardo Arrivabene, S.A.*, 280 F.2d 119, 124 (2d Cir. 1960) (right to priority extends to leases of personal property as well as real property because "no rational basis exists for drawing a distinction between the right to priority where contracts for the lease of real property are concerned and that right where other kinds of contracts are involved."); *Mathews v. Butte Machinery Co.*, 286 F. 801 (9th Cir. 1923) (according priority to claims for use by the trustee of personal property leased to the bankrupt); *see also NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984) (debtor must pay reasonable value for post-petition benefits received pending decision to accept executory contract).

PTAC's property without compensation.[46] Any claim that PTAC has against the Companies stemming from its ownership of the CNOLs as head of the Consolidated Group under federal law is separate and apart from a claim based on its equity stake.[47] Therefore, both the Health Insurers and Agents are simply wrong in asserting that the MOU would upend the distribution order in 40 P.S. § 221.44 by placing PTAC in its status as an equity-holder ahead of other creditors.[48]

In fact, courts routinely approve agreements "of this type."[49] The Commonwealth Court of Pennsylvania approved a settlement agreement between the Liquidator and the Creditors' Committees of Reliance Group Holdings, Inc. and Reliance Financial Services Corp.[50] The Commissioner agreed, among other things, to pay 17.5 cents net for every dollar of CNOLs used by the insurance subsidiary in liquidation (35 cents on the dollar with a 50 percent rebate) so that members of the consolidated tax group would, inter alia, (i) make $1.25 billion in CNOLs

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46 *See Leonard v. Vrooman*, 383 F.2d 556, 560 (9th Cir.1967) ("[A] trustee wrongfully possessing property which is not an asset of the estate may be sued for damages arising out of his illegal occupation in a state court without leave of his appointing court."); *Teton Millwork Sales v. Schlossberg*, 311 Fed. Appx. 145, 2009 WL 323141 (10th Cir. 2009) (finding that a receiver who was authorized by court to seize defendant's property held in the name of Teton Millwork Sales, an entity in which defendant held 25% interest, could be sued without leave of his appointing court when he seized 100% of the assets); *Hills v. Parker*, 111 Mass. 508, 511 (1873) ("When [a receiver] assumes to take or hold possession of property not embraced in the decree appointing him, and to which the debtor never had any title, he is not acting as the officer or representative of the court of chancery, but is a mere trespasser, and the rightful owner of the property may sue him in any appropriate form of action for damages or to recover possession of the property illegally taken or detained."); *see also Nat'l Automobile Serv. Corp. of Pa. v. Barford*, 289 Pa. 307 (1927) ("The Constitution guarantees to those who invest their property in business enterprises that it will not be taken without due process of law."); *Carlton Furniture Co. v. Jenkins & Kayser*, 5 Pa. D. & C. 186, 187 (Common Pleas Ct. Phila. 1924) ("There is no doubt that for a wrongful seizure of the goods of another, a receiver or trustee in bankruptcy can be sued in a state court.").

47 *See* TSA.

48 *See* Agents' Opp. at 6; Health Insurers' Obj. at 8–9.

49 Agents' Opp. at 8.

50 *See* Ex. 4 (Reliance Approval Order).

available to the insurer; and (ii) not deconsolidate.[51] The Commonwealth Court's approval order specifically held that ***the payment obligations of the Commissioner (as liquidator) to the shareholder were entitled to an administrative priority under P.S. 221.44(a)***.[52] To put the 17.5 cent tolling arrangement from Reliance in context, if the Commissioner in this case used all of the nearly $1 billion in CNOLs in its tax resolution, it would result in a $175 million payment under the Reliance formula (as opposed to the $10 million provided under the MOU).

Similarly, at the request of the Wisconsin insurance rehabilitator, the parent-head of the Ambac consolidated tax group agreed to refrain from deconsolidating and thus exposing the debtor to CODI-related adverse tax consequences without access to a CNOL tax shield.[53] The debtor also paid for the right to consume NOLs under a revised tax sharing agreement—15% for the first $479 million and 40% for the next $1.057 billion.[54] Under that agreement, $1 billion in CNOLs would cost the Estate over $280 million.

Here, $10 million for the ability to pursue the PLR and insolvency exception together with potential access to the CNOLs is an even better deal for the Rehabilitator.[55] These precedents illustrate not only the value of the CNOLs that the MOU seeks to put at the Companies' disposal, but the reasonableness of the price.

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[51] *See id.*, Settlement Agreement § 3(v).

[52] *See id.*, Order ¶ 4 ("any valid claim arising out of the breach of any obligation, including payment obligation, by the Liquidator or Reliance Insurance Company under the Settlement Agreement shall be deemed to be a first priority administrative claim for Reliance Insurance Company, pursuant to 40 P.S. §221.44(a).").

[53] *See* Ex. 5 (AMBAC Mediation Agreement).

[54] *See* Ex. 6 (AMBAC Amended TSA).

