No. 2020-1292

IN THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

MICHAEL CONWAY, in his capacity as Liquidator of
Colorado Health Insurance Cooperative, Inc.,

Plaintiff-Appellee,

v.

UNITED STATES,

Defendant-Appellant,

On Appeal from the United States Court of Federal Claims,
Case No. 1:18-cv-06123 (Judge Richard A. Hertling)

BRIEF FOR APPELLEE

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CERTIFICATE OF INTEREST

Counsel for Appellee Michael Conway, in his capacity as Liquidator of Colorado HealthOP certifies the following:

1. Full name of every party represented by me:

   Michael Conway, in his capacity as Liquidator of Colorado HealthOP

2. Name of Real Party in interest (Please only include any real party in interest NOT identified in Question 3) represented by me is:

   Michael Conway, in his capacity as Liquidator of Colorado HealthOP

3. Parent corporations and publicly held companies that own 10% or more of stock in the party: None.

4. The names of all law firms and the partners or associates that appeared for the party or amicus now represented by me in the trial court or agency or are expected to appear in this court (and who have not or will not enter an appearance in this case) are: None.

5. The title and number of any case known to counsel to be pending in this or any other court or agency that will directly affect or be directly affected by this court's decision in the pending appeal: None.

June 8, 2020

/s/ Stephen J. McBrady
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TABLE OF CONTENTS

Page

CERTIFICATE OF INTEREST i

TABLE OF AUTHORITIES iv

STATEMENT OF RELATED CASES x

INTRODUCTION 1

STATEMENT OF JURISDICTION 5

STATEMENT OF THE ISSUES 5

STATEMENT OF THE CASE 6

A. Colorado HealthOp and Colorado's Priority Framework for Insurer Liquidations. 6

B. Colorado's ACA Participation. 8

1. Colorado's ACA Reinsurance Program 9

2. Colorado's ACA Risk Adjustment Program 10

C. Liquidation Court Proceedings. 11

D. The Sequence of Events 12

E. The Decision Below 13

STANDARD OF REVIEW 16

SUMMARY OF ARGUMENT 17

ARGUMENT 20

I. Under McCarran-Ferguson And The ACA, The Controlling Issues Of Priority And Offset Are Subject To Colorado Law. 21

A. Colorado Insurance Liquidation Law Is Controlling Here. 21

B. The Government Identifies Nothing In The ACA That Conflicts With The Offset Rules Established By The Colorado

Legislature, Or Which Would Entitle HHS To Offset In Violation Of Colorado Law. 24

C. HHS's Regulations Provide No Authority To Engage In Offsets Not Permitted By Substantive Insolvency Law. 28

1. HHS's Administrative Offset Regulations Are Subject To The Laws Of Bankruptcy and Liquidation. 28

2. The Netting Regulation Does Not Address Insolvency Or Provide HHS With Any Substantive Rights Applicable Once A Liquidation Commences 31

D. The Government's Additional Arguments Also Fail 34

1. The Government Has No Federal Common Law Right of Offset that Would Override State Law 34

a. There is No Special Federal Government Law of Offset. 34

b. There Is No Basis To Create A Uniform Federal Offset Right For ACA Debts. 36

2. The Statute Cited by the Government Does Not Change the Result. 39

II. The Government's Claimed Offset Is Impermissible Under Colorado Law 40

A. Colorado Does Not Recognize A Common Law Right of Offset in Insurer Liquidations. 40

B. The Colorado Offset Statute Does Not Permit The Government's Offset. 44

1. The Relevant Debts and Credits Do Not Arise Out Of Contracts. 44

2. The Relevant Debts and Credits Lack Mutuality. 48

CONCLUSION 55

TABLE OF AUTHORITIES

Page(s)

Cases

Allendale Mut. Ins. Co. v. Melahn,
773 F. Supp. 1283 (W.D. Mo. 1991)....43

Am. Elec. Power Co. v. Connecticut,
564 U.S. 410 (2011)....36

In re Am. Home Mortgage, Holdings, Inc.,
501 B.R. 44 (Bankr. D. Del. Nov. 8, 2013)....49

In re Art Metal U.S.A., Inc.,
109 B.R. 74 (Bankr. D.N.J. 1989)....54

In re Balducci Oil Co., Inc.,
33 B.R. 847 (Bankr. D. Colo. 1983)....44

Barnett Bank of Marion Cty., N.A. v. Nelson,
517 U.S. 25 (1996)....21, 24

In re Bevill, Bresler & Schulman Asset Mgmt., Corp.,
896 F.2d 54 (3d Cir. 1990)....50

Bluewater Ins. Ltd. v. Balzano,
823 P.2d 1365 (Colo. 1992)....*passim*

Brazos Elec. Power Co-op, Inc. v. United States,
144 F.3d 784 (Fed. Cir. 1998)....5

In re Britton,
83 B.R. 914 (E.D.N.C. 1988)....30

In re Candor Diamond Corp.,
76 B.R. 342 (Bankr. S.D.N.Y. 1987)....50

Citizens Bank of Maryland v. Strumpf,
516 U.S. 16 (1995)....48

In re Cullen,
329 B.R. 52 (Bankr. N.D. Iowa 2005)....49

Doe v. United States,
58 F.3d 494 (9th Cir. 1995) 54

In re Fernandes Super Markets, Inc.,
1 B.R. 299 (Bankr. D. Mass. 1979)..49

Gratiot v. United States,
40 U.S. 336 (1841) 35

Gray v. Rollo,
85 U.S. 629 (1873) 50

In re James River Coal Co.,
534 B.R. 666 (Bankr. E.D. Va. July 16, 2015) 49

In re Knedlik,
192 B.R. 559 (Bankr. D. Kan. 1995)..50

In re Liquidation of Home Ins. Co.
972 A2d 1019 (N.H. 2009)..41

In re Liquidation of Realex Grp., N.V.,
620 N.Y.S.2d 37 (N.Y. App. Div.1994) 41

Maine Cmty. Health Options v. United States,
140 S. Ct. 1308 (2020) 5, 9

Marré v. United States,
117 F.3d 297 (5th Cir. 1997) 35, 48

Montana v. United States,
124 F.3d 1269 (Fed Cir. 1997) 36

In re Orexigen Therapeutics, Inc.,
596 B.R. 9 (Bankr. D. Del. Nov. 13, 2018) 49

Ruthardt v. United States,
303 F.3d 375 (1st Cir. 2002).. 22, 23

Scott v. Armstrong,
146 U.S. 499 (1892) 41

Solis v. Home Ins. Co.,
848 F. Supp. 2d 91 (D.N.H. 2012)...23

Stamp v. Insurance Co. of North America,
908 F.2d 1375 (7th Cir. 1990) 43

Studley v. Boylston Nat. Bank,
229 U.S. 523 (1913) 48

Transit Cas. Co. v. Selective Ins. Co. of Se.,
137 F.3d 540 (8th Cir. 1998) 42

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

In re United Scis. of Am., Inc.,
893 F.2d 720 (5th Cir. 1990) 51

United States Nat'l Bank v. Indep. Ins. Agents of Am., Inc.,
508 U.S. 439 (1993) 45

United States v. DeQueen & E. R.R. Co.,
271 F.2d 597 (8th Cir. 1959) 48

United States v. Kimbell Foods, Inc.,
440 U.S. 715 (1979) 34, 36

United States v. Munsey Trust Co.,
332 U.S. 234 (1947) 35

United States v. Transocean Deepwater Drilling, Inc.,
767 F.3d 485 (5th Cir. 2014) 45

United States v. Yazell,
382 U.S. 341 (1966) 38

In re Winstar Commc'ns,
315 B.R. 660 (D. Del. 2004) 49

Federal Statutes

11 U.S.C. §109 21

15 U.S.C. §1011 .... 21, 26

15 U.S.C. §§1011-1015 .... 3, 21

15 U.S.C. §1012(a) 21

15 U.S.C. §1012(b) 21

26 U.S.C. §6402(a) 32

26 U.S.C. §6402(a)-(d) 31

28 U.S.C. §1295(a)(3) 5

28 U.S.C. §1491(a) 5

28 U.S.C. §1503 5

28 U.S.C. §2508 5

31 U.S.C. §3711 *et. seq.* 29

31 U.S.C. §3713 22

31 U.S.C. §3716 .... 29, 32

31 U.S.C. §3716(a)(1)-(4) 29

31 U.S.C. §3716(b)(1) 29

31 U.S.C. §3716(b)(2) 29

31 U.S.C. §3716(c) 32

31 U.S.C. §3720A 32

31 U.S.C. §3728 .... 32, 39, 40

42 U.S.C. §18041(d) .... *passim*

42 U.S.C. §18061 .... *passim*

42 U.S.C. §18061(a) 10

42 U.S.C. §18061(b) 9

42 U.S.C. §18061(b)(1) 9

42 U.S.C. §18063 .... 8, 9, 10, 53

State Statutes

C.R.S. §10-3-501, *et seq.* 7, 23

C.R.S. § 10-3-507(3)(d) 43

C.R.S. §10-3-520(1)(h) 7, 23

C.R.S. §10-3-529 47

C.R.S. §10-3-529(1) .... *passim*

C.R.S §10-3-529(5) 46

C.R.S. §10-3-529(6) 47

C.R.S. §10-3-535 11

C.R.S. §10-3-535(2) 12

C.R.S. §10-3-535(3) 12

C.R.S. §10-3-538 11

C.R.S. §10-3-538(1) 12

C.R.S. §10-3-541 .... 7, 23

C.R.S. §10-3-541(1) 7

Ill.Rev.Stat. ch. 73, § 818 (1983) 43

Regulations

7 C.F.R. §1951.103 (1995) 32

13 C.F.R. §140.5 (1993) 32

31 C.F.R. §901.3 30

41 C.F.R. §101-41.102(a)(3) 32

42 C.F.R. §156.1215(b) 33

42 C.F.R. §401.601 29

42 C.F.R. §401.607 .... 28, 29

42 C.F.R. §401.607(d)(1) 28

45 C.F.R. §153.210(c) 10

45 C.F.R. §153.235(b) 52

45 C.F.R. §156.121 32

45 C.F.R. §156.1215 31

48 C.F.R. §32.611 (1992) 32

48 C.F.R. §32.612 (1992) 32

Other Authorities

78 Fed. Reg. 72,370 (Dec. 2, 2013) 34

CMS, "Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers for the 2014 Benefit Year" (June 30, 2015), *available at* https://www.cms.gov/CCIIO/Programs-and-Initiatives/Premium-Stabilization-Programs/Downloads/RI-RA-Report-REVISED-9-17-15.pdf; 11

CMS, "Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers for the 2015 Benefit Year" (June 30, 2016), *available at* https://www.cms.gov/CCIIO/Programs-and-Initiatives/Premium-Stabilization-Programs/Downloads/June-30-2016-RA-and-RI-Summary-Report-5CR-063016.pdf 11

Garner's Dictionary of Legal Usage (3d ed. 2009) 46

STATEMENT OF RELATED CASES

No other appeal from this case has previously been before this or any other appellate court. Appellee is not aware of any related cases within the meaning of Federal Circuit Rule 47.5(b). *Farmer v. United States*, No. 20-1359, has been designated as a companion case for assignment to the same panel, with a briefing schedule that is scheduled to commence after the principal briefs in this case are filed. Both cases involve ACA insurers in liquidation, but upon review, there does not appear to be any direct substantive overlap between the issues in the two cases.

