

Hearing Date and Time: October 26, 2011 at 10:00 a.m. (prevailing Eastern Time)
Objection Deadline: October 19, 2011 at 4:00 p.m. (prevailing Eastern Time)

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Attorneys for the Debtor and Debtor in Possession

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

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<i>In re</i>	:
	:
	: Chapter 11
AMBAC FINANCIAL GROUP, INC.,	:
	:
	: Case No. 10-15973 (SCC)
Debtor.	:
	:
-----X	

AMBAC FINANCIAL GROUP, INC.,

Movant,

against

**UNITED STATES DEPARTMENT OF
THE TREASURY - INTERNAL
REVENUE SERVICE,**

Respondent.

-----X



NOTICE OF DEBTOR'S MOTION FOR ORDER (1) DETERMINING THAT CLAIM NUMBERS 3694 AND 3699 FILED BY DEPARTMENT OF THE TREASURY – INTERNAL REVENUE SERVICE SHALL BE ESTIMATED PURSUANT TO BANKRUPTCY CODE SECTION 502(c), AND (2) SETTING PROCEDURES, AND HEARING DATE, FOR ESTIMATION OF THE IRS CLAIMS INCLUSIVE OF DETERMINATIONS PURSUANT TO BANKRUPTCY CODE SECTION 505(a) OF THE DEBTOR'S LIABILITY FOR TAXES OWED AS A RESULT OF LOSSES INCURRED ON ITS POST-2004 CONTRACTS

PLEASE TAKE NOTICE that on October 12, 2011, Ambac Financial Group, Inc., as debtor and debtor in possession in the above-captioned chapter 11 case ("AFG" or the "Debtor") filed the attached *Debtor's Motion for Order (1) Determining that Claim Numbers 3694 and 3699 Filed by Department of the Treasury – Internal Revenue Service Shall be Estimated Pursuant to Bankruptcy Code Section 502(c) and (2) Setting Procedures, and Hearing Date, For Estimation of the IRS Claims, Inclusive of Determinations Pursuant to Bankruptcy Code Section 505(a) of the Debtor's Liability for Taxes Owed as a Result of Losses Incurred on its Post-2004 Contracts* (the "Motion") with the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). A hearing to consider the Motion is scheduled for **October 26, 2011 at 10:00 a.m. (prevailing Eastern Time)** before the Honorable Shelley C. Chapman, United States Bankruptcy Judge, in Courtroom 610 at the Bankruptcy Court, One Bowling Green, New York, New York 10004.

PLEASE TAKE FURTHER NOTICE that any objection to the Motion must be in writing, conform to the Federal Rules of Bankruptcy Procedure, the Local Bankruptcy Rules for the Southern District of New York, and the *Amended Notice, Case Management, and Administrative Procedures* approved by the Bankruptcy Court [Docket No. 75], be filed electronically by registered users of the Bankruptcy Court's electronic case filing system, and be served, so as to be received no later than **October 19, 2011 at 4:00 p.m. (prevailing Eastern**

Time), by (i) the chambers of the Honorable Shelley C. Chapman, United States Bankruptcy Judge, One Bowling Green, Courtroom 610, New York, New York 10004; (ii) counsel for the Debtor, Dewey & LeBoeuf LLP, Attn: Peter A. Ivanick, 1301 Avenue of the Americas, New York, New York 10019; (iii) counsel for the statutory committee of creditors, Morrison & Foerster LLP, Attn: Anthony Princi, 1290 Avenue of the Americas, New York, New York 10104; (iv) counsel for the Office of the Commissioner of Insurance of the State of Wisconsin, Foley & Lardner LLP, Attn: Frank W. DiCastrì, 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202; (v) the Office of the United States Trustee for the Southern District of New York, Attn: Brian S. Masumoto, 33 Whitehall Street, 21st Floor, New York, New York, 10004; (vi) the U.S. Attorney, as counsel to the IRS; (vii) the civil process clerk at the office of the United States Attorney for the Southern District of New York, (viii) the Attorney General of the United States, and (ix) the District Director of the IRS, and (x) all entities which have filed a written request for notice pursuant to Rules 9014 and 2002 of the Federal Rules of Bankruptcy Procedure.

PLEASE TAKE FURTHER NOTICE that if no objection to the Motion is timely filed and served, the Bankruptcy Court may enter an order granting the relief requested in the Motion without further notice or opportunity to be heard.

Dated: October 12, 2011
New York, New York

Respectfully Submitted,

/s/ Peter A. Ivanick

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**UNITED STATES BANKRUPTCY COURT
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AMBAC FINANCIAL GROUP, INC.,

Movant,

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**UNITED STATES DEPARTMENT OF
THE TREASURY - INTERNAL
REVENUE SERVICE,**

Respondent.

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**DEBTOR'S MOTION FOR ORDER (1) DETERMINING THAT CLAIM NUMBERS
3694 AND 3699 FILED BY DEPARTMENT OF THE TREASURY – INTERNAL
REVENUE SERVICE SHALL BE ESTIMATED PURSUANT TO BANKRUPTCY CODE
SECTION 502(c), AND (2) SETTING PROCEDURES, AND HEARING DATE,
FOR ESTIMATION OF THE IRS CLAIMS INCLUSIVE OF DETERMINATIONS
PURSUANT TO BANKRUPTCY CODE SECTION 505(a) OF THE DEBTOR'S
LIABILITY FOR TAXES OWED AS A RESULT OF LOSSES INCURRED
ON ITS POST-2004 CONTRACTS**

TO THE HONORABLE SHELLEY C. CHAPMAN,
UNITED STATES BANKRUPTCY JUDGE:

Ambac Financial Group, Inc., as debtor and debtor in possession in the above-captioned chapter 11 case (the "Debtor" or "AFG"), by and through its undersigned counsel, hereby submits this motion (the "Motion") for entry of an Order (1) determining that claim numbers 3694 and 3699 (the "IRS Claims") filed by Department of the Treasury – Internal Revenue Service shall be estimated pursuant to Bankruptcy Code Section 502(c), and (2) setting procedures, and a hearing date, for estimation of the IRS Claims inclusive of the determination pursuant to Bankruptcy Code Section 505(a) of certain Unresolved Tax Issues (defined below, in Relief Requested, as the "Unresolved Tax Issues"). The issues to be resolved at the hearing requested by this Motion determine the extent to which the Debtor may legally assert net operating losses ("NOLs"), which were incurred on "pay-as-you-go" credit default swap contracts ("CDS") issued by subsidiaries of the Debtor after 2004 (the "Post-2004 Contracts"). Resolution of issues concerning the existence of NOLs is necessary to estimate and/or determine the IRS Claims, and allows calculation of the amount of the Debtor's past and future tax liability. In support of this Motion, the Debtor respectfully represents:

Preliminary Statement

1. The core of the dispute between the Debtor and the IRS – and a critical uncertainty creating an impediment to confirmation by this Debtor of a feasible chapter 11

reorganization plan - is whether the impairment losses on the Post-2004 Contracts, which generated NOLs, were properly determined by the Debtor. Resolution of the related Unresolved Tax Issues is dispositive of whether NOLs existed to be carried back to earlier tax years as reported on AFG's 2007 and 2008 consolidated federal tax returns ("Tax Returns," and each, a "Tax Return"), thus generating the tax refunds (the "Tax Refunds") that are the subject of the IRS Claims, and whether unused NOLs exist that may be carried forward and used in future years.

2. The Debtor has calculated the NOLs generated by the Post-2004 Contracts, from issuance through tax year 2010, to have a face value equal to approximately \$7 Billion (USD). A portion of the NOLs generated by the Post-2004 Contracts have been asserted in Tax Returns filed by AFG pre-petition or by the Debtor post-petition, and the Debtor calculates the remaining NOLs related to the Post-2004 Contracts to have a face value equal to approximately \$4.7 Billion (USD). The NOLs may be the most valuable asset of the Debtor's estate, and without determination of their amount, the Debtor's liability for the IRS Claims remains contingent and unliquidated, and the Debtor's ability to confirm a plan of reorganization is severely impaired. Confirmation and consummation of a plan by this Debtor depend greatly upon the speedy resolution of the disputed issues raised by the IRS. Absent resolution as per this Motion, prolonged litigation will doom the restructuring effort, even if the Debtor ultimately prevails.

3. Moreover, the time and expense of fully litigating the IRS Claims and underlying disputes to a final resolution pursuant to the Federal Rules of Civil Procedure will certainly trigger conversion of the Debtor's Chapter 11 reorganization effort to liquidation under chapter 7, because the Debtor will run out of money, despite the agreement (more fully described in

paragraph 35 below) by Ambac Assurance Corporation ("AAC"), a wholly-owned subsidiary of the Debtor, to pay 85% of its costs. (Notably, the IRS has taken substantial discovery to date in the Adversary Proceeding (defined below) and the parties have engaged in lengthy mediation sessions.)

4. In contrast, expediting the adjudication of the IRS Claims and the underlying disputes will not prejudice the IRS, inasmuch as the IRS has already had almost a full year to conduct discovery in the Adversary Proceeding (defined below) and the parties have engaged in lengthy mediation.

5. Therefore, this is the clearest possible case to invoke Bankruptcy Code section 502(c), which mandates estimation of contingent or unliquidated claims as to which non-abbreviated liquidation would otherwise unduly delay administration of the case, and to exercise the authority conferred by section 505(a) of the Bankruptcy Code, which gives this Court subject matter jurisdiction to determine the Debtor's liability for, and the amount of, any tax, in a time frame that enables the Debtor to reorganize in the face of an unresolved claim asserted by a taxing authority and great uncertainties as to the Debtor's rights in NOLs and liabilities for taxes.

Procedural History

6. On November 8, 2010, the Debtor commenced a voluntary case under Chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). The Debtor was prompted to file this case as a result of the issuance by the IRS, on October 28, 2010 of an Information Document Request (the "IDR") relating to tax refunds issued to AFG based on the NOLs reflected on AFG's 2007 and 2008 Tax Returns and concerns as to the IRS's intention to summarily assess and recapture the Tax Refunds. Because of the threat of immediate assessment without formal notice and IRS collection aimed at AFG and its subsidiaries, which

(absent injunction) could include liens and levies on assets of all entities in the Debtor's consolidated group, the Debtor sought protection under chapter 11 on November 8, 2010. The IRS issued Notices of Proposed Adjustment ("NOPAs") on May 4, 2011, and on May 10, 2011. The NOPAs included (as annexed thereto) an IRS Engineer's Reports, which raised specific disputes to AFG's tax treatment of the Post-2004 Contracts and calculation of NOLs, as well as with the Tax Returns filed in 2007, 2008 and 2009 (the 2009 tax return being also a "Tax Return"). The IDR and the NOPAs, together with the IRS Engineer's Reports annexed to the NOPAs, are attached hereto as "Exhibit A").

7. The IRS filed the IRS Claims on May 5, 2011, thereby asserting a priority claim against the Debtor of \$807,242,021.91 for return of the Tax Refunds claimed in the Tax Returns for 2007 and 2008, and for other related charges, which the IRS contends to have been claimed in error by AFG, based on the same reasons set forth in the NOPAs. The Debtor filed its Objections to the IRS Claims on June 5, 2011. The IRS Claims and the Debtor's Objections thereto are attached hereto as Exhibit B.

8. On November 9, 2010, the Debtor initiated a declaratory judgment proceeding, Adv. Pro. Case No. 10-4210 (SCC) (the "Adversary Proceeding"), against the IRS by filing a complaint with the Bankruptcy Court [Adv. Pro. Docket No. 1] (the "Complaint"), seeking, in part, to obtain an injunction pursuant to Bankruptcy Code sections 362(a) and 105(a) to prevent IRS from taking any enforcement action against AFG and its subsidiaries. The Complaint also addresses the merits of the parties' dispute and contends, among other things, that the Debtor applied the proper accounting method and discount rate with respect to its losses on the Post-2004 Contracts.

9. Determining the proper tax treatment and calculation of NOLs arising from the performance of the Post-2004 Contracts is necessary to estimate the IRS Claims. This court has subject matter jurisdiction and also has the discretionary authority under section 505(a) of the Bankruptcy Code to finally determine the Unresolved Tax Issues and to estimate the IRS Claims. The issues are joined, integrally related and ripe for adjudication.

10. Without a speedy and final determination of the Unresolved Tax Issues upon completion of the hearing requested by this Motion, the Debtor's reorganization effort will be doomed. The Debtor could run out of the cash needed to confirm and go effective with its reorganization plan if resolution of these issues is delayed even three (3) months.

11. Moreover, the IRS Claims cannot be ascertained or calculated without a determination of the Unresolved Tax Issues, and therefore, the IRS Claims are contingent and unliquidated. Thus, estimation of the IRS Claims is mandatory under section 502(c). While adjudication of Unresolved Tax Issues in the context of estimating the IRS Claims would also be required pursuant to section 502(c) (which provides an alternative and mandatory basis under which to decide the tax issues between the parties), the Debtor cannot effectively reorganize without the certainty afforded by a final judgment under section 505(a) as to its legal rights to assert NOLs in future tax years. Significantly, the legal viability of the Debtor's NOLs is fundamental to the determination of the Debtor's liability to disgorge the Tax Refunds. Therefore, one cannot be determined without the other.

12. The IRS has had full discovery of the Unresolved Tax Issues. Discovery, including informal discovery, in the Adversary Proceeding has been in progress for almost a year, and discovery is substantially completed pursuant to a consensual schedule that has been extended with the Debtor's consent. Depositions of fact witnesses are complete, requests for

admissions were issued, interrogatories and responses have been exchanged, and expert reports have been exchanged. Responses to requests for admission are due on October 24, 2011; Expert rebuttal reports are scheduled to be exchanged on or before October 19, 2011 and expert depositions must be completed by November 2, 2011. The last day of discovery is November 2, 2011.

13. The amount of the NOLs resulting from the post-2004 Contracts and the Debtor's liability, if any, for the IRS Claims must be determined before AFG runs out of money and fails to confirm a chapter 11 plan that will maximize value for all parties in interest.

Jurisdiction

14. This court (the "Bankruptcy Court") has subject matter jurisdiction to determine the IRS Claims pursuant to 28 U.S.C. § 1334. This includes subject matter jurisdiction to determine issues of tax law dispositive of the Debtor's liability for taxes as a result of the post-2004 Contracts pursuant to 11 U.S.C. § 505(a) and to estimate the IRS Claims pursuant to 11 U.S.C. § 502(c). This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B). Venue is proper before the Bankruptcy Court pursuant to 28 U.S.C. §§ 1408 and 1409.

General Background

15. The Debtor. The Debtor is a holding company and a Delaware corporation. AAC is a Wisconsin-domiciled financial guarantee insurance company whose business includes the issuance of financial guarantee insurance policies to support public finance, structured finance, and international finance transactions, including the Post-2004 Contracts. AAC is a wholly-owned subsidiary of the Debtor.

16. Tax Returns Filed by AFG. In 2008 and 2009, AFG filed its tax returns for the years 2007 and 2008, and applications for tentative refunds for these tax years. These applications asserted NOLs, which AFG carried back to the prior tax years, resulting from the

performance of the Post-2004 Contracts. Pursuant to these applications, the Debtor received Tax Refunds totaling approximately \$708,115,837. The Debtor has also filed tax returns for 2009 and 2010, in which the Debtor has carried forward NOLs that were unused in the 2007 and 2008 tax years. The Debtor calculates that NOLs of \$ 4.7 Billion exist that have not been used as of the 2010 tax year, and, if the Debtor's determination of NOLs is correct, the Debtor will utilize any remaining NOLs in future tax years. In the NOPAs (which were issued after the filing of the 2009 return and before the 2010 return), the IRS contested the calculation of the amount of NOLs as to 2007 through 2009, and thus, has contested the existence, of NOLS used to support AFG's application for the Tax Refunds. Because the Debtor used the same accounting methodology in tax year 2010, the IRS's disputes as to 2007 through 2009 tax losses are relevant to the 2010 tax year, as well as to all future tax years in which remaining NOLs could be carried forward.

17. Wisconsin Rehabilitation Proceeding. On March 24, 2010, the Office of the Commissioner of Insurance of the State of Wisconsin ("OCI") commenced a rehabilitation proceeding, Dane County, Wisconsin Case No. 10-cv-1576, with respect to a segregated account of AAC established pursuant to Wisc. Stat. § 611.24(2) (the "Segregated Account"). The Circuit Court of Dane County, Wisconsin (the "State Court") has confirmed a rehabilitation plan, but that plan is not yet implemented and the proceeding remains pending. A specifically described list of policies and liabilities were allocated to the Segregated Account. All policies and liabilities of AAC not specifically allocated to the Segregated Account remain in the general account of AAC (the "General Account").

18. State Court Injunction. In connection with the Segregated Account rehabilitation proceeding, the State Court entered an order enjoining actions in respect of the Segregated

Account by policyholders, counterparties, or other parties (the "Segregated Account Injunction").

19. The Bank Settlement. On June 7, 2010, AFG and AAC entered into a Settlement Agreement (the "Bank Settlement") with the counterparties to outstanding credit default swaps with Ambac Credit Products, LLC that were guaranteed by AAC. Pursuant to the terms of the Settlement Agreement, in exchange for the termination of certain obligations, AAC paid to the counterparties cash and newly issued surplus notes of AAC (the "Surplus Notes"). The IRS has indicated that it may assert that the Surplus Notes should be characterized as equity of AAC for U.S. federal income tax purposes and if it is determined the Surplus Notes represent more than 20% of the total value of the stock of AAC, a deconsolidation event may have occurred with respect to AAC. To the extent a deconsolidation event occurs, the NOLs and other tax attributes allocable to AAC and the other subsidiaries of AAC may no longer be available for use by AFG, AAC or any of the remaining members of AFG consolidated tax group. Moreover, if the Surplus Notes are characterized as equity of AAC and it is determined the Surplus Notes represent more than 50% of the total value of the stock of AAC, an ownership change may have occurred with respect to AAC and the AAC tax attributes, including NOLs, may be subject to limitation as provided under various provisions of the Internal Revenue Code. Based on the opinion of its accountants, AFG filed its 2010 U.S. federal consolidated tax return characterizing the Surplus Notes as debt and included AAC and its subsidiaries as members of the AFG consolidated tax group.

20. IRS Information Document Request, Followed by Issuance of NOPAs and IRS Claims, Present Disputed Issues and a Threat to AFG's Reorganization. On October 28, 2010, the IRS issued to AFG an IDR seeking detailed information regarding the basis for the Debtor's

entitlement to the Tax Refunds. In addition, the Debtor was informed by the IRS revenue agent assigned to the audit of the AFG corporate group that the IRS was examining the propriety of the Tax Refunds and may seek to recoup payment of the Tax Refunds from the Debtor or non-debtor affiliates in the Debtor's consolidated tax group. The possibility of IRS enforcement action and liens resulted in AFG's petition for relief under the Bankruptcy Code. On May 4, 2011, the IRS issued three NOPAs, contesting in each the Debtor's right to retain tentative tax refunds (the "Tax Refunds") in the total amount of \$708,115,837 that were paid to the Debtor between December 2008 and February 2010 based on the 2007 and 2008 Returns. The IRS also sent the Debtor a revised NOPA on May 10, 2011. The NOPAs, which are the basis of the IRS Claims, and the analysis contained in the IRS Engineer's Reports thereto, dispute the Debtor's method of calculating NOLs and characterization of the Post-2004 Contracts, and relate the dispute to the 2009 Tax Return, as well as the Tax Returns for 2007 and 2008. *See* Exhibit A. While the issues raised by the IRS remain unresolved, the Debtor cannot confirm and effectuate a plan of reorganization.

21. Allocation of Liabilities to Segregated Account. Effective November 7, 2010, any and all liabilities (including contingent liabilities) AAC has or may have, now or in the future, to the IRS and/or the Department of the Treasury (the "Treasury") in regard to, or in respect of, the Tax Refunds were allocated to the Segregated Account.

22. Commencement of AFG Chapter 11 Case. On November 8, 2010 (the "Commencement Date"), the Debtor commenced a voluntary case under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code"). The Debtor continues to operate its businesses and manage its properties as debtor in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

23. Expansion of State Court Injunction. On the Commencement Date, the State Court granted an expansion of the Segregated Account Injunction to prevent the IRS from asserting liens against and levying upon the assets of AAC and its subsidiaries and to prevent the Debtor or parties related to the Debtor from pursuing certain claims against the Segregated Account, the General Account, or AAC's subsidiaries.

24. AFG Adversary Proceeding Against IRS. On November 9, 2010, the Debtor commenced the Adversary Proceeding, requesting, *inter alia*, a determination that the Debtor and the members of its consolidated group have no tax liability for tax years 2003 through 2008 and are entitled to retain the full amount of the Tax Refunds based upon the Debtor's method of calculating NOLs. As described above, discovery in the Adversary Proceeding has been on-going for almost a year, and is scheduled to conclude on November 4, 2011. As a result, the parties will have had full discovery of the issues as to which this Motion seeks a hearing and determination.

25. Committee Appointment. On November 17, 2010, the United States Trustee for the Southern District of New York (the "U.S. Trustee") appointed a statutory committee of unsecured claim holders [Bankr. Ct. Docket No. 27] (the "Committee"). No trustee or examiner has been appointed in this chapter 11 case.

26. IRS Reference Withdrawal Motion. On January 13, 2011, Respondent, on behalf of the IRS, filed a motion with the United States District Court for the Southern District of New York (the "District Court") to withdraw its reference of the Adversary Proceeding to the Bankruptcy Court pursuant to 28 U.S.C. § 157(d), Case No. 11-cv-00270 (PGG). The Debtor opposed this motion, and on February 8, 2011, the Respondent requested expedited

consideration of the withdrawal motion. The District Court has not yet held a hearing or ruled on the IRS's motion.

27. Disputes Raised in the NOPAs Regarding Debtor's Right to NOLs. The NOPAs included, and were transmitted to the Debtor with, reports and analyses prepared by the IRS to explain the basis for the IRS's dispute of the Debtor's right to retain the Tax Refunds. In the NOPAs and in the analytical reports sent by the IRS in May of 2011, the IRS asserts the Debtor applied the wrong accounting method and discount rate to determine its losses on the Post-2004 Contracts, and therefore, is not entitled to assert NOLs based on these Post-2004 Contracts. The NOPAs and related reports sent by the IRS to the Debtor are attached hereto as Exhibit A.

28. The IRS Claims and Debtor's Objection. On May 5, 2011, the IRS filed the IRS Claims. On June 14, 2011, the Debtor filed the IRS Claims Objection. The IRS Claims and the Debtor's Objections thereto are attached as Exhibit B.

29. The Second Amended Plan and Amended Plan Settlement. On September 30, 2011, the Debtor filed its second amended plan of reorganization [Docket No. 599] (the "Second Amended Plan"), which embodies a global settlement among the Debtor, AAC, OCI, the Rehabilitator and the Committee (the "Amended Plan Settlement"). Pursuant to the Amended Plan Settlement, AAC, with OCI's approval, will pay the Debtor for its future use of NOLs. The expected stream of payments resulting from AAC's use of NOLs is a significant part of the value to creditors provided by the Second Amended Plan. In fact, a successful resolution of the IRS dispute and this Court's entry of an order finding that neither an ownership change within the meaning of section 382 of the Internal Revenue Code (IRC § 382) with respect to AAC, nor a deconsolidation event within the meaning of section 1504 of the Internal Revenue Code (IRC § 1504), occurred during the 2010 taxable year are conditions precedent to

consummation of the Second Amended Plan and conditions to the effectiveness of the Amended Plan Settlement.

30. The Parties' Disputes as to Tax Treatment of Post-2004 Contracts and Discount Rate. The 2007 and 2008 Tax Returns filed by AFG, as well as the 2009 tax return filed by the Debtor, together with the NOPAs and related analyses and the IRS Claims, which contest the methodology employed in all three tax returns, create a dispute between the Debtor and the IRS as to fundamental tax and accounting treatment and characterization of the tax losses realized on the Post-2004 Contracts.

31. The IRS has Issued a Proposed Regulation Requiring Treatment of CDS in the Same Manner Used by AFG. Since sending the NOPAs that raised this dispute, and after many years of study during which the IRS ignored AFG's request for a change of accounting method with respect to its Post-2004 Contracts, *and* while the IRS was mediating these issues with the Debtor, the IRS, on September 15, 2011, issued a proposed regulation that resolves – prospectively – a key issue underlying the disputes in this case consistently with the manner employed in the 2007, 2008 and 2009 tax returns filed pre-petition by AFG and the 2010 tax return filed by the Debtor. The proposed regulation would add credit default swaps to the list of swaps categorized as notional principal contracts ("NPC") governed by Treasury regulation section 1.446-3. *See* Prop. Treas. Reg. 1.446-3(c)(1)(iii) ("Notional principal contracts governed by this section include contracts commonly referred to as interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, credit default swaps, weather-related swaps, and similar agreements that satisfy the requirements of paragraph (c)(1)(i)"). The regulations are proposed to apply to

contracts entered into on or after the date the final regulations are published in the Federal Register.

