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 Official Committee of Unsecured Creditors*

UNITED STATES BANKRUPTCY COURT
 FOR THE SOUTHERN DISTRICT OF NEW YORK

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	:	
In re:	:	Chapter 11
	:	Case No. 10-15973 (SCC)
AMBAC FINANCIAL GROUP, INC.,	:	
	:	
Debtor,	:	
-----	:	
AMBAC FINANCIAL GROUP, INC.,	:	Adv. Pro. No.: 10-4210
	:	(SCC)
Plaintiff,	:	
and	:	
	:	
THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS,	:	
	:	
Intervenor,	:	
v.	:	
	:	
UNITED STATES OF AMERICA,	:	
	:	
Defendant.	:	
-----	x	

**JOINDER OF THE OFFICIAL COMMITTEE OF UNSECURED
 CREDITORS TO THE 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 AND TO THE DEBTOR'S
MEMORANDUM OF LAW IN SUPPORT THEREOF**

AND

REQUEST THAT THE IRS' CLAIMS BE ESTIMATED AT ZERO

The Official Committee of Unsecured Creditors (the "Committee") of Ambac Financial Group, Inc. ("Ambac" or the "Debtor") by and through its undersigned counsel submits this joinder (the "Joinder") to the Debtor's Motion, dated October 12, 2011 [Docket No. 632] and the Debtor's supporting Memorandum of Law also dated October 12, 2011 [Docket No. 633]. The Committee reserves all rights to be heard before the Court with respect to this matter.

The Committee also requests that the IRS's Claims be estimated at *zero* for the reasons set forth in the Debtor's Motion and supporting Memorandum of Law, and particularly for the following reasons, which are more fully explained herein:

- On September 15, 2011, the Treasury Department and the IRS promulgated proposed regulations which effectively concede the Debtor's tax return position regarding the nature of the Post-2004 CDS contracts.
- In light of this concession, the Claims are based on the erroneous premise that the Debtor required the prior consent of the IRS to report and deduct impairment losses on the Post-2004 CDS contracts.
- The Defendant's primary technical witnesses have been unable to rebut neither the discount rate the Debtor used to compute the losses at issue in this case nor the reasonableness of the accounting method used by the Debtor in determining those losses.

I. The Defendant's Proposed Regulations Constitute a Concession of the Key Substantive Issue in This Proceeding

The Internal Revenue Service and the Treasury Department are charged by statute to provide authoritative regulatory guidance on behalf of the Defendant. Treasury Regulations have the force and effect of law. *See Mayo Found. for Medical Educ. & Research v. United States*, 131 S.Ct. 704 (2011). Recent proposed Treasury regulations dictate that credit default swaps (“CDSs”) shall be treated as notional principal contracts (“NPCs”) for federal income tax purposes. Whether the Debtor’s CDS contracts are NPCs has been the key substantive issue in this proceeding. Indeed, the unresolved nature of this issue was the primary basis upon which the Defendant predicated its motion to withdraw the case to the district court.¹ Even though such regulations are technically only effective on a prospective basis, the Defendant has effectively conceded the substance of the controlling issue in favor of the Debtor and, thus, the merits of the Debtor’s case.

On September 15, 2011, the IRS and the Treasury published proposed regulations under the rulemaking authority granted by section 446 of the Internal Revenue Code (“IRC”). Specifically, Prop. Reg. § 1.446-3(c)(1)(iii) declares that the definition of notional principal contracts includes credit default swaps. The following explanation was provided by these agencies in the preamble to the regulations:

In Notice 2004-52 (2004-2 CB 168), the Treasury Department and the IRS described four possible characterizations of a credit default swap. See § 601.601(d)(2)(ii)(b). These proposed regulations resolve this uncertainty by adding credit default swaps to the list of swaps categorized as notional principal contracts governed by the rules of § 1.446-3.

¹ Despite the Defendant’s multiple requests since its filing on January 13, 2011, the District Court has not to date scheduled such motion for a hearing.

The IRS first announced it was studying the proper characterization of credit default swaps in 2004. Because of the growing importance of the credit default swap instrument to world financial markets, the IRS invited and received comments from major market participants and others. *See* IRS Notice 2004-52 (2004-2 C.B. 168). After conducting a thorough study of these comments and of the complex administrative factors relating to the resolution of the tax aspects of important financial products, the Treasury and the IRS definitively established in the proposed regulations that CDS contracts were notional principal contracts. This is exactly the treatment that the Debtor adopted for the Post-2004 CDS contracts at issue in this case.

As the Debtor notes, the proposed regulations are effective with respect to contracts entered into on or after the date final regulations are issued. However, given the importance of proposed regulations generally as an authoritative statement of what the rules will be, the IRS has instructed every IRS attorney to refrain from taking any position in litigation contrary to proposed regulations. *See* Chief Counsel Notice 2002-043 (October 17, 2002) (the “Notice”).

The Notice is exceptionally clear:

It has been a longstanding policy of the Office of Chief Counsel that we are bound by our published positions, whether in regulations, revenue rulings, or revenue procedures, and that we will not argue to the contrary. Accordingly, we do NOT take positions in litigation . . . inconsistent with a position that the Service has taken in published guidance *or in proposed regulations*. This policy applies even when attorneys disagree with the published guidance or even if there are plans to revoke, change or clarify the position taken in the published guidance.

(Italics only added.) Proposed regulations typically are prospective as of the date of final issuance. Thus, the IRS has explicitly instructed its attorneys to abandon litigating positions contrary to regulatory rules even those that *are not yet effective*.

Particularly in the face of the Notice’s directive, we are not aware of any sound basis for the IRS’ continuance of its defense in this case. The IRS’ present substantive defense on this

issue undermines the integrity of the published guidance, which guidance is not in the purview of the Department of Justice but that of its client agency.