INTRODUCTION

This action, filed by Michael Conway, the Colorado Commissioner of Insurance, as Liquidator of Colorado Health Insurance Cooperative, Inc. ("Colorado HealthOP"), seeks payments that the Centers for Medicare & Medicaid Services ("CMS") (and CMS's parent agency, the U.S. Department of Health and Human Services ("HHS")) owes Colorado HealthOP under Section 1341 of the Affordable Care Act ("ACA"), 42 U.S.C. §18061, the reinsurance risk pool operated by CMS.

The Government does not dispute what CMS owes Colorado HealthOp under Section 1341. Nor does the Government question the Liquidator's statutory duty to collect that debt, and distribute it to Colorado HealthOp's creditors in accordance with the priorities set by Colorado's insurance liquidation statute, which assigns obligations to policyholders a higher priority than the federal government's claims. The Government nonetheless argues that as operator of a different ACA risk pool, CMS is also a creditor of the estate, and it is entitled to use its claim against the estate by way of offset to pay its debt to the estate, irrespective of priority assigned to its claim by Colorado law.

As the Court of Federal Claims, Hertling, J., held, the Government's position is untenable because Colorado insolvency law provides the rule of decision in determining whether the offset is permissible; the offset is prohibited under Colorado law; and nothing in federal law overrides Colorado law on this point.

There are short, and longer, answers to the Government's contentions. The short answers are:

1. Nothing in the ACA or its regulations addresses insolvency or how ACA obligations are to be treated in an insolvency proceeding. CMS's Netting Regulation, on which the Government primarily relies, is a payment convenience uncontroversial outside of insolvency. But like other forms of administrative offset, it has no application at all in an insolvency setting, whether liquidation or bankruptcy. Here Colorado insurer liquidation law is controlling.

2. The Government alternatively invokes a common law offset right. But the common law offset right possessed by the federal government is simply the same right possessed by a private party. It is not a special federal government rule that authorizes the Government to offset when a private party could not. Moreover, state law presumptively provides the rule of decision, and given that insurer liquidation has been held to be part of the business of insurance reserved to the States (and for many other reasons detailed by Judge Hertling), there is no legal or policy justification for manufacturing a uniform federal right of offset for ACA cases to displace the state law rule of decision.

3. The Government's proposed offset is inconsistent with Colorado law, which limits offset to mutual debts and credits arising from contracts. The Government does not claim a contractual debt. And the offset here is not "mutual"—CMS is paying the debt owed by one pool of insurers using a credit owed

to a different pool of insurers. The absence of mutuality is dispositive under both Colorado law and the common law rules that the Government invokes.

There are longer answers as well. The Government relies on the ACA's general payment and offset procedures, specifically a Netting Regulation utilized by CMS. But when a company is in liquidation, general payment obligations and ordinary prerogatives of debtor-creditor relations, including the self-help of offset, are subject to overarching insolvency laws that determine how debts of the insolvent company may be paid, and in what order. Nothing in the ACA, or the Netting Regulation, addresses insurance insolvency, and, therefore, nothing in the ACA or the Netting Regulation displaces Colorado law on those subjects.

To be sure, for more than 200 years, federal debts have been granted a statutory "super-priority"—meaning, they are paid first, even in a state-administered liquidation. But there is an exception. The McCarran-Ferguson Act, 15 U.S.C. §§1011-1015, preserves insurance regulation for the States. And since *U.S. Dep't of Treasury v. Fabe*, 508 U.S. 491, 507 (1993)—a case the Government fails to even acknowledge in its brief—the law has been clear that to the extent state insurance liquidation law prioritizes payments to policyholders, *as it does here*, that is part of the business of insurance to which the federal super-priority must give way.

Even more importantly, the ACA itself expressly limits preemption to state laws that "prevent the application of the provisions of this title," 42 U.S.C. §18041(d), thus preserving the State's primary role over insurance.

The "netting" rule cited by the Government is not a "provision of" the ACA. And nothing in the ACA grants HHS any authority to adopt rules that would override state insolvency law. To the contrary, like other forms of administrative offset, the netting rule by its own terms establishes only a payment convenience, not a substantive rule of decision applicable in an insolvency or liquidation setting.

The Government's argument that it can rely on a common law right of offset is also a misstatement of the law. The cases are explicit that the Government's common law offset right is simply the same common law right of offset available to private parties, not a special rule or prerogative available to the federal government. Moreover, as Judge Hertling explained, there is no plausible rationale for the creation of a uniform rule of federal common law here. Congress has made clear that insurance regulation, including liquidation of insurers, is primarily for the States, and especially here, because the ACA programs themselves were substantially subject to state control.

The claimed offset is impermissible under Colorado insurance liquidation law—and, for that matter, under the common law theory the Government invokes. The offset claimed by the Government here is not authorized by Colorado statute because the obligations (1) do not arise from contract; and (2) are "non-mutual." On this last point, the money owed Colorado HealthOp comes from a reinsurance pool which includes different insurers than the risk adjustment pool, which has the claim on the estate. While both programs happen to be *operated* by CMS, they do not use

federal funds. The insurers who pay into, and receive payment from, one are not identical to those who pay into, and receive payment from the other. Mutuality exists only when a credit and a debt are owed to and from the same persons in the same capacity.

STATEMENT OF JURISDICTION

This case was properly filed in the Court of Federal Claims under the Tucker Act, 28 U.S.C. §1491(a), seeking damages arising from CMS's failure to pay money due and owing under a money-mandating statute, 42 U.S.C. §18061. *See Maine Cmty. Health Options v. United States*, 140 S. Ct. 1308 (2020) (confirming Tucker Act jurisdiction and a cause of action for damages arising from money-mandating statutes). That court's jurisdiction covers the asserted offset claim. *See* 28 U.S.C. §§1503, 2508; *Brazos Elec. Power Co-op, Inc. v. United States*, 144 F.3d 784, 787 (Fed. Cir. 1998). After granting summary judgment on liability to the Liquidator, the court below entered final judgment on the jointly-stipulated quantum on October 18, 2019. This Court has jurisdiction over the Government's appeal under 28 U.S.C. §1295(a)(3).

STATEMENT OF THE ISSUES

Given that Colorado HealthOp is in liquidation, can CMS, as operator of the ACA's Section 1343 risk adjustment program, use its Section 1343 claims against Colorado HealthOp to offset what it owes Colorado HealthOp as the operator of the

ACA's Section 1341 reinsurance program, rather than pay the debt and receive payment on its claim in accordance with the Colorado priority statute?

That issue has both state and federal law components:

1. As a matter of Colorado insurance liquidation law, is the claimed offset barred because (1) the debts and credits at issue are not contractual; and (2) are not "mutual"?[1]

2. Does any provision of federal statutory law, common law, or regulation, preempt Colorado law limiting offset in connection with the liquidation of a Colorado insurance company?

STATEMENT OF THE CASE

A. Colorado HealthOp and Colorado's Priority Framework for Insurer Liquidations.

Colorado HealthOP was formed as a Colorado nonprofit corporation and insurer subject to comprehensive insurance regulation under Colorado law. It was qualified as a CO-OP under ACA Section 1322 and provided comprehensive health insurance benefits to approximately 83,000 individuals, families, and businesses in Colorado.

After Colorado HealthOP encountered financial difficulties, the District Court for the City and County of Denver ("Liquidation Court") placed Colorado HealthOP

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[1] As seen below, mutuality is a requirement even for the common law offset that the Government invokes here, and thus the lack of mutuality is dispositive even under the Government's common law theory.

in liquidation on January 4, 2016. Those liquidation proceedings are governed by the Colorado Insurers' Rehabilitation and Liquidation Act, C.R.S. §10-3-501, *et seq*. (the "Liquidation Act").

Michael Conway, the Colorado Insurance Commissioner, was appointed Liquidator, subject to court supervision. As Liquidator, he is responsible for liquidating all assets, including collecting all debts, owed the insurer, C.R.S. §10-3-520(1)(h), and then distributing the proceeds to the various classes of creditors in accordance with a priority framework established by the Colorado legislature. C.R.S. §10-3-541.

Under that framework, administrative expenses are paid first as Class 1 claims. Policyholder claims rank next, as Class 2 claims. *Id.* Class 3 is reserved for federal government claims. *Id.* All other creditor claims are assigned a lower priority. The result is that federal government claims are paid after policyholder claims, but before all other creditors.[2] This ordering of priorities mirrors the priority ranking for insurance liquidations that the Supreme Court approved in *Fabe*.

