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IN THE COMMONWEALTH COURT OF PENNSYLVANIA

In 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

VERIFIED SUR-REPLY OF COMMISSIONER TERESA D. MILLER, IN HER CAPACITY AS STATUTORY REHABILITATOR, IN FURTHER SUPPORT OF THE JOINT APPLICATION FOR SETTLEMENT APPROVAL

The Health Insurers'[1] Opposition sets forth a series of legal positions on tax and receivership law. But their advocacy alone cannot eliminate the risk attendant

[1] Defined terms used in this Sur-reply are as set forth in the Application for Approval of the Settlement. The Commissioner reserves her right to contest the standing of both the Health Insurers and the Agents to object to the Settlement

in any further litigation with the PTAC Intervenors—the risk of not prevailing in either the first or final (after appeal) instance—or the unavoidable cost of and further delay attendant to such a fight. The Court should overrule their objections without further discovery or hearing.

I. <u>ARGUMENT</u>

A. The Court should reject the Health Insurers' attempt to impose a standard of review different from the abuse-of-discretion standard mandated by Pennsylvania law.

The Health Insurers seek to ignore controlling Pennsylvania receivership law by applying a flawed interpretation of a bankruptcy standard of review, arguing that the abuse of discretion standard applies "only to review of the plan of rehabilitation." (Health Insurers' Reply at 2.) Deference under the abuse-of-discretion standard, however, is well-established in receivership law generally; in fact, the Pennsylvania Supreme Court has held that Article V "*explicitly defers all actions* to the skill of the Commissioner and implicitly recognizes her expertise in these matters." *Foster v. Mutual Fire, Marine, and Inland Ins. Co. ("Mutual Fire II")*, 614 A.2d 1086, 1091 (Pa. 1992) (emphasis added). The same Court has stated, in this very receivership, that "judicial review … should proceed subject to

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Agreement, as neither of them has demonstrated an interest sufficient to press the concerns that they raise. Moreover, the PTAC Intervenors have contested their standing, and neither has submitted a response to that challenge. *See* PTAC Intervenors' Response to the Health Insurer's Objections to Settlement Approval, at 14 n.56 (filed July 26, 2016).

a more deferential overlay relative to the … Commissioner." *In re Penn Treaty Network Am. Ins. Co.*, 119 A.3d 313, 323 (Pa. 2015).

Although *Mutual Fire II* involved confirmation of a rehabilitation plan and *Penn Treaty* concerned a petition to convert from rehabilitation to liquidation, neither decision limited the abuse-of-discretion standard to either context, as the Health Insurers claim. To the contrary, those decisions recognize that Article V "defers *all actions*" and all "determinations of fact and public policy" to the Commissioner. *Mutual Fire II*, 614 A.2d at 1091-92 (emphasis added); *accord Penn Treaty*, 614 A.2d at 321-22 ("'Only the strongest showing to the contrary could justify the court's refusal to follow the recommendations of the administrative officer to whom the supervision of insurance companies has been intrusted [sic] by the Legislature.'" (quoting *In re New York Title & Mortg. Co.*, 281 N.Y.S. 715, 729 (N.Y. Sup. Ct. 1933))). That legislative determination requires the Court to apply an abuse-of-discretion standard of review to rehabilitation plan approval or conversion, just as it requires the Court to apply the same standard to approval of a settlement in rehabilitation.

The Health Insurers further claim that the Commissioner has "retreat[ed] from the *Jevic* standard," as if to suggest that the Commissioner has advocated for application of *Jevic* as controlling precedent in the standard of review context. (Health Insurers Rep. Br. at 2.) That is simply untrue. *Mutual Fire II* and *Penn*

Treaty provide the binding legal precedent for this receivership, specifically here, in terms of standard of review. The Commissioner has consistently taken the position that *Jevic* applied only "*[b]y analogy*." (Appl. to Approve Settlement ¶ 14.) Of course, *Jevic* cannot dictate the standard of review in this case; the standard of review in this Commonwealth is established by Article V and relevant Pennsylvania Supreme Court decisions.

The Health Insurers would have the Court believe that *Jevic* ignores the distinction between payments made to equity holders to resolve their propriety claims and payments made for other purposes. That is not the case. In *Jevic*, the settlement was undisputedly made to compromise an equity holder's proprietary claim against the bankruptcy estate—and the court recognized that in certain, limited circumstances such payments are appropriate. *In re Jevic Holding Corp.*, 787 F.3d 173, 177 (3d Cir. 2015). By contrast, the Settlement Agreement here is not a compromise of the PTAC Intervenors' proprietary claim in any respect. It instead represents a compromise for the purpose of resolving uncertain tax issues regarding the Companies' NOLs, facilitating an expeditious transition to liquidation (which the PTAC Intervenors would otherwise oppose), saving more than $14 million in agent commissions and premium taxes, and avoiding further costs to estates that have been described as a quickly melting ice cube.

The Health Insurers ignore the distinction between payments to settle longstanding receivership disputes[2] and payments made to satisfy an equity holder's claim to the insurer's assets under § 544(i), 40 P.S. § 221.44(i). Yet that distinction—payments made to preserve estate assets versus payment of claims—is well-recognized in state receivership law. The propriety of a payment to an equity holder cannot be determined without considering the purpose for the payment.