The incongruity of the IRS' stance in this case could not be clearer: while the IRS after arduous study and analysis has now definitively concluded that the credit default swaps at issue should properly be treated as notional principal contracts, it is asking this Court to adjudge that the Debtor's prior determination to that effect be deemed invalid. To avoid such a manifestly inequitable ruling, the Debtor's Post-2004 CDS contracts should be treated as NPCs.²

II. The Defendant's Position Is Based on the Erroneous Premise that the Debtor Needed Prior IRS Consent to Report Impairment Losses

The other major legal issue in this case relates to the IRS' insistence that the Debtor adhere to a procedural requirement to obtain IRS consent before changing an accounting method. *See* IRC section 446(e). However, the consent requirement does not apply where there has been no change in accounting method. Here, the Debtor's (correct) adoption of NPC treatment for its Post-2004 CDS contracts enabled it to also adopt for the first time a new accounting method for the losses generated by those contracts. The Debtor has called this the statutory impairment method. In doing so, the Debtor did not *change* an established method. Instead, it applied a new method with respect to a new accounting item, i.e., reasonably anticipated credit protection payments on the Post-2004 contracts.³ Thus, the consent requirement of section 446(e) does not apply to the Debtor's use of a method to account for and deduct contract losses.

Different cash flows occur during the course of an NPC. Under the NPC characterization of the Post-2004 CDS contracts, the 1993 NPC regulations identify three separate cash flows: (i)

² Of course, quite independently of the effect of the proposed regulations on the Government's litigating posture, the Debtor has made an ample showing in its pleadings and discovery responses that its Post-2004 CDS contracts satisfy the criteria for NPC classification under the existing regulatory regime.

³ No such payments had been previously anticipated by the Debtor.

periodic payments, i.e., payments by the counterparty to the Debtor akin to premium payments (Treas. Reg. § 1.446-3(e)(1)), (ii) nonperiodic payments, here the contingent payments from the Debtor to the CDS counterparty upon the occurrence of a credit event (Treas. Reg. § 1.446-3(f)(1)), and (iii) termination payments (Treas. Reg. § 1.446-3(h)(1)).

The treatment of these distinct cash flows as separate accounting items is consistent with the 1993 NPC regulations and supported by authorities. *See* Rev. Rul. 2002-30, 2002-1 C.B. 971; *Capital One Financial Corp. & Subs. v. Commissioner*, 130 T.C. 147 (2008). In Rev. Rul. 2002-30, the IRS addressed the question of accounting methods with respect to two cash flows of an NPC: the periodic premiums and the nonperiodic payments. It concluded that two separate accounting methods should apply to these cash flows. For the premium payments, it required recognition under a daily ratable method. For the nonperiodic payments, it required recognition under an “economic substance” accounting method. In *Capital One*, the IRS successfully argued that credit card late fee income was a separate accounting item from credit card interest income. The IRS, and the Tax Court, rejected the taxpayer’s argument that late fee income was a component of interest. Thus, *Capital One* was not entitled, absent IRS consent, to apply the same accounting method to its late fee income that it used for its interest income.⁴

In light of these authorities, the separate cash flows of the Debtor’s Post-2004 CDS contracts, like the separate income streams addressed in *Capital One* and the periodic and nonperiodic payments in Rev. Rul. 2002-30, are appropriately treated as separate accounting items. The Debtor was thus entitled to adopt a reasonable method of accounting with respect to

⁴ The Defendant’s own witness, Diana Imholz, provided consistent testimony in her deposition. Ms. Imholz is the branch chief at IRS Chief Counsel in charge of guidance regarding financial products. When asked whether the Debtor used the wait and see method, she replied that she believed they used the option method but that “I think wait and see – you can do wait and see for one side, but not the other.” *See* ¶ 8, Exhibit A, Affidavit of Edward L. Froelich attached hereto (hereinafter “Froelich Aff.”). In effect, according to Ms. Imholz, a taxpayer can apply one method to one “side” or payment of a CDS contract, and a different method to the other side or payment.

the anticipated credit protection payments on the Post-2004 CDS contracts. It did not need prior IRS consent to adopt its statutory impairment method.

Furthermore, it is clear that the Defendant rejected the use of the “wait and see” accounting method for NPC contingent nonperiodic payments in favor of a reasonable amortization method such as the one ultimately adopted by the Debtor. The Debtor had historically used a type of wait and see method with respect to premium payments on its CDS contracts. In the preamble to the Defendant’s 2004 proposed regulations regarding the proper accounting for contingent nonperiodic payments on NPCs, the Defendant raised several criticisms of the wait and see method and encouraged instead the use of a reasonable estimation or amortization method. *See* 69 Fed. Reg. 8886 (February 26, 2004). In light of this specific instruction of the IRS, the Debtor refrained from extending the wait and see method it had adopted for its premium income payments to the contingent nonperiodic payments, i.e., the anticipated credit protection payments, and instead applied a reasonable amortization method. So, not only was the Debtor entitled to adopt a new method to account for the anticipated credit protection payments, it did so in a manner consistent with the Defendant’s specific guidance.

III. The Defendant’s Technical Witnesses Have Not Provided Any Significant Criticism of the Debtor’s Statutory Impairment Method

Without its arguments that (1) the Debtor’s CDS contracts are not NPCs and (2) that the Debtor needed prior IRS consent to adopt the statutory impairment method, the Defendant is left with attacking the validity of the method itself. To date, its primary technical witnesses, Mr. Mott, an IRS Engineer, and Dr. David LaRue, a proposed expert witness, have been unable to offer a fundamental critique of the Debtor’s impairment method.

