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

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*In re* :  
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**AMBAC FINANCIAL GROUP, INC.,**  
  
**Debtor.**

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

**AMBAC FINANCIAL GROUP, INC.,**

**Movant,**

**against**

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

**Respondent.**

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**MEMORANDUM OF LAW IN SUPPORT 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**

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Ambac Financial Group, Inc. ("AFG" or the "Debtor") submits this memorandum of law in support of *Debtor's Motion for Order (1) Determining that Claim Numbers 3694 and 3699 Filed by the 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"), filed herewith. As set forth below, under the facts here, pursuant to section 502(c) of the Bankruptcy Code, the IRS Claims<sup>1</sup> are required to be estimated for purposes of allowance and distribution and this court should thereby determine, pursuant to Bankruptcy Code section 505(a), issues of the Debtor's tax liability that are dispositive of the IRS Claims, as well as the IRS's ability to prohibit the Debtor from claiming net operating losses ("NOLs") resulting from its Post-2004 Contracts. The Motion requests the Court to order the implementation of reasonable and necessary procedures, and to set November 21, 2011 as the date for a Hearing to estimate the IRS Claims and to adjudicate the Unresolved Tax Issues.

### **SUMMARY OF ARGUMENT**

The IRS has raised significant issues regarding, and disputing, the determination by the Debtor of NOLs reported on the Tax Returns filed for the 2007, 2008, 2009 and 2010 tax years. These issues (defined in the Motion as the "Unresolved Tax Issues") were raised by the IRS in an Information Document Request (the "IDR") issued on October 28, 2010, in verbal communications made by an IRS revenue agent, in the Notices of Proposed Adjustment (the "NOPAs") issued on May 4 and 10, 2011, and in

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<sup>1</sup> Capitalized terms not defined herein have the meanings ascribed in the Motion.



the proofs of claim filed by the IRS (the "IRS Claims") filed on May 5, 2011. These issues relating to proper determination and calculation of NOLs must be resolved expeditiously, to determine or to estimate the Debtor's liability for the IRS Claims, and to determine the legality and amount of the Debtor's rights to NOLs that exist for use in future tax years. The absence of these determinations now stands as an impediment to the successful conclusion of this chapter 11 case.

Resolution of these issues is dispositive of this chapter 11 case, for without a full resolution of the impact of the performance of the Post-2004 Contracts on the Debtor's liability for taxes in past and future years, the feasibility of the Debtor's proposed reorganization plan cannot be assessed and the plan may not be confirmed and effectuated.<sup>2</sup> The following Unresolved Tax Issues are central to the IRS Claims and the Debtor's liability for taxes, and the amount of that liability, and thus pose an imminent and severe threat to the Debtor's reorganization effort:

- 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 Debtor was appropriate to calculate the CDS impairment loss 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 and, as a result, is estopped from arguing that change was impermissible?

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<sup>2</sup> The plan provides that resolution of the issues surrounding the Debtor's right to claim NOLs is a condition to effectiveness.

- 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?

At present, the IRS has issued the NOPAs and the IDR, and has filed the IRS Claims for over \$800 million. The Adversary Proceeding that remains pending in this Court (notwithstanding the IRS's pending motion for reference withdrawal and the IRS's repeated attempts over many months to cause the District Court to determine that motion expeditiously) has provided the parties full opportunity for discovery of all facts relating to the issues. Discovery in the Adversary Proceeding is substantially complete, save for expert rebuttal reports and expert depositions, which are scheduled to be completed by November 2, 2011. Discovery is scheduled to be completed in full by November 9, 2011.

Given the current pace of litigation regarding the Tax Refunds and underlying Unresolved Tax Issues, the time during which AFG can obtain confirmation of a feasible plan will expire before any determination of the key legal issues that could establish AFG's right to claim NOLs and its duty, if any, to repay any amount of the Tax Refunds. The Unresolved Tax Issues between the IRS and the Debtor cannot be allowed to undermine this reorganization case by the passage of time. This Court has subject matter jurisdiction and the authority under sections 502(c) and 505(a) to resolve the parties' disputes as to Unresolved Tax Issues so the reorganization case may proceed to a conclusion before the Debtor's resources are exhausted.

As set forth in the Motion, a delay in emergence of this Debtor from chapter 11 of even two or three months past November 2011 may render reorganization moot. The costs of full-blown litigation of the IRS Claims further compound the situation, by adding millions of dollars of expense at the trial court level, and the possibility of extended

appeals. If a plan cannot be confirmed in a reasonable amount of time, the estate will lose the significant value delivered to creditors by the Second Amended Plan. The disputed issues between the IRS and the Debtor threaten the entire estate with huge, unnecessary loss, as the time and expense of fully litigating the Unresolved Tax Issues between the Debtor and the IRS from discovery to a final resolution pursuant to the Federal Rules of Civil Procedure could trigger conversion of the Debtor's reorganization effort to liquidation under chapter 7.

Without an expedited resolution of the tax treatment of the Post-2004 Contracts, the Debtor will run out of the cash needed to sustain a reorganization effort. The fact that the IRS has recently proposed prospective regulations on a key issue, which is to be among the subjects of the requested Hearing, strongly suggests that the Unresolved Tax Issues are capable of immediate determination. Therefore, this is the clearest possible case for this Court to utilize the authority conferred under Bankruptcy Code sections 502(c) and 505(a) to determine the Unresolved Tax Issues and to estimate contingent or unliquidated claims whose liquidation would otherwise unduly delay administration of the case.