> [T]he separate claims of a person who happened to be both a shareholder and policyholder of an insurance company in liquidation would be afforded different treatment. His claim as a policyholder would be processed [at the policyholder level], and his claim as a shareholder of the enterprise would be processed [at the shareholder level]. The different claims of a shareholder would not all be relegated to the lowest priority simply because the person happened to be a shareholder.

In re: Liquidation of Sec. Cas. Co., 537 N.E.2d 775, 783 (Ill. 1989).

When, as here, a proposed settlement enables the Commissioner to "preserv[e] or recover[] the assets of the insurer[,]" it properly qualifies as an administrative expense, not as a compromise of an equity holder claim.[3] 40 P.S.

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[2] Those disputes include, *inter alia*, the rights and application of tax attributes, the nature and extent of rehabilitative efforts, purported acts and omissions of the Commissioner, and the need for liquidation of the Companies.

[3] The Health Insurers take issue with the Commissioner's reference to Section 544 applying in liquidation, not in rehabilitation, unless specifically adopted in a plan of rehabilitation. (Health Insurers Rep. Br. at 3-4.) As explained in *Grode v. Mutual Fire, Marine & Inland Insurance Co.* ("*Mutual Fire I*"), 572 A.2d 798, 803 (Pa. Commw. Ct. 1990), "[t]he liquidation provision establishes an

§ 221.44(a); *see also In re Liquidation of Home Ins. Co.*, 913 A.2d 712, 723-35 (N.H. 2006) (treating a settlement as an administrative level expense even though the benefits of the settlement were distributed to parties who only qualified as lower-order creditors). The Health Insurers fail to acknowledge much less address the *Home* decision.

Moreover, even if the Settlement Agreement were a compromise of an equity-level claim, *Jevic* itself permits such a compromise if "specific and credible grounds [exist] to justify [the] deviation." *Jevic*, 787 F.3d at 184. Thus, the benefits that policyholders and the Companies' estates will receive from the Settlement Agreement would even justify such a deviation under *Jevic*.

Of greatest import, based on all of the information before the Commissioner and her predecessors during the past seven years of litigation, she has reached the informed and reasoned conclusion that the benefits afforded by the settlement could not be obtained absent the Settlement Agreement.

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order of distribution, Section 544 of the Act, 40 P.S. § 221.44; the Act's rehabilitation section does not." The Commissioner's identical point is a simple observation related to the structure of Article V, nothing more. Health Insurers are distracted by their effort to defeat the settlement at all costs, regardless of the merit of the resolution of the lengthy disputes. Where, as here, the settlement preserves assets for the benefits of the estates, and is in best interests generally of the policyholders, creditors and the public, it is valid and consistent with the terms and provisions of Article V.

B. The record sufficiently establishes that the Settlement Agreement is an appropriate exercise of the Commissioner's discretion.

The Health Insurers claim that the Commissioner has failed to produce support in the record to establish that the Settlement Agreement is fair and reasonable and in the best interests of the Companies' policyholders. (Health Insurers Rep. Br. at 6-8.) However, the record is replete with evidence establishing the need for, and fairness of, that Agreement.

To summarize certain statements of law and relevant evidence available in the record to illustrate the dispute the Commissioner seeks to settle with PTAC, the Commissioner offers the following:

1. Background Principles and Facts

The Commissioner believes that no party can dispute the following:

1. Under § 1501 of the Internal Revenue Code (the "Code"), an "affiliated group" of corporations may file a consolidated tax return. 26 U.S.C. § 1501.

2. An "affiliated group" consists of "includable corporations" connected through stock ownership meeting the requirements of 26 U.S.C. § 1504(a)(2) and having a common parent. 26 U.S.C. § 1504(a)(1)(A).

3. The common parent must directly own stock in at least one of the other corporations in the group. 26 U.S.C. § 1504(a)(1)(B).

4. PTAC owns all of the issued and outstanding stock of PTNA, PTNA owns all of the issued and outstanding stock of ANIC, and ANIC owns all of the issued and outstanding stock of AINIC.

5. PTAC, PTNA, and ANIC are members of an "affiliated group" of corporations that files a consolidated tax return, 26 U.S.C. §§ 1501-1502, and PTAC, as the parent corporation (subject to certain limited exceptions not relevant here), "is the sole agent that is authorized to act

in its own name regarding all matters relating to the federal income tax liability for the consolidated return year for each member of the group[.]" Treas. Reg. § 1.1502-77(a)(1). As the sole agent, PTAC prepares and files the consolidated tax return with the IRS.

6. A consolidated filing is expressly conditioned on the prior consent of all members of the affiliated group, and their agreement to follow all regulations promulgated under § 1502 of the Code. 26 U.S.C. § 1501.

7. Those regulations provide, among other things, that each member of an affiliated group must initially calculate its own separate taxable income "in accordance with the provisions of the Code covering the determination of taxable income of separate corporations, subject to [certain] modifications." Treas. Reg. § 1.1502-12.

8. Between 2003 and 2014, PTAC, PTNA and ANIC filed consolidated tax returns.

9. Specific rules under the Code and Treasury Regulations apply when a life insurance company files a consolidated return with companies that are not life insurance companies (referred to as a "life/nonlife group"). 26 U.S.C. § 1503(c); Treas. Reg. § 1.1502-47.