Taking Mr. Mott first, he was tasked with examining the soundness of the discount rate that the Debtor used to compute the present value amounts of anticipated impairments on the

CDS contracts. Mr. Mott is not an economist, engineer, CPA, tax professional, actuary or lawyer. While Mr. Mott claimed in his Engineer's Report that the discount rate was too low, and therefore that the impairment losses were too high, he did not state what the rate should be in that report and was unable during his deposition to provide any information regarding what the appropriate rate should be. When asked for the basis for his position that the Debtor's methodology to compute the discount rate was flawed he responded that the Debtor had orally advised him that it had not considered all relevant assets. (*See* ¶ 11, Froelich Aff.) This testimony was plainly inconsistent with the Debtor's written response which it provided during the IRS audit which stated that relevant assets were taken into account in accordance with relevant statutory accounting guidelines. (*Id.* at ¶ 12.) In fact, during the deposition, counsel reconstructed the computational process with Mr. Mott at the end of which Mr. Mott agreed that the rate used by the Debtor was consistent with the relevant asset values and investment income (the two primary factors in determining the discount rate) as reflected in the Debtor's financial statements. (*Id.* at ¶ 13.) Mr. Mott further admitted that the weighted average return on assets was the appropriate method to value the relevant assets. This was the methodology used by the Debtor. (*Id.* at ¶ 14.) In short, Mr. Mott's conclusions regarding the Debtor's discount rate amount to nothing more than aspirations based on irrelevant or erroneous data.

Dr. LaRue was tasked with examining the adequacy of the Debtor's statutory impairment method generally. He holds degrees in business, accounting and economics. While he clearly has expertise and experience in GAAP financial accounting, he has none in statutory or SAP accounting. SAP accounting principles, and not GAAP, are the basis for the financial statements of Ambac's operating subsidiary, AAC, which is the entity that incurred the CDS contract losses at issue in this case. Putting aside Dr. LaRue's lack of expertise in a critical accounting field, his

report provides no economic analysis regarding whether the Debtor's statutory impairment method clearly reflects income within the meaning of IRC section 446(b). His report instead identifies several alleged features of the Debtor's method which result in a "systematic distortion of income." Those features are: (i) that the Debtor offset the impairment losses by the claims paying ability of its subsidiary, ACP, (ii) that the Debtor offset the impairment losses by future premiums on non-impaired CDS contracts and (iii) that the Debtor offset the losses with the premiums from the impaired CDS contracts. However, even assuming the validity of Dr. LaRue's critique, correction of these features result in an *increase* of statutory impairment losses. An increase in statutory losses creates a corresponding increase in tax losses. These so-called distortive features thus are not compelling reasons to invalidate the Debtor's method as a whole. In the final analysis, Dr. LaRue's report does nothing to undermine the overall adequacy of the Debtor's impairment method as a reasonable estimation and amortization method.

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WHEREFORE the Committee respectfully requests that this Court issue an order, granting (i) the relief requested in the Motion, or alternatively, (ii) that Claims 3694 and 3699 be estimated at zero and (iii) such other and further relief as the Court may deem just and appropriate.

Dated: October 20, 2011
New York, New York

Respectfully submitted,

/s/ Anthony Princi

Anthony Princi

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Exhibit A to Joinder

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

)	
In re)	Chapter 11
)	
AMBAC FINANCIAL GROUP, INC.,)	Case No. 10-15973 (SCC)
)	
)	
Debtor.)	
)	

AFFIDAVIT OF EDWARD L. FROELICH IN SUPPORT OF

**JOINER OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS TO THE
 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 AND TO THE DEBTOR’S MEMORANDUM OF LAW IN
 SUPPORT THEREOF**

AND

REQUEST THAT THE IRS’S CLAIMS BE ESTIMATED AT ZERO

IN THE CITY OF WASHINGTON)
) ss.:
 THE DISTRICT OF COLUMBIA)

I, Edward L. Froelich, being duly sworn, state the following under penalty of perjury.

1. I am an attorney in the law firm of Morrison & Foerster LLP (“Morrison & Foerster” or the “Firm”). The Firm maintains offices for the practice of law, among other locations in the United States and worldwide, at 2000 Pennsylvania Ave., N.W., Washington, D.C. I am an attorney duly admitted and in good standing to practice before the Courts of the District of Columbia, the State of Maryland, the United States Tax Court, the United States Court of Federal Claims, and the United States Supreme Court.

2. I submit this Affidavit (the “Affidavit”) in support of the Joinder of the Official Committee to the Debtor’s motion, dated October 12, 2011 (the “Motion”) [Docket No. 632] for an 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. Except as otherwise indicated, the facts set forth in this Affidavit are personally known to me and, if called as a witness, I could and would testify thereto.

3. Morrison & Foerster has been retained as counsel to the Committee in the Debtor’s Chapter 11 case. I have been involved in Morrison & Foerster’s representation of the Committee throughout this Chapter 11 case, primarily in the adversary proceeding, No. 10-4210, in which the Committee is an intervenor (the “Adversary Proceeding”).

4. Pursuant to the Adversary Proceeding discovery schedule approved by this Court and modified by agreement of the parties, counsel have taken numerous depositions. Debtor’s counsel deposed two IRS employees: Diana Imholz and Howard T. Mott.

5. I was not present at these depositions but have reviewed the transcriptions thereof and base the following statements on my review.

6. Mr. Imholz was deposed on August 16, 2011 (hereinafter, the “Imholz Deposition”), and her deposition was duly transcribed by a court reporting service hired by the Debtor.

7. Ms. Imholz is the branch chief at IRS Chief Counsel in charge of guidance regarding financial products.

8. A true and correct copy of pages 65-66 of the Imholz deposition testimony are attached hereto as Exhibit 1.

9. Mr. Mott was deposed on August 10, 2011 (hereinafter, the “Mott Deposition”), and his deposition was duly transcribed by a court reporting service hired by the Debtor.