32. Substance of the Proposed Regulation Defining Notional Principal Contracts. Proposed Treasury Regulation section 1.446-3(c)(i) would define a notional principal contract as "a financial instrument that requires one party to make two or more payments to the counterparty at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts." Proposed Treasury Regulation section 1.446-3(c)(iv) would still exclude an "option" contract from the definition of notional principal contracts. The proposed regulations also provide a special rule for credit default swaps: "A credit default swap contract that permits or requires the delivery of specified debt instruments in satisfaction of one leg of the contract is a notional principal contract if it otherwise satisfies the requirements of paragraph (c)(1)(i) of this section." Prop. Treas. Reg. 1.446-3(c)(iii)(A). If the proposed regulation were to apply retrospectively to the Post-2004 Contracts, the regulation would support the characterization of the Post-2004 Contracts as NPCs, as has been asserted by AFG. The proposed regulation is, however, prospective.

33. While Not Dispositive, the Proposed Regulation Confirms AFG's Tax Position, Thus Suggesting an Expedient Resolution of the Parties' Dispute. Because the proposed regulations would apply to contracts entered into on or after finalization, their issuance is not technically dispositive of the issues between the IRS and the Debtor. However, an internal IRS directive from the Office of the Chief Counsel of the IRS instructs all IRS attorneys to refrain from taking a position in litigation that is contrary to published guidance, *including proposed regulations*. See Chief Counsel Notice 200-0-043 (October 17, 2002). Thus, though the

Department of Justice is not technically bound by this directive, it is clear that the IRS's proposed rulemaking enhances the Debtor's position on this fundamental issue. That said, the IRS would be hard pressed to argue against its own prospective regulation in the instant matter. Additionally, the proposed regulation shows that the Unresolved Tax Issues can be resolved in an expedited proceeding. The issues have been well-considered and developed.

34. The IRS Claims are not Fixed or Liquidated. The issues to be the subject of the hearing that the Debtor seeks by this Motion will determine the Debtor's liability to return the Tax Refunds. The parties dispute the proper tax accounting method by which the Debtor should calculate losses generated by the Post-2004 Contracts, as well as the appropriate discount rate and rationale for determining the appropriate discount rate. The parties dispute, alternatively, whether the IRS is estopped from prohibiting the Debtor from applying the accounting method that resulted in payment of the Tax Refunds. Application of different tax accounting methods potentially applicable to CDS losses results in vastly different calculations of losses and of tax liability. Variations in the discount rate to be used to determine the Debtor's tax obligations result in wide differences in the value of the IRS Claims and the value of the Debtor's NOLs. Although the determination of NOLs has future consequences in tax years to come, post-confirmation, the questions relating to the NOLs give rise to a present controversy that is subject to adjudication under Bankruptcy Code section 505(a). Resolution of all these issues, and all questions subsumed by these issues, is required to establish that the Debtor has liability as asserted in the IRS Claims, to establish the amount, if any, of the IRS Claims and to determine the amount of NOLs that may be included, *albeit* indirectly, among the Debtor's assets available for distribution to creditors. Estimation and determination of tax liability are appropriate here, where determination of the IRS Claims and the proper tax treatment of the

Post-2004 Contracts through a full trial of the issues remaining to be determined would delay the bankruptcy case to such a degree that reorganization would otherwise be rendered impossible, and the issues are dispositive of the estate's value to creditors.

35. Liquidity Forecast. As of October 7, 2011, the Debtor had total cash of approximately \$53 million, including \$6.5 million in retainers and escrow. Attached as Exhibit C is a spreadsheet prepared by the Debtor, showing the Debtor's liquidity forecast. If the Debtor were to emerge from chapter 11 in December 2011, the Debtor would then have a cash balance of approximately \$21 million, excluding the \$30 million payment that would be made pursuant to the Plan and held in escrow. This amount decreases dramatically as a result of the accrual of monthly expenses, and would be exhausted if the IRS Claims were to delay the Debtor's emergence from chapter 11 much beyond December. While the chapter 11 case is pending, the average monthly run rate of expenses (net of reimbursement from AAC, pursuant to agreement with the Debtor, for 85% of legal fees related to IRS litigation) is approximately \$2.5 - \$4.5 million, depending on legal expenses. Accordingly, a 3 month delay to emergence (*i.e.*, assuming an exit from chapter 11 in March), would add an additional approximately \$7.5 - \$13.5 million of expenses, leaving the Debtor with total cash of approximately \$7.1 - \$13 million at emergence, excluding the \$30 million payment that would be made pursuant to the Plan and held in escrow. The Debtor has tentatively projected the post-emergence, annual run-rate of expenses to be just over \$5 million. Therefore, in order to exit chapter 11 with enough cash to cover operating expenses for 3 - 5 years, the Debtor needs cash at exit of approximately \$15 - \$25 million, assuming that the IRS Claims remain unresolved and, as a result, the Second Amended Plan cannot be implemented. As such, the Company does not currently project enough liquidity to sustain more than a modest delay in confirmation beyond December 2011

without jeopardizing its chances of a successful reorganization.¹ If the case continues beyond that time, cash will be depleted, insufficient resources may remain to consummate a plan and the Debtor's efforts to preserve any value for creditors by confirming a plan could be doomed. Although AAC will bear 85% of the cost of litigating with the IRS going forward, the costs of full-blown litigation of the IRS Claims further compound the situation, by adding millions of expense at the trial court level, and the possibility of extended appeals. Notably, appeals of an estimation will also be less expensive than appeals of a standard adjudication because trial courts have substantial discretion in how they estimate.

36. Delay in Adjudication of the Unresolved Tax Issues Will Result in Irreparable Harm. The Unresolved Tax Issues pose an immediate threat to the Debtor's reorganization prospects. Given the current pace of litigation and the numerous fronts on which the IRS and the Debtor have engaged in disputes regarding the Unresolved Tax Issues (as defined below) that determine the NOLs and thus the Tax Refunds, the time during which the Debtor can obtain confirmation of a feasible plan will expire before any determination of the key legal issues that could establish the amount of the Debtor's NOLs and/or a duty to repay any amount of the Tax Refunds. Resolution of these issues cannot be allowed to delay the expeditious conclusion, and ultimate success, of this chapter 11 reorganization.

Relief Requested

37. By this Motion, the Debtor requests entry of an order, substantially in the form attached hereto as Exhibit D, determining that the IRS Claims are subject to estimation,

¹ The aforementioned values do not reflect the anticipated receipt of approximately \$3.6 million of interest and principal on the PFM note (a note held by AFG as consideration for the pre-petition sale of a subsidiary) through 2013 or \$0.5 million related to Ambac Bermuda in 2012, which may afford the Company the ability to withstand an additional month of delay. Additionally, the aforementioned values do not reflect the annual operating expense support of \$5 million that would be paid annually in arrears pursuant to the Plan.

inclusive of the determination of the Unresolved Tax Issues, and establishing procedures and setting a date for a hearing to estimate the IRS Claims pursuant to Bankruptcy Code section 502(c) for all purposes, including allowance, and distribution and to determine, pursuant to Bankruptcy Code section 505(a), the legality of the Debtor's assertion of NOLs in the amounts calculated by the Debtor. The Unresolved Tax Issues include, and are not limited to, the following tax issues (the "Unresolved Tax Issues") required to estimate the IRS Claims and to ascertain the NOLs that the Debtor may utilize in past and future tax years:

- a. Whether the Debtor's Post-2004 Contracts are Notional Principal Contracts under Treasury Regulations §1.446-3?
- b. Whether the Debtor's use and application of the impairment method to account for losses on its Post-2004 Contracts clearly reflects income and the economic substance of the Post-2004 Contracts and represents a reasonable amortization method with respect to such losses under IRC § 446?
- c. Whether the discount rate used by the Debtor is appropriate to calculate the CDS impairment losses for tax years 2007 through 2010?
- d. Whether the Debtor's use of the impairment method for the first time in 2007 constituted an impermissible change in accounting method, or alternatively, whether the IRS abused its discretion in withholding its consent to such change or alternatively whether the IRS is estopped from arguing that change was impermissible?
- e. Whether an ownership change, within the meaning of Section 382 of the Internal Revenue Code, with respect to AAC or a deconsolidation event occurred during the 2010 taxable year as a result of the Bank Settlement or any other reason?

Basis for Relief Requested

38. Timing. Resolution of the IRS Claims and related issues relevant to the tax treatment of the Post-2004 Contracts in the context of a contested matter through the claims objection process or the Adversary Proceeding, or in a tax court forum, would unduly delay the administration of the Debtor's estate. Pursuant to the Bankruptcy Court's *Order Pursuant to*

Section 105(a) of the Bankruptcy Code to Implement a Schedule for Completion of Discovery, entered on March 2, 2011 [Adv. Pro. Docket No. 39] and amended by agreement of the parties, discovery in the Adversary Proceeding will be completed November 4, 2011. Further, as noted above, the District Court has not yet held a hearing or ruled on the IRS's motion to withdraw the reference of the Adversary Proceeding to the Bankruptcy Court.

39. IRS Claims Amount and the Debtor's Realization of NOLs is Dispositive of Feasibility. Given the size and the alleged priority status of the IRS Claims, and the importance of the NOLs derived from the Post-2004 Contracts to the Debtor's plan of reorganization, the Debtor effectively cannot prove feasibility of its chapter 11 plan absent estimation of the IRS Claims and a determination of the issues relevant to calculation of the NOLs. Absent these determinations – made in an expedited manner - the Debtor's efforts to preserve value for the benefit of creditors cannot continue, let alone succeed. Accordingly, the IRS Claims are subject to mandatory estimation pursuant to section 502(c) of the Bankruptcy Code, and this Court should exercise its jurisdiction under section 505(a) of the Bankruptcy Code to determine the extent to which the Debtor is entitled to claim NOLs as a result of the Post-2004 Contracts.

40. Proposed Estimation Procedure. The proposed “Order, Pursuant to Sections 105(a), 363(b), 502(c) and 505(a) of the Bankruptcy Code and Federal Rules of Bankruptcy Procedure 3007, 7042, 9013, 9014 and 9019, Establishing Procedures to Estimate IRS Claims and Determine Issues of Tax Liability, and Fixing Notice Procedures and Approving Form and Manner of Notice,” attached hereto as Exhibit D (the "Tax Hearing Procedures Order") creates an appropriate procedure for estimating the IRS Claims in an appropriate and timely manner, as set forth below.

41. Proposed Briefing Schedule and Timing. The Tax Hearing Procedures Order allows the parties to complete discovery according to the mutually agreed-upon and previously described schedule established in the Adversary Proceeding, and requires a hearing on estimation and determination of tax issues ("Hearing") within thirty (30) days following the close of discovery, on November 4, 2011. The Tax Hearing Procedures Order requires each of the Debtor and the IRS to serve and to file, on or before November 9, 2011, an Objection Statement, in the case of the Debtor, and a Statement of Claim, in the case of the IRS. The Tax Hearing Procedures Order allows each of the parties to respond within five (5) business days by filing and serving a Statement of Position. Pre-hearing Statements, in which the parties are required to list disputed issues of fact and law and witnesses to be presented, are required to be filed within five (5) calendar days prior to the hearing. The Debtor has, as set forth in the attached proposed order, proposed November 21, 2011, or as soon thereafter as the Court can hear the matter, as the appropriate date for the estimation hearing. If this date is set as a hearing date, Pre-hearing statements would be due on November 16, 2011. Prior to that date, and ten (10) business days following the last expert deposition in the Adversary Proceeding, which would be November 9, 2011, the Debtor's Estimation Objection and the IRS's Statement of Claim would be due, and Statements of Position by either party that desired to submit a rebuttal would be due on November 16, 2011.

42. Proposed Estimation Hearing Procedure. The Hearing required by the proposed Tax Hearing Procedures Order, attached as Exhibit D, shall be conducted as follows: The Hearing is to be held not later than November 21, 2011, or as soon thereafter as the Court can hear the matter. At the Hearing, and subject to the Bankruptcy Court's discretion to increase or decrease the hearing time and time per witness, each party shall have thirty (30) minutes to

explain its position to the Bankruptcy Court. During the Hearing and as necessary to provide evidence as to disputed facts, the parties shall examine such witnesses as are included in the Parties' Pre-hearing Statements and each party shall be entitled to cross-examine witnesses, subject to time limits the court can expand or contract. The evidentiary and legal record shall be confined to the IRS Claims and the Debtor's Objection thereto, the Objection Statement and Statement of Claim, the parties' Statements of Position (each as defined in the Tax Hearing Procedures Order), witness testimony presented at the Hearing, and any evidence; provided, however, that the Bankruptcy Court may allow or require additions to the record in its discretion upon a showing of cause by any party.

43. The Requested Determinations are for All Purposes. Upon the Bankruptcy Court's review of the submissions and testimony described in the preceding paragraph and oral argument at the Estimation Hearing, the Tax Hearing Procedures Order provides that the Bankruptcy Court shall estimate the IRS Claims for all purposes, including allowance and distribution, pursuant to Bankruptcy Code section 502(c), including, and as an inclusive part of the adjudication of, all related Unresolved Tax Issues pursuant to section 505(a) of the Bankruptcy Code, for all purposes.

44. Power to Estimate. This court has the discretion to impose the procedures set forth in the Order, as described below. Precedent, as described in the *Memorandum of Law in Support of the Motion*, reveals that estimation procedures may be employed to ascertain claims in summary fashion as long as elemental due process is provided, and that the Bankruptcy Court's method of estimation is subject to appellate review solely for abuse of discretion or if the result is clearly erroneous.

45. The Parties have Already Had Extensive Discovery. The Bankruptcy Court's Discovery Order, as amended by agreement of the parties, sets November 2, 2011 as the date on which discovery is to be completed. Hence, by the end of the current discovery schedule, the IRS has been afforded roughly a year since the commencement of this case to conduct discovery on the issues to be considered at the proposed Hearing. Following the close of discovery, the briefing process and hearing, as described in the proposed Tax Hearing Procedures Order, may proceed expeditiously to adjudicate the Unresolved Tax Issues, in order that the IRS Claims, and the intermediate issue of the Debtor's entitlement to NOLs based on the Post-2004 Contracts, can be determined and/or estimated for purposes of allowance and distribution, and the Debtor's reorganization case may be administered without delay.

46. The Proposed Tax Hearing Procedures Order Establishes Fair Procedures for Estimation and for Determination of Tax Issues. As an example of expedited estimation procedures, there is attached hereto, as Exhibit E, a copy of the *Order, Pursuant to Sections 105(a), 363(b) and 502(c) of the Bankruptcy Code and Federal Rules of Bankruptcy Procedure 3007, 7042, 9013, 9014 and 9019, (1) Establishing Procedures to Estimate Unliquidated and Contingent Claims, (2) Establishing Procedures to Adjudicate Counterclaims, (3) Establishing Procedures to Compromise Claims and Counterclaims and (4) Fixing Notice Procedures and Approving Form and Manner of Notice* (the "Enron Order"), which was entered by this court on February 18, 2004 in the chapter 11 case of *In re Enron Corp.*, Case No. 01-16034 (AJG). The *Enron* estimation order provides an example of the brevity that may be imposed upon the estimation process, even when dealing with complex fraud claims. The proposed Tax Hearing Procedures Order, like the attached *Enron* Order, maintains burdens of proof and affords the parties both substantive and procedural due process. At the same time, the Tax Hearing

Procedures Order – like that entered in the *Enron* case – prevents the fatal delay to the Debtor's reorganization case by claims that, because undetermined, threaten to derail a complex reorganization in which many other creditors' interests are at stake.

Notice

47. Notice of this Motion has been provided by fax, e-mail, overnight delivery, or hand delivery to (i) attorneys for the Committee, (ii) attorneys for OCI, (iii) the U.S. Trustee, (iv) the civil process clerk at the office of the United States Attorney for the Southern District of New York, (v) the Attorney General of the United States, and (vi) the District Director of the IRS, and (vii) all entities which have filed a written request for notice pursuant to Rules 9014 and 2002 of the Federal Rules of Bankruptcy Procedure. The Debtor submits that no other or further notice need be provided.

Conclusion

WHEREFORE the Debtor respectfully requests that the Bankruptcy Court enter an order, substantially in the form attached hereto as Exhibit D, determining that the IRS Claims are subject to estimation for all purposes, including allowance and distribution, pursuant to Bankruptcy Code section 502(c), and that all related Unresolved Tax Issues shall be adjudicated pursuant to section 505(a) of the Bankruptcy Code for all purposes, including, as necessary, for the purpose of estimating the IRS Claims, and establishing procedures, and setting a date, for a hearing to estimate the IRS Claims and to determine the Unresolved Tax Issues pursuant to Bankruptcy Code sections 502(c) and 505(a) and granting the Debtor such other and further relief as is just.

Dated: October 12, 2011
New York, New York

Respectfully Submitted,

/s/ Peter A. Ivanick

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Attorneys for the Debtor and Debtor in Possession

EXHIBIT A

(NOPAs and Engineers' Reports)

NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 1
Name and title of person to whom delivered Rachell Gupta, Esquire		Date: March 15, 2011

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Entity for this proposed adjustment: Ambac Assurance Corporation ("AAC" or "TP") EIN #39-1135174

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Years	Amount	Account or return line	SAIN NO	Issue Code
200712	756,713,558	1120 PC-Schedule A-Line 31	714-03	09300-99-12
200812	3,413,450,726	1120 PC-Schedule A-Line 31	714-03	09300-99-12

ISSUES:

1. Should Ambac Financial Group, Inc. ("AFG", "Ambac", or the "Taxpayer") be allowed to claim \$756,713,558 and \$3,413,450,726 of credit default swap losses on its 2007 and 2008 Federal income tax returns respectively?
2. Consequently, should the Taxpayer be allowed to retain \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years, arising from the carry back of the credit default swap losses claimed on its 2007 and 2008 Federal income tax returns?

CONCLUSION:

1. No. In 2007, the Taxpayer changed its original option method of accounting for its post-2004 credit default swap contracts ("post-2004 CDS contracts") to a so-called "impairment" method of accounting without securing the consent of the IRS Commissioner as required by § 446(e) and the regulations thereunder. Without such consent, the Taxpayer was prohibited from changing its method of accounting and should have stayed on its original option method. Under the option method of accounting, the Taxpayer could not claim \$756,713,558 and \$3,413,450,726 of ordinary losses on its 2007 and 2008 Federal income tax returns respectively. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

Even if the Taxpayer did not change its method of accounting, but adopted a "new" method of accounting

Taxpayer Representative's action (check one)

AGREED:
 AGREED IN PART:
 DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager *Engel R. Hamilton* Date: *May 4 2011*

NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 1
Name and title of person to whom delivered Rachell Gupta, Esquire		Date: March 15, 2011

for its post-2004 CDS contracts, Taxpayer's impairment method of accounting does not clearly reflect income within the meaning of § 446(b). The Taxpayer's original option method of accounting does clearly reflect income. Under § 446(b), therefore, the IRS Commissioner has the authority to require the Taxpayer to continue to use its option method of accounting for its post-2004 CDS contracts. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

2. No. Because the IRS Commissioner properly disallowed losses on the post-2004 CDS contracts of \$756,713,558 and \$3,413,450,726 on the 2007 and 2008 Federal income tax returns respectively, these losses cannot be carried back to the 2003 through 2007 tax years. Consequently, the Taxpayer should not be allowed to retain the \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years that are attributable to such loss carrybacks.

Reasons for Proposed Adjustment

See Attached Form 886A, Engineer Report with Annexes #1 through 8 and Exhibit A

Reviewed and approved by FP Manager: _____ Date: _____

Taxpayer Representative's action (check one)

AGREED: AGREED IN PART: DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager _____ Date: _____

NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 2
Name and title of person to whom delivered Rachell Gupta, Esquire		Date: March 15, 2011

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Entity for this proposed adjustment: Ambac Assurance Corporation ("AAC" or "TP") EIN #39-1135174

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Years	Amount	Account or return line	SAIN NO	Issue Code
200912	2,881,788,001	1120 PC-Schedule A-Line 13	714-03	09300-99-12

This subsequent year (200912) references the 886A, Engineer Report with Annexes #1 through 8 and Exhibit A for the (200712-200812) years.. **SEE AS FOLLOWS**

ISSUES:

1. Should Ambac Financial Group, Inc. ("AFG", "Ambac", or the "Taxpayer") be allowed to claim \$756,713,558 and \$3,413,450,726 of credit default swap losses on its 2007 and 2008 Federal income tax returns respectively?
2. Consequently, should the Taxpayer be allowed to retain \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years, arising from the carry back of the credit default swap losses claimed on its 2007 and 2008 Federal income tax returns?

CONCLUSION:

1. No. In 2007, the Taxpayer changed its original option method of accounting for its post-2004 credit default swap contracts ("post-2004 CDS contracts") to a so-called "impairment" method of accounting without securing the consent of the IRS Commissioner as required by § 446(e) and the regulations thereunder. Without such consent, the Taxpayer was prohibited from changing its method of accounting and should have stayed on its original option method. Under the option method of accounting, the Taxpayer could not claim \$756,713,558 and \$3,413,450,726 of ordinary losses on its 2007 and 2008

Taxpayer Representative's action (check one)

AGREED:
 AGREED IN PART:
 DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager: *Erasmus R. Hamilton* Date: *May 4, 2011*

NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 2
Name and title of person to whom delivered Rachell Gupta, Esquire		Date: March 15, 2011

Federal income tax returns respectively. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

Even if the Taxpayer did not change its method of accounting, but adopted a "new" method of accounting for its post-2004 CDS contracts, Taxpayer's impairment method of accounting does not clearly reflect income within the meaning of § 446(b). The Taxpayer's original option method of accounting does clearly reflect income. Under § 446(b), therefore, the IRS Commissioner has the authority to require the Taxpayer to continue to use its option method of accounting for its post-2004 CDS contracts. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

2. No. Because the IRS Commissioner properly disallowed losses on the post-2004 CDS contracts of \$756,713,558 and \$3,413,450,726 on the 2007 and 2008 Federal income tax returns respectively, these losses cannot be carried back to the 2003 through 2007 tax years. Consequently, the Taxpayer should not be allowed to retain the \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years that are attributable to such loss carrybacks.

Reasons for Proposed Adjustment

See Attached Form 886A, Engineer Report with Annexes #1 through 8 and Exhibit A for the 2007-2008 tax years

Reviewed and approved by FP Manager: _____ Date: _____

Taxpayer Representative's action(check one)

AGREED:
 AGREED IN PART:
 DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager	Date:
---------------------	--------------

Name of taxpayer AMBAC FINANCIAL GROUP INC & SUBS	Issue No. 3
Name and title of person to whom delivered RACHEL GUPTA, ESQUIRE	Date 04/21/2011
Entity for this proposed adjustment AMBAC PRIVATE HOLDINGS LLC % KEVIN DOYLE GENERAL COUNSEL	

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Years	Amount	Account or return line	SAIN NO.	Issue Code
200612	\$ 562,000.00			
200712	(\$ 579,745.00)			
200612	\$ 742,668.00			

Reasons for Proposed Adjustment (If the explanation of the adjustment will be longer than the space provided below, the entire explanation should begin on Form 886-A (Explanation of Items).)

SEE 886-A

Taxpayer's / Representative's Action:
 Agreed Agreed in Part Disagreed Have additional information; will submit by:

Taxpayer's / Representative's Signature _____ Date _____

If Disagreed in Part or in Full - Check here for consideration of Fast Track Settlement
 Taxpayer IRS

Team Manager *Eugene R. Hermitian* _____ Date *May 4, 2011*

Form 886-A (REV JANUARY 1994)	EXPLANATIONS OF ITEMS		SCHEDULE NO. OR EXHIBIT 1
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")	YEAR/PERIOD ENDED 200712-200812	

AMBAC FINANCIAL GROUP, Inc. ("AFG", "Ambac", or the "Taxpayer")

Form 5701 ADJUSTMENTS:

200712	\$756,713,558	1120 PC-Schedule A-Line 31	714-03	09300-99-12
200812	\$3,413,450,726	1120 PC-Schedule A-Line 31	714-03	09300-99-12

ISSUES:

1. Should Ambac Financial Group, Inc. ("AFG", "Ambac", or the "Taxpayer") be allowed to claim \$756,713,558 and \$3,413,450,726 of credit default swap losses on its 2007 and 2008 Federal income tax returns respectively?
2. Consequently, should the Taxpayer be allowed to retain \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years, arising from the carry back of the credit default swap losses claimed on its 2007 and 2008 Federal income tax returns?

CONCLUSION:

1. No. In 2007, the Taxpayer changed its original option method of accounting for its post-2004 credit default swap contracts ("CDS contracts") to a so-called "impairment" method of accounting without securing the consent of the IRS Commissioner as required by § 446(e) and the regulations thereunder. Without such consent, the Taxpayer was prohibited from changing its method of accounting and should have stayed on its original option method. Under the option method of accounting, the Taxpayer could not claim \$756,713,558 and \$3,413,450,726 of ordinary losses on its 2007 and 2008 Federal income tax returns respectively. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

Even if the Taxpayer did not change its method of accounting, but adopted a "new" method of accounting for its post-2004 CDS contracts, Taxpayer's impairment method of accounting does not clearly reflect income within the meaning of § 446(b). The Taxpayer's original option method of accounting does clearly reflect income. Under § 446(b), therefore, the IRS Commissioner has the authority to require the Taxpayer to continue to use its option method of accounting for post-2004 CDS contracts. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

2. No. Because the IRS Commissioner properly disallowed losses on the post-2004 CDS contracts of \$756,713,558 and \$3,413,450,726 on the 2007 and 2008 Federal income tax returns respectively, these losses cannot be carried back to the 2003 through 2007 tax years. Consequently, the Taxpayer should not

EXPLANATIONS OF ITEMS		SCHEDULE NO. OR EXHIBIT 1
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676		TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")
		YEAR/PERIOD ENDED 200712-200812

be allowed to retain the \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years that are attributable to such loss carrybacks.