#### **PERTINENT FACTS**

- The relevant facts are set forth in the Motion, and are incorporated here.

#### **ARGUMENT**

##### **I. Bankruptcy Code Section 505(a) authorizes this Court to Determine the Disputed Tax Issues.**

Bankruptcy Code section 505(a)(1) provides, in relevant part, that the Court

may determine the amount or legality of any tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

11 U.S.C. § 505(a)(1). By the Motion, the Debtor asks the Court to enter an Order setting a hearing date and establishing procedures to estimate the IRS Claims pursuant to Bankruptcy Code section 502(c), which requires determinations of the Unresolved Tax Issues. Jurisdiction exists under Bankruptcy Code section 502(c) which mandates that this Court decide the Unresolved Tax Issues, because these issues currently render the IRS Claims contingent and unliquidated. These same issues also determine the Debtor's right to assert in future tax years the NOLs resulting from the Post-2004 Contracts and the Court is, thus, allowed to make its determination as to the unresolved Tax Issues under section 505(a).

Express authority exists under both Bankruptcy Code sections 502(c) and 505(a) to decide the issues on which this reorganization depends. Because of the magnitude of the IRS Claims and because the Debtor's interest in these NOLs is the most valuable asset of the estate, the Debtor is unable to determine plan feasibility or obtain confirmation without a final resolution of the Unresolved Tax Issues. Thus, this Court should exercise its power under sections 502(c) and 505(a) of the Bankruptcy Code to resolve the disputed issues expeditiously.

**A. Bankruptcy Code Section 505(a) Authorizes the Determinations of Unresolved Tax Issues Needed to Assess the Debtor's Rights with Respect to Tax Liabilities in Past and Future Tax Years.**

This Court has the authority to determine the disputed issues for the purpose of all tax years in which the Debtor's Post 2004-Contracts will be relevant, even if those years follow the effective date of a confirmed plan. Bankruptcy courts have used their authority under Bankruptcy Code section 505(a) to determine a bankruptcy estate's tax liability before the tax actually becomes due. *See IRS v. Amoskeag Bank Shares, Inc. (In re Amoskeag Bank Shares, Inc.)*, 239 B.R. 653, 659 (D.N.H. 1998) (rejecting IRS's

argument that section 505(a) does not authorize a determination of a tax before the tax is due; holding that waiting until the tax has accrued will impose a hardship on the parties and is inconsistent with the legislative history that section 505(a)(1) was intended to allow debtors to settle the estate quickly without facing potential post-bankruptcy tax liabilities); *Unsecured Creditors Comm. of Goldblatt Bros., Inc. v. United States (In re Goldblatt Bros.)*, (Bankr. N.D. Ill. 1989) (bankruptcy court has authority under section 505(a)(1) to determine future tax liability of fund established post-confirmation to pay creditor claims); *In re Kilen*, 129 B.R. 538, 548-49 (Bankr. N.D. Ill. 1991) (jurisdiction existed to decide future tax consequences of events having occurred pre-petition, even though the debtor's future liability depended upon the future occurrence of a contingency, assessment by the IRS, that may never occur; determination did not impact estate, yet was essential to preserve debtor's statutory right to a fresh start). *Cf. In re UAL Corp.*, 336 B.R. 370, 371-72 (Bankr. N.D. Ill. 2006) (In *dicta*, court opined that "the tax issues subject to bankruptcy adjudication under section 505(a) must be those that generate or offset claims against the estate, thus including matters that arose before the case was filed or during its administration.")

Here, the Debtor is asking this Court to determine the Debtor's liability for taxes as a result of the losses incurred on the Post-2004 Contracts, which requires the intermediate determination of the legality of the IRS's disallowance of NOLs in the amounts calculated by the Debtor. The IRS has raised the Unresolved Tax Issues in various ways both before and during this chapter 11 case – through the issuance of the NOPAs and IDR, oral communications made by the IRS's auditor assigned to this case, through pleadings and discovery in connection with the Adversary Proceeding, and by

filing the IRS Claims. The Unresolved Tax Issues create a controversy that has been joined as to the Debtor's tax liability for 2007 through 2010 and as to the positions to be taken by the Debtor in carrying forward to future years the NOLs based upon the Post-2004 Contracts (all of which were pre-petition contracts). The Unresolved Tax Issues are ripe for adjudication, and this Court has jurisdiction to determine the questions as they bear upon the legality of the Debtor's chosen tax accounting methodology and the amount of the Debtor's past and future tax liability. *See In re Amoskeag*, 239 B. R. at 659 ("waiting until after the tax has accrued would impose a hardship . . . section 505 was intended to allow the trustee to settle the estate quickly without 'facing potential post-bankruptcy tax liabilities . . . ") (quoting S. Rep. No. 95-989, at 68 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5787, 5854.)