To protect that priority framework, Colorado limits the circumstances under which an insurer's creditors can use claims against the liquidating insurer to offset

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[2] The "distribution of claims from the insurer's estate shall be in accordance with the order in which each class of claims is set forth in this section. Every claim in each class shall be paid in full . . . before the members of the next class receive any payment." C.R.S. §10-3-541(1).

debts *to* the liquidating insurer's estate. *See Bluewater Ins. Ltd. v. Balzano*, 823 P.2d 1365, 1374 (Colo. 1992) (unauthorized offset "would be contrary to the order of distribution provided in the liquidation act"). An *unauthorized* offset seeks to avoid the statutory priority framework—to "jump the line"—by using a creditor's control of one of the estate's assets (the debt owed the insurer) to pay off a claim, rather than await distribution according to the statutory priority framework. Some offsets are now authorized by statute in Colorado. *See* C.R.S. §10-3-529(1). Specifically, offsets are allowed for mutual debts and credits, whether arising from one or more contracts. *Id.*

B. Colorado's ACA Participation.

While in operation, Colorado HealthOP offered insurance on Colorado's ACA exchange and, as such, was required to participate in a variety of ACA programs. The two at issue here—the Section 1341 transitional reinsurance program, 42 U.S.C. §18061, and the Section 1343, risk adjustment program, 42 U.S.C. §18063—are independent government-operated risk-sharing pools, to be administered by individual States, or (at the State's option) by HHS on the State's behalf. The Supreme Court recently summarized the "'Reinsurance' and 'Risk Adjustment' programs" as follows:

> The former [Reinsurance] ran from 2014 to 2016 and required insurers to pay premiums into a pool that compensated carriers covering "high risk individuals." §1341, 124 Stat. 208, 42 U. S. C. §18061. The latter [Risk Adjustment] is still in effect and annually transfers funds from insurance plans with relatively low-risk enrollees to plans with higher risk enrollees. See §1343, 124 Stat. 212, 42 U.S.C. §18063.

See Maine, 140 S.Ct. at 1316, n.1. Each program, in each state, comprised a separate pool of different insurers. Payments out from each pool were limited to payments in from the insurers in the pool, with no recourse to federal (general treasury or taxpayer) funds. More specifically:

1. Colorado's ACA Reinsurance Program

ACA §1341 created a "Transitional reinsurance program for individual market in each State." States were to establish a program under which a "Reinsurance entity" would obtain mandatory collections from all insurers in the State (on and off of the exchanges) and use those collections to pay insurers covering the most costly enrollees in the benefit year. *See* 42 U.S.C. §18061(b); *see* Appx5. The program is a closed pool: reinsurance payments in from all insurers financed reinsurance payments out to insurers covering high risk individuals, all without use of federal taxpayer or general treasury funds.

States were to be responsible for administering the pool—to "establish and maintain"—through a "reinsurance entity." 42 U.S.C. §18061(b)(1). The statute provides that the State "shall . . . establish (or enter into contract with) 1 or more

applicable reinsurance entities to carry out the reinsurance program." 42 U.S.C. §18061(a). However, rather than operate the reinsurance pool itself, a State could choose to have HHS do so. 45 C.F.R. §153.210(c). That is what Colorado chose to do.

For benefit year 2015, Colorado HealthOp was a §1341 net payee, meaning that it was, and is, owed money. In its "Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers for the 2015 Benefit Year" CMS confirmed that it owed Colorado HealthOP a Reinsurance payment of $38,664,334.67. Of that sum, Colorado HealthOP was paid $14,174,535, leaving $24,489,799 to be paid. By stipulation of the parties, that was the amount for which the Court of Federal Claims entered judgment in this case.

2. Colorado's ACA Risk Adjustment Program

Section 1343 of the ACA, 42 U.S.C. §18063, created a different risk sharing pool, populated differently than the reinsurance pool. The risk adjustment program was designed to transfer funds from a state's "low actuarial risk plans" to "high actuarial risk plans" within the same state. 42 U.S.C. §18063. Section 1343 provides that *each State shall* assess charges for payments into the risk adjustment program, and in turn *the State* shall distribute those collections to the insurers in the program. The ACA provides that the program will be operated by each State and "each State shall provide a payment to health plans and health insurance issuers." However, any State may elect to have HHS, through CMS, "operate"—the statutory term that the

Government has used – the State's program and Colorado, like most States, chose that approach.

Under the applicable formula, Colorado HealthOp owed money to the risk adjustment pool.[3] In the proof of claim that CMS submitted to the Liquidator, CMS cited the unpaid risk adjustment balance as the basis for the set off it claimed in failing to pay the Liquidator what was due and owing under the reinsurance program.

C. Liquidation Court Proceedings.

In December 2016, CMS submitted proofs of claims purportedly "owed by Debtor [Colorado HealthOP] under the Affordable Care Act and federal law." Appx63. For all of its claims, CMS asserted a general federal super-priority—an entitlement to be paid first—citing "Federal Law and 507c.42(3)."[4] *Id.* CMS's assertion of that super-priority was inconsistent with the Supreme Court's decision in *Fabe*, and has not been asserted by the Government in this litigation.

Pursuant to the requirements and authority provided to the Liquidator in C.R.S. §§10-3-535 & 10-3-538, the Liquidator reviewed and evaluated the proofs of claim.

[3] *See* CMS, "Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers for the 2014 Benefit Year" (June 30, 2015), *available at* https://www.cms.gov/CCIIO/Programs-and-Initiatives/Premium-Stabilization-Programs/Downloads/RI-RA-Report-REVISED-9-17-15.pdf; CMS, "Summary Report on Transitional Reinsurance Payments and Permanent Risk Adjustment Transfers for the 2015 Benefit Year" (June 30, 2016), *available at* https://www.cms.gov/CCIIO/Programs-and-Initiatives/Premium-Stabilization-Programs/Downloads/June-30-2016-RA-and-RI-Summary-Report-5CR-063016.pdf.

[4] The Government's reference to "507c.42(3)" appears to have been cribbed perhaps from some other legal document. That is a citation form used for Iowa statutes.

On April 17, 2017, consistent with the requirements and authority set forth in C.R.S. §10-3-535(2)&(3), the Liquidator asked CMS for additional information on the claims, claimed offsets, and priority, by June 1, 2017. The Liquidator stated that if CMS "fail(s) to respond . . . the Liquidator reserves the right to . . . deem the omitted information not to support your position in this matter." Appx214. CMS failed to timely respond. It requested an extension nearly a month after the deadline. The Liquidator granted the extension, but CMS again failed to respond. Appx221. On August 30, 2017, pursuant to C.R.S. §§10-3-535(2) and 10-3-538(1), the Liquidator determined*, inter alia*, that the Government's claims based in the Affordable Care Act, other than the surplus note claims, would properly be classified in Class 3 claims and that the offsets were taken without court authorization. Appx222-223. On December 11, 2017, the Liquidator moved the Liquidation Court to affirm his claim determination. Appx226. The Liquidation Court granted the motion. Appx236.

D. The Sequence of Events

The Government's rendition of events leaves timing somewhat obscure. Suffice it that CMS asserted and internally recorded the claimed offsets against payments scheduled to be made *after* the liquidation commenced. The basic sequence (*see* Appx4) is:

(1) The Liquidation Court placed Colorado HealthOp in liquidation in January 2016;

(2) In March 2016, CMS made a reinsurance payment of $14,154,424 to Colorado HealthOp for the previous year. Later that month, the Liquidator sent CMS a notice to creditors to submit their claims in the liquidation proceeding;

(3) In June 2016, CMS published the amounts it owed insurers for the prior benefit year, including that it owed Colorado HealthOp $38,644,223.02 in reinsurance obligations (later amended to $38,664,334.67), of which it had paid $14,174,535;

(4) In August 2016, CMS notified the Liquidator that it intended to offset amounts owed the estate under the reinsurance program against what CMS claimed under the risk-adjustment program;

(5) In December 2016, CMS submitted proofs of claim to the Liquidator;

(6) Between February 2017 and May 2018, CMS internally recorded the offsets at issue.

E. The Decision Below

The Liquidator brought this case in the Court of Federal Claims seeking payment of what it is owed under the reinsurance program. The Liquidator noted that the Government had raised offset as its sole defense to non-payment. Appx45. The Liquidator moved for summary judgment. The Government moved to dismiss.

The Government did not argue that the text of the ACA created any super-priority for ACA payment obligations, or expressly permitted CMS to offset against amounts owed once an insurer entered liquidation. It cited the general HHS administrative offset regulations and the so-called Netting Regulation as its source of

authority for the offset. The Government based its argument below primarily on preemption theories. It also argued that Colorado law permitted the offset. By the time of the reply, the Government had abandoned the suggestion that HHS's administrative offset authority justified the offset here.

After argument, Judge Hertling denied the Government's motion to dismiss, and granted the Liquidator's motion for summary judgment on liability, allowing the parties to determine quantum. The parties then stipulated to the damages as originally pleaded, $24,489,799, and the court entered judgment for that amount. Appx21.

Judge Hertling summarized his holding as follows:

> The Court holds that HHS's offset was invalid under Colorado's insurance liquidation priority scheme. Because neither the ACA nor another statute authorizes the Netting Rule's application in the insurance liquidation context, HHS must have taken its offset in its capacity as a creditor. Although federal law governs HHS's rights as a creditor in implementing the nationwide reinsurance and risk-adjustment programs, its interest in uniformity is insufficient to warrant this Court creating a federal common law rule to displace Colorado's insurance liquidation priority scheme.

Appx7. Judge Hertling noted that the ACA itself limits the ACA's preemptive effect to state laws that "prevent the application of provisions of this title." 42 U.S.C. §18041(d). Although the ACA imposes various obligations on insurers, all of those obligations are subject to overarching bankruptcy or liquidation law once those laws are triggered. Nothing in the ACA purports to override any aspect of bankruptcy or liquidation law, whether relating to priority or offset.

Focusing on the Government's argument that HHS's Netting Regulation provided authority for offset here, Judge Hertling noted that the rule was not itself a "provision" of the ACA. Moreover, nothing in the ACA suggested that HHS was granted any authority to promulgate rules applicable to insolvency. And the Netting Rule itself—like other laws and regulations providing for administrative set-off—was itself, both in its text and its intention, only an administrative payment convenience. It contained no suggestion that it addressed, applied in connection with, or was intended to override, the overarching rules that apply in insolvency proceedings, whether bankruptcy or liquidation.

Judge Hertling also rejected the Government's argument that its unilateral offset was permissible under Colorado law. The "default" rule in Colorado is that except as permitted by statute, offsets are not allowed because such offsets derogate from the statutory priority scheme. Colorado's offset statute only affirmatively permits offset for contractual debts.

Having focused on the most Colorado-specific ground for rejecting the offset here, Judge Hertling did not reach the second ground asserted by the Liquidator why the Colorado offset statute would did not permit the offset here: Offset is permissible only for *mutual* debts and credits, and mutuality is strictly construed against the party claiming a right to offset. Here, mutuality was lacking because while both programs happen to be *operated by* CMS (though either could have been operated by Colorado), the reinsurance and risk adjustment risk pools are each closed pools

populated by different insurers. Thus, the offset here amounted to the improper triangulation of payments: using the debt owed one party or group of parties to pay the claim of another party or group of parties.