10. Mr. Mott is a financial analyst in the Large Business & International operating division of the IRS.

11. A true and correct copy of pages 89-90 of the Mott Deposition testimony is attached hereto as Exhibit 2.

12. A true and correct copy of pages 123-125 of the Mott Deposition testimony is attached hereto as Exhibit 3.

13. A true and correct copy of pages 126-129 of the Mott Deposition testimony is attached hereto as Exhibit 4.

14. A true and correct copy of page 74 of the Mott Deposition testimony is attached hereto as Exhibit 5.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true
and correct.

Dated: October 20, 2011

/s/ Edward L. Froelich

Edward L. Froelich

Sworn to before me on this
20th day of October, 2011

/s/ Teresa M.S. Brunot

Notary Public

My Commission Expires: February 29, 2012

Teresa M.S. Brunot
Notary Public
District of Columbia

Exhibit 1
Imholz Deposition
Pages 65-66

62	1 DIANA IMHOLTZ 2 became the reviewer of the case, and then Lauren 3 became the docket attorney. 4 Q Oh, so it is still under your 5 jurisdiction? 6 A That is right. 7 Q Thank you for that clarification. 8 Now, let's take a look at the letter from 9 KPMG to the IRS to your attention. It is dated 10 September 2, 2008. It is Bates stamped USA 00566 11 through USA 00568. 12 Do you see that? 13 A Yes. 14 Q What is your understanding of this letter? 15 A My understanding is that in September of 16 2008 Ambac filed this supplemental letter to clarify 17 what their -- what they thought their present method 18 of accounting was, and that -- that based on what 19 they concluded their present method of accounting 20 was they were tweaking what they wanted as far as 21 the proposed method in the Form 3115. 22 Q Did you understand what that tweaking 23 entailed? 24 A I can't say that I read the letter 25 carefully enough to fully appreciate the	64	1 DIANA IMHOLTZ 2 Notional Principal Contracts -- needed to be accrued 3 over the term of the NPC. And they gave two 4 different methods for doing that. 5 The first method was the noncontingent 6 swap -- swap method. 7 The second method was, in some 8 circumstances, taxpayers could elect mark-to-market 9 treatment. 10 Q And what is mark-to-market treatment? 11 A It is basically you value the contract 12 each year, and based on whether or not the value of 13 that contract is positive or negative, that is what 14 you take into account for tax purposes. 15 Q Is your understanding that that is the 16 same as the GAAP treatment for CDS contracts -- or 17 let me rephrase that -- GAAP treatment for Notional 18 Principal Contracts? 19 A I don't know off -- I don't know. 20 Q And you also mentioned the noncontingent 21 swap method. 22 A Right. 23 Q What is that? 24 A Well, it was, in some ways, similar to 25 mark-to-market in the sense that they were trying to
63	1 DIANA IMHOLTZ 2 distinction. When it came in in September of 2008 I 3 would have taken the letter, I would have put it in 4 the file, and I would have left it there just 5 because until we were going to resolve the first 6 issue, we were not going to continue to process the 7 case. 8 Q Do you recall any discussions you had with 9 anyone at KPMG or the taxpayer regarding this letter 10 of September 2, 2008? 11 A No, I do not. 12 Q Did you have any discussions, that you 13 recall, with Joseph Jordan of KPMG? 14 A No, I do not. 15 Q Now, earlier you referred to the proposed 16 2004 regulations. What regulations were those? 17 A The proposed 2004 regulations addressed 18 how to compute -- or how to tax contingent 19 non-periodic payments on Notional Principal 20 Contracts. 21 Q What did they indicate about contingent 22 non-periodic payments on Notional Principal 23 Contracts? 24 A The proposed regs indicated that 25 contingent non-periodic payments needed -- on	65	1 DIANA IMHOLTZ 2 get taxpayers to accrue the contingent payment over 3 the term of the contract. But what they did was 4 they would -- you would have to estimate what you -- 5 you would start out estimating what you thought the 6 payment was going to be. You would spread that out. 7 Then it made you -- it required you to do 8 redeterminations, I think, each year. So if your 9 estimates were not accurate, you would have to 10 readjust your, I guess, the amount each year based 11 on what actually got paid out. 12 Q Was there any other method that the 13 proposed regs permitted the taxpayer to adopt? 14 A I don't believe so. 15 Q Did the proposed regs permit a taxpayer to 16 adopt any reasonable amortization method to amortize 17 contingent non-periodic payments? 18 A The reg tax did not. 19 Q Did the preamble to those proposed regs 20 talk about that? 21 A I think that the preamble may have 22 suggested it. 23 Q Did the preamble or the proposed regs talk 24 about what was known as the wait-and-see method? 25 A I believe the preamble had a discussion

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1 DIANA IMHOLTZ
 2 about wait-and-see.
 3 **Q Do you recall that the preamble indicated**
 4 **that it was rejecting the wait-and-see for --**
 5 A For Notional Principal Contracts. I
 6 believe that they were -- the preamble language was
 7 meant to discourage taxpayers from using
 8 wait-and-see on their Notional Principal Contracts.
 9 **Q Do you know whether or not Ambac was using**
 10 **the wait-and-see method in reporting its**
 11 **contingent -- sorry -- reporting its CDS**
 12 **transactions at any point?**
 13 A They were using option treatment, which
 14 has a similar result in the sense that it defers
 15 income and expense, but I think wait-and-see -- you
 16 can do wait-and-see for one side, but not the other.
 17 But they were doing option treatment.
 18 **Q What is the significance of the preamble**
 19 **to proposed regulations?**
 20 MS. SCHOENBERGER: Object to the form of
 21 the question.
 22 BY MR. HILL:
 23 **Q Do you have an understanding of what the**
 24 **preamble to the proposed 2004 regulations means?**
 25 A In the context of what they generally are