Section 505, as an exception to the Declaratory Judgment Act, 28 U.S.C. section 2201, provides this Court straightforward statutory authority to grant the Motion and to set a hearing to declare the Debtor's right to assert NOLs. *See U.S. v. Gonzales*, 520 U.S. 1, 6, 117 S. Ct. 1032, 1035 (1997); *see also U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240-42, 109 S. Ct. 1026, 1031-32 (1989) (plain meaning of legislation should be conclusive, except in rare cases in which literal application of statute will produce result demonstrably at odds with intention of its drafters; in such cases, intention of drafters, rather than strict language controls). The express exception for section 505(a) relief from the general prohibition on federal court declaratory relief in respect of federal taxes (*see* 28 U.S.C. section 2201) gives bankruptcy courts broad discretion to determine the amount and legality of any tax of a debtor, even a tax that is not yet due, if there is a present dispute and a threat to the estate. Given the length of time it took the IRS to

propose regulations on the subjects raised by the Unresolved Tax Issues (since 2004, when the IRS requested comments on the proposed treatment of CDS and CDOs and acknowledged their growing importance to the world's financial markets) and given that the IRS never responded to AFG's request, three years ago, for an accounting method change, together with the obvious time and expense that would be expended to litigate these issues to conclusion in any other manner, it is difficult to imagine a more appropriate case for invoking the purposes of section 505(a).

Section 505(a) does not limit the Court's subject matter jurisdiction or power to pre-confirmation tax liabilities; rather, it provides the Court with wide latitude to determine the "amount or legality of any tax." Congress knew how to limit a bankruptcy court's jurisdiction with respect to tax claim determinations, because in the very next subsection, section 505(b)(2), Congress created a mechanism for the discharge of tax claims, but limited such discharge to "taxes incurred during the administration of the estate." Section 505(a)(1) contains no such limitation. "Where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. U.S.*, 464 U.S. 16, 23 (1983), *see also Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F. 3d 329 (2d Cir. 2011) (settlement payment was within plain language of Bankruptcy Code section 546(e), which excludes from avoidance "any transfer that concludes or consummates a securities transaction"); *In re Johnson*, 708 F.2d 865, 868 (2d Cir. 1983) (agreeing with other circuit courts, and holding, that when interpreting the statutory language of the

Bankruptcy Act relating to good faith requirements, courts "should not read into the Act any per se limitations or requirements...that Congress did not enact").

The adjudication of the issues described herein through the expeditious procedures and hearing sought by this Motion will allow the Debtor to ascertain its existing tax obligation and a valuable estate asset. Moreover, the Debtor will be able to calculate and use NOLs derived from the Post-2004 Contracts to offset taxes that would otherwise be due in future years. The adjudication of these issues is also crucial to the effectuation of the Debtor's Second Amended Plan and the Amended Plan Settlement embodied therein. The expected stream of payments from AAC to the Reorganized Debtor that, pursuant to the Amended Plan Settlement and with the consent of OCI, will result from AAC's future use of NOLs constitutes a significant part of the value to creditors provided by the Second Amended Plan. Further, 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 with respect to AAC nor a deconsolidation event within the meaning of section 1504 of the Internal Revenue Code occurred during the 2010 taxable year as a result of the Bank Settlement or for any other reason are conditions precedent to consummation of the Second Amended Plan and conditions to the effectiveness of the Amended Plan Settlement.

When Congress excepted Bankruptcy Code section 505 from the general rule that federal courts may not enter declaratory judgments in respect of federal taxes, see 28 U.S.C. § 2201, Congress authorized the bankruptcy courts to do exactly what this Motion asks - to declare the rights of the parties so as to resolve claims in respect of the tax



liabilities arising as a consequence of the Post-2004 Contracts, to save the Debtor's reorganization effort from imminent and certain derailment.

**B. The Court's Jurisdiction is Expressly Granted by Statute.**

The Debtor has standing to raise the Unresolved Tax Issues, and this Court has jurisdiction over a justiciable controversy. Bankruptcy Code section 505 grants bankruptcy courts "broad jurisdiction to determine tax liabilities arising either before or after the filing of a case under title 11." 15 *Collier on Bankruptcy* P TX5.04[1] (15th ed. rev. 2009); *see also Kohl v. IRS (In re Kohl)*, 397 B.R. 840, 845 (Bankr. N.D. Ohio 2008) (bankruptcy courts are vested by section 505(a)(1) "with broad jurisdiction to determine tax liabilities arising either before or after the filing of a case under title 11"); *In re Schmidt*, 205 B.R. 394, 395 (Bankr. N.D. Ill. 1997) (bankruptcy court has jurisdiction to determine post-petition tax liabilities); *In re Goldblatt*, 106 B.R. at 529 (bankruptcy court has broad jurisdiction to determine tax liability in all core proceedings).

Bankruptcy courts have determined tax liabilities using their authority under 505(a) even if the taxes are not yet due. In *United States v. Kearns*, 177 F.3d 706, 710 (8<sup>th</sup> Cir. 1999), the court held the bankruptcy court had jurisdiction to determine issues as to future tax years that were not referred to in the IRS's proof of claim. There, the court reasoned that "we cannot share an interpretation of the Bankruptcy Code that precludes a debtor from having the benefit of carrying back deductions that are intimately related to the adjudged tax liability." In *In re Kilen*, 129 B.R. 538 (Bankr. N.D. Ill. 1991), the court denied the United States' motion to dismiss the debtor's complaint to determine the debtor's trust fund tax liability under section 505(a), even though the IRS had not yet assessed any liability for the underlying taxes and had not filed a proof of claim. The

court held that "[t]he fact that the IRS has not determined the amount of Kilen's trust fund liability or even whether it will assess Kilen for unpaid trust fund taxes does not mean that the IRS has no claim against Kilen which can give rise to an actual controversy in bankruptcy." *Id.* at 548. "To require [the debtor] to wait until the IRS has made an assessment before he can have his tax liability determined might harm him severely and unnecessarily." *Id.* at 549. Thus, the court ruled that it had jurisdiction to determine the Debtor's tax obligations under section 505(a). *Id.* at 550. *See also Popa v. Peterson (In re Popa)*, 238 B.R. 395, 398-99 (N.D. Ill. 1999) (affirming bankruptcy court ruling that it may determine future tax implications of a potential sale of the debtor's property); *Amoskeag*, 239 B.R. at 659 (D.N.H. 1998) (bankruptcy court has ability to determine future tax liabilities under section 505 where "waiting until after the tax has accrued would impose a hardship on the parties").