Judge Hertling also rejected the Government's request to create a uniform rule of federal offset for ACA debts. He noted that the presumptive approach to such issues is that federal law embraces applicable state law as the rule of decision. He found no basis to depart from that presumptive rule. By virtue of McCarran-Ferguson, States are granted primary authority over insurance. He likewise considered each of the factors that might justify creating a special federal common law rule of offset, and determined that none of them supported such a rule here. "The ACA's state-by-state structure, the ACA's own non-preemption provision, and the role Congress assigned to HHS in administering the reinsurance and risk-adjustment programs on behalf of states undermine HHS' argument that federal interests require a uniform rule [providing HHS with a priority or right of offset for debts owed under the ACA]." Appx16.

He thus rejected CMS's claimed offset. After the parties agreed on quantum, Judge Hertling entered judgment for the Liquidator in the claimed amount on October 21, 2019. Appx21.

STANDARD OF REVIEW

Both the federal and state law issues presented by this appeal are issues of law, reviewable de novo.

SUMMARY OF ARGUMENT

The McCarran-Ferguson Act specifies that the business of insurance is a matter of state, not federal, law. Because of McCarran-Ferguson, and the explicit exclusion of insurers from federal bankruptcy law, insurer insolvencies are governed by state law. Moreover, as the Supreme Court explained in *Fabe*, 508 U.S. at 507, to the extent state liquidation law seeks to prioritize distributions to policyholders, the state is engaged in the business of insurance. Therefore, the statutory "super-priority" granted debts to the federal government in other insolvency settings will not override state insurance liquidation law protecting policyholders. Congress can, of course, override state liquidation laws, but it must do so by statute manifesting that intent.

While the ACA is assuredly a statute relating to insurance, nothing in the ACA addresses, or purports to address insolvency, or liquidation, or grants HHS any power to create rules applicable to insolvency which might override state insurance liquidation laws protecting policyholders. In fact, the ACA's own non-preemption provision, 42 U.S.C. §18041(d), confirms the primacy of state regulatory authority over the business of insurance. Entitled, "No interference with State regulatory authority," 42 U.S.C. §18041(d), that section eliminates any argument for field preemption, "frustration," and "obstacle" preemption, by allowing preemption only for state laws that "*prevent the application of the provisions of this title*." No provision of the ACA addresses insolvency, debt collection, priority, or offset, or other aspects of insurer bankruptcy or liquidation. Therefore, the Government's claimed offset can

neither overcome the McCarran-Ferguson Act, nor the ACA's own "non-preemption" provision.

That the ACA, or ACA regulations, state a general rule—for example, by creating seemingly absolute payment obligations—does not determine how the rule applies in liquidation proceedings. Insolvency law is an overlay of law that applies on top of ordinary substantive law. For example, the ACA imposes payment obligations on insurers in no uncertain terms. But when liquidation (or bankruptcy) proceedings commence, all such mandates are subject to the overarching umbrella of insolvency law, including limitations on offset and other forms of self-help. As Judge Hertling explained, the absence of any provision of the ACA (or regulations) addressing insolvency, priority, liquidation or anything similar precludes the Government's principal theories here.

That is why the Government's reliance on its so-called Netting Regulation is misplaced. First, the fact that it is merely a regulation, not a provision of the statute, is itself sufficient to refute the notion that a "provision" of the ACA displaces state liquidation priority or offset rules. Equally important, neither the text of the Netting Regulation, nor its history, suggests that it was intended as anything more than a conventional payment convenience, rather than the kind of substantive rule that would be applicable within the framework of insolvency law.

The Government's assertion that it is entitled to assert a common law right of offset also fails at the starting gate. The common law right of offset recognized in the cases is not, as the Government would have it, a special uniform rule applicable to federal debts. Rather, it is simply the same common law of offset available to private parties, whether as self-help outside of litigation, or within federal bankruptcy (which applies common law principles for offset). Within a state liquidation, the federal government again has the same offset rights as a private party.

There is also no basis to create any special uniform federal offset rule here. As Judge Hertling explained, insurance is a field that Congress has explicitly preserved for the States. The ACA itself confirms state primacy. And even with respect to these specific programs, the States' presumptive role as the operator of the programs precludes any reasonable suggestion that the courts should create a uniform rule of offset that would supplant the state rule of decision.

The offset taken by the Government here is improper under Colorado law. As the Colorado Supreme Court explained, Colorado does not recognize a common law offset right in an insurer liquidation. Allowing a creditor to unilaterally offset against debts owed the liquidating insurer where not authorized by the legislature, would fundamentally upset the priority framework set forth by statute. Subsequent to that ruling, the Colorado legislature authorized offset for contractual debts, but only where the debts are mutual. There is no contractual debt at issue here.

Nor were the debts mutual. CMS "operates" two distinct, closed-pool programs with different participants. The insurers in the risk adjustment pool, and for whom CMS acts a creditor of Colorado HealthOp, are not the same insurers who are in the reinsurance program that owes money to Colorado HealthOp. CMS's unique role here as "operator" (in lieu of the State) of two independent risk-sharing pools, does not qualify the debts and credits here as "mutual." The absence of mutuality precludes offset whether under Colorado law, or under the common law theories the Government invokes.

ARGUMENT

Once a bankruptcy or liquidation commences, ordinary rules and prerogatives governing creditor-debtor relations and self-help, whether through offset or litigation, become subject to the overarching rules for the collection of debts and distribution of assets that govern insolvency. As demonstrated below, the right of unilateral offset that the Government claims here is not permissible under Colorado insurance liquidation law. Because the Government claims that its offset is permissible as a matter of federal law irrespective of Colorado law, and begins with that argument, Colorado HealthOp likewise begins with the federal issues and then turns to Colorado law.

I. Under McCarran-Ferguson And The ACA, The Controlling Issues Of Priority And Offset Are Subject To Colorado Law.

A. Colorado Insurance Liquidation Law Is Controlling Here.

The McCarran-Ferguson Act, 15 U.S.C. §§1011-1015, recognizes the States as the primary authority over the business of insurance. That Act, and the explicit exemption of domestic insurers from federal bankruptcy law, 11 U.S.C. §109, ensures that the liquidation of an insurance company will be governed by state law.

Moreover, reversing ordinary principles of federal preemption, McCarran-Ferguson provides that "Act[s] of Congress" not expressly purporting to regulate the "business of insurance" do not "invalidate, impair, or supersede" state laws that do. 15 U.S.C. §1012(a) & (b). "[S]ilence on the part of the Congress shall not be construed to impose any barrier to the regulation . . . [of insurance] business by the several States." 15 U.S.C. §1011.

Absent a "clear statement" in a federal statute that "specifically requires otherwise," "state laws enacted 'for the purpose of regulating the business of insurance' do not yield to conflicting federal statutes." *Fabe*, 508 U.S. at 507. McCarran-Ferguson does not require an explicit statement of intention to preempt, such as "'state law is pre-empted,' or the like." *Barnett Bank of Marion Cty., N.A. v. Nelson*, 517 U.S. 25, 43 (1996). But at a minimum there must be a statutory direction that Congress would anticipate as creating a conflict between federal law and state regulatory authority—resulting in federal law prevailing. *Id.* at 42. Nothing in the

ACA addresses, and therefore creates any conflict, with state insolvency law addressing insurer liquidation.

In *Fabe*, the Supreme Court addressed how state liquidation law impacts federal claims against an insolvent insurer. The Government there argued for application of a part of the federal Debt Collection Act known as the Federal Priority Statute, 31 U.S.C. §3713, a 200-year-old law granting super-priority to debts owed the federal government, facially applicable in all insolvency proceedings, federal or state. Although federal super-priority was of long lineage, and addressed insolvency, it was not addressed to insurance and, therefore, could not trump a state law governing insurance. *Fabe*, 508 U.S. at 493-94.

The issue then was whether insurance liquidation law was part of the business of insurance reserved to the states. The Supreme Court said yes: If a state seeks to maximize distributions to policyholders through its ranking of priorities, that ranking is part of the business of insurance. *See id.* at 505-06, 509. Therefore, state insurer liquidation laws can grant policyholder claims a higher priority than federal government claims, although (because of the super-priority statute) the federal government must be given priority over other creditors.[5] *Id.; see also Ruthardt v. United*

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[5] In passing, the Government observes that in Colorado (and most other states) policyholder claims in cases of insolvency are covered by state guaranty funds. Gov't Br. at 23, n.7. The Government does *not* assert that this changes the analysis here, nor could it. That a state guaranty fund pays the policyholder claims means merely that (continued...)

States, 303 F.3d 375, 379-384 (1st Cir. 2002) (guaranty funds that paid policyholders stand in the shoes of the policyholders and are entitled to priority over U.S. government claims); *Solis v. Home Ins. Co.*, 848 F. Supp. 2d 91 (D.N.H. 2012) (upholding priority for policyholder claims and rejecting the Government's claim to super-priority for a particular government program). That is exactly the framework Colorado has adopted.

The Colorado Insurers' Rehabilitation and Liquidation Act, C.R.S. §10-3-501 *et seq*., requires the liquidator to collect *all* debts owed the liquidating insurer. C.R.S. §10-3-520(1)(h). Claims on the insurer are paid only according to the statutory order of priority. And following *Fabe*, under Colorado law, expenses and payments owed policyholders are granted the highest priorities (Class 1 and 2). Debts to the federal government are ranked next (Class 3), meaning the federal government is paid after policyholders, but before other creditors. C.R.S. §10-3-541.

Fabe controls here. The allowance or disallowance of offsets is part and parcel of the priority structure governing insurer liquidation. *See* C.R.S. §10-3-529(1). As the Colorado Supreme Court explained, taking an offset *not* authorized by the legislature is improper because it "would be contrary to the order of distribution provided in the

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(continued)
the guaranty fund stands in the shoes of the policyholders for priority—and claimed super-priority—purposes. *See Ruthardt v. United States,* 303 F.3d 375, 379-384 (1st Cir. 2002) (applying *Fabe* to hold that guaranty fund repayment properly ranks before claims by the federal government).

liquidation act." *Bluewater*, 823 P.2d at 1374. An unauthorized offset would allow a creditor, like CMS here, to unilaterally promote its own lower-priority claim (here a Class 3 claim), over higher priority claims (Class 2 policyholder claims). Because (as shown below), the claimed offset here was not authorized by the Colorado legislature, "any exercise of the right to offset . . . would create a preference for the [party claiming the offset] over the policyholders in the distribution of [the liquidating insurer's] assets, contrary to public policy." *Id.* at 1376. In contrast, the disallowance of an *unauthorized* offset simply puts the party claiming the offset in the position of "other" general creditors who must get in line behind the policyholders. *Bluewater*, 823 P.2d at 1374.