[55] *See* MOU § I.D.3–4.

II. THE HEALTH INSURERS' ALTERNATIVE IS BOTH PROHIBITED BY PTAC'S BYLAWS AND WOULD RISK SQUANDERING THE COMPANIES' ASSETS.

Even if the Health Insurers had sought to expand the scope of their limited Intervention Order or moved for permission to file their objection to the MOU, their proposed alternative to the settlement would not work.[56] The Health Insurers propose that the Commissioner cause PTNA to issue more shares to deconsolidate the Companies from the Consolidated Group. That fails for at least the following reasons.

First, the Rehabilitator cannot, as the Health Insurers propose, "issue enough shares of PTNA to break the consolidation and exit the consolidate[d] group."[57] Article XI, Section I of PTNA's bylaws allow the shareholders to "prescribe that any by-law made by them shall not be altered or repealed by the Board of Directors."[58] The shareholder (PTAC) has prohibited issuing stock by its subsidiary. Article VIII, Section 7 of PTNA's bylaws forbid the company from issuing shares of stock without the affirmative vote of the shareholders (*i.e.*, PTAC, being the sole shareholder).[59] Further, that section "shall not be altered or repealed by the Board of Directors."[60] Accordingly, the Rehabilitator lacks the power under 40 P.S. § 221.16(b) to execute the Health Insurers' scheme and any putative attempt to do so would be void *ab initio*. Issuing additional PTNA shares is also impossible because it would be a fraudulent transfer

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[56] This Court's June 19, 2015 Order permitted the Health Insurers "limited intervention" to participate in proceedings "related to the Second Amended Plan (or any future modifications thereof), and any petitions for liquidation." Because opposing the MOU's approval is none of those things, the Health Insurers have no standing to oppose it under Pennsylvania Rule of Appellate Procedure 3375. And the Agents fail to explain how they would benefit from their objection, other than imposing costs and delay. Therefore, the Court need not consider the objections. But even on the merits, the objections fail. In contrast, Broadbill has standing to be heard based upon its status as a party to the MOU. PTAC has standing as the owner of PTNA and ANIC (as well as a party to the MOU).

[57] Health Insurers' Obj. at 10.

[58] Ex. 17 (PTNA Bylaws I).

[59] *See* Ex. 18 (PTNA Bylaws II).

[60] *Id.*

under 12 P.S. § 5104 as it would converting PTAC's property in the CNOLs "without payment to PTAC."[61] It would also lead to PTNA liability for conversion of property belonging to PTAC and claims for breach of fiduciary duties.[62] Such a maneuver would result in years of additional litigation, and PTAC would contest its effect with the IRS.

Second, the Health Insurers are wrong that PTNA would "retain the net operating losses attributable to its operations."[63] The Health Insurers cite no authority for that proposition—not under the Internal Revenue Code, Treasury Regulations, or case law.[64] This is at best the Health Insurers' current unproven theory. Nor do they offer an expert on this issue. At a minimum, the Health Insurers' proposed deconsolidation would result in the loss of a substantial part of the CNOLs. Interestingly, the Health Insurers' lead counsel in this case—Harold Horwich—is thanked for his contribution to an article analyzing the Ambac rehabilitation and stating that deconsolidation "might severely restrict the use of [Ambac Financial Group's insurance subsidiary] net operating losses."[65] That article also concludes that "all members of a consolidated tax group are jointly and severally liable for taxes."[66]

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[61] *See* 12 P.S. § 5104.

[62] *See In re Hayes Lemmerz Int'l, Inc.*, 340 B.R. 461, 480 (Bankr. D. Del. 2006) (a claim for conversion of property that might also constitute a breach of contract "does not deprive it of its status as an independent tort" and is entitled to administrative status); *In re Enron Corp.*, 2003 WL 1562201, at *4 (Bankr. S.D.N.Y. March 17, 2003) (claim for post-petition conversion of natural gasoline was entitled to administrative priority); *see also Segal v. Rochelle*, 382 U.S. 375, 379 (1966) (interest in a tax refund is property of the estate).

[63] Health Insurers' Obj. at 11.

[64] *See id.* at 10–12 (citing only the Rehabilitator's power of the directors, officers, and managers under 40 P.S. § 221.16(b)).

[65] Bill Goddard, *The New World Order: Financial Guaranty Company Restructuring and Traditional Insurance Insolvency Principles*, 6 BROOK. J. CORP. FIN & COM. L. 137, 138 (2011) (thanking Harold Horwich "for his insightful guidance in the development of this work").

[66] *Id.* at 149; *see also* at 167.