In each of these cases, the determination of the future tax liability was necessary for the bankruptcy court to determine the propriety of an existing dispute about the Debtor's tax liability, over which it had jurisdiction (*e.g.* chapter 11 plans, sales of property, *etc.*), and which posed a discernable threat to the Debtor's ability to make post-confirmation distributions to creditors. In cases where courts have declined to exercise jurisdiction under section 505(a), the salient distinctions have been that the debtor sought a determination as to which absolutely no dispute had been raised, *see, e.g., In re Dycoal*, 327 B.R. 220, 227 (Bankr. W.D. Pa 2005) (no jurisdiction exists where the IRS has not disallowed tax credits or challenged the findings upon which such credits depend), or the unsettled tax issue would have no impact on distributions by the estate. *See, e.g., In re Newman* 402 B.R. 908, 915-16 (Bankr. M.D. Fla. 2009) (where debtor's tax debt was

non-dischargeable, and plan had been confirmed, resolution of the dispute between the debtor and the IRS would have no impact on the distributions to be made by the estate, and therefore, court reasoned that the purposes of section 505(a) jurisdiction were not served, court declined to resolve tax questions). *See also, Allis-Chalmers Corp. v. Goldberg (In re Hartman Material Handling Sys., Inc.)*, 141 B.R. 802 (Bankr. S.D.N.Y. 1992) (court declined exercise of 505(a) jurisdiction where pre-petition net operating losses had never been asserted in a filed tax return, nor challenged by the IRS, and no reservation of jurisdiction over tax issues was contained in the already-confirmed plan).

Here, the contested matter involves the Debtor's right to retain refund amounts claimed based on proper characterization of, and calculation of losses on, its Post-2004 Contracts and its right to claim the related NOLs in future years. These issues are central to the success of the Debtor's reorganization effort, and the Court has indisputable subject matter jurisdiction and authority over these interrelated disputes. *See, e.g., In re Schmidt*, 205 B.R. at 398 (even though tax dispute involved liability of a non-debtor, court accepted section 505(a) jurisdiction because the third parties' liability had a direct effect on the estate and resolution was necessary to rehabilitation of debtor and efficient administration of the estate); *In re Popa*, 238 B.R. at 404 (where requested declaration of tax issues was "central to the distribution of the estate" jurisdiction was proper under section 505(a)).

Through the Hearing requested by this Motion, the Debtor seeks to determine its tax obligations for 2007 and 2008 and its right in future years to assert NOLs arising from the Post-2004 Contracts. The disputed issues are triggered by, and are intimately related to the Debtor's tax liability for years past (*i.e.* the Debtor's liability to return the Tax

Refunds, as alleged by the IRS Claims), as well as to the future. The events as to which the Debtor seeks a determination are the subject of filed tax returns and an existing, well-developed and on-going dispute, which has been raised pre-confirmation. Failure to resolve the issues at hand will prevent the Debtor from reorganizing and will cost the estate extreme loss of value. In these circumstances, Bankruptcy Code section 505(a)(1) authorizes the Court to hear and determine the Unresolved Tax Issues in the manner requested by this Motion.

**C. The Court is Authorized to Enter Declaratory Judgments in Respect of the Debtor's Taxes, Not Just to Allow or Disallow Pre-existing Tax Claims.**

The Declaratory Judgment Act provides, in relevant part, that federal courts may not enter declaratory judgments in respect of taxes, except under, *inter alia*, Bankruptcy Code section 505. *See* 28 U.S.C. § 2201(a). Bankruptcy courts may enter orders declaring the rights of any interested party seeking such relief, as long as federal jurisdiction otherwise exists. *See, e.g., Guaranty National Insurance Co., v. Gates*, 916 F.2d 508, 511 (9th Cir. 1990) (federal jurisdiction under *Ex Parte Young* doctrine); *Proler Steel Corp. v. Luria Bros. & Co.*, 223 F. Supp. 87, 89 (S.D. Tex. 1963) (federal jurisdiction under the Copyright Act). Here, federal jurisdiction exists under 28 U.S.C. section 1334(b).

One of the principal purposes of the Declaratory Judgment Act is to allow a party to bring an action asserting its non-liability before actual injury or damages. *Bruhn v. STP Corp.*, 312 F. Supp. 903, 906 (D. Colo. 1970); *see also Broadview Chemical Corp. v. Loctite Corp.*, 417 F.2d 998, 1001, (2d Cir. 1969), *cert. den.* 397 U.S. 1064, 90 S.Ct. 1502 (1970) (declaratory judgment should be permitted "when the judgment will serve in clarifying and settling the legal relations in issue, and . . . when it will terminate and

afford relief from the uncertainty, insecurity, and controversy giving rise to the proceeding.") (quoting Borchard, *Declaratory Judgments* 294, 299 (2d ed. 1941); *Sherwin-Williams Co. v. Holmes County*, 343 F.3d 383 (5th Cir. 2003) (proper purpose of Declaratory Judgment Act is to allow potential defendants to resolve a dispute without waiting to be sued or until the statute of limitations expires, and the mere fact that a declaratory judgment action is brought in anticipation of other suits does not require dismissal of the declaratory judgment action by the federal court). Even though the act that will create liability has not yet occurred, courts may grant declaratory relief as long as one or both parties have taken steps or pursued a course of conduct which will result in inevitable litigation. *Bruhn v. STP Corp.*, 312 F. Supp. at 906.