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1 DIANA IMHOLTZ
 2 supposed to be mean I could probably answer that
 3 question.
 4 In general, preambles are meant to explain
 5 why the language in the reg text was -- was included
 6 in. In general, preambles are meant to go through
 7 and say, well, here is why we put this rule in, and
 8 kind of just give a little bit of explanation to
 9 that effect. And so to a certain extent the
 10 preamble in the proposed 2004 NPC regs would have
 11 been meant to kind of explain the thinking as to the
 12 reg text for that -- for that reg.
 13 **Q And do you have familiarity with the**
 14 **proposed regulations in general?**
 15 A I do.
 16 **Q And why does the Service issue proposed**
 17 **regulations?**
 18 A Because it allows -- first, they are
 19 required to under, I guess, the APA. But they do it
 20 because a lot of times, you know, we want to put a
 21 rule out there and we want comments from the
 22 industry as to whether or not those are -- that is a
 23 workable solution, and/or if -- so inevitably what
 24 will happen is once you propose the reg you request
 25 comments. There is usually, at least a public

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1 DIANA IMHOLTZ
 2 hearing scheduled. A lot of times they are
 3 cancelled. But it gives the opportunity for the
 4 industry to kind of comment on, you know, a proposed
 5 regulation and say, well, this is why this rule may
 6 not work, and have you considered this. And so that
 7 is why usually you see a proposed reg.
 8 **Q Does a proposed reg serve any other**
 9 **purpose?**
 10 MS. SCHOENBERGER: I will object to the
 11 question as exceeding the scope of the witness'
 12 authorization.
 13 BY MR. HILL:
 14 **Q Well, let me put it in the context of the**
 15 **proposed 2004 reg that is at issue in the case.**
 16 **Does it serve any other purpose?**
 17 A A proposed reg?
 18 **Q Yes, the proposed 2004 reg.**
 19 MS. SCHOENBERGER: I will object to the
 20 form of the question.
 21 A I think it puts the taxpayer on notice as
 22 to what our thinking is about a particular issue.
 23 For example, here, I think we were trying
 24 to say, you know, just give you a heads up; we think
 25 that if you have a Notional Principal Contract with

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1 DIANA IMHOLTZ
 2 a contingent payment, we think it needs to be
 3 accrued.
 4 **Q Going back to Ambac's Form 3115. Did the**
 5 **Service make a determination at any point that the**
 6 **method of accounting that Ambac was on was**
 7 **permissible or impermissible?**
 8 A As part of processing the Form 3115?
 9 **Q Yes.**
 10 A No.
 11 **Q So you made no determination whatsoever**
 12 **whether the method they were on was permissible or**
 13 **impermissible?**
 14 A That is correct. It was part of the
 15 processing of Form 3115.
 16 **Q Did the Service make a determination as to**
 17 **whether or not the method they were seeking to go on**
 18 **was permissible or impermissible?**
 19 A We would not have gotten to that point as
 20 part of processing the Form 3115, because we had to
 21 first determine whether or not Credit Default Swaps
 22 should be treated as NPCs. Before that decision was
 23 made it would have been difficult to determine
 24 whether or not their proposed method was proper or
 25 improper.

Exhibit 2
Mott Deposition
Pages 89-90

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1 **Howard T. Mott**
2 **use for purposes of discounting loss reserves a rate**
3 **equal to the average rate of return on admitted**
4 **assets?**
5 MR. FILOR: Objection. That type of
6 question is beyond the scope of the engineer
7 report that he did and what he's authorized
8 to testify about. Any general opinions about
9 what types of rates or policies tax, are
10 appropriate for taxpayers generally he should
11 not disclose, it's beyond the scope of what
12 he's authorized to testify about.
13 MR. HILL: Well, I'm asking him not
14 about for tax purposes, I'm asking him, he's
15 testified that he was looking at Ambac's
16 methodology and I'm asking for purposes of
17 computing the discount rate, and I'm asking
18 would it be an appropriate methodology for
19 computing the discount rate for loss reserves
20 as identified in SSAP 60 to use a rate equal
21 to the average rate of return on admitted
22 assets.
23 MR. FILOR: Well, you know, again, I
24 think what you're asking could be interpreted
25 as guidance from the IRS about what taxpayers

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1 Howard T. Mott
2 can do. His findings were what they are. I
3 won't say exactly what the findings are, I'm
4 sure you're going to get there, the findings
5 are for various reasons why what Ambac did
6 with its discount rate were inappropriate.
7 He didn't make a finding what an appropriate
8 rate would be for any particular taxpayer.
9 So that's the distinction that we need to be
10 cognizant of.
11 BY MR. HILL:
12 **Q Can you answer that question?**
13 A My counsel has stated that I should
14 not.
15 MR. HILL: Dan, is that correct,
16 you're instructing him not to answer that
17 question?
18 MR. FILOR: Would you mind reading
19 back the question?
20 (Whereupon, the requested portion was
21 read back by the Reporter:
22 "Question: So are you saying that
23 it's appropriate for an insurance company
24 like Ambac to use for purposes of discounting
25 loss reserves a rate equal to the average

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1 Howard T. Mott
2 rate of return on admitted assets?")
3 MR. FILOR: To the extent that you can
4 answer the question without offering an
5 opinion by the IRS about what an appropriate
6 rate is for companies to use, you can answer
7 it.
8 A In response to your question, the
9 process appears to be guidance for the industry as a
10 whole. To the extent that the process results in a
11 rate, that would be for the individual taxpayer to
12 determine.
13 **Q Well, let me put it this way: Did you**
14 **make a determination as part of your report that the**
15 **methodology that Ambac utilized for purposes of**
16 **determining the discounting of its loss reserves was**
17 **correct or incorrect?**
18 A The key word in your sentence being
19 the process?
20 MR. HILL: Could you read back the
21 question?
22 A My determination was that the process
23 was incorrect.
24 **Q What about the methodology they used?**
25 A The methodology was also incorrect.