10. PTNA and ANIC are licensed as life insurers. A life insurance company cannot use or generate a "net operating loss" ("NOL"). 26 U.S.C. § 805(b)(4). Instead, a life insurance company whose deductions exceed its income generates an "operations loss." 26 U.S.C. § 810.

11. These different types of losses must be tracked separately by subgroup and are subject to different carryforward and carryback rules. *Compare, e.g.*, 26 U.S.C. § 172(b)(1)(A), *with* 26 U.S.C. § 810(b)(1).

12. Treasury Regulation § 1.1502-47 adopts a subgroup approach to determine taxable income for life insurance companies (comprising the life subgroup, here PTNA, ANIC and AINIC) separate from the determination for all other companies in the consolidated group (comprising the nonlife subgroup, which in this case includes PTAC and its nonlife subsidiaries).

13. Under the subgroup approach, income and losses are combined for the life subgroup (as if the subgroup filed its own consolidated return) and

then separately for the nonlife subgroup on the same basis. Treas. Reg. § 1.1502-47(h).

14. If both subgroups had losses, there would be both a nonlife subgroup NOL and a life subgroup operations loss; in no event would there only be a single consolidated NOL. Treas. Reg. § 1.1502-47(h).

15. Each member of the affiliated group is severally (not jointly) liable for the tax computed under section 1502 for the group. Treas. Reg. § 1.1502-6(a).

16. It is common for the companies in a consolidated tax return group to enter into a "tax sharing agreement," also referred to as "tax allocation agreements." These are private agreements governed by state law. *In re Amwest Ins. Grp., Inc.*, 285 B.R. 447, 452 (Bankr. C.D. Cal. 2002) ("[I]t is clear that the interpretation of the Tax Allocation Agreement is based on state law."); *In re First Cent. Fin. Corp.*, 269 B.R. 481, 490 (Bankr. E.D.N.Y. 2001) ("As a matter of state corporation law, parties are free to allocate among themselves their ultimate tax liability by an express agreement, or by a clearly implied agreement."), *aff'd*, 377 F.3d 209 (2d Cir. 2004); Fairbanks Dep. Tr. 89:20-91:6; 91:20-92:7; 145:8-146:6; 182:10-183:19, attached as Exhibit A.

17. A tax sharing agreement has no effect on federal tax liability; each member remains severally liable for the group's tax liability, Treas. Reg. §§ 1.1502-6(a), (c); a tax sharing agreement simply governs the manner in which members allocate intra-member cash-flow once the group's tax liability has been determined.

18. From the perspective of the IRS, tax sharing agreements are of no consequence to the tax liability potentially allocable to each member company in an affiliated group. Treas. Reg. 1.1502-6(c). Such agreements have no impact on total tax liability attributable to the group—*i.e.*, the total collected by the IRS. *Id.*

19. Tax sharing agreements enable members of a consolidated group to divide among themselves the cash-flow responsibility of each member for the group's tax payments to the IRS.

20. On June 6, 2001, PTAC and its subsidiary corporations entered into the Penn Treaty America Corporation Affiliated Tax Sharing Agreement

(“TSA”), appended to Amendment to 2000 Annual Registration Statement, collectively attached to Exhibit B.

21. Each of PTAC, PTNA, ANIC and AINIC are parties to the TSA. *See* Tax Sharing Agreement (Ex. B).

22. Intervenors PTAC and Woznicki continue to maintain their opposition to a liquidation of the Companies. *See, e.g.*, PTAC Intervenors’ Reply Brief Support of Second Quarter 2015 Supplemental Application for Relief at 2 (filed Aug. 28, 2015) (“Both Companies’ Boards have authorized Woznicki to intervene in these rehabilitation proceedings to object, contest, and oppose the efforts and attempts by the Rehabilitator to liquidate PTNA and ANIC and otherwise seek to avoid liquidation through achieving an appropriate rehabilitation.”); *see also* PTAC Intervenors’ First Quarter 2016 Supplemental Application for Relief ¶ 14 (filed May 3, 2016) (“The Intervenors continue to incur professional fees, costs, and expenses to defend against the Rehabilitator’s continued efforts to pursue liquidation. The Intervenors’ continued advocacy on behalf of the Companies is vital to fending off the Rehabilitator’s improper liquidation efforts.”)

2. The Parties’ Disputed Positions

a. The Commissioner’s Position

23. The Commissioner’s tax plan was described initially in the Second Amended Plan as involving the restructuring of policies by the Court to reduce the aggregate liability under all policies to the amount that could be funded by each Company’s assets, and to deem the unfunded liability to be indebtedness of the Company that in due course would be discharged by the Court. *See* Second Amended Plan, at 79-81.

24. The Second Amended Plan required that the Court order approving the Plan would restructure the existing non-self-sustaining long-term care policies and unfunded accident and health policies to reduce the liability associated with each policy to the Policy’s Initial Funded Restructured Policy Value as of the Effective Date. *See* Second Amended Plan, at 79-81. This would have had the effect of reducing the tax reserves and converting the unfunded portion of the liability (defined in the Plan as the Unfunded Benefit Liability) into an indebtedness. In general, if a life insurance company reduces its tax

reserves as measured from the beginning to the end of the taxable year, the insurer has income under 26 U.S.C. § 803.