Here, it is beyond question that the Debtor and the IRS are at loggerheads over the Unresolved Tax Issues relating to the Post-2004 Contracts, that resolution of the stalemate is essential to determination of the Debtor's tax liabilities, in the past and the future, and that absent favorable resolution, the estate will suffer a massive loss of value. Therefore, the Debtor is entitled to a declaration of its non-liability for return of the Tax Refunds and the legality of its assertion of NOLs, exactly as contemplated by the Declaratory Judgment Act.

The declaratory judgment remedy under section 505 affords the Debtor a final resolution of critical tax issues and is available in those circumstances where, as here, the Debtor's ability to offset NOLs has not yet arisen, but most certainly will arise following the effective date of the Plan. The NOLs at issue are simply extra NOLs over the NOLs the Debtor used to obtain the Tax Refunds the IRS wants to reclaim. Thus, estimation of the IRS Claims inexorably includes a determination of the availability of and ability to

use, these NOLs. Because the question of whether the Debtor may legally assert NOLs will determine the value that the estate may ultimately yield to creditors, and because of the threat posed by delay, a declaratory judgment and/or estimation hearing, and a declaration that the NOLs may be used, is not only justified under the applicable law, but is also required by the circumstances.

**D. The Tax Determination is Ripe for Adjudication.**

The tax issues described in this Motion are ripe for adjudication. Here, all of the relevant facts regarding the tax characterization and accounting treatment of the Post-2004 Contracts have been the subject of extensive discovery requested by the IRS and lasting almost a year. No further factual development is required for the Court to decide the legal questions and make the requested determinations.<sup>3</sup> A speedy conclusion to the hearing sought by the Motion is critical to a successful chapter 11 plan involving billions of dollars in claims.

Where no further factual development is required for a court to adjudicate a matter and the party seeking relief would suffer substantial harm absent relief, courts uniformly find that the matter in question is ripe for adjudication. *See Abbott Laboratories v. Gardner*, 387 U.S. 136, 87 S.Ct. 1507 (1967) (partially superseded by statute on other grounds) (complaints against governmental regulation were ripe for adjudication where no further fact development was needed and party seeking relief clearly would be harmed by withholding court consideration); *Pacific Gas and Electric Co. v. State Energy Resources Conservation and Development Commission*, 461 U.S. 190, 201-202, 103

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<sup>3</sup> The issue of whether an ownership change or deconsolidation event occurred in 2010 as a result of the Bank Settlement or for any other reason has not been fully developed factually. The IRS has requested, and the Debtor will provide the IRS with, documentation relevant to this issue prior to the return date of this Motion.

S.Ct. 1713, 1721 (1983) (postponement of judicial relief left utility industry "in the lurch" unable to make business plans, hence issue was ripe for adjudication); *Center for Biological Diversity v. Kempthorne*, 588 F.3d 701, 708-709 (9th Cir. 2009) (substantial delay and imminent harm would be caused by denial of judicial determination of developed factual issues, hence ripeness test is satisfied); *Arch Mineral Crop. v. Babbitt*, 104 F.3d 660, 665 (4th Cir. 1997) (if matter is not dependent on future uncertainties or contingencies, matter is ripe for judicial resolution). In short, this matter is ripe for adjudication, and the Debtor is entitled to a hearing in a determination of the issues enumerated by the Motion, so that the amount of the NOLs that the Debtor may claim from the Post-2004 Contracts can be fixed and so this Court can determine the Debtor's liability for federal income tax arising for the years 2007 and 2008.

## **II. Bankruptcy Code Section 502(c) Mandates Estimation of the IRS Claims.**

As shown above, this Court has full authority and jurisdiction to enter a declaratory judgment adjudicating the Unresolved Tax Issues and thereby settling finally the legality of the Debtor's assertion of NOLs for all purposes, including determination of the IRS Claims. Even if this Court were to decline to decide the Unresolved Tax Issues pursuant to the discretionary authority granted under Bankruptcy Code section 505(a), resolution of these issues is mandatory under Bankruptcy Code section 502(c).

The Unresolved Tax Issues render the IRS Claims contingent and unliquidated. The Bankruptcy Code provides a solution to the existence of such claims that, if resolved through normal litigation processes, would prevent a debtor from assessing the merits of a chapter 11 plan and reorganizing pursuant to a viable plan. Section 502(c) mandates that:

[t]here shall be estimated for purposes of allowance under this section –

(1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case...

11 U.S.C. § 502(c)(1). *See also Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 957 (2d Cir. 1993) ("[t]he clearly stated purpose of sec. 502(c)(1) is to allow estimation of claims in order to avoid undue delay in the administration of bankruptcy proceedings"); *In re G-I Holdings, Inc.*, 323 B.R. 583, 599 (Bankr. D.N.J. 2005) ("Section 502(c) of the Bankruptcy Code is drafted in mandatory terms").