FACTS:

In 1998, the Taxpayer, through its wholly owned subsidiary, Ambac Assurance Corporation ("AAC"), formed Ambac Credit Products ("ACP"), a Delaware limited liability company, to engage in the business of writing credit default swaps ("CDSs"). The Taxpayer represents that, under the CDSs, ACP was a credit protection seller on municipal and corporate obligations and asset-backed securities (collectively "Reference Obligations").¹ ACP sold credit protection with respect to certain credit events related to a Reference Obligation, including a default by the issuer of the Reference Obligation in payment of principal or interest when due or bankruptcy of the issuer.² Finally, the Taxpayer represents that while all of the CDS contracts that ACP wrote from 1999 through 2004 (the "pre-2005 CDS Contracts") provided for physical or cash settlement and contract termination upon the occurrence of a credit event, the CDS contracts that ACP wrote from 2005 through 2008 (the "post-2004 CDS contracts") did not generally require physical or cash settlement and contract termination.³

The Taxpayer treated both its pre-2005 and post-2004 CDS contracts as put options, subject to the option method of accounting, on its Federal income tax returns for tax years 2005 and 2006.⁴ Under the option method, the Taxpayer deferred both the revenue and expenses associated with its CDS contracts until a recognition event, i.e., until the contract expires, is exercised, or sold. In 2007, the Taxpayer changed its method of accounting solely for its post-2004 CDS contracts from an option method to a so called "impairment" method.

On April 14, 2008, the Taxpayer filed an Application for Change in Accounting Method (Form 3115) with the IRS, Office of Chief Counsel, seeking consent to change its method of accounting for its post-2004 CDS contracts beginning with the 2007 tax year. In its Attachment to Form 3115, Ambac described the item being changed as "[t]he accounting for revenue and expenses attributable to credit protection payments from credit default swap contracts entered into in 2005 and subsequent tax years that are properly characterized as notional principal contracts as defined in section 1.446-3 of the Income Tax Regulations."⁵ The Taxpayer wrote that it had treated the credit default swap contracts entered into in 2005 and subsequent tax years as put options and it had therefore deferred both the associated revenue and expenses until and unless a recognition event occurred.⁶ It proposed to treat the post-2004 CDS

* * * *

¹ See Complaint for Injunctive Relief and Declaratory Judgment Determining Amount of Tax Liability, *Ambac Financial Group, Inc. v. United States*, Adv. Pro. No. 10-04210 (Bkr S.D.N.Y.), at 6-7 (the "Complaint").

² *Id.*

³ *Id.* at 8.

⁴ See Forms 8275, filed with Taxpayer's 2005 and 2006 Federal income tax returns.

⁵ See Attachment to Form 3115 Application for Change in Accounting Method, Statement 3, Part II, Question 12a.

⁶ *Id.*, Question 12b.

10-15973-scc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56 Exhibit A		SCHEDULE NO. OR EXHIBIT
Form 886-A (REV JANUARY 1994)	EXPLANATIONS OF ITEMS Page 9 of 26	
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")	YEAR/PERIOD ENDED 200712-200812

contracts as Notional Principal Contracts ("NPCs") under Proposed Treasury Regulations § 1.446-3 (hereinafter, the "Proposed Regulations").⁷

The Form 3115 was followed by a supplemental letter, dated September 2, 2008. The Taxpayer took the contrary position that: 1) it had not adopted a method of accounting before 2007 for the credit event payments that it may have to make under the post-2004 CDS contracts; 2) it would treat these payments as contingent non-periodic payments under an NPC; and 3) it would accrue deductions for these payments by using the quarterly changes in the net impairment value of the post-2004 CDS contracts, as determined for statutory accounting purposes under the impairment method.

On December 8, 2008, the Taxpayer filed its 2007 Federal income tax return. Although it had not received the consent to do so as required by § 446(e), the Taxpayer implemented the "impairment" method of accounting for its post-2004 CDS contracts on its 2007 tax return. As a result, the Taxpayer claimed \$756,713,558 of losses for its post-2004 CDS contracts.

On August 17, 2009, the Taxpayer filed its 2008 Federal income tax return. As it had done on its 2007 return, the Taxpayer accounted for its post-2004 CDS contracts under the "impairment" method of accounting on its 2008 tax return. It claimed \$3,413,450,726 of losses on its post-2004 CDS contracts. The Taxpayer had not received consent to change its method of accounting for post-2004 CDS contracts when it filed its 2008 tax return.

On September 23, 2008, August 11, 2009, and December 21, 2009, the Taxpayer filed claims for tentative carry back adjustments on Form 1139 (Corporate Application for Tentative Refund). The Taxpayer received the tentative tax refunds from the IRS Service Center in three different installments in December, 2008, September, 2009, and February, 2010.

On August 9, 2009, after filing its 2007 Federal income tax return and a few days prior to filing its 2008 Federal income tax return, the Taxpayer received an opinion from KPMG (hereinafter, the "KPMG opinion") regarding the tax treatment of its post-2004 CDS contracts. The KPMG opinion concluded, among other things, that, if challenged by the IRS, more likely than not, ... Ambac can account for the credit event payments that it may have to make under the post-2004 CDS contracts by using the quarterly net impairment values as determined for purposes of Ambac's financial statements under the statutory accounting rules for insurance companies.⁸ At the same time, however, based on the specific characteristics of Taxpayer's post-2004 CDS contract, the KPMG opinion concluded that, more likely

* * * *

⁷ In Notice 2001-44, 2001-2 CB. 77, the IRS solicited comments on the appropriate method for the inclusion or deduction of contingent non-periodic payments made to NPCs. Subsequently, the IRS published Proposed Treasury Reg. 1.446-3 ("Proposed Regulations") on February 26, 2004 (corrected on March 23, 2004). The Proposed Regulations have not been finalized.

⁸ See KPMG Opinion, AMBAC-USA-0000321-389, at 343.

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(REV JANUARY 1994)		
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")	YEAR/PERIOD ENDED 200712-200812

than not, Taxpayer's post-2004 CDS contracts do not constitute insurance for Federal income tax purposes.⁹

On October 28, 2010, the IRS audit team issued an Information Document Request ("IDR"), asking the Taxpayer to explain its accounting method for the credit default swap losses claimed on its 2007 and 2008 Federal income tax returns and its legal position regarding its entitlement to the resulting tentative Federal tax refunds for the 2003 through 2007 tax years. On November 9, 2010, the Taxpayer filed for Chapter 11 Bankruptcy in the United States Bankruptcy Court for the Southern District of New York. The Taxpayer also commenced an adversary proceeding against the IRS, seeking a declaratory ruling in its favor that it has no tax liability for tax years 2003 through 2008 and it is entitled to retain the full amount of the tax refunds.¹⁰

In its Response to Government's Second Set of Informal Discovery Requests, the Taxpayer explains that, under the impairment method of accounting, the net credit impairment amount of each Post-2004 CDS contract reflected the expected cash flows under each contract using Taxpayer's own assumptions regarding the performance of the payment obligation.¹¹ The Taxpayer applied the impairment method to all of the Post-2004 CDS contracts and it used its performance assumptions to generate a projection of the cash flows it would be expected to make and receive. It then discounted the projected payments to their present value by using the same statutory discount rate that it used to determine insurance-related loss reserves. It also netted the present value of any future expected losses against claims paying resources to arrive at a net present value credit impairment amount and record the change in the net present value of the credit impairment amount at the end of each quarter in its statutory financial statements as realized losses or gains for the quarter. The Taxpayer treated those losses as tax losses on its 2007 and 2008 Federal income tax returns. Finally, the Taxpayer represents that it used a 4.5% discount rate in calculating both its insurance reserves for insurance regulatory purposes and its impairment losses on the post-2004 CDS contracts for Federal income tax purposes for 2007 and 2008.¹² The Taxpayer does not explain how it derived the 4.5% discount rate number.

The following is a summary of Taxpayer's consolidated income and losses as originally filed on its 2003-2008 Federal income tax returns.

Consolidated Income and Losses as Originally Filed:

	200312	200412	200512	200612	200712	200812
AFG	(82,487,369)	(125,261,135)	(79,743,294)	(109,432,113)	(93,583,234)	(138,725,032)

* * * *

⁹ *Id.*, at 351.

¹⁰ See Complaint for Injunctive Relief and Declaratory Judgment Determining Amount of Tax Liability, *Ambac Financial Group, Inc. v. United States*, Adv. Pro. No. 10-04210 (Bkr S.D.N.Y.), at 2 (the "Complaint").

¹¹ See Ambac's Response to Government's Second Set of Informal Discovery Requests, at 3.

¹² *Id.*, footnote 2.

Form 886-A 5973-scc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56	EXPLANATIONS OF ITEMS	SCHEDULE NO. OR EXHIBIT 1
(REV JANUARY 1994)		
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")	YEAR/PERIOD ENDED 200712-200812

AAC	535,561,693	612,706,495	694,761,255	718,141,277	44,524,294	(3,104,674,424)
SUBS	12,544,476	(72,679,728)	(10,518,652)	69,909,459	16,284,854	32,591,539
TOTAL	465,618,800	414,756,632	604,499,309	678,618,623	(32,774,086)	(3,210,807,917)

Summary of NOL Losses yearly as reflected on Forms 1139:

Years	Amount
200712	32,774,086
200612	678,618,623
200512	604,499,309
200412	414,756,632
200312	222,038,814

Tax Refunds received yearly:

200712	38,142,748.00
200612	236,529,966.00
200512	210,799,742.00
200412	144,929,795.00
200312	<u>77,713,584.00</u>
TOTAL	708,115,835.00

LAW:

Section 446(a) of the Internal Revenue Code generally provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. Treas. Reg. § 1.446-1(b) further provides that if a taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, clearly reflects income. Once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner's selection may be challenged

Form 886-A (REV JANUARY 1994)	10-15973-scc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56	EXPLANATIONS OF ITEMS 19 of 26	SCHEDULE NO. OR EXHIBIT 1
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")	YEAR/PERIOD ENDED 200712-200812	

only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970); Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir.), cert. denied, 342 U.S. 860 (1951).

Treas. Reg. § 1.446-1(e)(2) provides that a taxpayer who changes his method of accounting shall, before computing his income upon such new method for tax purposes, secure the consent of the Commissioner. "Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder." See also American Can Co. v. Commissioner, 317 F.2d 604, 606 (2d Cir. 1963); Wright Contracting Co. v. Commissioner, 316 F.2d 249, 254 (5th Cir. 1963); Broida, Stone & Thomas, Inc. v. United States, 309 F.2d 486 (4th Cir. 1962) (affirming 204 F.Supp. 841 (N.D.W.Va.1962)); Commissioner v. Liquidating Corp., 292 F.2d 225, 231 (3d Cir. 1961).

Under Treas. Reg. § 1.446-1(e)(2)(ii)(a), a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. Rev. Proc. 91-31, 1991-1 C.B. 566. Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11th Cir. 1984); Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

Section 2.06 of Rev. Proc. 2002-18 provides that the Commissioner may require a taxpayer that has changed a method of accounting without the Commissioner's consent to change back to its former method. The Commissioner may do so even when the taxpayer changed from an impermissible to a permissible method. The change back to the former method may be made in the taxable year the taxpayer changed without consent, or if that year is closed by the running of the period of limitations, in the earliest open year. See Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961); Wright Contracting Co. v. Commissioner, 316 F.2d 249 (5th Cir., 1963), cert. denied 375 U.S. 879 (1963), reh'g denied 375 U.S. 981 (1964), acq. 1966-2 C.B. 7; Daktronics, Inc. v. Commissioner, T.C. Memo. 1991-60; Handy Andy T.V. and Appliances, Inc. v. Commissioner, T.C. Memo. 1983-713.

Although the Commissioner is authorized to consent to a retroactive accounting method change, a taxpayer does not have a right to a retroactive change, regardless of whether the change is from a permissible or impermissible method. Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Proc. 97-27, § 2.04; Rev. Proc. 2002-18, §§ 2.01(2) and 2.03; Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 682 (1980); Diebold, Inc. v. U.S., 891 F.2d 1579, 1583 (Fed. Cir. 1989), cert. denied 498 U.S. 823.

Form 886-A 5973-ssc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56	EXHIBIT A SCHEDULE NO. OR EXHIBIT 1
EXPLANATIONS OF ITEMS	
(REV JANUARY 1994)	
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")
	YEAR/PERIOD ENDED 200712-200812

TAXPAYER'S POSITION:

Taxpayer's position is described in detail in its original Form 3115, supplemental letter, and Complaint. In summary, the Taxpayer argues that it is entitled to retain the \$708,115,835 of Federal tax refunds for the following reasons: 1) Its position on its 2005 and 2006 tax returns of deferring both the associated revenue and expenses until a recognition event and reporting no deduction for future credit default payments is consistent with accounting for contingent non-periodic payments under the impairment method because the Taxpayer had not incurred any obligations under the post-2004 CDS contracts until 2007 and therefore no impairments occurred in those years. Accordingly, the reporting of a tax deduction in 2007 under the impairment method does not represent a change in the method of accounting for contingent non-periodic payments; 2) Its post-2004 CDS contracts should be treated as Notional Principal Contracts in accordance with the Proposed Regulations under Treas. Reg. § 1.446-3; and 3) As an insurance company subject to tax under Section 831 of the Internal Revenue Code of 1986, the Taxpayer is required to follow statutory accounting provisions in computing its taxable income. Taxpayer's method of accounting for contingent non-periodic payments for statutory accounting purposes is the impairment method and the impairment method is a 'reasonable' method for accounting for the contingent non-periodic payments on the post-2004 CDS contracts under the Proposed Regulations.

GOVERNMENT'S POSITION:

The Taxpayer changed its method of accounting and tax return position in 2007 without the Commissioner's consent as required by the Internal Revenue Code and the Treasury Regulations thereunder. Taxpayer's argument that it did not change to a new method of accounting in 2007 is incorrect. By deferring both the revenue and expenses associated with its post-2004 CDS contracts until a recognition event, the Taxpayer, in effect, elected the option method of accounting for its post-2004 CDS contracts. Under the option method, the Taxpayer treated the credit default swap contracts entered into in 2005 and subsequent tax years as "put options" and, therefore, deferred both the revenue and expenses from annual credit protection payments until a recognition event occurred (e.g., disposition of a bond received on exercise of the contract or maturity of the contract). In other words, the Taxpayer deferred both its fixed premium payments receivable and its expected obligations until a recognition event in the future. The Taxpayer would not have deferred expected cash flows in this manner had it been employing the impairment method. Such deferral, however, is perfectly consistent with the option method of accounting, which must be considered to be the Taxpayer's method of accounting for post-2004 CDS contracts for years 2005 and 2006.

By contrast, the deduction of Taxpayer's expected obligations under the post-2004 CDS contracts in 2007 and 2008 is consistent with the impairment method of accounting rather than the option method. Consequently, the Taxpayer made an unauthorized change of accounting method for its post-2004 CDS contracts from the option method to the impairment method in 2007. Since the Taxpayer did not receive the consent of the Commissioner to make such accounting method change as required by § 446(e), it should be put back on its original option method of accounting for 2007 and 2008.

Form 8864 5973-ssc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56	SECTION NO. OR EXHIBIT 1
EXPLANATIONS OF ITEMS	
(REV JANUARY 1994)	
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")
	YEAR/PERIOD ENDED 200712-200812

Taxpayer's midstream reliance on Proposed Treas. Regulation §1.446-3(g)(6)(vii), published on March 23, 2004, is incorrect as well. On August 9, 2004, the IRS published Notice 2004-52, Request for Information about Credit Default Swaps (hereinafter, the "Notice"). Notice 2004-52 requested further information regarding certain financial transactions commonly known as credit default swaps in connection with the consideration by Treasury and the IRS of taxpayer requests for specific guidance on the tax treatment of credit default swaps. The Notice acknowledged that credit default swaps can be analogized, among other derivatives, to Notional Principal Contracts. Other derivatives credit default swaps could be analogized to under the Notice were put options, financial guarantees, and insurance contracts. The Notice did not draw any conclusions as to which of these derivatives credit default swaps should be analogized to for Federal income tax purposes, but instead requested public commentary in recognition of the economic similarities of a CDS instrument to various other financial transactions and the fact that the various analogies correspond to significantly different tax treatments. The Proposed Treas. Regulations under Section 1.446-3(g)(6)(vii), published on March 23, 2004, related to the inclusion into income or deduction of a contingent non-periodic payment provided for under a Notional Principal Contract ("NPC"). The Proposed Regulations did not rule, however, that a CDS instrument can be treated as an NPC for Federal income tax purposes. If the Proposed Regulations were to become final regulations, they would allow a taxpayer to elect a mark-to-market method for certain NPCs providing for non-periodic payments. The election would apply to any contract that is held at the close of the taxable year. To date, however, the Proposed Regulations have not been finalized. Taxpayer's reliance on the Proposed Regulations for treatment of its post-2004 CDS contracts as NPCs is therefore unfounded.

Finally, even if the Taxpayer were correct in asserting that it did not adopt a new method of accounting, but instead accounted for its post-2004 CDS contracts under the impairment method of accounting since 2005, the Taxpayer's impairment method of accounting does not clearly reflect income for the following two reasons: 1) it does not include the fixed premium payments provided for under the post-2004 CDS contracts into income, but includes the impairment amounts as deductions, thereby deferring Taxpayer's income and accelerating Taxpayer's expenses; and 2) it uses an unreasonably low discount rate to calculate the present value of Taxpayer's expected future obligations, or so-called "impairment" amounts, on the post-2004 CDS contracts.

On its Forms 8275, Disclosure Statements, for the 2005 and 2006 tax years, the Taxpayer disclosed that it treated its credit default swaps as put options, i.e., income from the credit default swaps is not recognized until the option expires, is exercised, or sold.¹³ The Taxpayer explains that it will continue to use this characterization "until such time as the IRS issues further guidance on the tax treatment of credit default swaps." On Form 8275 for the 2007 tax year, the Taxpayer disclosed that, beginning in 2005, its CDS contracts were altered to adopt a "pay as you go" approach.¹⁴ It concluded that these contracts were properly characterized as notional principal contracts and, in April 2008, filed a Form 3115 seeking permission to properly recognize premium income on the contracts as received. The Taxpayer further represented that it would continue to defer recognition of premium income on the post-2004 CDS

* * * *

¹³ See Forms 8275, filed with Taxpayer's 2005 and 2006 Federal income tax returns.

¹⁴ See Form 8275, filed with Taxpayer's 2007 Federal income tax return.

Form 886-A 5973-scc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56	SCHEMULE NO. OR EXHIBIT
(REV JANUARY 1994)	1
EXPLANATION OF ITEMS	
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")
	YEAR/PERIOD ENDED 200712-200812

contracts until the IRS rules on its request for change in accounting method. On the same Form 8275, the Taxpayer also disclosed that it was using the impairment method for the inclusion or deduction of contingent non-periodic payments made pursuant to NPCs. In other words, the Taxpayer continued to defer the premium payments, but began to accrue its expected losses with respect to its post-2004 CDS contracts, creating an inconsistency between the income and the loss side of the instruments.

Additionally, the Taxpayer used an unreasonably low discount rate of 4.5% for calculating the present value of its expected obligations, or so called "impairment" losses. The Taxpayer states that the 4.5% discount rate approximates the average return on Taxpayer's admitted assets as required under SSAP 60 for insurance reserves.¹⁵ The Taxpayer represents that its average rate of return on admitted assets for the year ended December 31, 2009 was 6.74%. The Taxpayer also represents that it was directed by the Wisconsin Insurance Commissioner to use a discount rate of 5.1% for both its insurance reserves and impairment losses on the post-2004 CDS contracts. Although the Taxpayer has not argued that the credit default swaps are insurance, it cites the necessity to comply with state "insurance regulations" such as SSAP No. 5 in support of its claim for a deduction with respect to "impairment" of its positions in the credit default swaps in issue. Taxpayer's reliance on state insurance regulations to determine the amount and timing of its CDS impairment losses for tax purposes is misguided. It is well-settled that where an insurer claims for tax purposes a loss or expense arising from a non-insurance transaction, the proper deductibility and timing of such an item is not governed by the state insurance regulatory rules. See State Farm Mut. Auto. Ins. Co. v. C.I.R., 135 T.C. No. 26 (Nov. 8, 2010) (explaining that insurance regulator's treatment of loss under statutory accounting rule SSAP No. 5 is not controlling for tax purposes because the loss was an "extracontractual loss" rather than a loss on an insurance contract). Based on its own valuation, the Government concludes that the 4.5% discount rate used by the Taxpayer to calculate the present value of its expected obligations is low, and it unreasonably inflates Taxpayer's tax losses for the 2007 and 2008 tax years.¹⁶

CONCLUSION:

Taxpayer's change from an option method to an impairment method of accounting for its post-2004 CDS contracts constitutes a change of accounting method. The Taxpayer made such change in method of accounting in 2007 without having secured the consent of the Commissioner as expressly required by § 446(e). Accordingly, pursuant to Rev. Proc. 97-27 and Rev. Proc. 2002-18, the Taxpayer should be put back on its original option method of accounting.

Additionally, the impairment method of accounting is an impermissible method of accounting as it does not clearly reflect Taxpayer's income. Under § 446(b), the Commissioner is authorized to place the Taxpayer on a method of accounting which does clearly reflect income, such as the Taxpayer's original option method of accounting. Section 446(b) thus furnishes additional and independent authority to return the Taxpayer to its original option method of accounting for its post-2004 CDS contracts.

* * * *

¹⁵ See Ambac's Response to Government's Second Set of Informal Discovery Requests, at 3, footnote 2.

¹⁶ See IRS Engineer Report, attached hereto as Exhibit A.

Form 886-A 5973-scc Doc 632-1 Filed 10/12/11 Entered 10/12/11 21:03:56	SECTION NO. OR EXHIBIT 1
EXPLANATIONS OF ITEMS	
(REV JANUARY 1994)	
NAME OF TAXPAYER Ambac Assurance Corporation ("AAC"), Ambac Financial Group Inc. ("AFG"), collectively "Ambac" or the "Taxpayer", EIN # 13-3621676	TAX IDENTIFICATION NUMBER 39-1135174 ("AAC")
	YEAR/PERIOD ENDED 200712-200812

The credit default swap losses claimed on the Taxpayer's 2007 and 2008 Federal income tax returns are not allowed under the option method of accounting. Accordingly, these losses, and the loss carrybacks resulting from these losses, must be disallowed. Consequently, Taxpayer is not allowed to retain its Federal tax refunds for tax years 2003 through 2007.

EXHIBIT A

ENGINEER'S REPORT

HOWARD T. MOTT

Taxpayer applied a 4.5% discount rate in its calculation of net impairment losses for the financial reporting years ending 12/31/2007 and 12/31/2008. Taxpayer's responses to discovery include the following statements: "AAC based its CDS performance assumptions on the characteristics of the pool of securities supporting the reference obligation that was the subject of the CDS contract as provided by a third party trustee"; "used the performance assumptions to generate a projection of the cash flows it would be expected to make and receive"; "properly discounted the projected payments to their present value using the statutory discount rate as defined for purposes of calculating Taxpayer's financial guarantee loss". Footnote to italics above is as follows: "AAC used a 4.5% discount rate in calculating both its insurance reserves and its impairment losses on the Post-2004 CDS Contracts for 2007 and 2008. This rate approximates the average rate of return on ACC's admitted assets as required under SSAP 60 for insurance reserves. AAC's average rate of return on its admitted assets for the year ended December 31, 2009 was 6.74%. However, the Wisconsin Insurance Commissioner directed the company to use a discount rate of 5.1% for both AAC's insurance reserves and impairment losses on the Post-2004 CDS Contracts. Although SSAP5 does not provide guidance on the discount rate to be used for impairment losses on CDS contracts, AAC applied the same discount rate for this purpose as it used to discount its insurance reserves. The Wisconsin Insurance Commissioner confirmed the validity of this approach by requiring the use of the same discount rate for both AAC's insurance reserves and impairment losses for 2009."

Taxpayer stated in a March 24, 2011 meeting that its admitted reserves were 80% invested in AAA rated tax exempt Muni/GIC equivalent obligations yielding approximately 4.5% and stated that the appropriate discount rate to apply was the 'risk free' rate of 4.5% for US Treasuries (implied market standard is the 30 year Treasury maturity) based on investment portfolio credit profile. Taxpayer was asked to provide additional detail supporting the calculation of the 4.5% discount rate; response attached as Annex A. Taxpayer was asked to confirm the average weighted life of the CDS portfolio against which impairment losses were being reported for the years under audit as detailed in the Taxpayer's public financial statements. Taxpayer was requested to provide the corporate weighted average cost of capital and replied that the company did not make such a calculation. Taxpayer was asked to provide the 'term maturity' benchmark used in the determination of the "risk free" rate equivalent and declined to do so; see IDR request HTM-1 as attached as Annex B. Conclusion derived from Taxpayer interaction is that the Taxpayer constructed its own discount rate.