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1 Howard T. Mott
2 Had the methodology been correct, the process would
3 have been correct and then the result would have
4 been correct.
5 **Q Did Ambac's methodology involve using**
6 **a rate equal to the average rate of return on**
7 **admitted assets?**
8 A No.
9 **Q And can you explain why?**
10 A According to my research, and the
11 provided definition of admitted assets contained in
12 Plaintiff Exhibit 5, your client did not follow the
13 guidance given to the industry.
14 **Q How did they not follow the guidance**
15 **given to the industry?**
16 A I refer to the meeting that we
17 initially had where Ambac identified its rate as
18 being a derivation of the tax free Muni/GIC rate of
19 that line item of invested -- of admitted assets.
20 Period.
21 **Q And is something wrong with that?**
22 A You read the definition of admitted
23 assets, you're not to take a part of admitted assets
24 in your calculation, according to the industry
25 documentation and guidance provided by NAIC.

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1 Howard T. Mott

2 **Q What admitted assets, to your**

3 **knowledge, did Ambac exclude from its determination**

4 **of the discounting of its loss reserves?**

5 MR. FILOR: Objection to form. Vague

6 as to time.

7 **Q During the period at issue of your**

8 **report.**

9 A I'll reference again the initial

10 meeting held with the taxpayer at which time it

11 identified for the attendees that its process of

12 using or identifying a calculation -- a discount

13 rate was to take the tax exempt Muni/GIC asset class

14 rate of return on admitted assets as being

15 equivalent of its discount rate. That it excluded

16 all other asset classes. Per its statement to us.

17 **Q What other asset classes would that**

18 **entail, do you know?**

19 A If you reference the

20 publicly-available documents, there is a chart that

21 lists all admitted assets as filed with the State of

22 Wisconsin that will detail what you asked about.

23 **Q Let me show you what we'll mark for**

24 **identification as Plaintiff's Exhibit 6.**

25 (Annual Statement of Ambac Assurance

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1 Howard T. Mott

2 **Corporation for Year Ended December 31, 2008**

3 **marked as Plaintiff Exhibit 6, as of this**

4 **date.)**

5 BY MR. HILL:

6 **Q Mr. Mott, do you recognize this**

7 **document?**

8 A Yes, sir.

9 **Q What is it?**

10 A It's the Annual Statement of the Ambac

11 Assurance Corporation of Madison in the State of

12 Wisconsin to the Insurance Department of the State

13 of for the year ended December 31st, 2008.

14 **Q And is this one of the**

15 **publicly-available documents you were just referring**

16 **to?**

17 A Yes, sir.

18 **Q And can you show me in this statement**

19 **what admitted assets you believe that Ambac took**

20 **into account in determining its discount rate and**

21 **what admitted assets you believe they did not take**

22 **into account in determining the discount rate?**

23 MR. HILL: And for the record this is

24 Bates stamped USA016066 through USA016199.

25 MR. FILOR: To the extent, Larry, you

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1 Howard T. Mott

2 know a particular page that would speed the

3 process, feel free to let us know.

4 Otherwise, you know, obviously take your time

5 to look through the document.

6 A (Reviews.)

7 I would reference page S10 -- I'm not

8 sure that's a 1. It could be S-I-zero and then the

9 one, because there's a difference between the one

10 and the I. It's USA Bates 016140.

11 At the top of which page it is

12 entitled Summary Investment Schedule. In the

13 far-right columns they are titled Admitted Assets as

14 Reported in the Annual Statement. There's a

15 paragraph titled 3, Amount, and a paragraph titled

16 4, Percentage.

17 It lists under nine categories

18 entitled One, Bonds, with multiple subcategories.

19 Two, Other Debt and Other Fixed Income Securities.

20 Three, Equity Interest. Four, Mortgage Loans.

21 Five, Real Estate Investments. Six, Contract Loans.

22 Seven, Receivables for Securities. Eight, Cash,

23 Cash Equivalence and Short-Term Investments. And

24 nine, Other Invested Assets. For most of those

25 primary categories there are totals listed in the

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1 Howard T. Mott

2 far-right columns and percentages. Period.

3 **Q Okay. And what is your understanding**

4 **of which of these categories, investment categories**

5 **Ambac did not include in its calculation of the**

6 **discount rate?**

7 A It is my opinion that they derived

8 their number from Category 1.4, and that has

9 subcategories 1.4-1 through 1.4-4.

10 **Q And are you saying that it's your**

11 **opinion that they did not take into account any**

12 **other categories, investment categories listed on**

13 **this page?**

14 A It was the representation by your

15 client that they only use the tax exempt asset,

16 admitted assets in their determination of their

17 discount rate.

18 **Q Was that representation made in**

19 **writing?**

20 A To my recollection, yes, it was made

21 verbally. I questioned them about them and asked

22 them to provide confirmation of such a statement,

23 which I believe they did.

24 **Q Did you independently verify whether**

25 **or not they took these other investment categories**

Exhibit 3
Mott Deposition
Pages 123-125

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1 Howard T. Mott
 2 (Letter dated April 28, 2011 marked as
 3 Plaintiff Exhibit 9, as of this date.)
 4 BY MR. HILL:
 5 Q Why don't you put 8 side by side with
 6 9.
 7 A (Complies.)
 8 Q In Exhibit 8, Bates stamp
 9 AMBAC-USA0497230, second paragraph, you wrote:
 10 Taxpayer stated in the March 24, 2011 meeting that
 11 its admitted reserves were 80 percent invested in
 12 Triple A rated tax exempt Muni/GIC equivalent
 13 obligations yielding approximately 4.5 percent and
 14 stated that the appropriate discount rate to apply
 15 was the risk-free rate of 4.5 percent for U.S.
 16 Treasuries (implied market standard is the 30-year
 17 Treasury maturity) based on investment portfolio
 18 credit profile. Taxpayer was asked to provide
 19 additional detail supporting the calculation of the
 20 4.5 percent discount rate; response attached as
 21 Annex A.
 22 Now, Annex A is at Bates stamp
 23 AMBAC-USA0497295. Take a look at this document. I
 24 think you testified earlier that you hadn't seen
 25 this before.