Courts have regularly held that claims should be estimated under section 502(c) of the Bankruptcy Code where their resolution depends on the outcome of another case or proceeding.<sup>4</sup> *See, e.g., In re Chemtura Corp.*, 448 B.R. 635, 649-50 (Bankr. S.D.N.Y. 2011) ("[e]stimation . . . provides a means for a bankruptcy court to achieve reorganization, and/or distributions on claims, without awaiting the results of legal proceedings that could take a very long time to determine." (Citing *In re Adelpia Bus. Solutions, Inc.*, 341 B.R. 415, 422 (Bankr. S.D.N.Y. 2003))); *In re Lionel L.L.C.*, No. 04-17324, 2007 WL 2261539, at \*2 (Bankr. S.D.N.Y. Aug. 3, 2007) ("when the liquidation of a claim is premised on litigation pending . . . and the final outcome of the matter is not forthcoming, the bankruptcy court should estimate the claim"); *see also O'Neill v. Continental Airlines, Inc. (In re Continental Airlines, Inc.)*, 981 F.2d 1450, 1461 (5th Cir. 1993) (bankruptcy courts may estimate claims to "avoid the need to await the resolution

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<sup>4</sup> Although many of these courts refer to "outside" litigation, and the Adversary Proceeding is in fact pending as an adversary proceeding in this bankruptcy court, this distinction is without a difference. A review of the decisions cited above reveals that those courts were concerned with the delay occasioned by litigation of issues of non-bankruptcy law, and that the venue of the "outside" litigation is not the crux of the need for estimation. That the Adversary Proceeding sits in a bankruptcy forum is a coincidence of AFG's status as a Debtor.



of . . . lawsuits . . . by means of anticipating and estimating the likely outcome of these actions," and "promote a fair distribution to creditors through a realistic assessment of uncertain claims"(citing *In re Ford*, 967 F.2d 1047, 1053 (5th Cir. 1992))). Because the existence of the IRS Claims depend on the resolution of issues that would otherwise remain pending for a long time, thus, unduly delaying AFG's ability to reorganize, estimation pursuant to section 502(c) is required. Courts have established this to be a primary purpose of section 502(c)'s mandatory provisions.

The Second Circuit's decision in *Mazzeo v. United States (In re Mazzeo)*, 131 F.3d 295 (2d Cir. 1997), is in accord. In *Mazzeo*, a chapter 13 case concerning debtor eligibility, the Second Circuit held a claim is "'liquidated' . . . where the claim is determinable by reference to an agreement or by a simple computation." *Id.* at 304 (quoting 2 *Collier on Bankruptcy* ¶ 109.06[2][c] (15th ed. rev. 1997)). On the other hand, "[i]f that value depends instead on 'a future exercise of discretion, not restricted by specific criteria, the claim is unliquidated.'" *Id.* (quoting *United States v. Verdunn*, 89 F.3d 799, 802 (11th Cir. 1996)). Here, it is the IRS's own attempt to invoke its discretion on many issues that renders the IRS Claims unliquidated. To date, the IRS Claims have not been determined, because there has been no resolution of the proper characterization and discount rate applicable to the Post-2004 Contracts. The parties are lacking the "simple computation" to be used to calculate or ascertain the Debtor's liability. In fact, the IRS has admitted that no retrospective guidance has yet been promulgated regarding tax treatment of the pay-as-you-go CDS contracts at the heart of the tax issues here. *See Answer of the IRS in Adversary Proceeding*, ¶ 19.

Subsequent to filing the Answer, the IRS proposed regulations to deal with this very issue. Those proposed regulations require that credit default swaps such as the Post-2004 Contracts to be treated as notional principal contracts. Thus the proposed regulations resolve a fundamental issue in this case in favor of the Debtor. Although the proposed regulations are prospective, 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). 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 in the Adversary Proceeding.

In *Verdunn*, a decision on which the *Mazzeo* court heavily relied and quoted, the Eleventh Circuit rejected the debtor's argument that a tax claim was unliquidated. Because there were "established Internal Revenue Code criteria" by which to calculate the amount of the debtor's liability, the *Verdunn* court held that the IRS's claim in that case was liquidated, and therefore should be included in the determination of whether that debtor was chapter 13 eligible. *Verdunn*, 89 F.3d at 803. There, the IRS rules and regulations were well established.<sup>5</sup>

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<sup>5</sup> The *Verdunn* and *Mazzeo* cases also differ obviously from the case at bar because those cases were decided under Bankruptcy Code section 109(e), and considered whether the initiation of those cases was allowed based on the asserted value of disputed claims against the respective debtors. Bankruptcy Code section 109(e) serves as a gatekeeper to chapter 13 eligibility, in which the amount of asserted claims, even if the existence of the claims is disputed, is the determinant. Section 502(c), on the other hand, is a section of the Bankruptcy Code that facilitates (and, indeed, mandates) expedited resolution of a viable case where unknowns as to the debtor's liability to make distributions on allowed claims would otherwise prevent reorganization. Given the different perspectives of these sections of the Bankruptcy Code, even should the terms "contingent and unliquidated" be construed to focus on the asserted claim versus the estate's allowance of and liability for distributions on that claim, a court faced with an immediate threat to an otherwise viable reorganization effort may, nonetheless, estimate under section 502(c). "Section 502(c) requires estimation in certain circumstances; it does not prohibit estimation in circumstances other than those set forth in the section." *In re King*, 102 B.R. 184, 186 (Bankr. D. Neb. 1989) (dismissing an