The relationship between the Taxpayer's yield on its admitted investment portfolio is not analogous to a projected loss experience on a Credit Default Swap portfolio. Taxpayer's representations imply a constructed methodology application (extrapolation of a discount rate relative to the admitted investment yield rate) in its determination of a discount rate. Such determination is deficient for the calendar years ending 12/31/2007, 12/31/2008, and 12/31/2009 in that 1) no formulaic differentiation is visible between a risk free rate and the discount rate applied; 2) the discount rate should be a derivation of the risk free rate applied to CDS liabilities - weighted average life - as detailed in the Taxpayer's public financial documents 3) no percentage calculation by admitted asset class investments recognizing a credit differential and a margin differential between US Treasuries and each asset class is evident; 4) no relationship identifying secondary market activity of the underlying asset class which could have been used to make the T/P's constructed approach more robust is evident;

5) no reasoned analysis of 'benchmark' maturities in deriving either an appropriate 'adjusted' risk free rate or a comparable 'discount rate' matching either the assumed life of admitted invested assets or the weighted average life of the CDS exposures is visible; and 6) the implicit representation that economic conditions impacting on CDS performance, inherent in applying the same discount rate in the years 2007 and 2008, does not recognize the disruptive economic dynamics occurring within the financial marketplace during 2007, 2008 specifically, continuing into 2009, and on-going.

The use of a 4.5% discount rate for each of the years 2007 and 2008 is not supported; the application of a 5.1% rate stipulated by the Wisconsin Commissioner of Insurance for the 2009 year is not supported; the Taxpayer's calculated internal rate of 6.74% admitted asset yield for the year 2009 is not supported as an appropriate discount rate for the year 2009, and the 5.1% stipulated rate by the Wisconsin Commissioner of Insurance for 2010 is not supported. The discount rate(s) used are low and are inconsistent with publicly released financial reporting detail as well as with internal analysis applied in assessing CDS portfolio exposures and projected future performance.

KW

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EXPLANATIONS OF ITEMS

(REV JANUARY 1994)

SCHEDULE NO. OR
EXHIBIT
1

NAME OF TAXPAYER
AMBAC FINANCIAL GROUP INC & SUBS

TAX IDENTIFICATION NUMBER
13-3621676

YEAR/PERIOD ENDED
200612-200712

TAXPAYER WAS INVESTED IN THE WEINSTEIN COMPANY HOLDINGS LLC FOR THE 200612 AND 200712 YEARS.

THE WEINSTEIN COMPANY HOLDINGS LLC WAS AN INVESTOR IN GENIUS PRODUCTS LLC.

BOTH OF THE ABOVE ENTITIES WERE EXAMINED BY THE IRS.

THE GENIUS EXAMINATION CONCLUDED FIRST AND SENT OUT THE RESULTS TO THE LINKED INVESTORS. THE AMOUNTS PER THE SUBSTITUTE FORM 886S ARE SHOWN ABOVE AS A DECREASE IN DEDUCTION OF \$562,600.00 FOR THE 200612 YEAR AND AN INCREASE IN THE DEDUCTION OF \$579,745.00 FOR THE 200712 YEAR.

AT THE CONCLUSION FOF THE WEINSTEIN COMPANY HOLDING LLC EXAMINATION AN ADJUSTMENT OF \$37,017,846.00 WAS MADE AGAINST ORDINARY INCOME. AMBAC PRIVATE HOLDINGS LLC'S PORTION OF THIS ADJUSTMENT IS $2.00624\% \times \$37,017,846.00$ OR AN INCREASE TO INCOME OF \$742,668.00 AS SHOWN ABOVE.

THE 2007 EXAMINATION OF WEINSTEIN COMPANY HOLDINGS LLC HAS BEEN DETERMINED TO HAVE NO CHANGES TO ITS ORIGINAL FILING.

Form 4564 (Rev. September 2006)	Department of the Treasury - Internal Revenue Service	Request Number HTM - 2 (C)-2
Information Document Request		
To: (Name of Taxpayer and Company Division or Branch) AMBAC FINANCIAL GROUP INC ONE STATE STREET PLAZA NEW YORK, New York 10004-1505		Subject Advisory Services - BlackRock Solutions
		SAIN number 804
		Submitted to: Rachell Gupta, Esquire
		Dates of Previous Requests (mm/dd/yyyy) 4/4/2011

Please return Part 2 with listed documents to the requester identified below

Description of documents requested:

Response to the IDR HTM - 2 provided various documentation pertinent to the engagement of BlackRock Solutions pursuant to the Advisory Services Agreement engaged by Davis Polk & Wardwell L.L.P. as of January 8, 2010.

Definitions of the following were requested in HTM - 2 :

Liability Appraiser Base Case

Liability Appraiser Stress Case

Liability Appraiser Market Value

and the ABS CDO Considerations Schedules(s) thereto related.

The documents provided include:

Schedule A, Description of Services, page 3, paragraph C. Transparency in Liability Appraiser Assumptions and Techniques indicates the following: "Black Rock will prepare a presentation in Powerpoint format detailing its analytical approach and model methodologies by relevant asset class for the Insured Transactions

and

The third bullet point in Schedule A Description of Services, page three (C), indicates "BlackRock will provide a detailed description of its Base and Stress case scenarios including the key assumptions, market trends and macroeconomic factors."

Please provide copies of the BlackRock Powerpoint presentation to complete the information requested in HTM - 2

Information due by	5/18/2011	At next appointment <input type="checkbox"/>	Mail in <input type="checkbox"/>
From:	Name and Title of Requester Mott, Howard T Engineer	Employee ID number 1000860430	Date (mm/dd/yyyy) 5/3/2011
	Office Location: 24 Belden Ave. Norwalk, Connecticut 06850-3314		Telephone: 203 252 1276

NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 1
Name and title of person to whom delivered Rachel Gupta, Esquire		Date: May 4, 2011

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Entity for this proposed adjustment: Ambac Assurance Corporation ("AAC" or "TP") EIN #39-1135174

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Years	Amount	Account or return line	SAIN NO	Issue Code
200712	756,713,558	1120 PC-Schedule A-Line 31	714-03	09300-99-12
200812	3,413,450,726	1120 PC-Schedule A-Line 31	714-03	09300-99-12

ISSUES:

- Should Ambac Financial Group, Inc. ("AFG", "Ambac", or the "Taxpayer") be allowed to claim \$756,713,558 and \$3,413,450,726 of credit default swap losses on its 2007 and 2008 Federal income tax returns respectively?
- Consequently, should the Taxpayer be allowed to retain \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years, arising from the carry back of the credit default swap losses claimed on its 2007 and 2008 Federal income tax returns?

CONCLUSION:

1. No. In 2007, the Taxpayer changed its original option method of accounting for its post-2004 credit default swap contracts ("post-2004 CDS contracts") to a so-called "impairment" method of accounting without securing the consent of the IRS Commissioner as required by § 446(e) and the regulations thereunder. Without such consent, the Taxpayer was prohibited from changing its method of accounting and should have stayed on its original option method. Under the option method of accounting, the Taxpayer could not claim \$756,713,558 and \$3,413,450,726 of ordinary losses on its 2007 and 2008 Federal income tax returns respectively. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

Even if the Taxpayer did not change its method of accounting, but adopted a "new" method of accounting

Taxpayer Representative's action (check one)

AGREED:
 AGREED IN PART:
 DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager <i>Roger A. Hamilton</i>	Date: <i>May 4, 2011</i>
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Page 28 of 26
NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 1
Name and title of person to whom delivered Rachel Gupta, Esquire		Date: May 4, 2011

for its post-2004 CDS contracts, Taxpayer's impairment method of accounting does not clearly reflect income within the meaning of § 446(b). The Taxpayer's original option method of accounting does clearly reflect income. Under § 446(b), therefore, the IRS Commissioner has the authority to require the Taxpayer to continue to use its option method of accounting for its post-2004 CDS contracts. The \$756,713,558 and \$3,413,450,726 of credit default swap losses for the 2007 and 2008 taxable years are therefore disallowed.

2. No. Because the IRS Commissioner properly disallowed losses on the post-2004 CDS contracts of \$756,713,558 and \$3,413,450,726 on the 2007 and 2008 Federal income tax returns respectively, these losses cannot be carried back to the 2003 through 2007 tax years. Consequently, the Taxpayer should not be allowed to retain the \$708,115,835 of Federal tax refunds for the 2003 through 2007 tax years that are attributable to such loss carrybacks.

Reasons for Proposed Adjustment

See Attached Form 886A

Taxpayer Representative's action (check one)

AGREED: AGREED IN PART: DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager

Eugene R. Akerman

Date:

May 4 2011

Pg 24 of 26
NOTICE OF PROPOSED ADJUSTMENT

Name of Taxpayer Ambac Financial Group, Inc. ("AFG" or "Taxpayer")	EIN# 13-3621676	Issue No. 2
Name and title of person to whom delivered Rachel Gupta, Esquire		Date: May 4, 2011

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Entity for this proposed adjustment: Ambac Assurance Corporation ("AAC" or "TP") EIN #39-1135174

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Years	Amount	Account or return line	SAIN NO	Issue Code
200912	2,881,788,001	1120 PC-Schedule A-Line 31	714-03	09300-99-12

Reasons for Proposed Adjustment

See Form 5701 for the 200712-200812 tax years and attached Form 886A, Exhibit A, and Annexes # 1 through 8.

Taxpayer Representative's action (check one)

AGREED:
 AGREED IN PART:
 DISAGREED:

HAVE ADDITIONAL INFORMATION; Will submit by _____

Case Manager <i>Gregory R. Hamilton</i>	Date: <i>May 4, 2011</i>
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Form **5701**
(Rev. December 2006)

Department of the Treasury - Internal Revenue Service

Notice of Proposed Adjustment

Name of taxpayer AMBAC FINANCIAL GROUP INC & SUBS	Issue No. 3
Name and title of person to whom delivered RACHEL GUPTA, ESQUIRE	Date 05/04/2011
Entity for this proposed adjustment AMBAC PRIVATE HOLDINGS LLC % KEVIN DOYLE GENERAL COUNSEL	

Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

Years	Amount	Account or return line	SAIN NO.	Issue Code
200612	\$ 562,000.00			
200712	(\$ 579,745.00)			
200612	\$ 742,668.00			

Reasons for Proposed Adjustment (If the explanation of the adjustment will be longer than the space provided below, the entire explanation should begin on Form 886-A (Explanation of Items).)

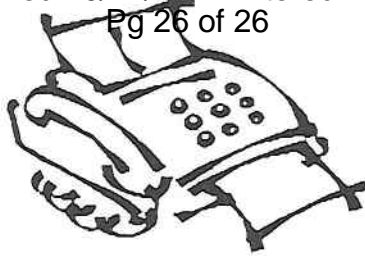
SEE 886-A

Taxpayer's / Representative's Action:
 Agreed Agreed in Part Disagreed Have additional information; will submit by:

Taxpayer's / Representative's Signature	Date
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If Disagreed in Part or in Full - Check here for consideration of Fast Track Settlement
 Taxpayer IRS

Team Manager <i>Engene R. Hamilton</i>	Date <i>May 4, 2011</i>
---	----------------------------



Internal Revenue Service
110 W. 44th Street – 10th Floor
New York, NY 10036
FAX: 212-719-6432

Date: 5-10-11

To: Tom STAS

Phone Number: _____ Fax Number: 212-208-384

From: Pat

I can be reached at: 212-719-6435 or e-mail to: _____

1 Page(s) plus this coversheet

Comments:

Confidential Facsimile Communication

This communication is intended for the sole use of the individual to whom it is addressed. This communication may contain privileged information that is confidential and exempt from disclosure under applicable law. If the reader of this communication is not the intended recipient or the employee, you are hereby notified that any distribution or copying of this communication may be strictly prohibited. If you have received this communication in error, please notify the sender immediately by phone and return the communication to the address above via United States Postal Service.
Thank You.

EXHIBIT B

(IRS Claims & Debtor's Objection Thereto)

Peter A. Ivanick
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Allison H. Weiss
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1301 Avenue of the Americas
New York, New York 10019
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Fax: (212) 259-6333

- and -

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Tel: (650) 845-7000
Fax: (650) 845-7333

Attorneys for the Debtor and Debtor in Possession

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

-----X	
<i>In re</i>	:
	:
	:
AMBAC FINANCIAL GROUP, INC.,	:
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	:
Debtor.	:
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	:
-----X	

**Chapter 11
Case No. 10-15973 (SCC)**

**NOTICE OF DEBTOR’S OBJECTION TO PROOF OF CLAIM
NUMBERS 3694 AND 3699 FILED BY THE DEPARTMENT
OF THE TREASURY – INTERNAL REVENUE SERVICE**

PLEASE TAKE NOTICE that on June 14, 2011, Ambac Financial Group, Inc., as debtor and debtor in possession in the above-captioned chapter 11 case (the “Debtor”) filed the attached *Debtor’s Objection to Proof of Claim Numbers 3694 and 3699 Filed by the Department of the Treasury – Internal Revenue Service* (the “Objection”) with the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”). A hearing to consider the Objection is scheduled for **July 19, 2011 at 10:00 a.m. (prevailing Eastern Time)** before the

Honorable Shelley C. Chapman, United States Bankruptcy Judge, in Courtroom 610 at the Bankruptcy Court, One Bowling Green, New York, New York 10004.

PLEASE TAKE FURTHER NOTICE that any response to the Objection must be in writing, conform to the Federal Rules of Bankruptcy Procedure, the Local Bankruptcy Rules for the Southern District of New York, the *Amended Notice, Case Management, and Administrative Procedures* approved by the Bankruptcy Court [Docket No. 75], and the *Order Pursuant to Section 105(a) of the Bankruptcy Code and Bankruptcy Rule 3007 Granting Relief From Certain Limitations of Bankruptcy Rule 3007 and Establishing Procedures for Objecting to Claims* [Docket No. 225], be filed electronically by registered users of the Bankruptcy Court's electronic case filing system, and be served, so as to be received no later than **July 5, 2011 at 4:00 p.m. (prevailing Eastern Time)**, by (i) the chambers of the Honorable Shelley C. Chapman, United States Bankruptcy Judge, One Bowling Green, Courtroom 610, New York, New York 10004; (ii) counsel for the Debtor, Dewey & LeBoeuf LLP, Attn: Jeffrey Chubak, 1301 Avenue of the Americas, New York, New York 10019; (iii) counsel for the statutory committee of creditors, Morrison & Foerster LLP, Attn: Anthony Princi, 1290 Avenue of the Americas, New York, New York 10104; (iv) counsel for the Office of the Commissioner of Insurance of the State of Wisconsin, Foley & Lardner LLP, Attn: Frank W. DiCatri, 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202; (v) the Office of the United States Trustee for the Southern District of New York, Attn: Brian S. Masumoto, 33 Whitehall Street, 21st Floor, New York, New York, 10004; and (vi) all entities which have filed a written request for notice with the Bankruptcy Court.

PLEASE TAKE FURTHER NOTICE that if no response to the Objection is timely filed and served, the Bankruptcy Court may enter an order sustaining the Objection without further notice or hearing.

Dated: June 14, 2011
New York, New York

Respectfully Submitted,

/s/ Allison H. Weiss
Peter A. Ivanick
Lawrence M. Hill
Allison H. Weiss
DEWEY & LEBOEUF LLP
1301 Avenue of the Americas
New York, New York 10019
Tel: (212) 259-8000
Fax: (212) 259-6333

- and -

Todd L. Padnos (admitted *pro hac vice*)
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Attorneys for the Debtor and Debtor in Possession

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- and -

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Tel: (650) 845-7000
Fax: (650) 845-7333

Attorneys for the Debtor and Debtor in Possession

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

-----X	
<i>In re</i>	:
	:
	:
AMBAC FINANCIAL GROUP, INC.,	:
	:
	:
Debtor.	:
	:
	:
-----X	

**Chapter 11
Case No. 10-15973 (SCC)**

**DEBTOR’S OBJECTION TO PROOF OF CLAIM NUMBERS
3694 AND 3699 FILED BY THE DEPARTMENT OF THE
TREASURY – INTERNAL REVENUE SERVICE**

TO THE HONORABLE SHELLEY C. CHAPMAN,
UNITED STATES BANKRUPTCY JUDGE:

Ambac Financial Group, Inc., as debtor and debtor in possession in the above-captioned chapter 11 case (the “Debtor”), by and through its undersigned counsel, hereby submits this objection (the “Objection”) to proof of claim numbers 3694 and 3699 (the “IRS Claims”), filed

by the Department of the Treasury – Internal Revenue Service (the “IRS”) on May 5, 2011, and respectfully represents:

Preliminary Statement

The IRS Claims, which are substantially duplicative of one another, assert a priority claim against the Debtor of \$807,242,021.91. The Debtor believes that the IRS Claims are premised on the erroneous assumption that \$708,115,837 in tax refunds paid to the Debtor between December 2008 and February 2010 (the “Tax Refunds”) on account of carrying back losses that resulted from its credit default swap contracts (the “CDS Contracts”) were erroneously paid to the Debtor. However, as described below, the Tax Refunds were not erroneously paid to the Debtor.

Up until 2007, Ambac Assurance Corp. (“AAC”), the Debtor’s principal operating subsidiary, treated its CDS Contracts as put options subject to the “wait and see” method of accounting for federal income tax purposes. In preparing its 2007 federal income tax return, the Debtor, in consultation with its accounting firm, KPMG, determined that its Post-2004 CDS Contracts (as defined below) should have been treated as “notional principal contracts” within the meaning of Treas. Reg. § 1.446-3(c)(1)(i) (“NPCs”), rather than as put options subject to the “wait and see” method of accounting.

As described below, proposed regulations promulgated in 2004 by the Department of the Treasury (the “Treasury”) concerning NPCs (i) require that a taxpayer use either of two methods to account for “contingent nonperiodic payments,” such as payments made to credit protection buyers in respect of CDS Contracts upon the occurrence of a credit event—the “noncontingent swap” method or the “mark-to-market” method; and (ii) specify that these two methods apply to NPCs entered into on or after 30 days after the proposed regulations are finalized. *See* Prop. Treas. Reg. § 1.446-3 (the “2004 Proposed Regulations”).

In addition, the Preamble to the 2004 Proposed Regulations (the “Preamble”) provides that (i) the “wait and see” method of accounting for contingent nonperiodic payments is “inconsistent” with existing rules and regulations; and (ii) taxpayers that have not adopted an accounting method for NPCs providing for contingent nonperiodic payments must adopt a method that takes such payments into account over the life of the contract under a “reasonable amortization method.”

Because the 2004 Proposed Regulations had not been finalized in 2007 (and to date, have never been finalized), the Debtor adopted the “impairment” method of accounting as a reasonable accounting method with respect to the contingent nonperiodic payments under the Post-2004 CDS Contracts. The Debtor filed with the IRS its Accounting Method Application (as defined below) in April 2008 and supplemented that application in a September 2008 letter, specifying that AAC had not adopted an accounting method with respect to losses incurred for the first time in 2007 in respect of the Post-2004 CDS Contracts, and that AAC was adopting the impairment method as an initial accounting method with respect to those losses. The IRS has never formally ruled on the Accounting Method Application. As a result of the application of the impairment method, the Debtor reported significant losses in respect of the Post-2004 CDS Contracts and filed claims for tentative carryback adjustments between September 2008 and December 2009. Based on these claims, the IRS refunded the Tax Refunds to the Debtor between December 2008 and February 2010.

The Debtor is entitled to the Tax Refunds, and the IRS should not be entitled to assert claims in respect of such refunds, because AAC’s use of the impairment method beginning in 2007 with respect to the contingent nonperiodic payments under the Post-2004 CDS Contracts was the initial adoption of a proper method of accounting. Even if AAC’s use of the impairment

method could somehow be considered an impermissible change in accounting method, the IRS's withholding of consent from AAC to use the impairment method should be deemed an abuse of discretion, given that the Preamble expressly disavowed the "wait and see" method of accounting for NPCs with contingent nonperiodic payments, which AAC had been utilizing up until 2007, and the impairment method conforms with the Preamble and the IRS's prior guidance.

Alternatively, even if AAC's use of the impairment method could somehow be considered improper, the IRS should be equitably estopped from challenging AAC's use of such method in light of the fact that the IRS never formally ruled on the Debtor's Accounting Method Application and the Debtor's 2007 consolidated federal income tax return put the IRS on notice of AAC's use of the impairment method.

Jurisdiction

1. This court (the "Bankruptcy Court") has jurisdiction to determine this matter under 28 U.S.C. § 1334 and section 505(a) of title 11 of the United States Code (the "Bankruptcy Code"). This is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper before the Bankruptcy Court pursuant to 28 U.S.C. §§ 1408 and 1409.

General Background

2. The Debtor is a holding company and a Delaware corporation. AAC is a Wisconsin-domiciled financial guarantee insurance company whose business includes the issuance of financial guarantee insurance policies to support public finance, structured finance, and international finance transactions.

3. In 2008 and 2009, the Debtor filed with the IRS applications for tentative refunds entitling it to receive refunds for the tax years ending 2003 through 2008. Pursuant to these applications, the Debtor received Tax Refunds totaling approximately \$708,115,837 from carrying back losses that resulted from its CDS Contracts.

4. On March 24, 2010, the Office of the Commissioner of Insurance of the State of Wisconsin (“OCI”) commenced a rehabilitation proceeding, Dane County, Wisconsin Case No. 10-cv-1576, with respect to a segregated account of AAC established pursuant to Wisc. Stat. § 611.24(2) (the “Segregated Account”). The rehabilitation proceeding remains underway in the Circuit Court of Dane County, Wisconsin (the “State Court”). A specifically described list of policies and liabilities were allocated to the Segregated Account. All policies and liabilities of AAC not specifically allocated to the Segregated Account remain in the general account of AAC (the “General Account”).

5. In connection with the Segregated Account rehabilitation proceeding, the State Court entered an order enjoining actions against the Segregated Account by policyholders, counterparties, or other parties (the “Segregated Account Injunction”).

6. On October 28, 2010, the IRS issued an information document request seeking detailed information regarding the basis for the Debtor’s entitlement to the Tax Refunds. In addition, the Debtor was informed that the IRS was examining the propriety of the Tax Refunds and may seek to recoup payment of the Tax Refunds from the Debtor or nondebtor affiliates in the Debtor’s consolidated tax group.

7. Effective November 7, 2010, any and all liabilities (including contingent liabilities) AAC has or may have, now or in the future, to the IRS and/or the Treasury in regard to, or in respect of, the Tax Refunds were allocated to the Segregated Account.

8. On November 8, 2010 (the “Commencement Date”), the Debtor commenced a voluntary case under chapter 11 of the Bankruptcy Code. The Debtor continues to operate its businesses and manage its properties as debtor in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code.

9. On the Commencement Date, the State Court granted an expansion of the Segregated Account Injunction to prevent the IRS from asserting liens against and levying upon the assets of AAC and its subsidiaries and to prevent the Debtor or parties related to the Debtor from pursuing certain claims against the Segregated Account, the General Account, or AAC's subsidiaries.

10. On November 9, 2010, the Debtor commenced an adversary proceeding, Adv. Pro. Case No. 10-4210 (SCC) (the "Adversary Proceeding"), against the IRS by filing a complaint with the Bankruptcy Court [Adv. Pro. Docket No. 1] (the "Complaint"). Count I of the Complaint requests a determination that the Debtor and the members of its consolidated group have no tax liability for tax years 2003 through 2008 and are entitled to retain the full amount of the Tax Refunds.

11. On November 17, 2010, the Office of the United States Trustee for the Southern District of New York (the "U.S. Trustee") appointed a statutory committee of unsecured creditors [Bankr. Ct. Docket No. 27] (the "Committee"). No trustee or examiner has been appointed in this chapter 11 case.

12. On January 13, 2011, the IRS filed a motion with the United States District Court for the Southern District of New York (the "District Court") to withdraw its reference of the Adversary Proceeding to the Bankruptcy Court pursuant to 28 U.S.C. § 157(d), Case No. 11-cv-00270 (PGG). The Debtor has opposed, and the District Court has not yet ruled on, the IRS's motion.

Background with Respect to the IRS Claims

13. From 1999 through 2008, Ambac Credit Products LLC ("ACP"), a wholly-owned subsidiary of AAC, sold credit protection to buyers of the same in the form of CDS Contracts. Pursuant to each CDS Contract, ACP agreed to pay credit protection buyers specified amounts

upon the occurrence of a “credit event” with respect to one or more “reference obligations.”

ACP received consideration in the form of periodic payments. AAC insured ACP’s performance under the CDS Contracts. Because ACP is disregarded for federal income tax purposes, AAC was treated as the party to the CDS Contracts.

14. Substantially all of the CDS Contracts that ACP entered into from 1999 through 2004 (the “Pre-2005 CDS Contracts”) were substantially similar. Likewise, substantially all of the CDS Contracts that ACP entered into from 2005 through 2008 (the “Post-2004 CDS Contracts”) were substantially similar. The following are the key differences between the Pre-2005 CDS Contracts and the Post-2004 CDS Contracts:

- (i) Loss Provisions: Certain Pre-2005 CDS Contracts provided for “physical settlement,” that is, the credit protection buyer had the right to sell the underlying reference obligation to ACP if a credit event occurred with respect to the reference obligation. In addition, certain Pre-2005 CDS Contracts provided for “cash settlement,” that is, ACP was required to pay the counterparty the difference between the fair market value of the reference obligation and the price specified in the Pre-2005 CDS Contracts upon the occurrence of a credit event. In contrast, the Post-2004 CDS Contracts generally were “pay as you go” contracts, that is, such contracts provided that ACP could not be compelled to buy the reference obligation and was merely required to make payments to the credit protection buyer where the issuer of the reference obligation failed to make scheduled principal or interest payments.
- (ii) Definition of “Credit Event”: In the Pre-2005 CDS Contracts, the definition of “credit event” included nonpayment of principal or interest or the bankruptcy of the issuer of the reference obligation. In the Post-2004 CDS Contracts, “credit event” was defined as a default by the issuer of a reference obligation in the payment of principal or interest when due.
- (iii) Reimbursement: The Post-2004 CDS Contracts included a provision requiring a credit protection buyer to reimburse ACP if the issuer of a reference obligation subsequently made payments on account of a previous shortfall in the payment of principal or interest that triggered a credit event. In contrast, the Pre-2005 CDS Contracts did not include any such reimbursement provision.