B. The Government Identifies Nothing In The ACA That Conflicts With The Offset Rules Established By The Colorado Legislature, Or Which Would Entitle HHS To Offset In Violation Of Colorado Law.

The Government argues that federal law nonetheless controls. And it is true, of course, that the ACA is a statute addressing insurance. But to prevail on its federal theory in light of McCarran-Ferguson, the Government must find something in the ACA demonstrating Congress's understanding that it was setting up some rule of offset or priority that would likely conflict with, and thus supersede, state law on the issue. *See Barnett Bank,* 517 U.S. at 43. The Government cannot make this showing.

To the contrary, the ACA demonstrates that it is *not* intended to displace state law regulating insurance, unless state law conflicts with the statute itself. Under the

title "*No interference with State regulatory authority*," the ACA specifies that "Nothing in this title shall be construed to preempt any State law that does not prevent the application of *the provisions of this title*." 42 U.S.C. §18041(d) (emphasis added). Thus, the ACA itself precludes claims of field preemption, or frustration of purpose preemption, requiring instead a direct conflict between state law and "the provisions of this title."

The Government's argument fails at this threshold because the Government does not identify *any* provision of the ACA in conflict with the Colorado insurance liquidation offset statute or any other provision of Colorado insolvency law. It cites nothing in the ACA, or any other "Act of Congress," granting the federal government any different right in that setting than would be possessed by any other creditor or debtor to engage in self-help by offset, or giving the federal government any priority or prerogative not possessed by other creditors. Moreover, the Government cites nothing in the ACA that authorizes HHS to promulgate regulations that would have that effect.

In addressing the issues in the case, the Government makes a fundamental error by suggesting that the ACA's generally-stated mandates, or CMS's general procedures and practices—provisions and practices not specifically addressed to insolvency, liquidation, or priority—override the special body of law that governs in an insolvency setting. There are, of course, many provisions of the ACA that impose clear, and seemingly absolute, payment obligations on insurers. And the Government,

of course, ordinarily has any number of options on how to enforce those obligations, ranging from self-help to lawsuits. But not even the Government argues that these seemingly absolute payment obligations are not subject to insolvency law once liquidation commences. That is because it is well understood that the overarching umbrella of insolvency law applies to the method and priority of payment of such obligations —and nothing in the ACA addresses that overarching framework of insolvency law. Thus, the decisive point here is that nothing in the ACA even arguably addresses insolvency, bankruptcy, or liquidation, and thus could sweep away the laws that apply in that setting.

The Government offers some broad assertions about the importance of insurer payments and programs under the ACA. These broad assertions might be significant if the parties were arguing about field preemption or general variants of conflict preemption, such as obstacle preemption, or frustration-of-purpose preemption, *i.e.*, that the ACA, by its nature or broad goals nullified state insurance regulations addressing the same subject matter. But that kind of preemption argument is precluded both by the McCarran-Ferguson Act and the ACA itself.

Under McCarran-Ferguson, "[S]ilence on the part of the Congress shall not be construed to impose any barrier to the regulation . . . [of insurance] business by the several States." 15 U.S.C. §1011. And the ACA's own non-preemption provision limits its preemptive force to situations where state law prevents the application of some provision of the ACA. 42 U.S.C. §18041(d). The broad purposes cited by the

Government do not address the issues associated with insurer liquidation at all, let alone mark the kind of clear conflict between the federal law and state law that would be required to overcome McCarran-Ferguson or the ACA's own limitation on preemption.

Indeed, once we enter the realm of general policy considerations, the notion that the ACA was intended to override state insolvency law becomes even more implausible.

First, such a law would be remarkably under-inclusive of any reasonable policy goal. Congress conceivably might have an interest in creating a special priority for the payment of an insurers' obligations under the ACA. But if Congress wanted an insurer's ACA debts and obligations to enjoy a special priority, it would be odd to provide for this priority only where CMS can exercise such priority via offset.

Second, as Judge Hertling observed, both programs at issue here were to be administered by the States. It is difficult to see how or why Congress could have had an interest in establishing special overriding federal offset right for programs, payments, and collections left in large part to the States.

Third, given that the basic purpose of the ACA is to provide and expand available insurance, it is reasonable to expect that if an insurer went into liquidation, Congress would itself have wanted to prioritize payments to policyholders, rather than to other insurers.

C. HHS's Regulations Provide No Authority To Engage In Offsets Not Permitted By Substantive Insolvency Law.

In this Court, the Government invokes only HHS's netting rule and, as seen below, the Government's reliance on that rule fails because nothing in it addresses insolvency, *i.e.* how offset is to be treated once a liquidation commences. In the court below, the Government also invoked HHS regulations authorizing administrative offset. Appellee discusses them briefly here because they highlight that absent a specific statute demonstrating otherwise, agency offset rights are always subject to applicable insolvency laws, and do not supersede them.

1. HHS's Administrative Offset Regulations Are Subject To The Laws Of Bankruptcy and Liquidation.

In the court below, the Government invoked 42 C.F.R. §401.607, HHS's administrative offset regulation, but declined to rely on that regulation in its reply brief. The regulation expressly provides that "CMS may offset, where possible, the amount of a claim [to be collected] against the amount of pay, compensation, benefits or other monies that a debtor is receiving or is due from the Federal government." 42 C.F.R. §401.607(d)(1).

In this Court, the Government feels duty bound to acknowledge the regulation, but relegates it to a footnote. *See* Gov't Br. at 16 n.5. And the Government concedes that the "payment rules codified in the Netting Regulation are consistent with longstanding practice" embodied in 42 C.F.R. §401.607. *Id.* That concession is correct and decisive here. Those regulations leave no doubt that whatever may be the

federal government's ordinary offset prerogatives outside of insolvency, once liquidation commences, issues like priority and offset are subject to the overarching rules that apply that setting.

The source of authority for 42 C.F.R. §401.607, is the Federal Debt Collection Act, 31 U.S.C. §3711 *et. seq*., which includes a detailed provision entitled Administrative Offset, 31 U.S.C. §3716. The statutorily-authorized process of administrative offset is subject to a range of prescribed procedures and requirements. 31 U.S.C. §3716(a)(1)-(4).

More important for present purposes, to engage in administrative offset, an agency like HHS must first adopt rules and regulations promulgated by the Department of Justice and the Department of the Treasury, or their equivalent. *See* 31 U.S.C. §3716(b)(1) & (2). In promulgating 42 C.F.R. §401.607, HHS opted for the latter, conforming its practices to regulations issued by the Department of the Treasury and the Department of Justice (31 C.F.R. parts 900-904). *See* 42 C.F.R. §401.601.

With that in mind, HHS's administrative offset regulation, 42 C.F.R. §401.607, undercuts the Government's theory here. Despite the fact that administrative offset is uncontroversial *outside* the realm of bankruptcy and liquidation, the right of self-help through administrative offset ends once bankruptcy or other legal proceedings begin. The agency prerogative of self-help via offset does not override substantive rules governing permissible offset once a bankruptcy or other judicial proceeding

commences. *See In re Britton*, 83 B.R. 914 (E.D.N.C. 1988) (provision for administrative offset does not override standards for permissible offset applicable in bankruptcy). Thus, even after the automatic stay is lifted, the bankruptcy court will apply substantive law standards applicable in bankruptcy, not administrative offset regulations, in determining whether an agency offset is permissible. *Id.* at 919-21.

Indeed, Treasury's own regulations are explicit that the self-help prerogative to offset is always subject to substantive law governing permissible offset, and further, that such self-help is impermissible once judicial proceedings, including bankruptcy, begin.[6] 31 C.F.R. §901.3.

Outside the realm of insolvency, there are rarely substantive obstacles to convenient offsets. But once bankruptcy begins, it is for the court to determine whether an offset is permissible. Because the Code does not contain substantive law on offset, federal bankruptcy courts apply common law principles to determine

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[6] As noted above, CMS's regulation "conforms to the [Treasury] regulations (31 C.F.R. parts 900-904)." The Treasury Regulation states:

> 31 C.F.R. §901.3 - Collection by administrative offset.
>
> (a) Scope.
>
> (2) This section does not apply to:
>
> …….
>
> (vi) Offsets or recoupments under common law, State law, or Federal statutes specifically prohibiting offsets or recoupments of particular types of debts; or
>
> (vii) Offsets in the course of judicial proceedings, including bankruptcy.

whether a proposed offset is permissible. Only where Congress, by statute, has clearly conferred a *substantive* right of offset on a federal agency, such as the specific statutory offset right granted Treasury for tax payments, 26 U.S.C. §6402(a)-(d),will bankruptcy courts apply federal statutory law.

2. The Netting Regulation Does Not Address Insolvency Or Provide HHS With Any Substantive Rights Applicable Once A Liquidation Commences

The same principles apply to the Netting Regulation, 45 C.F.R. §156.1215. Nothing about that regulation suggests that it is more than an administrative payment convenience. It creates no substantive rights applicable in an insolvency setting.

Moreover, to state the obvious, the Netting Regulation is not a provision of the ACA. And nothing in the ACA reflects that Congress ordered, permitted, or "anticipated" that HHS would promulgate s rules on offset that could override governing state liquidation law. To be faithful to the text of McCarran-Ferguson and the ACA's own preemption limitation limiting preemption to conflict with its provisions, any grant of authority to take offsets that would override Colorado's liquidation statute, must be found in an "Act of Congress" or the "provisions of" the ACA itself. The absence of any provision in the ACA is alone sufficient reason to reject the Government's reliance on its Netting Regulation.

Furthermore, even if one were to ignore the absence of statutory authority for HHS to promulgate a regulation overriding applicable state insolvency laws, the Netting Regulation, by its own terms, does not purport to do so. It suggests no

intention to create substantive rules. To the contrary, it is a payment convenience that operates *within* the confines of substantive law, including the special restrictions that come into force when a bankruptcy or liquidation commences.