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1 Howard T. Mott
 2 A Which before?
 3 Q Annex A, document Bates stamped
 4 0497295 through 0497297.
 5 A You'll have to go back to the notes.
 6 I indicated that my report ran through 497294. I
 7 can't, if this is the response, which I believe it
 8 to be, to my IDR, that's a different matter from.
 9 Q Okay. Do you recall seeing this
 10 document, Response to IRS on Discount Rate?
 11 MR. FILOR: Take your time and review
 12 the document.
 13 A (Reviews.) Who's the author of this?
 14 Q This is an IDR response.
 15 A Okay.
 16 Q To the IRS.
 17 A From?
 18 Q From Ambac to the IRS.
 19 MR. FILOR: Take your time to review
 20 it.
 21 A (Reviews.)
 22 If this is a response that you -- it
 23 would have been provided on a disk with a cover
 24 letter from your company and I would have read it.
 25 Q Okay. If you'd take a look at

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1 Howard T. Mott
 2 Plaintiff's Exhibit 9 now.
 3 A Right.
 4 Q Which is right next to you. That is a
 5 letter dated April 28, 2011 written by me to Sashka
 6 Koleva, copied to Howard T. Mott with enclosure.
 7 And if you look at the attachment, that looks like
 8 the same response to IDR, Response to IRS on
 9 Discount Rate as AMBAC0497295 to 297.
 10 A Right.
 11 Q Is that correct?
 12 A It appears to be so.
 13 Q Okay. And turning to the second page
 14 of that document.
 15 A Exhibit 9?
 16 Q Correct. The second page of the
 17 attachment, Response to IRS on Discount Rate.
 18 A Right.
 19 Q If you look midway down the second
 20 paragraph it says: The discount rate of 4.5 percent
 21 was computed in accordance with Statement of
 22 Statutory Accounting Principle 60, paren,
 23 quote-unquote, SSAP 60, end quote, and represents
 24 the average rate of return on admitted assets
 25 recognized for insurance regulatory purposes for the

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1 Howard T. Mott
 2 years ended December 31, 2007 and 2008. Do you see
 3 that?
 4 A Yes, sir.
 5 Q It doesn't say that only the admitted
 6 assets that you identified earlier were included in
 7 that calculation, does it?
 8 A It says: The discount rate of 4.5
 9 percent was computed in accordance with Statement of
 10 Statutory Accounting Principle 60 (SSAP 60) and
 11 represents the average rate of return on admitted
 12 assets recognized for insurance regulatory purposes
 13 for the years ended December 31, 2007 and 2008.
 14 Period.
 15 Q All right. So it doesn't say that any
 16 category of admitted assets were excluded from the
 17 calculation of the discount rate, does it?
 18 A It doesn't say that any assets
 19 category was excluded.
 20 Q Okay. And now take a look at --
 21 THE WITNESS: Excuse me.
 22 (Whereupon, discussion between witness
 23 and counsel.)
 24 THE WITNESS: Thank you.
 25

Exhibit 4
Mott Deposition
Pages 126-129

126	1 Howard T. Mott 2 BY MR. HILL: 3 Q Okay. Let's take a look now at -- 4 let's take a look now at what was previously marked 5 as Plaintiff's Exhibit 6, and turn to Bates stamp 6 USA016070. 7 MR. FILOR: Did you say 16070? 8 MR. HILL: Yes. 9 BY MR. HILL: 10 Q Okay. Do you have that in front of 11 you? 12 A Yes, sir. 13 Q And take a look at line 9. 14 And do you see that it says Net 15 Investment Income Earned (Exhibit of Net Investment 16 Income Line 17)? Do you see that? 17 A Uh-hum. 18 Q And do you see under column 1 for the 19 current year the number is \$460,961,000 and -- I'm 20 sorry, let's try that again -- \$460,961,520? 21 A Yes, sir. 22 Q And I'm going to ask you to plug that 23 number into this calculator. 24 A Is this preprogrammed? 25 Q No. Did you enter that number?	128	1 Howard T. Mott 2 you have in the calculator, the 461,000, roughly, by 3 that number 10 billion? 4 A Is this thing adjustable for -- 5 MR. LYNCH: You don't have enough 6 numbers? 7 THE WITNESS: No, it's too big. 8 MR. LYNCH: Is it too big? 9 THE WITNESS: I mean, it could default 10 to an E coefficient if I take it to the 11 fourth decimal, but the way it's set up. If 12 you want a round -- 13 MR. LYNCH: Yeah. 14 THE WITNESS: I think that will serve 15 the purpose if you do the 461 divided by 16 10,400. 17 MR. LYNCH: That's fine. 18 A 0.0443, approximately. 19 THE WITNESS: Is that close enough for 20 you? 21 MR. LYNCH: Yes. 22 BY MR. HILL: 23 Q So that's roughly 4.43 percent? 24 A Yes, sir. 25 Q And that's pretty close to the
127	1 Howard T. Mott 2 A I did. 3 Q Okay. Now, turn to page USA016140. 4 MR. FILOR: You said 140? 5 MR. HILL: Yeah. 6 A Right. 7 Q And Line 10. Do you see it says Total 8 Invested Assets at the bottom there, Line 10? 9 A Correct. 10 THE WITNESS: I think I just marked 11 these things. Am I supposed to do that? 12 Sorry. 13 BY MR. HILL: 14 Q Then there's a column, Admitted Assets 15 as Reported in the Annual Statement, do you see 16 that, the third column over? 17 A Yes, sir. 18 Q Do you see the number down there in 19 Line 10? 20 A On the column 3, yes. 21 Q Yes. 22 A 10 billion, right. 23 Q 10 billion? 24 A 396,611,270. 25 Q Okay. And could you divide the number	129	1 Howard T. Mott 2 discount rate that Ambac, of 4.5 percent that Ambac 3 came up with for the year 2008; is that correct? 4 MR. FILOR: Objection to form. 5 A 4.43 is close to 4.45. 6 Q Right. 7 A Yes, it is. 8 Q And if I told you that if you applied 9 the same methodology to MBIA and Assured Guaranty's 10 financial statements, you would come up with the 11 discount rates that they arrived at for those years 12 that you cited earlier, would that surprise you? 13 MR. FILOR: Objection to form. 14 A I don't know whether it would or it 15 wouldn't either. I haven't performed the 16 calculations in advance of this meeting. So if I 17 went through the exercise, assuming that the line 18 items that you've provided are acceptable, then yes, 19 I probably would have come up with a number, which 20 may or may not reflect the discount rates assumed by 21 each of those entities for any given year. It's 22 certainly possible. 23 Q All right. We can do that, we can do 24 those mathematics later, but. 25 Let's now turn --