15. Based on the nature of the Pre-2005 CDS Contracts, AAC treated such contracts as put options subject to the “wait and see” method of accounting for federal income tax purposes. Under this method, a taxpayer does not realize income or expense until a recognition event occurs. Thus, AAC did not realize income or expense until, for example, AAC disposed of a bond received from the exercise of a credit protection buyer’s physical settlement right or the contract expired unexercised. The IRS examined the Debtor’s 1999 through 2004 consolidated federal income tax returns and proposed no adjustments related to this treatment.

16. Despite the significant differences in the loss payment provisions of the Pre-2005 CDS Contracts and the Post-2004 CDS Contracts, AAC continued applying the “wait and see” method of accounting with respect to its income from the payments it received in respect of the Post-2004 CDS Contracts and therefore did not recognize income in either 2005 or 2006 because the contracts neither expired nor terminated. This treatment was fully disclosed on the Debtor’s consolidated federal income tax returns for 2005 and 2006.

17. As a result of adverse developments in the credit markets beginning in 2007, AAC suffered significant losses in its CDS Contract portfolio for both financial and statutory accounting purposes beginning in 2007.

18. In preparing its 2007 consolidated federal income tax return, the Debtor, in consultation with its accounting firm, KPMG, determined that based upon the differences between the Pre-2005 CDS Contracts and the Post-2004 CDS Contracts, the Post-2004 CDS Contract should have been treated as NPCs rather than as put options subject to the “wait and see” method of accounting.

19. As the 2004 Proposed Regulations concerning contingent nonperiodic payments on NPCs, such as payments made by ACP to credit protection buyers upon the occurrence of a

credit event in respect of the Post-2004 CDS Contracts, had not been finalized, the Debtor applied the “impairment” method of accounting to these losses. Under this method, changes in impairment were taken into account as taxable income or loss on a quarterly basis. Notably, as described below, the Preamble provides that taxpayers that have not adopted an accounting method for NPCs providing for contingent nonperiodic payments must adopt a method that takes such payments into account over the life of the contract under a “reasonable amortization method.”

20. In April 2008, the Debtor filed with the IRS an IRS Form 3115, Application for Change in Accounting Method (the “Accounting Method Application”). This application was supplemented by a letter dated September 2, 2008 that clarified that AAC had not adopted an accounting method with respect to losses incurred in respect of the Post-2004 CDS Contracts, as AAC had not incurred any losses with respect to such contracts until 2007, and that AAC would adopt the impairment method of accounting with respect to any such losses, consistent with the 2004 Proposed Regulations. The IRS has yet to formally rule on the Accounting Method Application.

21. As a result of the application of the impairment method of accounting with respect to the losses incurred under the Post-2004 CDS Contracts, the Debtor reported an approximately \$33 million taxable loss for 2007 and \$3.2 billion taxable loss for 2008. Section 6411(a) of title 26 of the United States Code (as amended, the “IRC”) allows a taxpayer to apply for a tax refund based on the carryback of net operating losses to prior taxable years based on a tentative claim arising from the transactions in the carryback year and provides for an accelerated process for IRS review of such refund claim. IRC § 6411(a).

22. Accordingly, on September 23, 2008, August 11, 2009, and December 21, 2009, the Debtor filed claims for tentative carryback adjustments on IRS Form 1139, Corporate Application for Tentative Refund, as a result of the carryback to prior taxable years of the net operating losses reflected on its 2007 and 2008 consolidated federal income tax returns. Based on these claims, in December 2008, September 2009, and February 2010, the IRS refunded to the Debtor approximately \$11,470,930, \$252,704,185, and \$443,940,722 in Tax Refunds, respectively, totaling approximately \$708,115,837.

23. Pursuant to a tax sharing agreement dated as of July 19, 1991 among the Debtor and its subsidiaries in its consolidated tax group, as amended, the Debtor distributed the Tax Refunds to AAC.

24. On May 5, 2011, the IRS filed the IRS Claims, both of which are attached hereto as Exhibit A. The IRS Claims list taxes allegedly due and interest and penalties thereon but do not explain the basis for the claims. Both IRS Claims assert a priority claim under section 507(a)(8) of the Bankruptcy Code of \$807,242,021.91 and a general unsecured claim of \$1,800.00. The Debtor believes that the IRS Claims are premised on the incorrect assumption that the Tax Refunds were erroneously paid to the Debtor.

Relief Requested

25. By this Motion, the Debtor requests entry of an order, substantially in the form attached hereto as Exhibit B, disallowing and expunging the IRS Claims on the grounds that the Tax Refunds were not erroneously paid to the Debtor.

Basis for Relief Requested

26. A filed proof of claim is deemed allowed unless a party in interest objects thereto. 11 U.S.C. § 502(a). If an objection refuting at least one of the claim's essential allegations is asserted, the claimant has the burden of demonstrating the validity of the claim. *See, e.g.,*

Sherman v. Novack (In re Reilly), 245 B.R. 768, 773 (2d Cir. B.A.P. 2000), *aff'd*, 242 F.3d 367 (2d Cir. 2000); *In re Oneida, Ltd.*, 400 B.R. 384, 389 (Bankr. S.D.N.Y. 2009); *In re DJK Residential LLC*, 416 B.R. 100, 105 (Bankr. S.D.N.Y. 2009).

27. Section 502(b)(1) of the Bankruptcy Code provides that the Bankruptcy Court shall allow a claim except to the extent that it “is unenforceable against the debtor and property of the debtor under any agreement or applicable law.” 11 U.S.C. § 502(b)(1). The IRS Claims are premised on the assumption that the Tax Refunds were erroneously paid to the Debtor under applicable tax law. As described below, this underlying premise is incorrect, and therefore, the IRS Claims should be disallowed and expunged in their entirety pursuant to section 502(b)(1) of the Bankruptcy Code.

The Tax Refunds Were Not Erroneously Paid to the Debtor

I. The Post-2004 CDS Contracts Are NPCs

28. As described above, in preparing its 2007 consolidated federal income tax return, the Debtor, in consultation with KPMG, determined that the Post-2004 CDS Contracts should have been treated as NPCs under Treas. Reg. § 1.446-3, which would impact the timing and character of income or loss under these contracts.

29. Treasury regulations define an NPC as “a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.” Treas. Reg. § 1.446-3(c)(1)(i). NPCs “include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements.” *Id.*

30. The Post-2004 CDS Contracts satisfy all elements required to be considered an NPC:

- (i) “Payment of amounts by one party to another at specified intervals”: The Post-2004 CDS Contracts provide for payment by the credit protection buyer to ACP at fixed quarterly payment dates.
- (ii) “Calculated by reference to a specified index”: Treas. Reg. § 1.446-3(c)(1) defines a “specified index” as, *inter alia*, “[a] fixed rate, price, or amount.” Under the Post-2004 CDS Contracts, payments are calculated by reference to a specified index because the credit protection buyer is required to pay a fixed amount based on a single fixed rate that does not vary over the term of the contract, a notional amount of reference obligations, and a period of time.
- (iii) “Upon a notional principal amount”: Treas. Reg. § 1.446-3(c)(3) defines a “notional principal amount” as “any specified amount of money or property that, when multiplied by a specified index, measures a party’s rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract.” “The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information.” Treas. Reg. § 1.446-3(c)(3). Treas. Reg. § 1.446-3(c)(4)(ii), in turn, defines “objective financial information” as “any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties’ circumstances (such as one party’s dividends, profits, or the value of its stock).” Under the Post-2004 CDS Contracts, the notional amount is a specified amount of money or property that, when multiplied by the applicable fixed rate and time factor, measures the credit protection buyer’s fixed amount. Although the notional amount may vary over the term of a Post-2004 CDS Contract, it varies based on objective financial information, that is, the performance of the reference obligation, and this information is not within the control of ACP or the credit protection buyer and is not unique to either party. Moreover, ACP and the credit protection buyer do not loan or borrow the notional amount from each other.
- (iv) “In exchange for specified consideration or a promise to pay similar amounts”: Under the Post-2004 CDS Contracts, the credit protection buyer pays fixed amounts to ACP in exchange for ACP’s promise to make payments upon the occurrence of specified credit events.

31. Pursuant to Treas. Reg. § 1.446-3(c)(1)(ii), contracts described in IRC § 1256(b), futures contracts, forward contracts, options, and instruments or contracts that constitute indebtedness are *not* NPCs. The Post-2004 CDS Contracts are clearly not IRC § 1256(b) contracts, futures contracts, forward contracts, or debt.

32. Moreover, the Post-2004 CDS Contracts are not properly characterized as options. “A contract is an option contract when it provides (A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specific future date or within a specified time period, (E) for consideration.” *Fed. Home Loan Mortg. Corp. v. Comm’r*, 125 T.C. 248, 261 (2005) (citing, *inter alia*, *W. Union Tel. Co. v. Brown*, 253 U.S. 101, 110 (1920)); *see also Dunn v. Commodity Futures Trading Comm’n*, 519 U.S. 465, 469 (1997) (defining an option contract as “a transaction in which the buyer purchases from the seller for consideration the right, but not the obligation, to buy or sell an agreed amount of [property] at a set rate at any time prior to the option’s expiration”). The Post-2004 CDS Contracts are not options because they do not concern the sale of property or the cash equivalent of property. Under the contracts, ACP is required to make payments to credit protection buyers upon the occurrence of a credit event on a “pay as you go” basis—there is no physical or cash settlement required of ACP.

33. In addition, “[o]ptions have been characterized as unilateral contracts because one party to the contract is obligated to perform, while the other party may decide whether or not to exercise his rights under the contract.” *Fed. Home Loan Mortg. Corp.*, 125 T.C. at 259 (citing *U.S. Freight Co. v. United States*, 422 F.2d 887, 894 (Ct. Cl. 1970)). Thus, the Post-2004 CDS Contracts are not options because both parties bear obligations throughout the terms of the contracts. Specifically, (i) ACP could be required to make multiple payments upon the occurrence of one or more credit events; (ii) credit protection buyers have no right to require ACP to purchase the reference obligation (or to pay the cash equivalent thereof); and (iii) credit protection buyers are required to make periodic payments and reimbursement payments to ACP in the event that specified payments are made with respect to the reference obligations.

II. The 2004 Proposed Regulations Required the Debtor to Adopt a “Reasonable Amortization Method” with Respect to Contingent Nonperiodic Payments Received Under NPCs

34. Treasury regulations promulgated in 1993 divide payments made pursuant to NPCs into the following three categories: (i) Periodic Payments: Periodic payments are payments made or received under an NPC that are payable at fixed intervals of one year or less during the entire contract term, that are based on a specified index, and that are based on either a single notional amount or a notional principal amount that varies over the contract terms in the same proportion as the notional principal amount that measures the other party’s payments, Treas. Reg. § 1.446-3(e)(1); (ii) Nonperiodic Payments: Nonperiodic payments are payments made or received under an NPC that are not periodic payments or termination payments, Treas. Reg. § 1.446-3(f)(1); and (iii) Termination Payments: Termination payments are any payments made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under an NPC. Treas. Reg. § 1.446-3(h)(1).

35. Pursuant to these regulations, taxpayers must recognize the ratable daily portion of periodic payments—those paid at least annually—and nonperiodic payments—all other payments which are not termination payments—for the taxable year to which those portions relate. Generally, a nonperiodic payment must be recognized over the term of an NPC in a manner that reflects the economic substance of the contract. *See* Treas. Reg. § 1.446-3(e)(2)(i); Treas. Reg. § 1.446-3(f)(2)(i).

36. The 1993 regulations do not distinguish between noncontingent and contingent nonperiodic payments, but the specific rules and examples provided address only noncontingent nonperiodic payments. The 2004 Proposed Regulations distinguish between two categories of nonperiodic payments made pursuant to NPCs: (i) Contingent Nonperiodic Payments: The 2004 Proposed Regulations define these payments as “any nonperiodic payment other than a

noncontingent nonperiodic payment;” and (ii) Noncontingent Nonperiodic Payments: The 2004 Proposed Regulations define these payments as “a nonperiodic payment that is either fixed on or before the end of the taxable year in which a contract commences or is equal to the sum of amounts that would be periodic payments if they are paid when they become fixed (including amounts determined as interest accruals).”

37. Pursuant to the 2004 Proposed Regulations, a taxpayer may use either of two methods to account for contingent nonperiodic payments: (i) the “noncontingent swap” method, which generally requires taxpayers to project the reasonably expected amount of a contingent nonperiodic payment and account for the projected payment over the term of the NPC as if it were a noncontingent nonperiodic payment, or (ii) the “mark-to-market” method, which requires taxpayers to recognize gains or losses that would be realized if the NPC were sold for its fair market value on the last business day of the taxable year.

38. The Preamble states that the “wait and see” method of accounting for contingent nonperiodic payments is “inconsistent” with the existing specific timing rules and with the general rule in Treas. Reg. § 1.446-3(f)(2)(i) respecting recognition of nonperiodic payments over the term of the contract.¹ Instead, “the parties must use a reasonable estimate of the payment for determining taxable income in the year before the payment is fixed.” In addition, the Preamble states that the proposed two accounting methods—the noncontingent swap method and the mark-to-market method—provide a timing regime that “clearly reflects the economics of the underlying contracts.”

¹ Treas. Reg. § 1.446-3(f)(2)(i) provides that “[a]ll taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.”

39. The 2004 Proposed Regulations provide that the two proposed accounting methods apply to NPCs entered into on or after 30 days after the proposed regulations are finalized, and that until such regulations are finalized, a taxpayer is *not* required to adopt either the noncontingent swap method or the mark-to-market method. The Preamble provides that a taxpayer that has not yet adopted a method of accounting for NPCs providing for contingent nonperiodic payments that are in effect or entered into on or after 30 days after publication of the proposed regulations must adopt any “reasonable amortization method” to amortize contingent nonperiodic payments and that such “reasonable amortization method” may be, but need not be, a method that satisfies the proposed regulations.

40. The 2004 Proposed Regulations were *never finalized*, and consequently, a taxpayer that had not yet adopted an accounting method for NPCs providing for contingent nonperiodic payments was required only to adopt a “reasonable amortization method” with respect to such payments.

III. The Impairment Method of Accounting Adopted by AAC Is a “Reasonable Amortization Method” Within the Meaning of the Preamble to the 2004 Proposed Regulations

41. IRC § 446(a) provides that taxable income “shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” IRC § 446(a). Treas. Reg. § 1.446-1(a) provides that no uniform method of accounting applies to all taxpayers, and taxpayers are free to choose any method of accounting that clearly reflects income so long as the method chosen is not inconsistent with a method specifically prescribed by the IRC, Treasury regulations, or IRC pronouncements. Thus, if a taxpayer’s method of accounting clearly reflects income, the IRS may not require the taxpayer to change to a method that, in the IRS’s view, more clearly reflects income. Further, a taxpayer generally must treat a single “item” of income or expense consistently. *See* Treas. Reg. § 1.446-1(a)(2).

42. The term “method of accounting” includes both the overall method of accounting of a taxpayer as well as the accounting treatment of “any item.” Treas. Reg. § 1.446-1(a)(1). A taxpayer “adopts” a method of accounting on the first return on which an “item” is present when the taxpayer uses a proper method. Treas. Reg. § 1.446-1(e)(1). In situations where a taxpayer selects an improper method of accounting, the method is considered “adopted” only after the taxpayer has used such method on two consecutive tax returns. *See* Rev. Rul. 90-38, 1990-1 C.B. 57; *Diebold v. United States*, 891 F.2d 1579 (Fed. Cir. 1989).

43. For tax accounting purposes, AAC applied the impairment method of accounting to account for ACP’s Post-2004 CDS Contracts. Adoption of the impairment method of accounting was proper because, as stated above, the Post-2004 CDS Contracts were properly characterized as NPCs rather than as put options subject to the “wait and see” method of accounting. Once the Post-2004 CDS Contracts, which required ACP to make contingent nonperiodic payments to credit protection buyers,² were properly characterized as NPCs, AAC was permitted under the 2004 Proposed Regulations to adopt any “reasonable amortization method” to amortize the contingent nonperiodic payments. AAC adopted the impairment method for tax purposes, which mirrored statutory accounting principles applicable to AAC as a regulated insurance company.³ Indeed, OCI reviewed and approved AAC’s adoption of the

² Such payments were not termination payments within the meaning of the 2004 Proposed Regulations because such payments would not extinguish or assign all or a proportionate part of a credit protection buyer’s remaining rights and obligations.

³ In general, insurance companies must use statutory accounting principles as the basis for tax accounting, and in particular, use the underwriting and investment exhibits of the annual statement filed with state regulators. *See, e.g., Home Group, Inc. v. Comm’r*, 875 F.2d 377, 382 (2d Cir. 1989) (holding that statutory accounting should be used as the starting point for tax accounting); *State Farm Mut. Automobile Ins. Co. v. Comm’r*, 135 T.C. 543, 553 (2010) (“State insurance commissioners’ preferences about reserves ... are not some intrusion on federal tax policy; using their annual statement is federal tax law”) (quoting *Sears, Roebuck & Co. v. Comm’r*, 972 F.2d 858, 865–66 (7th Cir. 1992)). Notwithstanding the foregoing, courts have held that tax accounting principles override statutory accounting (i) when there is an explicit rule in the IRC for the treatment of an item of income or loss or (ii) when the

impairment method for statutory accounting purposes as a reasonable method to properly account for the contingent liability that may arise from future credit event payments on the Post-2004 CDS Contracts.

44. The impairment method adopted for tax accounting purposes is a “reasonable” accounting method insofar as it applied to AAC because (i) it is a valid alternative to the “wait and see” accounting method, which, as set forth above, the IRS explicitly rejected in the Preamble; (ii) it properly matches income by netting the present value of future expected losses against the present value of projected future premiums; (iii) AAC based its Post-2004 CDS Contract performance assumptions on the characteristics of the pool of securities supporting the reference obligation, as provided by objective third-parties; (iv) the impairment accounting principles and impairment calculations were audited and accepted by AAC’s outside auditor, KPMG; (v) it is similar to, but more conservative than, the GAAP mark-to-market method applicable to financial statement accounting, insofar as the mark-to-market method calculated larger losses on the Post-2004 CDS Contracts and would have created an even larger tax loss than the tax accounting loss upon which the Tax Refunds are based; (vi) it measured the change in value of the Post-2004 CDS Contracts based upon the expected value of the future nonperiodic payments, consistent with the 2004 Proposed Regulations; and (vii) its application is consistent with the statutory accounting method applied by AAC and reported to OCI.

use of statutory accounting results in a mismatch between income and expenses. *Home Group*, 875 F.2d at 381–82. In addition, courts have held that the primacy of statutory accounting principles does not prevent the IRS from examining the precise numbers used by the taxpayer in its annual statement. *See Physicians Ins. Co. of Wis. v. Comm’r*, T.C. Memo. 2001-304. These exceptions to the general rule, however, do not apply to AAC’s accounting treatment of the Post-2004 CDS Contracts. First, there is no general tax accounting rule regarding the treatment of CDS Contracts. Second, the impairment method does not create a mismatch between income and expenses, as courts have objected to in the past regarding certain statutory accounting practices. AAC’s reliance on statutory accounting principles in reporting losses on its Post-2004 CDS Contracts was therefore proper.

IV. AAC's Use, Beginning in 2007, of the Impairment Method with Respect to Credit Event Payments Under the Post-2004 CDS Contracts Was Not an Unauthorized Change in Method of Accounting

A. Regulations Governing Changes in Methods of Accounting

45. Treas. Reg. § 1.446-1(e)(2)(i) provides “[e]xcept as otherwise expressly provided ... a taxpayer who changes the method of accounting employed ... shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted.”

46. Treas. Reg. § 1.446-1(e)(2)(ii)(a), in turn, provides that “a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan.” “Material item” is defined as “any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.” Treas. Reg. § 1.446-1(e)(2)(ii)(a). Treas. Reg. § 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does *not* include the correction of computational or posting errors, a change that does not involve the timing of an item, or a change in treatment resulting from a change in underlying facts.

47. Although the IRS generally has discretion over whether to consent to a taxpayer request to change a method of accounting, it is an abuse of discretion for the IRS to deny a request to change from an improper method to a proper method of accounting or to put the taxpayer on a method which itself does not clearly reflect income. *See, e.g., Exxon Mobil Corp. v. Comm’r*, 114 T.C. 293, 322 (2000); *Sierracin Corp. v. Comm’r*, 90 T.C. 341, 368 (1988); *Wright Contracting Co. v. Comm’r*, 36 T.C. 620, 633 (1961).

B. Arguments

(1) AAC's Use of the Impairment Method Beginning in 2007 Was the Initial Adoption of a Proper Method of Accounting and Thus Not an Improper Change in Method of Accounting

48. As noted above, the term “method of accounting” includes not only the taxpayer’s overall method of accounting, but also the accounting treatment of any particular item. Treas. Reg. § 1.446-1(a). The term “item” is used to indicate any recurring incidence of income or expense. The determination of whether a taxpayer has adopted a method of accounting is heavily dependent on the definition of “item,” because a taxpayer may adopt a new and different method for a new item. Consequently, a taxpayer’s reporting of a new and different item of income or expense for the first time does not necessarily involve a “change” of accounting method requiring prior IRS consent; prior IRS consent is required where there is a change in the treatment of “any material item.” The method of accounting for an item should not be confused with the characterization of a financial instrument for federal income tax purposes. Even if AAC adopted an option-like “wait and see” method of accounting for income on an NPC in the 2005 and 2006 taxable years does not mean that the post-2004 NPCs are options for federal income tax purposes. Instead, at worst AAC may have used an improper method for one payment stream under such contracts; it did not, however, adopt a method in 2005 and 2006 for deductions on such contracts.

49. Recently, the U.S. Tax Court in *Capital One Financial Corp. & Subs. v. Commissioner*, 130 T.C. 147 (2008) (“*Capital One*”), addressed the meaning of the term “item” for accounting method purposes. The Tax Court concluded that whether a particular type of income (or expense) constitutes an “item” depends upon a consideration of all relevant facts and circumstances concerning that item. The court pointed out that an “item” for purposes of the adoption or change in accounting method rules may be narrower than the broad items of income

listed under IRC § 61; to define an item too broadly could undermine the reasons for and objectives of IRC § 446(e). 130 T.C. at 160–61. Accordingly, because the taxpayers’ late fee income was merely one of several types of interest income earned on a pool of credit card receivables, but was earned for reasons independent of the reasons that other types of income were earned on the pool, the court held that the late fee income, rather than interest, was the item for which IRS consent to an accounting method change was required. The taxpayers’ retroactive recharacterization of the late fee income thus was an impermissible accounting method change under IRC § 446(e). *Id.* at 161, 170.

50. In the context of NPCs, the IRS would seem in fact to share the Tax Court’s view in *Capital One* of “item” for accounting method purposes. In Revenue Ruling 2002-30, a situation is described where a taxpayer enters into an NPC with another party, which NPC requires a nonperiodic payment to be made that is comprised of noncontingent and contingent components. Rev. Rul. 2002-30, 2002-1 C.B. At issue was the appropriate method for the inclusion into income or the deduction of the nonperiodic payment. Of note, the IRS ruled that the taxpayer and the other party were required to recognize the nonperiodic payment over the term of the NPC in a manner that reflected the economic substance of the NPC because “each component must be treated separately for purposes of applying the NPC rules in [Treas. Reg.] § 1.446-3.”

51. Following the principles enunciated in *Capital One* and Revenue Ruling 2002-30, AAC’s credit event payments properly characterized as contingent nonperiodic payments are items that are separate and distinct from the other streams of revenue (such as the periodic credit protection payments received) and expense under the Post-2004 CDS Contracts. As such and because ACP did not incur any losses with respect to the Post-2004 CDS Contracts prior to 2007,

AAC had not yet established a method of accounting with respect to this item. Accordingly, AAC was free to adopt the impairment method as an initial accounting method in 2007 with respect to this item as a result of determining that the Post-2004 CDS Contracts properly are characterized as NPCs.

(2) Alternatively, the IRS's Withholding of Consent from AAC to Use the Impairment Method Constitutes an Abuse of Discretion

52. The IRS has been found to have abused its discretion in cases where (i) the IRS purported to deny a taxpayer the opportunity to change from an incorrect method to a correct method, (ii) the court found that the taxpayer's method did clearly reflect income, and (iii) the IRS sought to deny the taxpayer's use of a method that is expressly sanctioned by the IRC or applicable regulations. *See, e.g., Sierracin Corp.*, 90 T.C. at 341 (holding that the Commissioner of the IRS abused his discretion in rejecting the taxpayer's application of the completed contract method); *see also Wright Contracting*, 36 T.C. at 636 (abuse of discretion might be found if the IRS withheld consent to allow the taxpayer to change from an improper to a proper method of accounting); *Nat'l Bank of Fort Benning v. United States*, 79-2 USTC ¶ 9627 (M.D. Ga. 1979) (same); *Benefit Life Ins. Co. v. United States*, 517 F. Supp. 740, 773 (D. Kan. 1980), *aff'd*, 726 F.2d 1491 (10th Cir. 1984) (same); *SoRelle v. Comm'r*, 22 T.C. 459, 469 (1954) (in the context of other questions, court made it clear that the IRS could not compel a taxpayer to remain on an improper accounting method).