If the Health Insurers are wrong about the effect of deconsolidation, the mistake would be potentially worth hundreds of millions of dollars in tax claims. And wrong they are because deconsolidation would impair the CNOLs—while at the same time increasing the risk that the IRS denies the PLR. Moreover, PTAC could then enforce the TSA to recover the value of the Rehabilitator's conversion of PTAC's property (which it would assert as an administrative claim). Additionally, nothing about this so-called solution prevents PTAC from preemptively taking a WSD, thus terminating CNOLs that would otherwise be available to the Estate to defray CODI taxes—particularly if the Rehabilitator cannot secure the PLR. In short, this strategy is untenable and would leave the Estate in far worse shape than if this Court were to grant the Joint Application.

The Health Insurers also incorrectly contend that the MOU's operative terms "are so vague" that this Court "cannot determine whether the Estate is receiving any value from the payment that it is making."[67] It is obvious what value is being exchanged and on what terms: The Estate is getting PTAC's cooperation with the IRS on the PLR (which the Estate cannot otherwise pursue), access to CNOLs with or without the PLR, and assurance that PTAC will not take actions that would impair the tax shield.[68] The Court is well aware of the terms of the agreement, having presided over its negotiation and documentation. The Court will also reserve

[67] Health Insurers' Obj. at 19.

[68] *See, e.g., Ferguson v. McKiernan*, 596 Pa. 78, 87 n.9 (2007) ("[C]ontracts are often designed to take effect only upon the occurrence of some future contingency."); *Dora v. Dora*, 392 Pa. 433 (1958) (finding enforceable a contract specifying the parties' obligations were to be performed only in the event of a future contingency); *see also Juliano v. Smith*, 2013 Mich. App. LEXIS 2104, at *13 (Mich. Ct. App. Dec. 17, 2013) (holding that contingencies do not indicate that parties left open material terms).

exclusive jurisdiction to interpret the agreement and to impose any supplemental terms that are necessary to effectuate its purpose.[69]

III. THE AGENTS' OBJECTIONS ALSO FAIL.

The Agents' objections must also be overruled (assuming the Agents have standing). We address above the assertions that PTAC is being paid for its equity (which is incorrect because PTAC is being compensated for use of its valuable asset and tax services) and that the public good favors rejecting the settlement (which defies common sense because it would risk damaging the Estate instead of paying a fraction of what may otherwise be the Companies' and policyholders' potential tax liability).

The Agents make one additional objection that requires brief mention, that no evidence demonstrates that the MOU best serves the policyholders, creditors, and public. This contention fails because interpreting the TSA and applying the CNOLs are legal—not factual—questions of tax law. The Court needs no evidence at all to address these issues. The record, however, has more than enough evidence to show that the MOU would resolve hundreds of millions of dollars in potential federal tax claims. For the last two years, litigation in this Court has focused almost exclusively on tax issues. Both Mr. Cantilo and Ms. Jones have testified about the potential catastrophic risks posed by the unresolved tax claims. Absent use of the CNOLs or a successful PLR, the Companies and policyholders risk an enormous tax liability.[70] Likewise, if PTAC were to take a worthless stock deduction, the CNOLs could become unusable for the Companies.

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[69] *See* Section I.I.8

[70] *See* Jones Tr. 184:20–185:4, 188:23–189:5.

Finally, without citing any law, the Agents claim that this Court should deny the Joint Application because of the MOU's non-debtor releases.[71] In analogous situations, bankruptcy courts frequently approve third-party releases.[72] The Rehabilitator has been investigating potential claims since 2009 and has not brought any claims against the parties she is releasing—because there are no claims here. Moreover, the statute of limitations has likely run on any negligence or intentional misconduct claims.[73] Of course, the Estate is getting releases from the released counter-parties, which provide corresponding value.

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[71] *See* Agents' Opp. at 5 ("[T]he Rehabilitator is releasing all current and former officers, employees, etc. of Penn Treaty, ANIC, and PTAC, among others, from all claims that could have been asserted.").

[72] *See, e.g., In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293 (2d Cir. 1992) (approving third-party releases where non-debtors provided compensation in exchange for their release); *In re A.H. Robins Co.*, 880 F.2d 694, 701 (4th Cir. 1989), *cert. denied*, 493 U.S. 959 (1989) (court may approve release if it play an important part in reorganization plan); *see also Matter of Munford, Inc.*, 97 F.3d 449, 455 (11th Cir. 1996) (bankruptcy code authorizes court to non-debtors from nonsettling parties' claims if fair and equitable, and integral to the settlement).

[73] *See* 42 P.S. § 5524 (tort actions, including fraud and breach of fiduciary duty, are subject to a two-year statute of limitations).

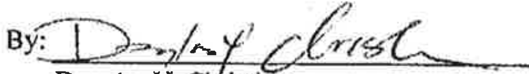
CONCLUSION

For the foregoing reasons, the Court should grant the Joint Application seeking approval of the MOU.

Dated: Harrisburg, Pennsylvania
July 26, 2016

Respectfully submitted,

BALLARD SPAHR LLP



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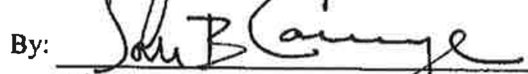

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