25. In 2015, in an attempt to confirm the applicability of § 108(a), the Commissioner began a process to submit a Private Letter Ruling request ("PLR") seeking a determination from the IRS that a discharge of debt under the Second Amended Plan would not result in taxable income to the Companies and that certain policy modifications under the plan would not have adverse tax consequences on policyholders. *See* Second Amended Plan, at 79-81; Verified Appl. to Approve Settlement Agreement ¶¶ 5.a, 5.b (filed June 14, 2016).

26. A PLR is "a written determination issued to a taxpayer by an Associate office in response to the taxpayer's written inquiry, filed prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions. A letter ruling interprets the tax laws and applies them to the taxpayer's specific set of facts." Revenue Procedure ("Rev. Proc.") 2016-1, I.R.B. 1.

27. A taxpayer ordinarily may rely on a letter ruling received from the IRS Associate office, subject to certain conditions and limitations. Rev. Proc. 2016-1 § 11.

28. In this receivership, the tax plan and the proposed treatment of the restructuring of the Policy liabilities as set forth in the anticipated PLR would eliminate or minimize any federal income tax liability resulting from the inability of the Companies to fund their policy liabilities by invoking an exclusion of discharge of indebtedness income under § 108(a) of the Code, which applies when an entity is insolvent. 26 U.S.C. § 108(a). *See* Second Amended Plan, at 79-81; Verified Appl. to Approve Settlement Agreement ¶¶ 5.a, 5.b (filed June 14, 2016).

29. The Commissioner intends to pursue a similar tax approach in the Companies' liquidation to ensure that policy liabilities of the Companies are restructured in a manner that will not result in taxable income to the estates by utilizing 26 U.S.C. § 108(a), and that any restructuring, continuation, guarantee, assumption or reinsurance of policy liabilities will not result in adverse tax consequences to policyholders. *See* Second Amended Plan, at 79-81; Verified Appl. to Approve Settlement Agreement ¶¶ 5.a, 5.b (filed June 14, 2016).

30. Revenue Procedure ("Rev. Proc.") 2016-1, 2016-1 I.R.B. 1, sets forth the procedure under which a taxpayer may request a PLR from the IRS.

31. The Commissioner will request rulings from the IRS in the PLR which will allow the Commissioner to confirm she may apply the exclusion from gross income in § 108(a) to the restructuring of policy liabilities and that there will be no adverse tax consequences to policyholders.

32. Rev. Proc. 2016-1 requires that a PLR request be accompanied by a penalties-of-perjury statement that "must be signed and dated by the taxpayer, not the taxpayer's representative."

33. Rev. Proc. 2016-1 provides that the "person who signs for a corporate taxpayer must be an officer of the corporate taxpayer who has personal knowledge of the facts and whose duties are not limited to obtaining a letter ruling or determination letter from the [IRS]."

34. Further Rev. Proc. 2016-1 provides that if "the corporate taxpayer is a member of an affiliated group filing consolidated returns, a penalties of perjury statement must also be signed and submitted by an officer of the common parent of the group."

35. On August 28, 2015, the Branch Chief of the Insurance Branch of the IRS Office of Chief Counsel, Financial Institutions and Products Division, left a voice mail for the Commissioner's tax counsel and expert witness, Lori Jones, advising that if the Companies intended to continue the discussion in relation to proposed PLR ruling requests, a power of attorney executed by PTAC would be necessary. *See* Jones Dep. Tr. 233:19-235:5, attached as Exhibit C.

36. As a consequence of a favorable ruling granting a requested PLR, the Companies would not need to offset income resulting from a reduction of tax reserves with loss-based deductions (*i.e*., operations loss carryovers/NOLs). By operation of law, however, tax attributes such as NOLs/operations loss carryforwards[4] would be reduced so that they will not be available to offset any future income. 26 U.S.C. § 108(b).

[4] Technically, life insurers generate operations loss carryovers and carrybacks (operating loss deductions). *See, e.g.*, 26 U.S.C. § 810.

37. If the IRS does not issue the requested ruling, or if the § 108(a) exclusion is not accepted by the IRS or a court, then income resulting from the reduction of the Companies' tax reserves would need to be offset with the Companies' available loss carryovers (which exceed their tax reserves). *See* Jones Dep. Tr. (Ex. C), at 131:13-136:2

38. The Companies also would be subject to the Alternative Minimum Tax, *see* 26 U.S.C. §§ 55, which has been estimated to be approximately $16-20 million. *See* Jones Dep. Tr. (Ex. C), at 134:23-135:12.