In AFG's case, on the other hand, according to the IRS, the tax calculation criteria have yet to be established. The case is more like the examples cited in footnote 13 of *Verdunn*, 89 F.3d at 802, n.13 (quoting 1 *T. Sedgwick, Measure of Damages*, § 300 at 570 (9th ed. 1912)), where "the elements from which to ascertain the amount of the demand are wholly at large." Here, the IRS Claims depend on determinations of (a) whether the IRS abused its discretion (i) by adjusting the Debtor's claim for losses, and (ii) by failing to respond to the Debtor's request for a change of accounting method, (b) whether the IRS is estopped by its prior inaction, and (c) whether the "impairment" method applied by the Debtor clearly reflects the income and deductions resulting from CDS contracts such that the Debtor is entitled to the Tax Refunds. Without answers to these elements that are needed to determine losses on the Post-2004 Contracts, the IRS demand remains "wholly at large." *Id.* The lack of resolution and the delays inherent in resolving the issues through the Adversary Proceeding and possible appeals, which threaten the reorganization case, mandate estimation.

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objection to a proof of claim on the basis that the amount of such claim was estimated). In fact, contingent and unliquidated claims are simply illustrations of the types of claims Congress intended for bankruptcy courts to estimate to allow for the timely and efficient resolution of a debtor's bankruptcy case.

section 502(c)] requires the estimation of any claim liquidation of which would unduly delay the closing of the estate, *such as* a contingent claim, or any claim for which applicable law provides only an equitable remedy, such as specific performance. This subsection requires that all claims against the debtor be converted into dollar amounts.

H. Rep. No. 595, 85th Cong., 1st Sess. 354, *reprinted in* 1977 U.S. Code Cong. & Admin. News 5963, 6310; S. Rep. No. 989, 95th Cong., 2d Sess. 65, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5851. (emphasis added). Here, resolution of the IRS Claims through full trial proceedings will unduly delay, and thus terminate, the Debtor's reorganization. Section 502(c) was clearly enacted to prevent just such an outcome. And also, here, the contingent and unliquidated state of the IRS Claims is not due to a dispute by the Debtor as to whether it is required to pay taxes (no doubt, we are all required to pay taxes); the IRS Claims are contingent and unliquidated because the parties have not resolved issues that will allow the Debtor's liability (or non-liability) to be calculated.

**A. The Proposed Order Establishes Appropriate and Necessary Procedures for Estimation of the IRS Claims.**

Neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure provide procedures or guidelines for estimation. Other than having to satisfy due process requirements of notice and hearing, bankruptcy courts have wide discretion in estimating claims. *Chemtura*, 448 B.R. at 648 (citing *In re Thompson McKinnon Sec., Inc.*, 191 B.R. 976, 989 (Bankr. S.D.N.Y. 1996)); *see also In re Seaman's Furniture Co. of Union Square, Inc.*, 160 B.R. 40, 42 (S.D.N.Y. 1993) (method of estimating claim may only be reversed for abuse of discretion). To estimate the allowable amount of a claim, "the bankruptcy court should use whatever method is best suited to the circumstances" at issue and recognizing that absolute certainty is not possible. *Addison v. Langston (In re Brints Cotton Mktg., Inc.)*, 737 F.2d 1338, 1341 (5th Cir. 1984) (quoting 3 *Collier on Bankruptcy*, ¶ 502.03 at 502-77 (15th ed. 1983)). Although the court is bound by the legal rules that govern the ultimate amount of the claim, it has wide discretion in establishing the method to be used to arrive at an estimate of the amount of a claim or claims. *Id.*; *see also Bittner v. Borne Chem. Co.*, 691 F.2d 134, 135 (3d Cir. 1982) (estimation requires only "sufficient evidence on which to base a reasonable estimate of the claim"); *In re Windsor Plumbing Supply Co., Inc.*, 170 B.R. 503, 521 (Bankr. E.D.N.Y. 1994) (advocating use of probabilities in estimation of claims rather than more simplistic all or nothing approach); *In re Baldwin-United Corp.*, 55 B.R. 885, 898 (Bankr. S.D. Ohio 1985) (estimation "does not require that the bankruptcy judge be clairvoyant").

Precedent reveals that estimation procedures may be employed to ascertain claims in summary proceedings, as guided by due process, and that the bankruptcy court's method of estimation is generally reviewed only for abuse of discretion. For example:

- In *In re Baldwin-United Corp.*, 55 B.R. 885, the court held an estimation hearing involving hundreds of millions of dollars of claims before the bench, and the hearing lasted only one full day. *Id.* at 899. "While generally consistent with the concept of a summary jury trial, the procedures called for no jury, and allowed live testimony by one witness per party. The order also set a discovery cutoff date, and allotted two days for the hearing." *Id.* (citations omitted).
- *In re Enron Corp.*, No. 01-16034, 2006 WL 544463 (Bankr. S.D.N.Y. Jan. 17, 2006) estimated a disputed claim for purpose of establishing an amount to retain in reserve. *Id.* at \*1. The Motion attaches as Exhibit E thereto 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*"). The *Enron Order* was entered by this court on February 18, 2004 in the chapter 11 case of *In re Enron Corp.*, Case No. 01-16034 (AJG) and provides an example of the brevity that may be imposed upon the estimation process, even when dealing with complex fraud claims and litigants much less sophisticated than the IRS.