53. Additionally, courts have held that the IRS abuses its discretion when it seeks to put the taxpayer on a method which itself does not clearly reflect income. *See, e.g., Dayton Hudson Corp. & Subs. v. Comm'r*, 153 F.3d 660 (8th Cir. 1998), *rev'g* 73 T.C.M. (CCH) 2978, 2993 (1997) (although finding there was no error in the Tax Court's conclusion that the taxpayer's method of accounting for shrinkage did not reflect income clearly, the court of

appeals reversed the judgment of the Tax Court because the IRS had acted arbitrarily in prescribing a different method that did not reflect income clearly).

54. As noted above, the Preamble expressly disavowed the “wait and see” method of accounting for NPCs with contingent nonperiodic payments. The impairment method, however, conforms with the Preamble and the IRS’s prior guidance. Moreover, in 2008, the Debtor put the IRS on notice of AAC’s desire to use the impairment method when it timely filed its Accounting Method Application. (As noted above, the IRS has failed to formally rule on such application.) Further, the Debtor fully disclosed its tax position with respect to the Post-2004 CDS Contracts on its 2007 and 2008 federal income tax returns.

(3) Alternatively, the IRS Should Be Equitably Estopped from Challenging AAC’s Use of the Impairment Method

55. “Equitable estoppel is grounded on notions of fair dealing and conscience and is designed to aid the law in the administration of justice where injustice would otherwise result.” *In re Vebeliunas*, 332 F.3d 85, 93 (2d Cir. 2003) (quoting *In re Ionosphere Clubs, Inc.*, 85 F.3d 992, 999 (2d Cir. 1996)).

56. Courts have estopped the IRS from asserting that it had not consented to an accounting method change where the IRS implicitly approved a change to a correct method (or a waiver in effect resulted) by accepting a taxpayer’s return giving notice that the method originally adopted had been changed. *See, e.g., Fowler Bros. & Cox v. Comm’r*, 138 F.2d 774, 775 (5th Cir. 1943) (sustaining the IRS’s position that by its acceptance of the taxpayer’s returns, it had impliedly consented to the taxpayer’s change in accounting method from the accrual basis of accounting to the cash basis of accounting); *Tampa Tribune Bldg. Co. v. Tomlinson*, 52 AFTR 1799 (S.D. Fla. 1957) (holding that the filing of returns by a taxpayer on a cash basis from 1932 to the time of trial, where in prior years returns had been filed on an accrual basis, *ipso facto*

gave the IRS notice of the accounting method change, and therefore, acceptance of the cash basis returns was tantamount to approval of such change and the IRS was estopped from questioning the change for the first time fifteen years later); *Linen Thread Co., Ltd. v. Comm'r*, 14 T.C. 725, 732 (1950) (change in the taxpayer's books, together with a change in the basis of the returns accepted by the IRS, was held tantamount to a request for permission to change the applicable accounting method and the approval of such change).

57. The IRS should be equitably estopped from now challenging AAC's use of the impairment method because the Accounting Method Application has been pending with the IRS since April 2008 and Debtor filed its 2007 consolidated federal income tax return reflecting the same treatment with respect to the credit event payments indicated in its Accounting Method Application, which return put the IRS on notice of AAC's use of the impairment method.

Conclusion

WHEREFORE, for the reasons set forth herein, the Debtor respectfully requests that the Bankruptcy Court enter an order, substantially in the form attached hereto as Exhibit B, disallowing and expunging the IRS Claims in their entirety and granting such other and further relief as is appropriate.

Dated: June 14, 2011
New York, New York

Respectfully Submitted,

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Attorneys for the Debtor and Debtor in Possession

EXHIBIT A

(IRS Claims)

UNITED STATES BANKRUPTCY COURT SOUTHERN DISTRICT OF NEW YORK		PROOF OF CLAIM
Name of Debtor: AMBAC FINANCIAL GROUP, INC.		Case Number: 10-15973-SCC
<i>NOTE: This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A request of payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.</i>		
Name of Creditor (The person or other entity to whom the debtor owes money or property): Department of the Treasury - Internal Revenue Service		<input type="checkbox"/> Check this box to indicate that this claim amends a previously filed claim.
Name and address where notices should be sent: Internal Revenue Service P.O. Box 7346 Philadelphia, PA 19101-7346		Court Claim Number: _____ <i>(If known)</i>
Telephone number: 1-800-913-9358 Creditor Number: 5527944		Filed on: _____
Name and address where payments should be sent (if different from above): Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202		<input type="checkbox"/> Check this box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars.
Telephone Number: (716) 961-5259		<input type="checkbox"/> Check this box if you are the debtor or trustee in this case.
1. Amount of Claim as of Date Case Filed: \$ 807,243,827.91		5. Amount of Claim Entitled to Priority under 11 U.S.C. §507(a). If any portion of your claim falls in one of the following categories, check the box and state the amount. Specify the priority of the claim.
If all or part of your claim is secured, complete item 4 below; however, if all of your claim is unsecured, do not complete item 4. If all or part of your claim is entitled to priority, complete item 5. <input checked="" type="checkbox"/> Check this box if claim includes interest or other charges in addition to the principal amount of claim. Attach itemized statement of interest or charges.		
2. Basis for Claim: Taxes (See instruction #2 on reverse side.)		<input type="checkbox"/> Domestic support obligations under 11 U.S.C. §507(a)(1)(A) or (a)(1)(B).
3. Last four digits of any number by which creditor identifies debtor: See Attachment		<input type="checkbox"/> Wages, salaries, or commissions (up to \$11,725*) earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier - 11 U.S.C. §507 (a)(4).
3a. Debtor may have scheduled account as: _____ (See instruction #3a on reverse side.)		<input type="checkbox"/> Contributions to an employee benefit plan - 11 U.S.C. §507 (a)(5).
4. Secured Claim (See instruction #4 on reverse side.) Check the appropriate box if your claim is secured by a lien on property or a right of setoff and provide the requested information. Nature of property or right of setoff: <input type="checkbox"/> Real Estate <input type="checkbox"/> Motor Vehicle <input type="checkbox"/> Other Describe: Value of Property: \$ _____ Annual Interest Rate ____ % Amount of arrearage and other charges as of time case filed included in secured claim, if any: \$ _____ Basis for perfection: _____ Amount of Secured Claim: \$ _____ Amount Unsecured: \$ _____		<input type="checkbox"/> Up to \$2,600* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use - 11 U.S.C. §507 (a)(7).
6. Credits: The amount of all payments on this claim has been credited for the purpose of making this proof of claim.		<input checked="" type="checkbox"/> Taxes or penalties owed to governmental units - 11 U.S.C. §507 (a)(8).
7. Documents: Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements or running accounts, contracts, judgments, mortgages, and security agreements. You may also attach a summary. Attach redacted copies of documents providing evidence of perfection of a security interest. You may also attach a summary. <i>(See instruction 7 and definition of "redacted" on reverse side.)</i> DO NOT SEND ORIGINAL DOCUMENTS. ATTACHED DOCUMENTS MAY BE DESTROYED AFTER SCANNING. If the documents are not available, please explain:		<input type="checkbox"/> Other - Specify applicable paragraph of 11 U.S.C. §507 (a)(__). Amount entitled to priority: \$ 807,242,027.91
Date: 05/04/2011	Signature: The person filing this claim must sign it. Sign and print name and title, if any, of the creditor or other person authorized to file this claim and state address and telephone number if different from the notice address above. Attach copy of power of attorney, if any.	FOR COURT USE ONLY
/s/ JIANPING HUANG, Bankruptcy Specialist (716) 961-5259	Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202	

Penalty for presenting fraudulent claim: Fine of up to \$500,000 or imprisonment for up to 5 years, or both. 18 U.S.C §§ 152 and 3571.



101597311050500000000007

Proof of Claim for Internal Revenue Taxes



Form 10
Attachment

Department of the Treasury/Internal Revenue Service

In the Matter of: AMBAC FINANCIAL GROUP, INC.
ONE STATE ST PLAZA
NEW YORK, NY 10004

Case Number	10-15973-SCC
Type of Bankruptcy Case	CHAPTER 11
Date of Petition	11/08/2010

The United States has not identified a right of setoff or counterclaim. However, this determination is based on available data and is not intended to waive any right to setoff against this claim debts owed to this debtor by this or any other federal agency. All rights of setoff are preserved and will be asserted to the extent lawful.

Unsecured Priority Claims under section 507(a)(8) of the Bankruptcy Code

<i>Taxpayer ID Number</i>	<i>Kind of Tax</i>	<i>Tax Period</i>	<i>Date Tax Assessed</i>	<i>Tax Due</i>	<i>Interest to Petition Date</i>
XX-XXX1676	CORP-INC	12/31/2003	I Unassessed	\$77,713,584.00	\$2,053,495.77
XX-XXX1676	CORP-INC	12/31/2004	I Unassessed	\$144,929,795.00	\$3,829,438.04
XX-XXX1676	CORP-INC	12/31/2005	I Unassessed	\$210,799,742.00	\$5,570,140.54
XX-XXX1676	CORP-INC	12/31/2006	I Unassessed	\$191,018,375.00	\$10,341,992.25
XX-XXX1676	CORP-INC	12/31/2007	I Unassessed	\$94,824,558.00	\$20,448,498.92
XX-XXX1676	CORP-INC	12/31/2008	I Unassessed	\$41,463,532.00	\$4,248,876.39
XX-XXX1676	MISC PEN	12/31/2008	04/18/2011	\$0.00	\$0.00
				\$760,749,586.00	\$46,492,441.91

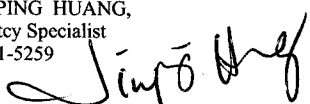
Total Amount of Unsecured Priority Claims: \$807,242,027.91

Unsecured General Claims

Penalty to date of petition on unsecured priority claims (including interest thereon) \$1,800.00

Total Amount of Unsecured General Claims: \$1,800.00

B10 (Official Form 10) (04/10)

UNITED STATES BANKRUPTCY COURT SOUTHERN DISTRICT OF NEW YORK		PROOF OF CLAIM
Name of Debtor: AMBAC FINANCIAL GROUP, INC.		Case Number: 10-15973-SCC
NOTE: This form should not be used to make a claim for an administrative expense arising after the commencement of the case. A request of payment of an administrative expense may be filed pursuant to 11 U.S.C. § 503.		
Name of Creditor (The person or other entity to whom the debtor owes money or property): Department of the Treasury - Internal Revenue Service		<input type="checkbox"/> Check this box to indicate that this claim amends a previously filed claim.
Name and address where notices should be sent: Internal Revenue Service P.O. Box 7346 Philadelphia, PA 19101-7346		Court Claim Number: _____ (If known)
Telephone number: 1-800-913-9358 Creditor Number: 5527944		Filed on: _____
Name and address where payments should be sent (if different from above): Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202		<input type="checkbox"/> Check this box if you are aware that anyone else has filed a proof of claim relating to your claim. Attach copy of statement giving particulars.
Telephone Number: (716) 961-5259		<input type="checkbox"/> Check this box if you are the debtor or trustee in this case.
1. Amount of Claim as of Date Case Filed: \$ 807,243,827.91		5. Amount of Claim Entitled to Priority under 11 U.S.C. §507(a). If any portion of your claim falls in one of the following categories, check the box and state the amount. Specify the priority of the claim.
If all or part of your claim is secured, complete item 4 below; however, if all of your claim is unsecured, do not complete item 4. If all or part of your claim is entitled to priority, complete item 5. <input checked="" type="checkbox"/> Check this box if claim includes interest or other charges in addition to the principal amount of claim. Attach itemized statement of interest or charges.		
2. Basis for Claim: Taxes (See instruction #2 on reverse side.)		<input type="checkbox"/> Domestic support obligations under 11 U.S.C. §507(a)(1)(A) or (a)(1)(B).
3. Last four digits of any number by which creditor identifies debtor: See Attachment		<input type="checkbox"/> Wages, salaries, or commissions (up to \$11,725*) earned within 180 days before filing of the bankruptcy petition or cessation of the debtor's business, whichever is earlier - 11 U.S.C. §507 (a)(4).
3a. Debtor may have scheduled account as: (See instruction #3a on reverse side.)		<input type="checkbox"/> Contributions to an employee benefit plan - 11 U.S.C. §507 (a)(5).
4. Secured Claim (See instruction #4 on reverse side.) Check the appropriate box if your claim is secured by a lien on property or a right of setoff and provide the requested information. Nature of property or right of setoff: <input type="checkbox"/> Real Estate <input type="checkbox"/> Motor Vehicle <input type="checkbox"/> Other Describe: Value of Property: \$ _____ Annual Interest Rate _____ % Amount of arrearage and other charges as of time case filed included in secured claim. if any: \$ _____ Basis for perfection: _____ Amount of Secured Claim: \$ _____ Amount Unsecured: \$ _____		<input type="checkbox"/> Up to \$2,600* of deposits toward purchase, lease, or rental of property or services for personal, family, or household use - 11 U.S.C. §507 (a)(7).
6. Credits: The amount of all payments on this claim has been credited for the purpose of making this proof of claim.		<input checked="" type="checkbox"/> Taxes or penalties owed to governmental units - 11 U.S.C. §507 (a)(8).
7. Documents: Attach redacted copies of any documents that support the claim, such as promissory notes, purchase orders, invoices, itemized statements or running accounts, contracts, judgments, mortgages, and security agreements. You may also attach a summary. Attach redacted copies of documents providing evidence of perfection of a security interest. You may also attach a summary. (See instruction 7 and definition of "redacted" on reverse side.) DO NOT SEND ORIGINAL DOCUMENTS. ATTACHED DOCUMENTS MAY BE DESTROYED AFTER SCANNING. If the documents are not available, please explain:		<input type="checkbox"/> Other - Specify applicable paragraph of 11 U.S.C. §507 (a)(____). Amount entitled to priority: \$ 807,242,027.91
Date: 05/04/2011	Signature: The person filing this claim must sign it. Sign and print name and title, if any, of the creditor or other person authorized to file this claim and state address and telephone number if different from the notice address above. Attach copy of power of attorney, if any.	
/s/ JIANPING HUANG, Bankruptcy Specialist (716) 961-5259 	Internal Revenue Service 130 South Elmwood Ave Buffalo, NY 14202	
		FOR COURT USE ONLY RECEIVED MAY 05 2011 KURTZMAN CARSON CONSULTANTS

Penalty for presenting fraudulent claim: Fine of up to \$500,000 or imprisonment for up to 5 years, or both. 18 U.S.C §§ 152 and 3571.

- Date Stamped Copy Returned
- No self addressed stamped envelope
- No copy to return



1015973110505000000000005

Proof of Claim for Internal Revenue Taxes



Form 10
Attachment

Department of the Treasury/Internal Revenue Service

In the Matter of: AMBAC FINANCIAL GROUP, INC.
ONE STATE ST PLAZA
NEW YORK, NY 10004

Case Number	10-15973-SCC
Type of Bankruptcy Case	CHAPTER 11
Date of Petition	11/08/2010

The United States has not identified a right of setoff or counterclaim. However, this determination is based on available data and is not intended to waive any right to setoff against this claim debts owed to this debtor by this or any other federal agency. All rights of setoff are preserved and will be asserted to the extent lawful.

Unsecured Priority Claims under section 507(a)(8) of the Bankruptcy Code

<i>Taxpayer ID Number</i>	<i>Kind of Tax</i>	<i>Tax Period</i>	<i>Date Tax Assessed</i>	<i>Tax Due</i>	<i>Interest to Petition Date</i>
XX-XXX1676	CORP-INC	12/31/2003	1 Unassessed	\$77,713,584.00	\$2,053,495.77
XX-XXX1676	CORP-INC	12/31/2004	1 Unassessed	\$144,929,795.00	\$3,829,438.04
XX-XXX1676	CORP-INC	12/31/2005	1 Unassessed	\$210,799,742.00	\$5,570,140.54
XX-XXX1676	CORP-INC	12/31/2006	1 Unassessed	\$191,018,375.00	\$10,341,992.25
XX-XXX1676	CORP-INC	12/31/2007	1 Unassessed	\$94,824,558.00	\$20,448,498.92
XX-XXX1676	CORP-INC	12/31/2008	1 Unassessed	\$41,463,532.00	\$4,248,876.39
XX-XXX1676	MISC PEN	12/31/2008	04/18/2011	\$0.00	\$0.00
				\$760,749,586.00	\$46,492,441.91

Total Amount of Unsecured Priority Claims: \$807,242,027.91

Unsecured General Claims

Penalty to date of petition on unsecured priority claims (including interest thereon) \$1,800.00

Total Amount of Unsecured General Claims: \$1,800.00

UNASSESSED TAX LIABILITY DETERMINED BY EXAM AUDIT

EXHIBIT B

(Proposed Order)

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

-----X	
	:
<i>In re</i>	:
	:
	: Chapter 11
AMBAC FINANCIAL GROUP, INC.,	:
	:
	: Case No. 10-15973 (SCC)
Debtor.	:
	:
-----X	

**ORDER GRANTING DEBTOR’S OBJECTION TO PROOF OF
CLAIM NUMBERS 3694 AND 3699 FILED BY THE DEPARTMENT
OF THE TREASURY – INTERNAL REVENUE SERVICE**

Upon the objection (the “Objection”)¹ of Ambac Financial Group, Inc. (the “Debtor”), as debtor and debtor in possession in this chapter 11 case, pursuant to section 502(b)(1) of the Bankruptcy Code, seeking entry of an order (this “Order”) disallowing proof of claim numbers 3694 and 3699 filed by the Department of the Treasury – Internal Revenue Service (the “IRS”); and the Bankruptcy Court having reviewed the Objection and the pleadings filed in the Adversary Proceeding; and the Bankruptcy Court having jurisdiction to consider the Objection and the relief requested therein in accordance with 28 U.S.C. § 1334, section 505(a) of the Bankruptcy Code, and Standing Order M-61 Referring to Bankruptcy Judges for the Southern District of New York Any and All Proceedings Under Title 11, dated July 10, 1984 (Ward, Acting C.J.); and consideration of the Objection and the relief requested therein being a core proceeding pursuant to 28 U.S.C. § 157(b); and venue being proper before the Bankruptcy Court pursuant to 28 U.S.C. §§ 1408 and 1409; and due and proper notice of the Objection having been provided; and a hearing having been held to consider the relief requested in the Objection (the “Hearing”); and upon the record of the Hearing and all of the proceedings had before the

¹ Capitalized terms used but not defined herein shall have the meanings set forth in the Objection.

Bankruptcy Court; and the Bankruptcy Court having determined that the relief sought in the Objection is in the best interests of the Debtor, its estate, its creditors, and all parties in interest, and that the legal and factual bases set forth in the Objection establish just cause for the relief granted herein; and after due deliberation and sufficient cause appearing therefor, it is hereby:

ORDERED that the Objection is granted; and it is further

ORDERED that proof of claim numbers 3694 and 3699 filed by the IRS against the Debtor are hereby disallowed in their entirety and expunged pursuant to section 502(b)(1) of the Bankruptcy Code; and it is further

ORDERED that the terms of this Order shall be immediately effective upon its entry; and it is further

ORDERED that this Court shall retain jurisdiction with respect to all matters related to the implementation of this Order.

Dated: _____, 2011
New York, New York

THE HONORABLE SHELLEY C. CHAPMAN
UNITED STATES BANKRUPTCY JUDGE

EXHIBIT C

(Liquidity Forecast)

Ambac Financial Group, Inc. Cash Projection

-- as of October 7, 2011

(Base Case Scenario)

	Oct 11	Nov 11	Dec 11
Sources:			
INTERCOMPANY SETTLEMENT FROM AAC (1)	680,000	680,000	1,907,256
AMBAC BERMUDA	-	-	-
Fresh Start - PWC (2)	-	-	1,000,000
AFG Escrow Payment from AAC	-	-	30,000,000
PFM NOTE INTEREST & PRINC 12/1/13	-	-	918,688
Investment Interest	-	-	-
AAC Reimbursement for Annual Operating Expenses (7)	-	-	-
Total Sources:	680,000	680,000	33,825,944
Uses:			
Direct Expenses (4)	(120,850)	(120,850)	(120,850)
Net I/C Settlements with Subs (3) (4)	-	(261,000)	(522,000)
D&O Insurance	-	-	(1,800,000)
Lathrop and Clark	(422)	-	(614)
Morrison and Foerster	(1,206,790)	(360,000)	(1,801,637)
Dewey and LeBeouf	(1,920,000)	(960,000)	(5,019,729)
Wachtel, et al.	(329,638)	(100,000)	(439,576)
KCC	(67,524)	(233,000)	(335,000)
Lazard	(229,436)	(123,000)	(6,286,000)
Blackstone	(318,333)	(163,000)	(6,509,000)
Cornerstone	(4,732)	-	-
Buttner	(249,910)	(100,000)	(111,023)
Whyte	(960)	-	(1,065)
Akin Gump	-	-	(900,000)
Brattle Group	-	-	-
Litigation Settlement	-	-	(2,500,000)
Administrative Claims	-	-	(23,725)
KPMG Tax	-	-	-
Fresh Start - PWC (2)	(600,000)	(700,000)	(700,000)
KPMG - MOR & Advisory	(49,952)	(17,600)	(86,433)
US Trustee	(13,000)	-	(20,000)
NYC Tax Settlement	(2,000,000)	-	-
Total Uses:	(7,111,548)	(3,138,450)	(27,176,651)
Net Operating Cash Flow	(6,431,548)	(2,458,450)	6,649,293
Short Term Investment (MMKT):	36,298,774		
Short Term Investment (VRDOs):	10,000,000		
Retainers and Escrow	6,524,670		
CASH & ST INVESTMENT CARRY FORWARD	-	46,398,324	43,948,090
MMKT YIELD	0.21%	0.21%	0.21%
Interest Sources from Investment	6,428	8,216	7,782
PROJECTED TOTAL CASH	46,398,324	43,948,090	50,605,166

NOTES:

- 1) AAC will reimburse 85% of legal fees related to IRS litigation.
- 2) Fresh Start - AAC to reimburse 50% up to \$1,000,000
- 3) Intercompany settlements to subsidiaries include Bonus accruals from AFG to AAC.
- 4) Operating Expenses are subject to volatility. OCI is reviewing AFG/AAC allocation process. Amounts expected to changed based
- 5) Retainer and escrow amounts subject to change based on receipt of retainer statements.
- 6) December professional fees assume that AFG will incur a full month's charges for December
- 7) \$5,000,000 per annum

Ambac Financial Group, Inc. Cash Projection
-- as of October 7, 2011
(Base Case Scenario)

	Jan 12	Feb 12	Mar 12	Apr 12	May 12	Jun 12	Jul 12	Aug 12	Sep 12	Oct 12	Nov 12	Dec 12
Sources:												
INTERCOMPANY SETTLEMENT FROM AAC (1)	-	-	-	-	-	-	-	-	-	-	-	-
AMBAC BERMUDA	500,000	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
AFG Escrow Payment from AAC	-	-	-	-	-	-	-	-	-	-	-	-
PFM NOTE INTEREST & PRINC 12/1/13	-	-	45,985	-	-	41,489	-	-	41,489	-	-	1,119,129
Investment Interest	-	-	-	-	-	-	-	-	-	-	-	-
AAC Reimbursement for Annual Operating Expenses (7)	-	-	-	-	-	-	-	-	-	-	-	-
Total Sources:	500,000	-	45,985	-	-	41,489	-	-	41,489	-	-	1,119,129
Uses:												
Direct Expenses (4)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)
Net I/C Settlements with Subs (3) (4)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)
D&O Insurance	-	-	-	-	-	-	(500,000)	-	-	-	-	-
Lathrop and Clark	-	-	-	-	-	-	-	-	-	-	-	-
Morrison and Foerster	-	-	-	-	-	-	-	-	-	-	-	-
Dewey and LeBeouf	-	-	-	-	-	-	-	-	-	-	-	-
Wachtel, et al.	-	-	-	-	-	-	-	-	-	-	-	-
KCC	-	-	-	-	-	-	-	-	-	-	-	-
Lazard	-	-	-	-	-	-	-	-	-	-	-	-
Blackstone	-	-	-	-	-	-	-	-	-	-	-	-
Cornerstone	-	-	-	-	-	-	-	-	-	-	-	-
Buttner	-	-	-	-	-	-	-	-	-	-	-	-
Whyte	-	-	-	-	-	-	-	-	-	-	-	-
Akin Gump	-	-	-	-	-	-	-	-	-	-	-	-
Brattle Group	-	-	-	-	-	-	-	-	-	-	-	-
Litigation Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Administrative Claims	-	-	-	-	-	-	-	-	-	-	-	-
KPMG Tax	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
KPMG - MOR & Advisory	-	-	-	-	-	-	-	-	-	-	-	-
US Trustee	-	-	-	-	-	-	-	-	-	-	-	-
NYC Tax Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Total Uses:	(120,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)	(620,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)
Net Operating Cash Flow	379,150	(381,850)	(596,865)	(120,850)	(381,850)	(601,361)	(620,850)	(381,850)	(601,361)	(120,850)	(381,850)	476,279
Short Term Investment (MMKT):												
Short Term Investment (VRDOs):												
Retainers and Escrow												
CASH & ST INVESTMENT CARRY FORWARD	50,605,166	50,993,277	50,620,457	50,032,556	49,920,566	49,547,556	48,954,970	48,342,789	47,969,499	47,376,633	47,264,173	46,890,692
MMKT YIELD	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%
Interest Sources from Investment	8,961	9,030	8,964	8,860	8,840	8,774	8,669	8,561	8,495	8,390	8,370	8,304
PROJECTED TOTAL CASH	50,993,277	50,620,457	50,032,556	49,920,566	49,547,556	48,954,970	48,342,789	47,969,499	47,376,633	47,264,173	46,890,692	47,375,275