39. The Commissioner's tax plan seeks to minimize total potential tax liability—thus preserving funds for policyholders, guaranty associations and other future creditors—regardless of whether and to what extent the insurers' operating loss carryovers are applied, and irrespective of the fact that they may be reduced under the Code. *See* Verified Appl. to Approve Settlement Agreement ¶¶ 5.a, 5.b (filed June 14, 2016).

b. The PTAC Intervenors' Position

40. The PTAC Intervenors' position depends, in large part, on the TSA between PTAC and the Companies. The third and fourth paragraph of the TSA provide:

> This Agreement shall constitute the basis of tax payments made by the Subsidiaries, if filing a consolidated return with PTA[C], as defined by the Internal Revenue Service. The Subsidiaries shall make payments to PTA[C], as required, in an amount equal to the tax provision required as if the Subsidiaries were not a member of the controlled group. Such tax provision, and payment, shall be calculated at the current statutory rate.
>
> At PTA[C]'s discretion, the Subsidiaries may be entitled to calculate and receive credit for any tax benefit or expense resulting from any credits or expenses arising as a result of inclusion in the controlled group, including but not limited to small life deductions, the use of parent company net operating losses, goodwill exclusion, DAC tax, and temporary differences.

See Tax Sharing Agreement (Ex. B) ¶¶ 3-4.

41. In February 2015, Broadbill objected to the Second Amended Plan asserting that it did not give "any assurance that the Commissioner's proposal will preserve the property interests of PTAC and other third parties, whose property rights are not owned or controlled by the Commissioner or his agents." *See* Broadbill's Objections to Second Amended Plan, at 11 (filed Feb. 13, 2015). Broadbill further asserted that "[a]ll of PTAC's property rights must be preserved. To the extent that the Commissioner presumes (or reserves the right) to include any property rights of PTAC in either the rehabilitation or liquidation of the Companies, Broadbill will object." *Id.* at 12.

42. In Answers to Interrogatories dated July 30, 2015, PTAC declared:

> "[It] is the head of the consolidated tax group with contractual and property rights related to consolidated net operating losses and other tax attributes. PTAC has not authorized any Private Letter Ruling to be sought, nor has it otherwise authorized any other action by PTNA, ANIC or the Commissioner concerning consolidated tax assets, tax-related rights and powers, including those related to tax attributes. These include without limitation assets, rights and powers under applicable tax sharing agreements, consolidated net operating losses and the Internal Revenue Code. Any actions by unauthorized persons are void, including those related to the putative Private Letter Ruling. PTAC reserves all rights and claims related to any unauthorized action concerning, use of or damage to the consolidated tax-related assets, rights and power, none of which are waived hereby." *See* Intervenors' Answers and Objections to the Rehabilitator's Second Set of Interrogatories, at 35, attached as Exhibit D.
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> "[T]he Rehabilitator may not use, interfere with or destroy PTAC's other property rights, including those related to tax assets. This includes, by way of example only, consolidated net operating losses and all other rights related [to] the consolidated tax group, including those incidental to the Tax Sharing Agreement. PTAC is the head of the consolidated tax group including PTNA and ANIC. To the extent that the Commissioner takes

any action not authorized by PTAC that uses, destroys or impairs these rights through actions incidental to the Plan, such action[s] are void." *See id.* at 38.

43. In their August 28, 2015 filing with the Court, PTAC argued that it is "the head of the consolidated tax group with contractual and property rights related to consolidated net operating losses and other tax attributes that the Rehabilitator seeks to use in her Plan. PTAC's authorization is needed to use consolidated tax assets, tax-related rights and powers, including those related to tax attributes." PTAC Intervenors' Reply Brief in Support of Second Quarter 2015 Supplemental Application for Relief at 22 (filed Aug. 28, 2015)

44. In an October 9, 2015 letter addressed to the Court, the PTAC Intervenors argued (among other things) that:

   - "[T]he tax positions as presented by the Rehabilitator in the contemplated [private letter ruling] seek to destroy PTAC's tax rights including the Worthless Stock Deduction, and fail to preserve the approximately $1 billion in tax attributes under the TSA." *See* Letter from D. Christian & S. Warren to the Court (Ex. E), at 3 (Oct. 9, 2015).

   - The PTAC Intervenors attempted to offer to resolve the disputed issues in various manners, including meeting jointly with the IRS prior to the Court "address[ing] the parties' tax disputes" and "settling the parties' disagreements regarding the tax attributes alone." *See* Letter from D. Christian & S. Warren to the Court (Ex. E), at 3 (Oct. 9, 2015).

   - "[T]he contemplated PLR fails to take any position to protect the $1 billion in tax attributes controlled by PTAC under the TSA; rather, it would squander them." *See* Letter from D. Christian & S. Warren to the Court (Ex. E), at 4 (Oct. 9, 2015).

   - "As presently contemplated, the PLR apparently envisions PTAC abdicating its rights to take a worthless stock deduction (not to mention its rights to the $1 billion in

CNOLs and rights under the TSA), over which it has complete discretion, without any compensation." *See* Letter from D. Christian & S. Warren to the Court (Ex. E), at 4 (Oct. 9, 2015).

- "As the controlling parent, PTAC alone determines the allocation of any tax credit received as a consequence of filing consolidated tax returns. Therefore, to the extent the Second Amended Plan's viability depends on the availability of these tax credits, PTAC's own tax rights (including the Worthless Stock Deduction and rights under the TSA) must be preserved. The [private letter ruling] (at least as now contemplated) seeks to injure those property rights." *See* Letter from D. Christian & S. Warren to the Court (Ex. E), at 5 (Oct. 9, 2015).

c. Significance of the Parties' Disputes

45. The Commissioner on the one hand, and the PTAC Intervenors on the other, disagree (among other things) as to the proper interpretation of the TSA. See Fairbanks Dep. Tr. (Ex. A), at 182:10-183:19 ("A. It is my understanding that there is a dispute as to how the tax sharing agreement should be interpreted. Q. [Health Insurers' Counsel] I think we've heard plenty of that.")