- In *Bittner v. Borne Chemical Co.*, 691 F.2d at 135, "[t]he parties agreed to establish guidelines for the submission of evidence at the hearing, and, in accordance with this agreement, the bankruptcy court relied on the parties' choice of relevant pleadings and other documents related to the state court litigation, and on briefs and oral arguments."
- The court in *In re Apex Oil Co.*, 92 B.R. 843 (Bankr. E.D. Mo. 1988) entered an order establishing summary trial procedures for estimation purposes, which included allowing each party only six hours to present their case with an additional forty-five minutes for closing remarks.
- In *In re MacDonald*, 128 B.R. 161 (Bankr. W.D. Tex. 1991), a "summary trial," as described in *In re Baldwin-United*, was used to estimate post-petition claims at \$1.00 based on actions for fraud, RICO violations, securities violations, and real estate fraud.
- The estimation procedure adopted in *Nat'l Labor Relations Bd. v. Greyhound Lines, Inc. (In re Eagle Bus Mfg., Inc.)*, 58 B.R. 421 (Bankr. S.D. Tex. 1993), used a "mini-trial" in which each side had seven hours to present evidence and testimony, as well as time to cross examine the witnesses of the opposing side, to estimate a claim for back pay at \$31,250,000 instead of the amended proof of claim asserting \$142,415,241.00.
- The bankruptcy court in *In re Pacific Gas & Elec. Co.*, 295 B.R. 635 (Bankr. N.D. Cal. 2003), allowed a three-day estimation hearing and determined that claims had no value for purposes of plan feasibility.

- In *In re Lionel LLC*, 2007 WL 2261539, at \*5, the court confirmed that "[i]n general, the truncated trial process that can be developed under 502(c) has been found to be consistent with the dictates of due process of law." (citations omitted).<sup>6</sup>

An estimation result is only overturned if completely unreasonable, where the bankruptcy court has abused its discretion, or the result is clearly erroneous. In *In re Enron Corp.*, 2006 WL 544463, at \*4, the court held that "[t]he standard utilized by an appellate court in reviewing a bankruptcy court's method of estimating a contingent or unliquidated claim is that of abuse of discretion." (Citing *In re Brints Cotton Marketing, Inc.*, 737 F.2d at 1341). In *Bittner*, 691 F.2d at 136, the Circuit Court concluded that:

In reviewing the method by which a bankruptcy court has ascertained the value of a claim under section 502(c)(1), an appellate court may only reverse if the bankruptcy court has abused its discretion. That standard of review is narrow. The appellate court must defer to the congressional intent to accord wide latitude to the decisions of the tribunal in question. Section 502(c)(1) of the Code embodies Congress' determination that the bankruptcy courts are better equipped to evaluate the evidence supporting a particular claim within the context of a particular bankruptcy proceeding.

(Citations omitted.) If the bankruptcy court's finding of fact in relation to the estimation is challenged, the review is limited to the clearly erroneous standard. *Id.* at 136 n.2.

This Court has the discretion to impose the procedures set forth in the Tax Hearing Procedures Order, which is attached as Exhibit D to the Motion. The Tax Hearing Procedures Order establishes reasonable time periods after the close of discovery in the Adversary Proceeding for the parties to present the Unresolved Tax Issues

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<sup>6</sup> In *Lionel*, additional limited discovery was allowed; in the *AFG* case, there will be no such need, as extensive discovery has already been taken per the consensual, often-extended discovery process in the Adversary Proceeding.

surrounding resolution of the IRS Claims, and for a hearing at which evidence and witnesses may be presented in summary form and legal arguments may be evaluated. Pursuant to the Tax Hearing Procedures Order, the parties each have ten (10) business days in which to submit statements of either objection to the IRS Claims or in support of the IRS Claims (as the case may be), five (5) business days to respond, and the opportunity to submit pre-hearing statements outlining outstanding issues to be resolved, and evidence to be presented. At a summary hearing, to be held on November 21, 2011 or as soon thereafter as this Court can hear the matter, the parties will have the opportunity to argue their positions and to present fact and expert witnesses. The procedures set forth in the Tax Hearing Procedures Order afford ample due process, yet permit this Court to determine and/or to estimate the IRS Claims for purposes of allowance and distribution in a timely manner that will protect the Debtor's reorganization effort.

**B. The IRS Claims Should be Estimated for Purposes of Allowance and Distribution.**

Claims estimation "can be used for a variety of purposes, including determining voting rights on a reorganization plan, gauging plan feasibility, determining the likely aggregate amount of a related series of claims, setting claim distribution reserves, or . . . allowing claims." *Chemtura*, 488 B.R. at 649 (citations omitted). Here, estimation for purposes of allowance and calculation of a distribution will enable the Debtor to reorganize in a timely manner, so as to maximize the estate's value for the benefit of all parties. If the IRS Claims are not estimated, the delay and expense inherent in the litigation required to resolve the IRS Claims will endanger an otherwise viable reorganization effort, which has already overcome significant hurdles.



The IRS Claims will remain unresolved and confirmation impossible until the questions posed by the Adversary Proceeding can be determined. In the meantime, lack of a resolution will destroy the Debtor's ability to administer its reorganization case and to reorganize so as to preserve value for all parties. Therefore, this Court must estimate the IRS Claims pursuant to section 502(c) of the Bankruptcy Code, and should establish procedures for estimation as described in the proposed *Order (1) Determining that Claim Numbers 3694 and 3699 Filed by the 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*, attached to the Motion as Exhibit D.

**CONCLUSION**

The Motion should be granted.

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New York, NY

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