NOTES:

- 1) AAC will reimburse 85% of legal fees related to IRS litigation.
- 2) Fresh Start - AAC to reimburse 50% up to \$1,000,000
- 3) Intercompany settlements to subsidiaries include Bonus accruals from AFG
- 4) Operating Expenses are subject to volatility. OCI is reviewing AFG/AAC a on 2012 budget
- 5) Retainer and escrow amounts subject to change based on receipt of retain
- 6) December professional fees assume that AFG will incur a full month's cha
- 7) \$5,000,000 per annum

Ambac Financial Group, Inc. Cash Projection

-- as of October 7, 2011

(Base Case Scenario)

	Jan 13	Feb 13	Mar 13	Apr 13	May 13	Jun 13	Jul 13	Aug 13	Sep 13	Oct 13	Nov 13	Dec 13
Sources:												
INTERCOMPANY SETTLEMENT FROM AAC (1)	-	-	-	-	-	-	-	-	-	-	-	-
AMBAC BERMUDA	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
AFG Escrow Payment from AAC	-	-	-	-	-	-	-	-	-	-	-	-
PFM NOTE INTEREST & PRINC 12/1/13	-	-	28,397	-	-	22,630	-	-	22,630	-	-	1,315,798
Investment Interest	-	-	-	-	-	-	-	-	-	-	-	-
AAC Reimbursement for Annual Operating Expenses (7)	5,000,000	-	-	-	-	-	-	-	-	-	-	-
Total Sources:	5,000,000	-	28,397	-	-	22,630	-	-	22,630	-	-	1,315,798
Uses:												
Direct Expenses (4)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)
Net I/C Settlements with Subs (3) (4)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)
D&O Insurance	-	-	-	-	-	-	(500,000)	-	-	-	-	-
Lathrop and Clark	-	-	-	-	-	-	-	-	-	-	-	-
Morrison and Foerster	-	-	-	-	-	-	-	-	-	-	-	-
Dewey and LeBeouf	-	-	-	-	-	-	-	-	-	-	-	-
Wachtel, et al.	-	-	-	-	-	-	-	-	-	-	-	-
KCC	-	-	-	-	-	-	-	-	-	-	-	-
Lazard	-	-	-	-	-	-	-	-	-	-	-	-
Blackstone	-	-	-	-	-	-	-	-	-	-	-	-
Cornerstone	-	-	-	-	-	-	-	-	-	-	-	-
Buttner	-	-	-	-	-	-	-	-	-	-	-	-
Whyte	-	-	-	-	-	-	-	-	-	-	-	-
Akin Gump	-	-	-	-	-	-	-	-	-	-	-	-
Brattle Group	-	-	-	-	-	-	-	-	-	-	-	-
Litigation Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Administrative Claims	-	-	-	-	-	-	-	-	-	-	-	-
KPMG Tax	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
KPMG - MOR & Advisory	-	-	-	-	-	-	-	-	-	-	-	-
US Trustee	-	-	-	-	-	-	-	-	-	-	-	-
NYC Tax Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Total Uses:	(120,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)	(620,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)
Net Operating Cash Flow	4,879,150	(381,850)	(614,453)	(120,850)	(381,850)	(620,220)	(620,850)	(381,850)	(620,220)	(120,850)	(381,850)	672,948
Short Term Investment (MMKT):												
Short Term Investment (VRDOs):												
Retainers and Escrow												
CASH & ST INVESTMENT CARRY FORWARD	47,375,275	52,262,814	51,890,219	51,284,955	51,173,187	50,800,398	50,189,175	49,577,212	49,204,142	48,592,635	48,480,390	48,107,125
MMKT YIELD	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%
Interest Sources from Investment	8,389	9,255	9,189	9,082	9,062	8,996	8,888	8,779	8,713	8,605	8,585	8,519
PROJECTED TOTAL CASH	52,262,814	51,890,219	51,284,955	51,173,187	50,800,398	50,189,175	49,577,212	49,204,142	48,592,635	48,480,390	48,107,125	48,788,592

NOTES:

- 1) AAC will reimburse 85% of legal fees related to IRS litigation.
- 2) Fresh Start - AAC to reimburse 50% up to \$1,000,000
- 3) Intercompany settlements to subsidiaries include Bonus accruals from AFG
- 4) Operating Expenses are subject to volatility. OCI is reviewing AFG/AAC a
- 5) Retainer and escrow amounts subject to change based on receipt of retain
- 6) December professional fees assume that AFG will incur a full month's cha
- 7) \$5,000,000 per annum

Ambac Financial Group, Inc. Cash Projection
-- as of October 7, 2011
(Base Case Scenario)

	Jan 14	Feb 14	Mar 14	Apr 14	May 14	Jun 14	Jul 14	Aug 14	Sep 14	Oct 14	Nov 14	Dec 14
Sources:												
INTERCOMPANY SETTLEMENT FROM AAC (1)	-	-	-	-	-	-	-	-	-	-	-	-
AMBAC BERMUDA	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
AFG Escrow Payment from AAC	-	-	-	-	-	-	-	-	-	-	-	-
PFM NOTE INTEREST & PRINC 12/1/13	-	-	-	-	-	-	-	-	-	-	-	-
Investment Interest	-	-	-	-	-	-	-	-	-	-	-	-
AAC Reimbursement for Annual Operating Expenses (7)	5,000,000	-	-	-	-	-	-	-	-	-	-	-
Total Sources:	5,000,000	-	-	-	-	-	-	-	-	-	-	-
Uses:												
Direct Expenses (4)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)
Net I/C Settlements with Subs (3) (4)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)
D&O Insurance	-	-	-	-	-	-	(500,000)	-	-	-	-	-
Lathrop and Clark	-	-	-	-	-	-	-	-	-	-	-	-
Morrison and Foerster	-	-	-	-	-	-	-	-	-	-	-	-
Dewey and LeBeouf	-	-	-	-	-	-	-	-	-	-	-	-
Wachtel, et al.	-	-	-	-	-	-	-	-	-	-	-	-
KCC	-	-	-	-	-	-	-	-	-	-	-	-
Lazard	-	-	-	-	-	-	-	-	-	-	-	-
Blackstone	-	-	-	-	-	-	-	-	-	-	-	-
Cornerstone	-	-	-	-	-	-	-	-	-	-	-	-
Buttner	-	-	-	-	-	-	-	-	-	-	-	-
Whyte	-	-	-	-	-	-	-	-	-	-	-	-
Akin Gump	-	-	-	-	-	-	-	-	-	-	-	-
Brattle Group	-	-	-	-	-	-	-	-	-	-	-	-
Litigation Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Administrative Claims	-	-	-	-	-	-	-	-	-	-	-	-
KPMG Tax	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
KPMG - MOR & Advisory	-	-	-	-	-	-	-	-	-	-	-	-
US Trustee	-	-	-	-	-	-	-	-	-	-	-	-
NYC Tax Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Total Uses:	(120,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)	(620,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)
Net Operating Cash Flow	4,879,150	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)	(620,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)
Short Term Investment (MMKT):												
Short Term Investment (VRDOs):												
Retainers and Escrow												
CASH & ST INVESTMENT CARRY FORWARD	48,788,592	53,676,382	53,304,037	52,670,627	52,559,104	52,186,561	51,552,952	50,941,231	50,568,402	49,934,507	49,822,500	49,449,472
MMKT YIELD	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%
Interest Sources from Investment	8,640	9,505	9,439	9,327	9,307	9,241	9,129	9,021	8,955	8,843	8,823	8,757
PROJECTED TOTAL CASH	53,676,382	53,304,037	52,670,627	52,559,104	52,186,561	51,552,952	50,941,231	50,568,402	49,934,507	49,822,500	49,449,472	48,815,379

NOTES:
 1) AAC will reimburse 85% of legal fees related to IRS litigation.
 2) Fresh Start - AAC to reimburse 50% up to \$1,000,000
 3) Intercompany settlements to subsidiaries include Bonus accruals from AFG
 4) Operating Expenses are subject to volatility. OCI is reviewing AFG/AAC a
 5) Retainer and escrow amounts subject to change based on receipt of retain
 6) December professional fees assume that AFG will incur a full month's cha
 7) \$5,000,000 per annum

Ambac Financial Group, Inc. Cash Projection

-- as of October 7, 2011

(Base Case Scenario)

	Jan 15	Feb 15	Mar 15	Apr 15	May 15	Jun 15	Jul 15	Aug 15	Sep 15	Oct 15	Nov 15	Dec 15
Sources:												
INTERCOMPANY SETTLEMENT FROM AAC (1)	-	-	-	-	-	-	-	-	-	-	-	-
AMBAC BERMUDA	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
AFG Escrow Payment from AAC	-	-	-	-	-	-	-	-	-	-	-	-
PFM NOTE INTEREST & PRINC 12/1/13	-	-	-	-	-	-	-	-	-	-	-	-
Investment Interest	-	-	-	-	-	-	-	-	-	-	-	-
AAC Reimbursement for Annual Operating Expenses (7)	5,000,000	-	-	-	-	-	-	-	-	-	-	-
Total Sources:	5,000,000	-	-	-	-	-	-	-	-	-	-	-

Uses:												
Direct Expenses (4)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)	(120,850)
Net I/C Settlements with Subs (3) (4)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)	-	(261,000)	(522,000)
D&O Insurance	-	-	-	-	-	-	(500,000)	-	-	-	-	-
Lathrop and Clark	-	-	-	-	-	-	-	-	-	-	-	-
Morrison and Foerster	-	-	-	-	-	-	-	-	-	-	-	-
Dewey and LeBeouf	-	-	-	-	-	-	-	-	-	-	-	-
Wachtel, et al.	-	-	-	-	-	-	-	-	-	-	-	-
KCC	-	-	-	-	-	-	-	-	-	-	-	-
Lazard	-	-	-	-	-	-	-	-	-	-	-	-
Blackstone	-	-	-	-	-	-	-	-	-	-	-	-
Cornerstone	-	-	-	-	-	-	-	-	-	-	-	-
Buttner	-	-	-	-	-	-	-	-	-	-	-	-
Whyte	-	-	-	-	-	-	-	-	-	-	-	-
Akin Gump	-	-	-	-	-	-	-	-	-	-	-	-
Brattle Group	-	-	-	-	-	-	-	-	-	-	-	-
Litigation Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Administrative Claims	-	-	-	-	-	-	-	-	-	-	-	-
KPMG Tax	-	-	-	-	-	-	-	-	-	-	-	-
Fresh Start - PWC (2)	-	-	-	-	-	-	-	-	-	-	-	-
KPMG - MOR & Advisory	-	-	-	-	-	-	-	-	-	-	-	-
US Trustee	-	-	-	-	-	-	-	-	-	-	-	-
NYC Tax Settlement	-	-	-	-	-	-	-	-	-	-	-	-
Total Uses:	(120,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)	(620,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)

Net Operating Cash Flow	4,879,150	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)	(620,850)	(381,850)	(642,850)	(120,850)	(381,850)	(642,850)
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Short Term Investment (MMKT):

Short Term Investment (VRDOs):

Retainers and Escrow												
CASH & ST INVESTMENT CARRY FORWARD	48,815,379	53,703,173	53,330,833	52,697,427	52,585,909	52,213,371	51,579,767	50,968,051	50,595,227	49,961,336	49,849,334	49,476,311
MMKT YIELD	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%	0.21%
Interest Sources from Investment	8,644	9,510	9,444	9,332	9,312	9,246	9,134	9,026	8,960	8,847	8,827	8,761

PROJECTED TOTAL CASH	53,703,173	53,330,833	52,697,427	52,585,909	52,213,371	51,579,767	50,968,051	50,595,227	49,961,336	49,849,334	49,476,311	48,842,222
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NOTES:

- 1) AAC will reimburse 85% of legal fees related to IRS litigation.
- 2) Fresh Start - AAC to reimburse 50% up to \$1,000,000
- 3) Intercompany settlements to subsidiaries include Bonus accruals from AFG
- 4) Operating Expenses are subject to volatility. OCI is reviewing AFG/AAC a
- 5) Retainer and escrow amounts subject to change based on receipt of retain
- 6) December professional fees assume that AFG will incur a full month's cha
- 7) \$5,000,000 per annum

EXHIBIT D

(Proposed Order)

Service Shall be Estimated Pursuant to Bankruptcy Code Section 502(c) and (2) Setting Procedures, and Hearing Date, For Estimation of the IRS Claims, Inclusive of Determinations Pursuant to Bankruptcy Code Section 505(a) of the Debtor's Liability for Taxes Owed as a Result of Losses Incurred on its Post-2004 Contracts (the "Motion"), dated October 12, 2011,¹ filed by Ambac Financial Group, Inc. ("AFG" or the "Debtor"), as debtor in possession, seeking entry of an order (i) determining that claim numbers 3694 and 3699 filed by the Department of the Treasury – Internal Revenue Service shall be estimated, inclusive of determinations of Unresolved Tax Issues, (ii) establishing procedures to estimate claims 3694 and 3699 Filed by the Department of the Treasury – Internal Revenue Service (the "IRS" or "Claimant") and to determine Unresolved Tax Issues, and (iii) fixing notice procedures; and it appearing that the Court has jurisdiction to consider the Motion; and it appearing that the relief requested in the Motion is in the best interest of the Debtor, its estate and creditors; and it appearing that due notice of the Motion has been given and no further notice need be given; and the Court having found that the entire record of this case supports the use of the Court's authority under Bankruptcy Code sections 502(c) and 505(a) to prevent undue delay to the administration of the case; and upon the representations made by counsel at the hearing; and upon good and sufficient cause appearing;

IT IS HEREBY ORDERED THAT the estimation of the IRS Claims and adjudication of the Unresolved Tax Issues shall be conducted in accordance with the following procedures:

¹ Capitalized terms used but not defined in this Order shall have the meanings ascribed to them in the Motion.

A. Discovery.

The Parties shall complete discovery in accordance with the *Order Pursuant to Bankruptcy Code section 105(a) Implementing a Schedule for Completion of Discovery*, dated March 3, 2011 as may be amended by agreement of the parties (the "Discovery Order"), *provided however*, that discovery for purposes of estimation of the IRS Claims shall be completed on or before November 2, 2011, regardless of any agreement of the parties to establish an alternative date, and provided further that the Court will allow appropriate additional discovery in connection with the Unresolved Tax Issues.

B. Pre-Hearing Briefing.

1. Debtor's Statement: On or before November 9, 2011, the Debtor may prepare and file with the Bankruptcy Court an objection for the purposes of estimation (the "Estimation Objection") to the IRS Claims, which shall state with particularity, pursuant to Fed. R. Bankr. P. 9013, the legal and factual bases for the Debtor's objection to the IRS Claims and for determining the Unresolved Tax Issues.

The Debtor's Statement shall provide, at a minimum, the following information, if applicable: (i) a declaration providing the specific legal and factual grounds and evidence on which the Debtor requests to fix and to liquidate the IRS Claims pursuant to Bankruptcy Code section 502(c); (ii) all issues of law and fact that are related and necessary to estimate the IRS Claims and that are to be determined pursuant to Bankruptcy Code section 505(a), (iii) any and all evidence to support the legal and factual assertions made in the Debtor's Statement; and (vi) a list of witnesses to be presented, together with annexed written declarations of the direct testimony of each such witness.

The Debtor's Statement shall not exceed thirty (30) pages in length, exclusive of affidavits, declarations or statements and documentary and statutory exhibits.

2. Service of Debtor's Statement. On or before November 9, 2011, the Debtor shall serve the United States (the "U.S.", the "IRS" or the "Claimant") in accordance with the procedures set forth below, with (i) a notice of the Debtor's Statement (the "Estimation Notice"), and (ii) a copy of Debtor's Statement. Service shall be effectuated (a) in accordance with Bankruptcy Rules 2002, 7004 and 9014, and Federal Rule of Civil Procedure 4, and shall be made to (i) attorneys for the Committee, (ii) attorneys for OCI, (iii) the U.S. Trustee, (iv) the civil process clerk at the office of the United States Attorney for the Southern District of New York, (v) the Attorney General of the United States, and (vi) the District Director of the IRS, and (vii) all entities which have filed a written request for notice pursuant to Rules 9014 and 2002 of the Federal Rules of Bankruptcy Procedure.

3. Claimant's Statement. On or before November 9, 2011, the Claimant may prepare the Claimant's Statement, for the purposes of estimation of the IRS Claims, which shall state with particularity, pursuant to Fed. R. Bankr. P. 9013, the legal and factual bases for the IRS Claims.

The Claimant's Statement shall provide, at a minimum, the following information, if applicable (i) a declaration for purposes of estimation pursuant to Bankruptcy Code section 502(c), providing the specific legal and factual grounds and evidence on which the Claimant bases the IRS Claims and which Claimant asserts to be relevant to determination of the Unresolved Tax Issues; (ii) all issues of law and fact that

are related and necessary to estimate the IRS Claims and that are to be determined pursuant to Bankruptcy Code section 505(a), (iii) any and all evidence to support the legal and factual assertions made in the Claimant's Statement, and (vi) a list of witnesses to be presented, together with annexed written declarations of the direct testimony of each such witness.

The Claimant's Statement shall not exceed thirty (30) pages in length, exclusive of affidavits, declarations or statements and documentary and statutory exhibits. The Claimant's timely filed proof of claim form and all of the documents attached thereto shall remain part of the record for estimation purposes and should not be included in or attached to the Claimant's Statement.

4. Service of Claimant's Statement, Default, and Discharge. The Claimant shall serve the Claimant's Statement upon the Debtor and the attorneys representing the Debtor in this case, and on (i) attorneys for the Committee, (ii) attorneys for OCI, (iii) the U.S. Trustee, and (vi) all entities which have filed a written request for notice pursuant to Rules 9014 and 2002 of the Federal Rules of Bankruptcy Procedure, in accordance with Bankruptcy Rules 2002 and 7004, and Federal Rule of Civil Procedure 4. If Claimant fails to file a timely a completed and executed Claimant's Statement so as to be received on or before November 9, 2011, the IRS Claims shall be deemed forever discharged, disallowed, waived and expunged against the Debtor and the Debtor's chapter 11 estate, and the Bankruptcy Court shall enter an appropriate order in connection therewith and in connection with relief sought under Bankruptcy Code section 505(a).

5. Parties' Rebuttals. The Debtor and Claimant may, in their discretion, on or before five (5) business days following the service of the Debtor's

Statement or Claimant's Statement, as the case may be, respond by completing, executing, and serving upon the other party, with a copy to all parties required to be served copies of the Debtor's Statement and Claimant's Statement, a rebuttal outlining the additional arguments and defenses with respect to estimation of the IRS Claim pursuant to Bankruptcy Code section 502(c) and the determinations requested under Bankruptcy Code section 505(a) as to the Unresolved Tax Issues, and the elements and evidence set forth in the Debtor's Statement or the Claimant's Statement, as the case may be. The rebuttals shall not exceed ten (10) pages in length, exclusive of affidavits, declarations or statements and documentary and statutory exhibits. As to each witness referred to in a Parties' rebuttal and not listed, or who will offer testimony in addition to that described, in the Debtor's Statement or Claimant's Statement, as the case may be, there shall be annexed to the rebuttal a written declaration of the witness's direct testimony.

C. Claims Resolution and Tax Issue Determination Process.

Initial and Mandatory Disclosures. Unless otherwise ordered by the Court, the information required to be provided in the Debtor's Statement and Claimant's Statement shall be deemed to satisfy any initial or mandatory disclosure required by Fed. R. Civ. P. 26, as applicable pursuant to Fed. R. Bankr. P. 9014.

D. Additional Submissions to the Court.

1. Estimation or Adjudication by Court. Unless the IRS Claims are settled, the Parties shall, as set forth above, compile and file with the Bankruptcy Court the IRS Claims, the Debtor's Statement, the Claimant's Statements, and the rebuttals (if any) (collectively, the "Claim File") for purposes of a hearing on estimation of the Claim pursuant to the Debtor's Statement.

2. Pre-hearing Order. Each of the Parties shall, no later than five (5) days prior to the Hearing Date, file a Pre-hearing Statement setting forth: 1) A summary of legal issues to be resolved, 2) A statement of disputed facts; 3) A list of witnesses to be presented; with a description of the subject of each witnesses' anticipated testimony, *provided that* to the extent that facts obtained through discovery refute, contradict or impeach material facts asserted by either party in their respective declarations or certified statements, either party shall include in the Pre-hearing Statement a written summary of such disputed facts, not to exceed five (5) pages, providing specific citations to such facts (including any transcripts) ("Discovered Evidence"). In the event a party submits Discovered Evidence, the non-submitting party shall have the right to dispute the admissibility or asserted interpretation of Discovered Evidence (including by submitting a summary of contrary evidence obtained through discovery) in a written statement not to exceed five (5) pages, including the specific disputes and reasons therefor (which statement shall also be deemed to be "Discovered Evidence" for purposes of these Procedures), no later than two (2) days prior to the Estimation Hearing.

E. Hearing.

1. Hearing. Unless otherwise ordered by the Bankruptcy Court, an Estimation Hearing shall be held on November 21, 2011.

2. Oral Argument. Subject to the Bankruptcy Court's discretion to increase or decrease the hearing time, each party shall have thirty (30) minutes to explain its position to the Bankruptcy Court.

3. Examination of Witnesses: During the Estimation Hearing and as necessary to provide evidence as to disputed facts, the parties shall examine such witnesses as are included in the Parties' Pre-hearing Statements, and each party shall be entitled to cross-examine witnesses. The court shall establish and may expand or contract the time for examination and cross-examination of witnesses, as deemed in its discretion to be necessary or appropriate.

4. Evidentiary and Legal Record. The evidentiary and legal record shall be confined to the Debtor's Statement, the Claimant's Statement, the rebuttals, the Pre-hearing Statements and related submissions, witness testimony presented at the Estimation Hearing and any Discovered Evidence; provided, however, that the Bankruptcy Court may allow or require additions to the record when deemed in its discretion to be necessary or appropriate.

5. Resolution. Upon the Bankruptcy Court's review of the submissions described in the preceding paragraph and oral argument at the Estimation Hearing, the Bankruptcy Court shall estimate the IRS Claims for all purposes under the Bankruptcy Code, and shall determine the Unresolved Tax Issues pursuant to Bankruptcy Code section 505(a), provided that no party's right to reconsideration under section 502(j) shall be impaired.

F. Settlement Stipulations. If the Debtor and Claimant agree to a compromise and settlement of the IRS Claims, or any portion thereof, and, in connection therewith, the Claimant is to be granted an allowed claim, the Debtor shall seek Bankruptcy Court approval of such compromise and settlement and corresponding

stipulation and order (the "Settlement Stipulation") in accordance with the terms and conditions of the Case Management Order on ten (10) days' notice. If no objections to the Settlement Stipulation are timely filed, the Debtor shall submit an order approving the Settlement Stipulation without further notice or hearing. If an objection is timely interposed, the matter will be scheduled for hearing at the next omnibus hearing date; provided, however, that, under no circumstances shall a Settlement Stipulation provide for payment other than in accordance with a confirmed plan in the Debtor's chapter 11 cases. If the Bankruptcy Court does not approve the Settlement Stipulation, the Debtor, at their discretion, may elect to negotiate further with Claimant or may deem settlement negotiations terminated and seek to estimate the IRS Claims pursuant to this Order.