46. The Commissioner interprets paragraph three of the TSA as allowing a member of the consolidated tax group to take into account the loss that is generated in earlier years in determining its potential obligation under the TSA. *See, e.g.,* Jones Dep. Tr. (Ex. C), at 56:4-16.

47. The Commissioner also interprets the TSA such that it does not require the Companies to compensate the parent for the use of the operations losses/NOLs that the Companies generated. *See* Jones Dep. Tr. (Ex. C), at 277:15-278:13.

48. The Commissioner further interprets the TSA such that the Companies do not need PTAC's permission to use or apply operations loss carry forwards that the Companies generate. *See* Cantilo Dep. Tr. Vol. 1 (Ex. F), at 216:13-16; 217:6-10, attached as Exhibit F; Jones Dep. Tr. (Ex. C) 56:17-25; 57:2-58:11.

49. The PTAC Intervenors, however, assert that "[u]nder the TSA PTAC has sole discretion over the use of 'any credit or expense arising as a result of inclusion in the controlled group.'" Letter from D. Christian & S. Warren to the Court, at 2-3 (Oct. 9, 2015) (Ex. E).

50. The PTAC Intervenors' tax expert, Gregory Fairbanks, was "instructed to assume that under the TSA, PTAC has sole discretion in how members of the TSA (including PTNA and ANIC) make payments with respect to the usage of current year deductions and credits as well as usage of consolidated net operating loss ("CNOL") carryovers." Letter from D. Christian & S. Warren to the Court (Ex. E), at 2-3 (Oct. 9, 2015); *see also* Fairbanks Rpt. (Ex. A) at 3 ¶ 13, attached as Exhibit G; Fairbanks Dep. Tr. (Ex. A), at 86:20-88;5; 89:5-18.

51. In his Report, Fairbanks stated that "estimated CNOLs are in the range of $800 to $900 million, or more," *see* Fairbanks Report (Ex. G) ¶ 14, and that "PTAC has not agreed to CNOL usage by PTNA or ANIC without compensation under the TSA," *Id.* ¶ 15.

52. Broadbill's counsel, during deposition questioning of Ms. Jones, described the parties' disagreement as follows: "We read the agreement as making the—all of the net operating losses consolidated, they are group assets that may be used at the discretion of the parent, PTAC, okay? That's not your reading. That's how we read it." *See* Jones Dep. Tr. (Ex. C), at 211:25-212:4; *see also id.* at 129:6-13.

53. During Mr. Cantilo's deposition, Broadbill's counsel further described the disagreement. *See* Cantilo Dep. Tr. Vol. 1 (Ex. F), at 191:20-192:2 ("Well, it's not difficult to construct that hypothetical under—if you have—if we're right in how the TSA works—now, you don't have to agree with me that we're right, but assuming that we're right in how the TSA works as written, and you cannot use the tax shield, there's going to be this $800 million tax hole that has to be filled somehow, right?"); *id.* at 192:23-193:2 ("Assume you don't get the PLR you asked for. We're still in that hypothetical. And assume also that we're right on our reading on the TSA, then there's going to be a shortfall of 35 percent of $800 million, roughly, right?"); *id.* at 202:11-16 ("But it could. Whether you agree with me or not, if I'm right and you're wrong in that universe, being wrong about your interpretation of the TSA could result in a shortfall of somewhere around $250 to $300 million, roughly, for PTNA, right?").

54. Ms. Jones has opined that if a worthless stock deduction is taken by PTAC with respect to the stock of PTNA, the operations loss deductions allocable to PTNA and ANIC would be subject to a specific provision in Section 382(g)(4)(D) of the Code, which would have the likely effect of eliminating the use of the PTNA and ANIC operations loss deductions to offset any future income. *See* Jones Opinion/Report, attached as Exhibit H; Rehabilitator's Fourth Supplemental Answers and Objections to Interrogatories, Response No. 38, attached as Exhibit I.

55. The PTAC Intervenors oppose the Commissioner speaking with the IRS on their behalf. *See* Cantilo Dep. Tr. Vol. 1 (Ex. F), at 211:5-8. Letter from D. Christian & S. Warren to the Court (Ex. E), at 3 (Oct. 9, 2015).

56. The PTAC Intervenors' objection to the Commissioner's approaching the IRS without its authorization is an impediment to securing the PLR. *See* Cantilo Dep. Tr. Vol. 1 (Ex. F) at 211:21-212:3.

57. Ms. Jones has testified that a transaction for consideration between the Companies and PTAC could eliminate uncertainty in respect of the utilization of NOLs and avoiding the potential of a worthless stock deduction that could deprive the Companies of the use of the NOLs. *See* Jones Dep. Tr. (Ex. C) at 189:6-190:7.

The record highlighted herein demonstrates the fundamental disagreements between the Commissioner and PTAC which will be resolved by virtue of the MOU settlement. The Commissioner *does not agree with and has not accepted* PTAC's position. However, the risks, uncertainty, delay, cost and potential harm to the policyholders, guaranty associations, and the public on balance favors the settlement agreement reached in the form of the MOU. The record is therefore sufficient to support the Court's approval of the Settlement Agreement.