First, 45 C.F.R. §156.121 does not even mentions offset or setoff. "Offset" and "setoff" are the words conventionally and consistently used to refer to the exercise of a legal right to pay debt through cross-payment—though the terms are sometimes used simply to refer to the process of doing so. But the regulation here simply references the benign concept of making "net" payments, or netting, the mechanical process of paying only the differential amount due. The absence of any mention of the legal terms contrasts with the many federal laws and regulations,[7] and hundreds of cases that refer to offset (or setoff) in discussing the legal right of a party to use cross-payment to pay debt. "Netting" is just payment convenience.

Second, the words of the regulation simply describe a process for efficient payment and collection in the ordinary course, nothing more. It provides that:

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[7] *E.g.*, 31 U.S.C. §3716 (administrative offset statute); 26 U.S.C. §6402(a) (IRS may setoff taxpayer's overpayment of tax against tax liability for prior years); 31 U.S.C. §3720A (federal agencies may refer past due debt to Treasury for offset against tax overpayment); 31 U.S.C. §3716(c) (Treasury disbursing officer offset statute); 31 U.S.C. §3728 (United States can setoff against judgment to recover a debt plaintiff owes to the United States); 7 C.F.R. §1951.103 (1995) (agency can setoff debts to the United States against ongoing Conservation Reserve Program payments); 13 C.F.R. §140.5 (1993) (SBA offset); 41 C.F.R. §101-41.102(a)(3) (GSA can setoff from ongoing payments to carriers); 48 C.F.R. §§32.611, 32.612 (1992) (United States can setoff obligations between itself and parties contracting with the United States).

> As part of its payment and collections process, HHS may net payments owed to issuers and their affiliates operating under the same tax identification number against amounts due to the Federal or State governments from the issuers and their affiliates under the same taxpayer identification number for advance payments of the premium tax credit, advance payment of and reconciliation of cost-sharing reductions, payment of Federally-facilitated Exchange user fees, payment of any fees for State-based Exchanges utilizing the Federal platform, and risk adjustment, reinsurance, and risk corridors payments and charges.

42 C.F.R. §156.1215(b). Netting is "part of its payment and collections process," not a right to take offsets not permitted by substantive law. CMS writes only one check, calculating amounts due against amounts owed under multiple programs, and even to related insurers operating under a single tax identification number. It does not purport to affirmatively provide a substantive right to offset that could apply once liquidation or bankruptcy has commenced.

Third, the Federal Register notice promulgating the regulation described it solely as a means of streamlining the payment and collection process:

> This process would permit HHS to calculate amounts owed each month, and pay or collect those amounts from issuers more efficiently.
>
> [. . .]
>
> To streamline payment and charge flows from all of these programs . . . we propose in § 156.1215(b) that HHS may net amounts owed to the Federal government against payments due to an issuer (or an affiliated issuer under the same TIN) under these programs in 2015 and later years. We believe that this process will enable HHS to operate a

> monthly payment cycle that will be efficient for both issuers and HHS.

78 Fed. Reg. 72,370-71 (Dec. 2, 2013).

In sum, nothing in the ACA authorizes HHS to take an offset after an insurer enters liquidation; nothing in the ACA authorizes HHS to promulgate regulations granting itself the power to do so; and the netting rule does not purport to do so. Colorado law, therefore, controls.

D. The Government's Additional Arguments Also Fail

1. The Government Has No Federal Common Law Right of Offset that Would Override State Law

a. There is No Special Federal Government Law of Offset.

The Government asserts in the alternative that courts should recognize or create a uniform rule of federal offset that would override state law. The argument has no merit, and was properly rejected by Judge Hertling.

First, the Government asserts that it already has a common law right to offset—and therefore Judge Hertling erred in considering whether to create a uniform federal offset rule applicable to all federal debts, or at least federal debts under the ACA. Gov't Br. 25. But the Government's argument is fundamentally misleading because the common law right to offset that it possesses is not any sort of special rule or prerogative of the federal government. It is not the kind of special federal common law rule of the kind discussed, for example, in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 728 (1979).

To the contrary, the very cases cited by the Government squarely hold that the Government has only the same common law right to offset as does a private party, no more. *United States v. Munsey Trust Co.*, 332 U.S. 234, 239 (1947), cited by the Government (at 25), is explicit. *See also Gratiot v. United States*, 40 U.S. 336, 370 (1841) ("It is but the exercise of the common right, which belongs to every creditor, to apply the unappropriated moneys of his debtor, in his hands, in extinguishment of the debts due to him."). That basic principle is repeated in the various cases cited by the Government. *See, e.g.*, *Marré v. United States*, 117 F.3d 297, 302 (5th Cir. 1997), cited by the Government at 25.

What this means is that just as a private party may, the Government may offset obligations as a simple payment convenience, or in litigation, where it is subject to mutuality and other requirements. *See Id.*, at 302. And in the context of *federal bankruptcy*, where common law offset also applies, the Government also has the same common law offset rights as does any other party in a federal bankruptcy. (Of course, because federal debts ordinarily have a super-priority, federal offset is not often of great moment in most bankruptcies.)

But the United States possesses no greater or different right than a private party in a state-administered liquidation. What the Government is actually arguing here is that CMS has offset rights *greater* than those possessed by a private party in a Colorado liquidation proceeding. The Government offers no support for that proposition.

b. There Is No Basis To Create A Uniform Federal Offset Right For ACA Debts.

As Judge Hertling recognized, however, it still remains necessary to determine "whether to create federal common law or to incorporate state law as the rule of decision." Appx13 (quoting *Montana v. United States*, 124 F.3d 1269, 1274 (Fed Cir. 1997)). As *Fabe* illustrates, and many cases confirm, the presumptive *federal* rule is that state law provides the rule of decision. "Absent a demonstrated need for a federal rule of decision, the Court has taken 'the prudent course' of 'adopt[ing] the readymade body of state law as the federal rule of decision until Congress strikes a different accommodation.'" *Am. Elec. Power Co. v. Connecticut*, 564 U.S. 410, 422 (2011) (quoting *Kimbell Foods, Inc.,* 440 U.S. at 740). But a court must still consider whether "application of state law would frustrate specific objectives of the federal programs" at issue. *Kimbell Foods, Inc.*, 440 U.S. at 728.

For any number of reasons, it is difficult to imagine a setting in which it would be less appropriate to call upon the courts to announce some overriding federal offset right.

First, Congress has statutorily declared through the McCarran-Ferguson Act that the business of insurance is entrusted to the States, not the federal government. And *Fabe* holds that the protection of payments to policyholders is part of that business of insurance.

Second, Congress has exempted insurers from federal bankruptcy law.

Third, the particular ACA programs at issue were to have a major *state* component. Indeed, they were presumptively to be operated by individual States themselves, belying any suggestion that there was some dominant federal interest, or that uniformity in approach to issues of liquidation was a concern.

Fourth, the ACA itself expressly disclaims any broad preemptive effect for its provisions.

Fifth, as the federal Debt Collection Act illustrates, Congress generally addresses issues of federal priority and offset by statute—but it has not created any such offset rights applicable here. Indeed, *Fabe* illustrates that the Government's debt was subject to state liquidation law and the Supreme Court was not detoured by any notion that it could create a priority rule as a matter of federal common law.

Sixth, since *Fabe*, if Congress wished to create a federal priority or offset rule for insurer liquidations, Congress could have done so (but expressly did not).

Seventh, given the ACA's fundamental objective of providing health care to citizens, Congress *itself* could reasonably want an insurer's obligations to its policyholders to take priority in this setting. But whether or not that would be Congress's choice, where States have made that choice there is assuredly no indication that Congress directed that choice to be overridden.

Against these considerations, the Government asserts a federal interest in efficiently processing payments for these programs on a monthly basis. Gov't Br. at 26-27. But as Judge Hertling recognized, that desire to pay is not the kind of *specific*

overriding interest that could justify creating a special federal offset rule here. To the contrary, government programs are important and "there is always a federal interest to collect moneys" owed the government. *United States v. Yazell,* 382 U.S. 341, 348 (1966). But generalities about the importance of that federal interest in collecting funds do not answer the question whether "the Federal Government may obtain a preferred right which is not provided by statute or specific agency regulation, which was not a part of its bargain, and which requires overriding a state law dealing with the intensely local interests." *Id.* at 349 (holding that the federal interest in collecting on loans did not require extending a preferred right to proceed against wife's separate property, in contravention of state law).

The Government tries to construct a more specific interest here, asserting that because the "risk adjustment and reinsurance programs are budget-neutral, applying offsets is critical for enabling HHS to direct funds on a monthly basis to those insurers who are entitled to them." Gov't Br. at 27. But that is a non-sequitur. The two programs are distinct; they are not cross-financed. And for each of them, insurers are paid out only what the pool takes in, no more. There is nothing novel in the fact that collections in are subject to the risk of insolvency of a participating insurer. And here, because the programs are budget-neutral, if CMS does not receive a risk adjustment payment from a particular insurer because it is insolvent—an always present risk—that limits what is paid out. Indeed, while one can imagine a federal interest that granted ACA debts a priority, it is difficult to imagine such a federal

interest that is limited only to the situation where CMS finds itself in a position to offset.

2. The Statute Cited by the Government Does Not Change the Result.

The Government concludes its brief by invoking a statute and an argument that it did not raise in any manner or form below—and which is consequently waived and forfeit. Specifically, the Government asserts that any ruling by this Court will be "futile" because 31 U.S.C. §3728 requires Treasury to take appropriate offsets when it pays a judgment. According to the Government, the judgment of the Court of Federal Claims in this case, and any ruling on the non-availability of offsets by this Court, would be procedural only, and would not affect the Treasury's ability to take an offset when it pays the judgment.

The Government is, again, fundamentally incorrect for at least two reasons. The first is that the cited statute is not specifically addressed to insurance and, therefore, under McCarran-Ferguson, it cannot supersede state laws governing the business of insurance.

Second, and equally important, the judgment at issue is not merely "procedural." To the contrary, the judgment and decision of the Court of Federal Claims, and this Court, will determine that the United States is not entitled to offset its risk adjustment claim against its reinsurance payment obligations; rather the risk adjustment claim can only be paid in accordance with the order of priorities

established by the Colorado legislature. Indeed, that is the very holding of *Fabe*. Section 3728 does not entitle the Treasury to an offset precluded by a ruling of this Court.