Exhibit 5
Mott Deposition
Pages 74

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1 Howard T. Mott
 2 same time period being evaluated.
 3 **Q And what relevance did this have in**
 4 **terms of how Ambac computed the discount rate?**
 5 A I can't answer that question. If you
 6 would rephrase it.
 7 **Q How did this factor into the findings**
 8 **in your report?**
 9 A Ambac's financial statements publicly
 10 disclosed make reference to the time period of its
 11 liabilities by weighted average, which is the
 12 appropriate thing to do. And I, in my research,
 13 determined that that was addressed within the NAIC
 14 guidance to all of these jurisdictions that it
 15 advises, including the State of Wisconsin.
 16 **Q And when you're referring to Ambac's**
 17 **financial reports, are you referring to what**
 18 **reports?**
 19 A In our -- for purposes of our
 20 conversation today, unless we specify, the general
 21 default will be all the SEC and all of the State of
 22 Wisconsin reports. And then if you want to get
 23 specific, we can do that.
 24 Taking into account that the years
 25 under audit were '07, '08, '09, and the fact that I

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1 Howard T. Mott
 2 reviewed '05, '06 and '010, you can certainly ask me
 3 whatever you want. You want any of those years?
 4 **Q Okay. So you looked at both the**
 5 **statutory financial statements as well as the GAAP**
 6 **financial statements?**
 7 A I looked at the SEC filings and the
 8 State of Wisconsin filings. I not necessarily
 9 pretend to be familiar with the terminology you just
 10 used.
 11 **Q Okay. Do you know what GAAP is?**
 12 A I've heard the acronym, I have no
 13 professional experience or education in that regard.
 14 **Q Okay. And did these particular**
 15 **materials, those Bates stamped 016374 through**
 16 **USA016376, have relevance to the SEC filings from**
 17 **your perspective?**
 18 MR. FILOR: Objection to form, but you
 19 can answer if you understand.
 20 A Yes.
 21 **Q And did they have any relevance**
 22 **related to the statutory financial statements that**
 23 **were filed?**
 24 A Yes, both the previous question and
 25 this question are answered within the context of the

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1 Howard T. Mott
 2 task that I was designated to do, which was to
 3 analyze the process used by your client pertinent to
 4 establishing a discount rate.
 5 **Q Okay. Let's turn next to the document**
 6 **that's Bates stamped USA016377 through USA016378.**
 7 **Do you recognize this particular document?**
 8 A (Reviews.)
 9 Yes. On Bates USA016377, yes.
 10 Yes, on USA016378.
 11 **Q What is USA016377?**
 12 A For purposes of my research, I refer
 13 to reference number 2008 -- 2009 hyphen '09, the
 14 next to last at the bottom of the page, referencing
 15 Statement Reference 60, Disclosure for Financial
 16 Guarantee Insurance Contracts. This is a report
 17 issued by, I can't remember whom, opining on, to
 18 quote: Summer 2009, hyphen, exposed revisions
 19 proposing the establishment of several disclosures
 20 within SSAP No. 60. Disclosures are similar to the
 21 intent of FAS 163 but have been modified to be
 22 applicable under current statutory accounting
 23 guidance. Fall 2009, hyphen, reexposed disclosures
 24 with modifications suggested by the financial
 25 guarantee subgroup. Period. Winter 2009, hyphen,

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1 Howard T. Mott
 2 adopted SSAP No. 60 disclosures. Period. Dated
 3 12/3 -- 12/5/2009. Excuse me.
 4 **Q What did you interpret this to mean?**
 5 A Again, for background purposes for the
 6 issue that I was assigned to, there were changes
 7 being made within the accounting profession
 8 attempting, particularly in regard to the financial
 9 upset in the marketplace, to get their arms around
 10 controlling reporting, accurate reporting of
 11 financial positions. And this is a document that to
 12 my understanding refers to deliberations being made
 13 by the subgroup assigned to this review. And this
 14 is, again, has the stamp at the bottom 2010 National
 15 Association of Insurance Commissioners.
 16 **Q And --**
 17 A Some of this will not have been
 18 pertinent to the years under audit. I can't find
 19 changes in 2010 and attempt to apply them
 20 historically that's out of limits timewise. That's
 21 sort of, what you call it, hindsight.
 22 **Q And it says: Disclosures for**
 23 **Financial Guarantee Insurance Contracts. What is a**
 24 **Financial Guarantee Insurance Contract?**
 25 MR. FILOR: Objection. Asked and