C. The Settlement Agreement is fair and reasonable because it provides immediate, significant benefits to policyholders, other creditors, and the Companies' estates.

1. The Settlement Agreement benefits policyholders and other creditors because it provides for expedient conversion to liquidation with the consent of the PTAC Intervenors.

The Health Insurers claim that obtaining the PTAC Intervenors' consent to liquidation does not provide a sufficient benefit to justify the settlement agreement because "the Rehabilitator drastically overestimates the time that even a contested conversion petition would take." (Health Insurers Rep. Br. at 8.) However, the Health Insurers can offer no guarantee regarding the duration of such contested proceedings or the ability to proceed with liquidation pending an appeal. The prior conversion petition and appeal consumed more than four years from opening arguments to disposition of the matter on appeal, and the PTAC Intervenors have stated, outside of the settlement context, they will continue their attempts to "fend[] off the Rehabilitator's improper liquidation efforts." *See* PTAC Intervenors' Reply Brief Support of Second Quarter 2015 Supplemental Application for Relief at 2-5 (filed Aug. 28, 2015). Even if a new contested conversion proceeding could be completed in half as much time, the Settlement Agreement would still hold value because an uncontested proceeding could be concluded in a relatively brief time—perhaps in a matter of days—with the certainty that no appeal would be taken. A contested proceeding will never

provide that level of efficiency or certainty, and each day saved represents additional estate assets that can be used to pay claims, including those of policyholders, against the estates rather than litigation costs.

The Settlement Agreement removes this uncertainty. Accordingly, the PTAC Intervenors' consent to liquidation represents a significant benefit that warrants approval of the Settlement Agreement.

2. The Settlement Agreement benefits policyholders and other creditors of the estates because it resolves tax disputes regarding use of the Companies' NOLs.

The Health Insurers highlight the PTAC Intervenors' argument that "'the settlement captures the cost associated with using an asset that another entity owns in order to continue operations' and that absent settlement, the Rehabilitator would be precluded from 'commandeering PTAC's property without compensation.'" (Health Insurers Rep. Br. at 11 (quoting PTAC Intervenors Resp. Br. at 11-12).) The Health Insurers then assert that those statements are based on a "false premise" that PTAC "somehow 'owns' the Companies' shares of the CNOLs." (*Id.*) They argue, relying on *In re Triad Guaranty, Inc.*, No. 14-1464, 2016 WL 3523834, at *19-22 (D. Del. June 27, 2016), that "[t]o the contrary, the Companies' portions of the CNOLs are property of the estate." (Health Insurers Rep. Br. at 11.) The Health Insurers are not plowing new ground in any of their comments or arguments.

The Commissioner does not disagree with *Triad* or with many of the points made by the Health Insurers. In the end, however, *the Health Insurers' points only underscore the dispute* between the Commissioner and the PTAC Intervenors that has unfolded over the past year. Except for basic principles of taxation, there was little agreement in respect of the tax issues, and the record is clear on that point.

As demonstrated above, the record evidences a fundamental disagreement between the Commissioner and the PTAC Intervenors regarding the meaning, application, and effect of the governing tax laws with respect to the NOLs The Commissioners' and the PTAC Intervenors' positions are diametrically opposed. The Commissioner has taken into account the benefit of resolving long-standing litigation, the risks involved in the application of the federal tax law, and the desire to obtain as much certainty as possible through a request for a PLR. Absent settlement, the resulting uncertainty would have required PTNA and ANIC to retain more assets that may now be distributed to policyholders and other creditors of the estates. In light of the uncertainties of litigation and the delay caused by such proceedings, the course selected by the Commissioner to resolve the dispute by method of settlement is reasonable.

In addition, the settlement avoids litigation over the Health Insurers' deconsolidation approach. Such litigation would include, e.g., PTAC's purported adoption of revised bylaws (attached as Exhibit 18 to their filing dated July 26,

2016), which prohibit the issuance of additional PTNA shares without PTAC's consent. Notwithstanding that action (or its propriety),[5] the likelihood of continued litigation relating to the implementation of the deconsolidation strategy further militates in favor of a settlement. The Settlement Agreement provides peace and certainty in relation to the disputed issues raised by the Health Insurers, and avoids disputes concerning tax or other strategies that the Commissioner will now be able to present to the IRS.

3. The Settlement Agreement benefits policyholders and other creditors because it resolves tax disputes regarding the PTAC Intervenor's right to take a worthless stock deduction.

The Health Insurers further argue that PTAC does not currently meet the requirements for a worthless stock deduction ("WSD"), and that, even if it did, the requirements would not affect the Companies until the first day of the first tax year that the Companies cease to be members of the consolidated group. (Health Insurers' Rep. Br. at 14.) Although PTAC may not currently satisfy the requirements for the WSD, the Health Insurers too readily dismiss the risks that remain—including the potential for abandonment of all of the PTNA stock by

[5] Similarly, the PTAC Intervenors' assertion that the Commissioner "released and/or would be barred" from taking any positions regarding taxes as a result of an interim and limited settlement agreement is disputed and not necessary to a disposition of the Settlement Application. *See* Commissioner's Omnibus Response to Settlement Objections, at 3 n.3 (filed July 25, 2016).