Dated: _____, 2011
New York, New York

THE HONORABLE SHELLEY C. CHAPMAN
UNITED STATES BANKRUPTCY JUDGE

EXHIBIT E

(Enron Order)

**UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK**

-----	x	
	:	
In re	:	Chapter 11
	:	
ENRON CORP., et al.,	:	Case No. 01-16034 (AJG)
	:	
Debtors.	:	Jointly Administered
-----	x	

**ORDER, PURSUANT TO SECTIONS 105(a), 363(b) AND 502(c) OF THE
BANKRUPTCY CODE AND FEDERAL RULES OF BANKRUPTCY
PROCEDURE 3007, 7042, 9013, 9014 AND 9019, (1) ESTABLISHING
PROCEDURES TO ESTIMATE UNLIQUIDATED AND CONTINGENT
CLAIMS, (2) ESTABLISHING PROCEDURES TO ADJUDICATE
COUNTERCLAIMS, (3) ESTABLISHING PROCEDURES TO COMPROMISE
CLAIMS AND COUNTERCLAIMS AND (4) FIXING NOTICE PROCEDURES
AND APPROVING FORM AND MANNER OF NOTICE**

Upon consideration of the motion, dated August 28, 2003,¹ filed by Enron Corp. (“Enron”) and certain of its affiliated debtor entities (collectively, the “Debtors”), as debtors and debtors in possession, seeking entry of an order (i) establishing procedures to estimate and settle unliquidated and contingent claims, (ii) establishing procedures to adjudicate counterclaims, (iii) establishing procedures to compromise claims and counterclaims and (iv) fixing notice procedures and approving form and manner of notice; and it appearing that the Court has jurisdiction to consider the Motion; and it appearing that the relief requested in the Motion is in the best interest of the Debtors, their estates and creditors; and it appearing that due notice of the Motion has been given and no further notice need be given; and the Court having found that the entire record of these cases supports the use of 502(c) to prevent undue delay to the administration of

¹ Capitalized terms used but not defined in this Order shall have the meanings ascribed to them in the Motion.

these cases; and upon the representations made by counsel at the hearing; and the Court having found that these Procedures do not shift any burdens of proof; and upon good and sufficient cause appearing;

IT IS HEREBY ORDERED THAT:

1. The estimation and settlement of the Claims, and the adjudication of Counterclaims, shall be conducted in accordance with the following procedures:

A. Debtors' Objection and Notice to Claimants

Estimation Objection/Notice Package. The Debtors may prepare and file with the Bankruptcy Court an objection to any Claim for the purposes of estimation (the "Estimation Objection"), which shall state with particularity, pursuant to Fed. R. Bankr. P. 9013, the legal and factual bases for the Debtors' objection. The Estimation Objection shall provide, at a minimum, the following information, if applicable: (i) the Claim number on the claims register; (ii) the name of the Claimant; (iii) the basis for asserting the Claim is contingent or unliquidated and subject to section 502(c) of the Bankruptcy Code, including a declaration (a) of the nature of the alleged contingency that has not occurred or (b) that the Claimant asserting such Claim has filed a proof of claim in an unliquidated amount or in no amount and the attachments, if any, to such proof of claim do not set forth a liquidated amount; (iv) to the extent a Claim is asserted in the proof of claim as liquidated but such assertion is disputed by the Debtors, a declaration providing the specific legal and factual grounds and evidence supporting such dispute; (v) to the extent a Claim is asserted in the proof of claim as liquidated and such assertion is not disputed but the liquidated amount of the Claim is disputed by the Debtors, a declaration providing the specific legal and factual grounds and evidence supporting such dispute (such Claim is subject to the Opt Out right for fully liquidated claims below); and (vi) the evidence to support the assertion of such objection, including names of all persons employed by or within the control of the Debtors, who are likely to have discoverable information relating to the Estimation Objection and any documents that the Debtors may rely upon in support of the

Estimation Objection. The Estimation Objection shall not exceed seven (7) pages in length, including the declaration, exclusive of documentary and statutory exhibits. The Debtors shall serve the affected Claimant, in accordance with the procedures set forth below, with (i) a notice of the Estimation Objection (the “Estimation Notice”), (ii) a copy of the relevant Estimation Objection, (iii) a form, substantially in the form annexed hereto as Exhibit “A”, to be completed and verified by each Claimant and setting forth the elements and evidence to support such Claimant’s Claim (the “Statement of Claim”) and (iv) a copy of this Claims Procedures Order shall constitute the Court’s Rule 16 Scheduling Order (collectively, the “Notice Package”).

Assertion of Counterclaims. The Debtors may assert a Counterclaim against a particular Claimant whose Claim is the subject of an Estimation Objection by setting forth in the Estimation Objection the elements and verified statement of evidence supporting such Counterclaim including names of all persons employed by or within the control of the Debtors, who are likely to have discoverable information relating to the Counterclaim and any documents that the Debtors may rely upon in support of the Counterclaim. In the event that a Counterclaim is submitted by the Debtors in the Estimation Objection, the Debtors’ Estimation Objection shall not exceed fifteen (15) pages in length.

Service of Notice Package. Service of the Notice Package shall be effectuated (a) in accordance with Bankruptcy Rules 2002 and 7004, Federal Rule of Civil Procedure 4 and this Court’s Second Amended Case Management Order Establishing, Among Other Things, Noticing Electronic Procedures, Hearing Dates, Independent Website and Alternative Methods of Participation at Hearings, dated December 17, 2002 (the “Case Management Order), (b) by first class mail, postage prepaid, upon the signatory on the Claimant’s proof of claim and other representative identified in the proof of claim and any attachment thereto, and (c) by first class mail, postage prepaid, on any attorney who has entered a notice of appearance on the Claimant’s behalf in the Debtors’ chapter 11 cases.

Estimation Notice. The Estimation Notice shall (i) provide the Claimant one hundred thirty-five (135) days notice of the hearing on the Estimation Objection (the “Estimation

Hearing”) and (ii) direct the Claimant to complete and return the executed Statement of Claim within thirty (30) days of the service date of the Estimation Notice.

B. Claimant’s Response - Statement of Claim

Statement of Claim. Within thirty (30) days of the service date of the Estimation Notice, the Claimant shall complete, execute, and serve upon the Debtors, attorneys for the Debtors and attorneys for the Creditors’ Committee (collectively, the “Estate Parties”), the Statement of Claim setting forth, among other things, a detailed explanation, and, if appropriate, itemization by amount of such Claimant’s Claim and the evidence to support the assertion of such Claim, including names of all persons employed by or within the control of the Claimant, who are likely to have discoverable information relating to the Claim and any documents that the Claimant may rely upon in support of the Claim, not to exceed ten (10) pages in length (including the Statement of Claim form (attached hereto as Exhibit A) and any affidavits, declarations or statements), exclusive of documentary and statutory exhibits. Any Statement of Claim that fails to specify an amount greater than \$0.00 shall be deemed to be \$0.00 for allowance and distribution purposes. The Claimant’s timely filed proof of claim form and all of the documents attached thereto shall remain part of the record for estimation purposes and should **not** be included in or attached to the Statement of Claim.

Claimant’s Response to Counterclaim. In the event that the Debtors assert a Counterclaim, the Claimant shall respond to such Counterclaim on or before thirty (30) days following service of the Debtors’ Estimation Objection by completing, executing and serving upon the Estate Parties a statement of position outlining the Claimant’s arguments and defenses with respect to the Counterclaims, including the evidence to support the assertion of such response, including names of all persons employed by or within the control of the Claimant, who are likely to have discoverable information relating to the Counterclaim and any documents that the Claimant may rely upon in support of the Counterclaim response (the “Response to Counterclaim”), which shall not exceed ten (10) pages in length (including any affidavits, declarations or

statements), exclusive of documentary and statutory exhibits.

Default, Grace Period and Discharge. The Claimant shall serve the Statement of Claim upon the Estate Parties in accordance with the terms of the Estimation Notice and the Case Management Order. If a Claimant fails to return timely a completed and executed Statement of Claim and Response to Counterclaim, as applicable, so as to be received on or before the thirtieth (30th) day following the date of service of the Estimation Notice, and receives a written grace period notice from the Debtors and does not complete and return the Statement of Claim so as to be received by the Estate Parties on or prior to the fifteenth (15th) day following the date of service of such grace period notice, such Claimant's Claim shall be deemed forever discharged, disallowed, waived and expunged against the Debtors and the Debtors' chapter 11 estates, and the Bankruptcy Court shall enter an appropriate order in connection therewith.

C. Debtors' Reply - Statement of Position

Statement of Position. In the event that a Claimant timely serves a Statement of Claim, the Debtors may, in their discretion, on or before thirty (30) days following the service of a Statement of Claim, respond to the respective Statement of Claim by completing, executing, and serving upon the relevant Claimant, with a copy to the attorneys for the Creditors' Committee, a statement (the "Statement of Position") outlining the Debtors' arguments and defenses with respect to the Claim and the elements and evidence set forth in the Statement of Claim. The Debtors' Statement of Position shall not exceed ten (10) pages in length (including any affidavits, declarations or statements), exclusive of documentary and statutory exhibits.

• **D. Opt-Out Procedures**

Right to Opt Out for Fully Liquidated Claims. In the event that an Estimation Objection disputes the allowance of a fully liquidated Claim (an "Exempted Claim"), the holder thereof shall have the absolute right to exclude such Claim from these Procedures, provided that, within thirty (30) days of the service date of the Estimation Notice, the Claimant shall complete, execute, and serve upon the

Debtors the appropriately marked opt out form attached hereto as Exhibit B (the “Opt Out Form”) and, to the extent desired, by submitting an additional pleading supporting such election (an “Exemption Election”). Claimants seeking exemption pursuant to this opt out provision shall not be required to complete and serve the Statement of Claim prior to the Court’s ruling on the Exemption Request. To the extent that a Claimant with an otherwise Exempted Claim does not make such election on the Opt Out Form, the Claimant shall be bound by these Procedures, and such Claimant shall have the Claim heard by the Bankruptcy Court pursuant to the terms and conditions hereof.

Requests to Opt Out or Have Modified Procedures for Overly Complex Claims. In the event that the facts and circumstances surrounding a Claim are too complex to be readily ascertained in the context of these Procedures (“Overly Complex Claim”), the holder of such Claim shall have the right to request exclusion of such Claim from these Procedures, provided that, within thirty (30) days of the service date of the Estimation Notice, the Claimant shall complete, execute, and serve upon the Debtors the appropriately marked Opt Out Form and, to the extent desired, by submitting an additional pleading supporting such request (the “Exemption Request”). Claimants seeking exemption pursuant to this opt out provision shall not be required to complete and serve the Statement of Claim prior to the Court’s ruling on the Exemption Request. A Claimant’s alleged Overly Complex Claim shall be exempted from these Procedures only upon the express consent of the Debtors or entry of an order by the Bankruptcy Court granting the Claimant’s Exemption Request. In the event an Overly Complex Claim is exempt from these Procedures, all rights of the Debtors or any party in interest shall be fully preserved, including any right to seek estimation of such Claim outside of these Procedures. In lieu of granting the Exemption Request, the Bankruptcy Court may, in its discretion, modify these Procedures and order such alleged Overly Complex claim to be estimated in accordance therewith.

Right to Sever Affirmative Request for Relief on Counterclaims. A Claimant shall have the absolute right to exclude from these Procedures the adjudication of the

Debtors' right to affirmative recovery on any Counterclaim by marking the appropriate box on the Statement of Claim form; provided, however, the Bankruptcy Court may nevertheless consider any Counterclaim asserted by the Debtors as a defense or offset in connection with estimation of such Claimant's Claim. To the extent that the Debtors assert a Counterclaim in their Estimation Objection, and the affected Claimant does not timely submit a demand to exclude the adjudication thereof from these Procedures, the Claimant shall be bound by these Procedures, and such Counterclaim shall be adjudicated by the Bankruptcy Court pursuant to the terms and conditions hereof.

E. Claims Resolution Process

Initial and Mandatory Disclosures. Unless otherwise ordered by the Court, the information required to be provided in the Estimation Objection and Statement of Claim or, in the case of a Counterclaim, the Statement of Position and Response to Counterclaim shall be deemed to satisfy any initial or mandatory disclosure required by Fed. R. Civ. P. 26, as applicable pursuant to Fed. R. Bankr. P. 9014.

Settlement Offer. At any time after receipt of a Statement of Claim, the Debtors (or the Claimant, if a Counterclaim is asserted in an Estimation Objection) may offer, in writing (with a copy to counsel for the Creditors' Committee), to settle a particular Claim or Counterclaim, as the case may be (the "Settlement Offer"). Subject to the procedures set forth herein, the Debtors may make a Settlement Offer to any Claimant who timely submits a completed and signed Statement of Claim that fulfills the requirements set forth above. Each Settlement Offer shall constitute a statement made for settlement purposes only and, pursuant to Rule 408 of the Federal Rules of Evidence, shall be inadmissible in any proceeding with respect to the Claim or a Counterclaim.

Claimant's Acceptance of Settlement Offer. Any recipient of a Settlement Offer shall be required to accept or reject the Settlement Offer or submit in writing (with a copy to counsel for the Creditors' Committee), a counter-offer (a "Counteroffer") within ten (10) days of service by the Debtors or the Claimant, as the case may be.

Acceptance or Rejection of Counteroffer. If a Counteroffer is tendered, the Debtors or Claimant shall be required to accept or reject the Counteroffer, in writing (with a copy to counsel for the Creditors' Committee) within ten (10) days of the service of the Counteroffer.

Creditors' Committee Involvement. The Debtors shall consult with, and provide periodic updates to, the Creditors' Committee on the number, size and nature of the Claims and on the Debtors' general plans to resolve the Claims. In the event that (1) a settlement provides for allowance of a Claim in an amount greater than One Hundred Million Dollars (\$100,000,000.00), (2) a settlement constitutes twenty percent (20%) or more of the estimated total allowed Claims against a particular Debtor and more than One Million Dollars (\$1,000,000.00), (3) a settlement (i) provides for allowance of a Claim in an amount greater than Twenty Million Dollars (\$20,000,000.00) and (ii) constitutes more than one hundred five percent (105%) of the amount reflected on the Debtors' books and records or (4) a settlement provides for allowance of a Claim of an employee or insider in an amount greater than One Hundred Thousand Dollars (\$100,000.00), then the Debtors shall obtain the consent of the Creditors' Committee prior to the acceptance or rejection of any such Settlement Offer or Counteroffer, and prior to filing any Settlement Stipulation (as defined below) in respect of such Settlement Offer or Counteroffer; provided, however, that in the case of De Minimis Settlements (as defined below), prior approval of the Creditors' Committee shall not be required and the procedures set forth below shall govern.

F. Additional Discovery

Additional Discovery. In the event that the Debtors or any Claimant determines that additional discovery beyond the initial and mandatory disclosures in connection with the estimation of any Claim or the adjudication of any Counterclaim is required, the parties shall negotiate in good faith the terms of an expedited discovery schedule, in writing signed in accordance with the requirements of Fed. R. Civ. P. 26(g), as applicable pursuant to Fed. R. Bankr. P. 9014, such that all discovery shall be concluded no later than twenty (20) days prior to the Estimation Hearing. Any such writings evidencing a discovery schedule shall be

deemed to be a stipulation pursuant Fed. R. Civ. P. 29, as applicable pursuant to Fed. R. Bankr. P. 9014. If a consensual discovery schedule cannot be negotiated, either party may arrange a telephonic chambers conference on notice to the other party and counsel to the Creditors' Committee, provided that such conference must be requested and held no later than fifty (50) days prior to the Estimation Hearing. The Court shall have the right to limit the number or types of discovery requests in accordance with the expedited nature of these Procedures.

Limited Use of Discovery. To the extent that facts obtained through discovery refute, contradict or impeach material facts asserted by either party in their respective declarations or certified statements, either party may submit to the Bankruptcy Court a written summary of such disputed facts, not to exceed five (5) pages, providing specific citations to such facts (including any transcripts) ("Discovered Evidence"), no later than fifteen (15) days prior to the Estimation Hearing. In the event a party submits Discovered Evidence, the non-submitting party shall have the right to dispute the admissibility or asserted interpretation of Discovered Evidence (including by submitting a summary of contrary evidence obtained through discovery) in a written statement not to exceed five (5) pages, including the specific disputes and reasons therefor (which statement shall also be deemed to be "Discovered Evidence" for purposes of these Procedures), no later than five (5) days prior to the Estimation Hearing.

G. Submissions to the Court

Exemptions Challenged by Debtors. In the event that the Debtors refuse a Claimant's Exemption Request or object to a Claimant's Exemption Election on the basis that the Claim is contingent, unliquidated, and properly subject to estimation pursuant to these Procedures, the Debtors shall, within twenty-five (25) days of service of the Claimant's Exemption Request or Election, compile and file with the Bankruptcy Court the Claimant's proof of claim, the Notice Package, the Claimant's Exemption Request or Election (as applicable), and the Debtors' response to such Exemption Request or Election (collectively, the "Exemption File") for a ruling on whether such Claim shall be subject to estimation in accordance with these Procedures. A hearing (an "Exemption Hearing") may be requested by the

Claimant pursuant to a Claimant's Exemption Request or Election or by the Debtors in their response thereto. Such Exemption Hearing shall be noticed for hearing on the next Hearing Day (as defined by the Second Amended Case Management Order) that is at least seven (7) calendar days after the Exemption File is filed with the Clerk of the Court and notice thereof is served upon the appropriate parties, or such other day as the Court so orders. In the absence of a request for an Exemption Hearing, the Court may, in its discretion, schedule an Exemption Hearing, or enter an order resolving such dispute based on the Exemption File without a hearing. In the event that the Debtors refuse a Claimant's Exemption Request or object to a Claimant's Exemption Election with respect to any Claim, these Procedures shall be suspended with respect to such Claim until an order is entered resolving the disputed Exemption Request or Exemption Election. In the event a Claimant's Exemption Request or Election is denied by the Court, the Court shall establish a schedule for the submission of a Statement of Claim by the Claimant, the Debtors' Statement of Position and the Estimation Hearing, if any, in the order resolving the disputed Exemption Request or Exemption Election.

Estimation or Adjudication by Court. In the absence of an Exemption Request or Election and unless a Claim is exempted by Court order or otherwise settled in accordance with these Procedures, the Debtors shall compile and file with the Bankruptcy Court the Claimant's proof of claim, the Notice Package, the Claimant's Statement of Claim, and the Debtors' Statement of Position (if any) (collectively, the "Claim File") for purposes of a hearing on estimation of the Claim pursuant to the Estimation Objection, and, if applicable, adjudication of a Counterclaim, in accordance with the Claims Procedures Order.

Extension of Time Periods. Upon mutual written consent, the parties may extend any time period provided in these Procedures prior to the Debtors' filing of the Claim File with the Bankruptcy Court.

H. Estimation Hearing

Hearing. Unless otherwise ordered by the Bankruptcy Court, an Estimation Hearing shall be held one hundred and

thirty-five (135) days after service of the Estimation Objection, or as soon thereafter as a regularly scheduled omnibus hearing may occur.

Oral Argument. Subject to the Bankruptcy Court's discretion to increase or decrease the hearing time, each party shall have fifteen (15) minutes to explain its position to the Bankruptcy Court.

Evidentiary and Legal Record. The evidentiary and legal record shall be confined to the Claim File and any Discovered Evidence; provided, however, that the Bankruptcy Court may allow or require additions to the record when deemed necessary or appropriate.

Resolution. Upon the Bankruptcy Court's review of the evidentiary submissions and oral argument at the Estimation Hearing, the Bankruptcy Court shall estimate the relevant Claims and adjudicate Counterclaims for all purposes under the Bankruptcy Code, provided that no party's right to reconsideration under section 502(j) shall be impaired. These Procedures shall not have any preclusive or collateral effect on third party litigation. Nothing in these Procedures shall be construed to limit either the Debtors' or a Claimant's valid right of setoff to the extent available under state law as preserved under section 553 of the Bankruptcy Code, or a Claimant's valid right of recoupment under non-bankruptcy law. Pursuant to section 502(d) of the Bankruptcy Code, any Claim of a Claimant from which property is recoverable under section 542, 543, 550, or 553 or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, or 549 of the Bankruptcy Code shall be disallowed, unless such Claimant has paid the amount, or turned over such property, for which Claimant is liable under section 522(i), 542, 543, 550, or 553.

I. Settlement Stipulations

De Minimis Settlements. Subject to Section I above, if the Debtors and a Claimant agree to a compromise and settlement of a Claim and, in connection therewith, the Claimant is to be granted an allowed Claim equal to or less than Twenty Million Dollars (\$20,000,000.00), where such settlement amount constitutes less than twenty percent (20%) of the estimated total allowed Claims for the

relevant Debtor, the Debtors shall file with the Clerk of the Bankruptcy Court and send to BSI, as Claims Agent, a stipulation setting forth such agreed upon amount (a “De Minimis Stipulation”). The De Minimis Stipulation shall become effective and binding upon all parties-in-interest upon its filing with the Clerk and shall not require the endorsement or approval of the Bankruptcy Court; provided, however, that, prior to the effective date of any chapter 11 plan for the Debtors, any De Minimis Stipulation shall be served upon attorneys for the Creditors’ Committee ten (10) days prior to the submission to the Clerk of the Bankruptcy Court; and, provided further, that, in the event that the Creditors’ Committee serves a written objection on the Debtors prior to the expiration of such ten-day period, the Debtors shall have the option of (y) withdrawing such De Minimis Stipulation and (z) treating such De Minimis Stipulation as a Settlement Stipulation, as defined below; and, provided, further, that, under no circumstances shall a De Minimis Stipulation provide for payment other than in accordance with the terms and conditions of a plan confirmed in the Debtors’ chapter 11 cases in accordance with section 1129 of the Bankruptcy Code.

Court-Approved Settlements. If the Debtors and a Claimant agree to a compromise and settlement of a Claim and, in connection therewith, the Claimant is to be granted an allowed Claim in excess of Twenty Million Dollars (\$20,000,000.00), the Debtors shall seek Bankruptcy Court approval of such compromise and settlement and corresponding stipulation and order (the “Settlement Stipulation”) in accordance with the terms and conditions of the Case Management Order on ten (10) days’ notice. If no objections to the Settlement Stipulation are timely filed, the Debtors shall submit an order approving the Settlement Stipulation without further notice or hearing. If an objection is timely interposed, the matter will be scheduled for hearing at the next omnibus hearing date; provided, however, that, under no circumstances shall a Settlement Stipulation provide for payment other than in accordance with a confirmed plan in the Debtors’ chapter 11 cases. If the Bankruptcy Court does not approve the Settlement Stipulation, the Debtors, at their discretion, may elect to negotiate further with the Claimant or may deem settlement

negotiations terminated and seek to estimate the Claim pursuant to the Claims Procedures Order.

1. The form of Statement of Claim, a copy of which is annexed hereto as Exhibit "A", is hereby approved.
2. Claims that are subject to the First Amended Order Governing the Mediation of Trading Cases, dated March 20, 2003, shall not be subject to the proposed Claims Procedures at any time.
3. Moreover, the Debtors shall not file Estimation Objections to Claims that are the subject of pending claims resolution proceedings. For purposes of these Procedures, claims resolution proceedings shall include any proceeding that results in the fixing and liquidation of Claims asserted against the Debtors, including adversary proceedings, non-bankruptcy court litigation, administrative proceedings before state or federal agencies, alternative dispute resolution proceedings commenced consensually by the parties or ordered by the Court, or claim objection proceedings that have been joined and pursuant to which the parties have commenced discovery.
4. The documents to be submitted in accordance with these Procedures, including the Estimation Objection, addenda to the Statement of Claim, Statement of Position, Response to Counterclaim and Discovered Evidence shall (i) be double-spaced and plainly typed or printed, (ii) have no erasures or interlineations which materially deface them, and (iii) bear endorsed on the first page the name, the initials of the first and last name of the attorney (unless a Claimant is proceeding without an attorney) followed by the last four digits of such attorney's social security number, the office and post office address, and the telephone number of the attorney for the filing party.
5. The relief granted herein is without prejudice to the rights of the Debtors or any party in interest to, among other things, object to any Claim at any time during the pendency of these chapter 11 cases by individual or omnibus objection.

Dated: New York, New York
February 18, 2004

s/ Arthur J. Gonzalez
HONORABLE ARTHUR J. GONZALEZ
UNITED STATES BANKRUPTCY
JUDGE

Exhibit A

STATEMENT OF CLAIM

Please complete the following items and submit a maximum of ten (10) pages explaining the elements and evidence in support of the amount you are claiming:

Claim number on docket	
Full legal name of claimant	
Name, address, and telephone number of legal counsel retained (if applicable)	
Amount claimed (if this amount differs from your filed Claim, provide explanation)	
Brief description of the nature of the claim (additional detail to be included in pages attached per above) (see detail required below)	
Debtor against which claim is asserted	

If you wish to sever and exempt the adjudication of the Debtors' Counterclaim(s) from these streamlined Procedures, place an "x" in the box to the right of the Opt-Out provision:

1. I elect to sever the Debtors' action for affirmative recovery on Counterclaim(s):

**Note that the Bankruptcy Court may nevertheless consider any Counterclaim asserted by the Debtors as a defense or offset in connection with estimation of such Claimant's Claim.*

Claimants must include the following information in the attached narrative outlining and justifying their claim against the Debtors:

1. A detailed description of the factual and legal basis of the claim (including detailed description of the contract, breach, event, incident, relationship, etc. giving rise to the claim)
2. Names, addresses, and contact information of all witnesses, affiants, or other persons involved with or having knowledge of the details surrounding the claim
3. Third parties implicated by the claim and/or named in litigation giving rise to the claim
4. A detailed description of the damages sought, including a calculation of and support for such damages that would sustain scrutiny in a court of law

I hereby declare under penalty of perjury that the information contained herein and in any attachment hereto is, to the best of my knowledge, accurate and complete.

Signature: _____

Date: _____

Exhibit B

Opt-Out Form

If you wish to opt out of these streamlined Procedures, place an “x” in the box to the right of the applicable Opt-Out provision:

- 2. I elect to opt out, because my claim is a Fully Liquidated Claim
- 3. I request to opt out or have modified procedures, because my claim is Overly Complex:

<input type="checkbox"/>
<input type="checkbox"/>

** Note that you are entitled to attach an additional pleading to support your Exemption Election or Exemption Request, pursuant to which you may request a hearing before the Bankruptcy Court. If your Election or Request is contested by the Debtors you will be notified and the Bankruptcy Court will determine whether your Claim will be subject to these Procedures.*