II. The Government's Claimed Offset Is Impermissible Under Colorado Law

A. Colorado Does Not Recognize A Common Law Right of Offset in Insurer Liquidations.

In *Bluewater*, the Colorado Supreme Court held that the taking of an unauthorized offset is contrary to public policy and inconsistent with the statutory system of priorities for the distribution of the assets of a liquidating insurer.[8] *See Bluewater*, 823 P.2d at 1374 (unauthorized offset improper because it "would be contrary to the order of distribution provided in the liquidation act"); *id.* at 1376. It further held that there is no common law right of offset recognized under Colorado law for insurance liquidations. In so holding, the Court was well aware that other States, usually by statute, had reached a contrary conclusion. Thus, the Colorado Supreme Court expressly distinguished New York and Illinois statutes broadly allowing offsets when permitted by common law. The court simply noted that

[8] It is easy to see how and why: Assume the Government owes money to the Colorado HealthOp in reinsurance payments. In the ordinary course, those dollars would be paid to the liquidator and distributed first to Priority 1 and Priority 2 creditors. The claim to risk adjustment payments would be classified as Priority 3, to be paid only after higher priority creditors were paid in full. If CMS were permitted to pay its own risk adjustment claim using the reinsurance payment it owes Colorado HealthOp, CMS would effectively "jump the line" and deprive higher ranking Colorado policyholders of funds otherwise available for distribution to them.

Colorado's insurance code contains no similar provision allowing common law offset, and that Colorado has "a different view of what is in the best interests of policyholders and the public." *Id.* at 1375-76. In Colorado, an offset must be authorized by law, regulation, or contract.

The Government suggests that *Bluewater* actually stands for the opposite proposition—that offsets are freely allowed in Colorado, and that offsets do not disrupt the priority framework for a liquidation because assets that are offset never part of the estate. Gov't Br. at 28. But the Government is misstating the controlling principle. The rule, as stated in the very cases cited by the Government, is that an *authorized offset* is consistent with the priority framework. *See* Gov't Br. at 28 and n.8 (citing *Scott v. Armstrong*, 146 U.S. 499, 507 (1892) ("[w]here a set-off is otherwise valid, it is not perceived how its allowance can be considered a preference . . .")); *In re Liquidation of Realex Grp., N.V.*, 620 N.Y.S.2d 37, 39 (N.Y. App. Div.1994) ("Although permitting offsets may conflict with the statutory purpose of providing for the pro rata distribution of the insolvent's estate to creditors, the Legislature has resolved the competing concerns and recognized offsets as a species of lawful preference."). The Government cites cases from various states where set-off has been broadly permitted often by incorporation of the common law rules, and, on that basis, has been held not to upset the priority framework.

For example, in *In re Liquidation of Home Ins. Co.* 972 A2d 1019, 1022-23 (N.H. 2009), *see* Gov't Br. at 28, n.8, the New Hampshire Supreme Court held that offset is

generally governed by statute, but where the conditions are fulfilled, the offset provides an exception to the priority framework. The other cases cited by the Government are to the same effect. *See also Transit Cas. Co. v. Selective Ins. Co. of Se.*, 137 F.3d 540, 543 (8th Cir. 1998) (acknowledging that "application of set-off principles works to the advantage of one particular creditor, or class of creditors, and to the disadvantage of others," but holding that "nothing in the Insurance Code nor in Missouri common law indicates that Missouri rejects the right of parties *to contract for a right to offset debts*.").

As *Bluewater* makes clear, however, Colorado has "a different view of what is in the best interests of policyholders and the public." *Id.* at 1375-76. The Government offers no Colorado case at all supporting its theory, which amounts to a wishful misreading of *Bluewater*.

In the first two parts of *Bluewater*, the court held that (1) regulations precluded the offset, and (2) allowing offsets not authorized by the legislature would conflict with the priority statute. The court acknowledged that a common law equitable right to offset would be allowed under (federal) bankruptcy law. But the court rejected the idea that any such right is available under *Colorado* law. The court said that while the Colorado legislature borrowed aspects of federal bankruptcy law, this:

> does not mean that other elements of bankruptcy, such as the recognized right to offset, were also intended. . . . The general intent of the liquidation act was to protect the public and to establish uniformity in liquidations of insurance companies. Here, the reinsurers' acquiescence in

> Aspen's delinquencies makes them "other" general creditors who must get in line behind the policyholders. § 10-3-507(3)(d). *In practice, the relief prayed for by the reinsurers, predicated on the existence of an equitable right to offset, would favor their private interest over the interest of policyholders, contrary to law. We hold that the full amount of the reinsurance proceeds due is a general asset to be collected and distributed according to the order of priorities provided in the liquidation act.*

Id. at 1374 (emphasis added).

Indeed, the Court began Section III of its opinion by citing the law of another state, Missouri, that likewise declined to recognize a common law right of offset, observing that "[t]he foregoing statutory analysis disposes of this case, and a common law analysis would not lead to a different result. *See Allendale Mut. Ins. Co. v. Melahn*, 773 F. Supp. 1283 (W.D. Mo. 1991) (no common law right to offset in Missouri)." *Bluewater*, 823 P.2d at 1374. And the court distinguished Colorado from states that had adopted common law offset *by statute*:

> [I]n *Stamp v. Insurance Co. of North America,* 908 F.2d 1375 (7th Cir. 1990), . . . the court construed a section of the Illinois insurance code which also specifically provided that certain mutual debts could be offset. *See* Ill.Rev.Stat. ch. 73, § 818 (1983). *It should be apparent by now that Colorado's insurance code has no similar provision.* We must decline to follow the New York court and the Seventh Circuit Court of Appeals, because both were required to construe and apply the New York and Illinois insurance codes respectively. *See Allendale Mut. Ins. Co. v. Melahn*, 773 F. Supp. 1283 (W.D. Mo. 1991) (contract provision preserving the right to offset according to New York insurance code not enforceable because contrary to Missouri insurance code).

Id. at 1375-76 (emphasis added). Put simply, *Bluewater* holds that there Colorado recognizes no common law right of offset.

B. The Colorado Offset Statute Does Not Permit The Government's Offset.

After *Bluewater*, the Colorado legislature enacted a statute allowing offsets for contracts in insurer liquidations. It provides that:

> mutual debts or mutual credits, whether arising out of one or more contracts between the insurer and another person in connection with any action or proceeding under this part 5, shall be set off, and the balance only shall be allowed or paid . . . .

C.R.S. §10-3-529(1).

The claimed offset here failed to satisfy the statute because: (1) the debts and credits do not arise out of *contract*; (2) the debts and credits are not mutual. The Government, as the party seeking offset, has the burden of establishing its entitlement to offset. *See*, *e.g.*, *In re Balducci Oil Co., Inc.*, 33 B.R. 847, 850-51 (Bankr. D. Colo. 1983) ("burden of proof is on the creditor asserting the setoff right"). Judge Hertling held that the fact that the offset claims did not arise from contract disposed of the Government's state law argument, and because he relied on the ground most specific to Colorado law, he did not address the broader question of lack of mutuality.

1. The Relevant Debts and Credits Do Not Arise Out Of Contracts.

To set off in an insurance liquidation under Colorado law, the debts and credits must "aris[e] out of one or more contracts." C.R.S. §10-3-529(1). The Government

argues that this is a misreading of the statute, and that the right of offset would somehow reach torts and statutory claims as well.

The Government pointedly does not quote the statute, but instead simply asserts that "the statute expressly authorizes offset '*whether*' the debts arise under contract." Gov't Br. at 30. But that is not what the statute actually says: The statute (quoted above in full) says offset is permitted for "mutual debts or mutual credits, whether arising out of one or more contracts . . . ." C.R.S. §10-3-529(1).

The Government's principal argument is based on punctuation, but it is ill-conceived. The Government notes that the "whether" clause in the statute is within commas, which often indicates that a clause is non-restrictive. But the basic problem with the Government's argument is that there are many reasons why words may be set off in commas, not merely to denote a non-restrictive clause, and a "purported plain-meaning analysis based only on punctuation is necessarily incomplete and runs the risk of distorting a statute's true meaning."[9] For example, as here, a clause that modifies a noun, and begins with "whether" and contains two options, is a perfectly

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[9] *See United States v. Transocean Deepwater Drilling, Inc.,* 767 F.3d 485, 495 (5th Cir. 2014) (quoting *United States Nat'l Bank v. Indep. Ins. Agents of Am., Inc.*, 508 U.S. 439, 454 (1993). Indeed, *Transocean* dealt with the classic "that/which" issue. And even in the classic "that/which" case, plain meaning trumps punctuation. Thus, while in general, "nonrestrictive clauses introduced by 'which' add nonessential parenthetic information and are set off by commas," *Transocean* held the clause in question to be restrictive because it was clear that the clause set off by commas gave "essential meaning about the preceding nouns." *Id.* at 494, 545.

conventional usage that is almost always bounded by commas. As Garner puts it: "*whether* usually directly follows the noun whose dilemma it denotes." Garner's Dictionary of Legal Usage (3d ed. 2009) at 941. So here, the mutual debts or mutual credits that are the subject of the offset are denoted by whether the debts and credits arise from one or more contracts. It would simply look wrong without the comma, especially since the denoting clause is actually modifying two nouns at the same time: "mutual debts or mutual credits."

For example, if the sentence were, "You can have the balloons, whether blue or green," no English language speaker would interpret that sentence as saying anything on the subject of orange or red balloons. Just as here, simplified, the statute applies to "mutual debts or mutual credits, whether arising out of one or more contracts." No reader would suggest that this sentence says anything on the subject of debts or credits arising in tort. The only reasonable contextual reading here is that the sentence is addressing mutual debts and credits, whether from one or more contracts.

In fact, as Judge Hertling observed, other provisions of the same offset statute echo that it is directed at contracts alone. For example, Subsection 5 of the offset statute permits certain offsets that are otherwise barred when "the contracts" meet certain requirements. *See* C.R.S §10-3-529(5) (describing permissible setoff in terms of contracts "accruing from business written where the contracts were entered into, renewed, or extended . . ."). Even more directly, the offset statute's effective date

provision specifies how it is effective with respect to contracts. *See* C.R.S. §10-3-529(6).[10]

The Government incorrectly asserts that Judge Hertling relied only on the effective date provision, and misunderstood it. It argues that the statute sets an effective date for all kinds of other claims, and supposedly then elaborates only for contracts. Gov't Br. at 30. But that is simply a willful misreading of the text: What the provision sets forth is a single operative sentence describing how the statute applies to contracts, with no hint that it applies to anything else, or how it would apply to anything else.[11]

Indeed, the context of the statute's enactment also confirms the point. C.R.S. §10-3-529 was intended to overturn the result in *Bluewater*, holding that no right of offset was available in connection with insurer obligations under reinsurance

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[10] That effective date provision says:

> This section shall be effective January 1, 1993, and shall apply to all contracts entered into, renewed, extended, or amended on or after said date and to debts or credits arising from any business written or transactions occurring after January 1, 1993, pursuant to any contract including those in existence prior to January 1, 1993, and shall supersede any agreements or contractual provisions which might be construed to enlarge the setoff rights of any person under any contract with the insurer. For purposes of this section, any change in the terms of, or consideration for, any such contract shall be deemed an amendment.