PTAC—which accelerates the ability to assert a WSD and would also result in an ownership change that would limit the Companies' ability to use their NOLs under 26 U.S.C. § 382. They also disregard the fact that, in a deconsolidation, the percentage of ownership change must be accounted both at the time deconsolidation occurs but also in respect of all shifts in stock on a combined basis during the three preceding years. There is no private letter ruling or other IRS guidance that addresses the Health Insurers' position that an exception for built-in gains could apply to allow the use of the NOLs against reductions in insurance tax reserves. If the deconsolidation approach were to be implemented, and the IRS disagreed with the Health Insurers' approach, the potential tax liability to PTNA and ANIC could be substantial. The concession to the Commissioner of the right to offset any such liability with the Companies' NOLs is a material benefit of the Settlement Agreement.

The Health Insurers further suggest "there is no authority that would cause the Companies to lose their CNOLs if they were deconsolidated from PTAC." (Health Insurers Br. at 16.) This argument too is oversimplified, and ignores the possible impact of the Unified Loss Rules under Treas. Reg. § 1.1502-36 that could reduce the Companies' NOLS (the loss duplication rules). Again, these are positions to assert in a litigated dispute, but the resolution of the impasse to resolve the tax disagreements and arrange for direct communication with the IRS on

balance is a reasonable exercise of judgment in furtherance of the interests of the policyholders, creditors and the public. None of those arguments should preclude the Court from approving the Settlement Agreement.

4. The amount to be paid to the PTAC Intervenors under the Settlement Agreement is clear.

In a transparent attempt to muddy the settlement waters, the Health Insurers declare that the "amount to be paid under the MOU—either $10 million or $15 million—remains a mystery." (Health Insurers' Rep. Br. at 20.) There is no mystery. The Settlement Agreement merely preserves the right of PTAC to pursue a purchase of AINIC. *See* Settlement Agreement § H.2, at 9. Any such purchase would itself be subject to the Court's further approval. Thus, the only settlement payment for which the Commissioner currently seeks approval is $10 million.

5. The Settlement Agreement benefits policyholders and other creditors because it avoids potential harm and achieves certainty.

In sum, by advocating competing legal interpretations, the Health Insurers have actually underscored the most important point supporting approval of the Settlement Agreement—the value of certainty in the face of uncertain legal outcome and the exercise by the Commissioner of her reasonable discretion in seeking that certainty in the best interests of the estates' statutory stakeholders. The Health Insurers would have the Court believe that the tax issues are a matter of clear-cut, blackletter law, and that the value of the Settlement Agreement is

illusory because those issues could not be resolved other than as they propose. However, the PTAC Intervenors and the Commissioner have each offered alternative arguments on those issues, any of which the Court might accept were it to rule on them. Certainly, the Health Insurers, like the other parties, firmly believe that their position is correct. But the firmness of a party's convictions does not mitigate the risk that the Court might disagree. The Settlement Agreement holds value because it removes that risk and replaces it with the certainty of a Court-approved resolution. As courts have recognized, "settlement is a compromise, a yielding of the highest hopes in exchange for certainty and resolution." *In re Gen. Motors Corp. Pick-up Truck Fuel Tank Prod. Liab. Litig.*, 55 F.3d 768, 806 (3d Cir. 1995); *accord Ruiz v. McKaskle*, 724 F.2d 1149, 1152 (5th Cir. 1984) ("[T]he court must be mindful that inherent in compromise is a yielding of absolutes and an abandoning of highest hopes.").

Thus, the *possibility*, indeed risk, the Court might render a decision in the PTAC Intervenors' or the Health Insurers' or the Commissioner's favor on the tax matters does not undermine the value of the Settlement Agreement to provide a *certain* outcome to those issues. There is no need for further hearing or discovery on this issue. The Settlement Agreement provides immediate benefits to the Companies' estates, and it should therefore be approved by the Court.

II. CONCLUSION

For the reasons set forth above, in the Joint Application for Approval of Settlement Agreement, and in her Omnibus Response to Settlement Objections, the Commissioner requests that the Court approve the Settlement Agreement with the PTAC Intervenors and overrule all objections to the contrary. The Commissioner additionally requests that any appeal of the settlement approval order be conditioned upon the posting of an appeal bond in the amount of at least $36 million.[6] If the Court declines to impose a mandatory bond, the Commissioner requests that the Court order any party seeking to stay execution of the Settlement Agreement pending appeal be required to post a supersedeas bond in the same amount.

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[6] The Commissioner adopts the points made as to the bond in her Omnibus Response to Settlement Objections, and stands on those arguments for purposes of the relief requested.

Dated: August 26, 2016

Respectfully submitted,

/s/ Stephen W. Schwab

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CERTIFICATE OF SERVICE

I certify that, on August 26, 2016, I caused the foregoing Sur-reply of Commissioner Teresa D. Miller to the Health Insurers' and Agents' Objection to the Application for Settlement Approval to be served on the counsel of record listed below. I further certify that the foregoing was posted to the Companies' receivership website and served in accordance with the Court's order governing service on parties appearing on the Master Service List.

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