[11] For example, whether it would apply to torts that happened before the statute but which were not liquidated at the time of enactment, or to statutory obligations created, but unpaid, before the enactment.

contracts—a situation in which offset has compelling equities. In overturning that result, the legislature addressed that contract setting, and nothing in the statute goes beyond that setting.

2. The Relevant Debts and Credits Lack Mutuality.

In any event, even where a contract exists, only "***mutual*** debts or ***mutual*** credits" can be set off. C.R.S. §10-3-529(1) (emphases added). In fact, mutuality is a requirement even for common law offset, and thus the Government's offset here fails even under the federal common law theory the Government espouses, and the very cases it cites in support. Gov't Br. 25-26. *See Marré*, 117 F.3d at 302; *United States v. DeQueen & E. R.R. Co.*, 271 F.2d 597, 599 (8th Cir. 1959).

The mutuality principle limits offset to the one circumstance where it is compelling, namely, where debts are owed to, and by, precisely the same person. *See Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913) ("the absurdity of making A pay B when B owes A"). The mutuality requirement limits the offset to that circumstance and enforces the converse: One man's credit cannot be used to pay another man's debt.

The Colorado liquidation statute does not specifically define "mutual," but a wealth of case law does. For debts and credits to be mutual, they must be between the same parties acting in the same capacity. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 18 (1995). Here the Government is acting in two different capacities, as the

"operator"—the statutory word and the word the Government used below—of two different, independent, risk pools, composed of different insurers.

The mutuality requirement is strictly construed against a party seeking setoff. *See In re Orexigen Therapeutics, Inc.*, 596 B.R. 9, 17 (Bankr. D. Del. Nov. 13, 2018); *In re Am. Home Mortgage, Holdings, Inc.*, 501 B.R. 44, 56 (Bankr. D. Del. Nov. 8, 2013) ("It is also widely accepted that 'mutuality is strictly construed against the party seeking setoff."). And as the cases demonstrate, the mutuality requirement has been held to preclude setoff in a variety of settings where one of the parties seeks to use a debt to the estate over which it has control to avoid subjecting its own claim, or the claim of some other party, to the priority structure applicable in bankruptcy. *E.g.*, *In re Fernandes Super Markets, Inc.*, 1 B.R. 299, 302 (Bankr. D. Mass. 1979) (funds held in trust may not be used for setoff because mutuality is lacking inasmuch as agent-trustee is not acting in his individual capacity); *see also In re Cullen*, 329 B.R. 52, 57 (Bankr. N.D. Iowa 2005). Indeed even a corporate relationship between a parent and a wholly-owned subsidiary will not satisfy the requirement of mutuality. *E.g.*, *Orexigen*, 596 B.R. at 18. Similarly, when a creditor acts a "conduit" of funds, there is no mutuality; it cannot use the funds owed to the estate, over which it has control, to advance its position as creditor. *See, e.g.*, *In re James River Coal Co.*, 534 B.R. 666, 672 (Bankr. E.D. Va. July 16, 2015) (creditor had no right to offset its own obligations against tax refund sums it was holding because those sums were deemed to be held in trust for the ultimate benefit of the state); *In re Winstar Commc'ns*, 315 B.R. 660 (D.

Del. 2004) (creditor could not avoid its own obligations by offsetting tax refunds because the creditor was acting in an agency capacity rather than in its individual capacity).[12] The reasons are obvious: If an entity were free to triangulate credits against debits outside of bankruptcy, it would be circumventing the basic bankruptcy process which requires that assets be collected for the estate, and paid out only according to the order of preference set by statute.

A few illustrations may be useful to clarify the difference between mutual and non-mutual debts and credits. Consider the situation in which Company X is a reinsurer and owes reinsurance payments to the liquidating insurer, but Company X also has a claim against the liquidating insurer for unpaid premiums. In that circumstance, Company X may take its claim for unpaid premiums as an offset against what it owes in reinsurance payments. Company X has a right to the premiums as a reinsurer; the money it owes, it also owes as a reinsurer.

In contrast, the mutuality requirement bars the triangulation of debt.

> The requirement of mutuality is that each party own his claim in his own right severally, with the right to collect in

[12] *See also In re Bevill, Bresler & Schulman Asset Mgmt., Corp.*, 896 F.2d 54, 57 (3d Cir. 1990) (no mutuality where creditor holds property of the debtor as a bailment); *Gray v. Rollo*, 85 U.S. 629, 632-33 (1873) (mutuality lacking where partnership has a claim against an individual, but the individual has a claim against only one partner); *In re Candor Diamond Corp.*, 76 B.R. 342 (Bankr. S.D.N.Y. 1987) (principal of corporation not the same as corporation); *In re Knedlik*, 192 B.R. 559, 561 (Bankr. D. Kan. 1995) (no setoff where "a debtor-creditor relationship gave rise to the first obligation and a fiduciary relationship gave rise to the other").

> his own name [and] in his own right and severally. The mutuality requirement is designed to protect against "triangular" set-off; for example, where the creditor attempts to set off its debt to the debtor with the latter's debt to a third party.

In re United Scis. of Am., Inc., 893 F.2d 720, 723 (5th Cir. 1990) (citations omitted). Thus, if Company X owes money to the liquidating insurer as a reinsurer, and Company X also happens to be acting as agent for a different reinsurer that has a claim *against* the liquidating insurer for unpaid premiums, Company X cannot use the other reinsurer's premium claim as a set-off to avoid paying its own debt.

Or, even closer to this case: Suppose that Fund X owes the liquidating estate $25 million, and the estate owes $25 million to Fund Y. In the ordinary course, the estate would gather the $25 million from Fund X. Fund Y, as creditor, may or may not receive payment of the $25 million, depending on the priority structure that governs the liquidation and the total assets of the estate.

But suppose then that both Funds are operated by the same entity. That operator might well like to short-circuit the priority structure of the liquidation or bankruptcy, and unilaterally use the $25 million that Fund X owes the insolvent company to pay Fund Y's claim in full. That approach might be perfectly harmless outside of bankruptcy. But in an insolvency setting, that offset—using one man's credit to pay another's debt—would take the process of collecting debts and paying creditors outside the liquidation proceedings (and priority rankings that govern those proceedings) and put it in the hands of the manager.

The offset here involves exactly the kind of triangulation of debt that the mutuality requirement prevents. Indeed, this is an obvious case of triangulation because while the Government (in lieu of Colorado itself) operates both programs, the sole beneficiaries of both the credit and debt are *two different pools of insurers*. CMS is literally using funds owed by one group of insurers—the reinsurers—to pay another (partly overlapping) group of insurers, the risk adjustment insurers, and thereby avoid subjecting their Class 3 claim to the priority framework of the Colorado Liquidation Act.

Reinsurance and Risk Adjustment are two distinct programs, with different stakeholders in each.

Under the Reinsurance program, the operator—CMS or the State—and the designated Reinsurance entity collects payments from all health insurance issuers in the state on a per-capita basis. This includes individual, small group, and large group market issuers of fully-insured major medical products, as well as self-funded plans. It uses the money paid in to make payments out to individual market plan issuers that cover high-cost enrollees. Any surplus in the payment pool is rolled forward to the next benefit year. 45 C.F.R. §153.235(b). There can be no deficit for which the Government is liable because the payment out is limited to what is paid in.

Under the Risk Adjustment program, the operator, the State or CMS, collects payments from plans that cover relatively low risk enrollees, and redistributes that money to plans that cover relatively high risk enrollees. 42 U.S.C. §18063. Transfers

within a given state net to zero, and Risk Adjustment funds cannot be used to make Reinsurance payments or to support any other ACA (or any other) program.

Indeed, the individual and distinct identity of the programs for mutuality purposes is highlighted by the fact that either or both of them were presumptively to have been operated by the State itself (or, for the reinsurance program, a state-appointed reinsurance entity). But while CMS has ended up as the "operator" of both programs, which gives it control of the money flow, the decisive point is that the insurers participating in the two pools are different. To put it simply, the money owed by the reinsurance program involves one group of insurers, and the money owed under the risk adjustment program is owed to another group of insurers.

In the court below, the Government observed that dozens of cases affirm the indisputable rule that the United States, and all its agencies, are deemed "one party" for mutuality purposes. Of course. There is but a single Treasury; that different agencies are involved, or two different programs are involved, does not change that fact. If this was simply two different federal benefit programs with different intended beneficiaries, that rule would control.

But that general rule is inapplicable in this special setting, where the agency involved has taken on a novel role. Here, CMS serves as "operator" of distinct pools of money taken from the different groups of insurers participating in the two pools, and then distributed within each of them. Neither one is supported with taxpayer or general Treasury funds. No case finds mutuality in a setting like this precisely because

the setting is unusual. That it is the Government that is in the unusual position of handling the money for both risk spreading pools cannot create mutuality where it is lacking. It is not the identity of the money handler, but the *identity of the parties whose money is being handled*, that determines mutuality.

For example, the Pension Benefit Guarantee Corporation (PBGC), although admittedly a federal agency, was not entitled to offset amounts it owed against amounts owed to the U.S. Postal Service and General Services Administration. The sums held by the PBGC were not taxpayer funds, but rather administered separately from taxpayer funds. *See, e.g.*, *In re Art Metal U.S.A., Inc.*, 109 B.R. 74 (Bankr. D.N.J. 1989). *See also Doe v. United States*, 58 F.3d 494 (9th Cir. 1995) (noting that the United States does not take the position, for example, that mutuality applies to the FDIC when it acts as receiver).

In sum, the mutuality requirement, which applies both under Colorado law and under common law principles, bars the offset taken here.

CONCLUSION

The judgment should be affirmed.

Dated: June 8, 2020

Respectfully submitted,

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UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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