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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration),

Plaintiff,

- against -

AG FINANCIAL PRODUCTS, INC.

Defendant.

Index No. 653284/2011
Justice Bernard J. Fried

PLAINTIFF'S OPPOSITION TO DEFENDANT'S MOTION TO DISMISS
THE FIRST AND THIRD CAUSES OF ACTION OF THE COMPLAINT

TABLE OF CONTENTS

PAGE

TABLE OF AUTHORITIES

PAGE

Cases

Statutes and Rules

Plaintiff Lehman Brothers International (Europe) (in administration) ("LBIE") submits this memorandum of law in opposition to the Motion to Dismiss the First and Third Causes of Action filed by Defendant AG Financial Products, Inc. ("AGFP").

PRELIMINARY STATEMENT

In this lawsuit, LBIE claims amounts that it is rightfully owed on 37 credit derivative transactions entered into with AGFP. These transactions were structured to compensate LBIE, as the buyer of credit protection, in the event of a default or other credit event occurring in relation to specified underlying assets. In exchange, LBIE was to pay regular payments to AGFP, as the seller of the credit protection. These transactions were a vital component of LBIE's credit management strategy. During the financial crisis of 2008 and 2009, the value of these transactions to LBIE increased dramatically. On their early termination, LBIE properly stood to be paid a significant part of that value. In response, AGFP, facing potentially devastating liabilities on the positions, embarked on a bad faith course of conduct aimed at avoiding these payments to LBIE.

LBIE's complaint sets forth three causes of action against AGFP – first, a claim for breach of the covenant of good faith and fair dealing based on AGFP's termination of nine credit derivative transactions in December 2008 (the "December 2008 Transactions"); second, a claim for breach of contract based on AGFP's calculation of the amounts payable upon termination of the remaining 28 credit derivative transactions in July 2009 (the "July 2009 Transactions"); and third, a claim for breach of the covenant of good faith and fair dealing based on AGFP's actions designed to bypass the method for calculating the payment on termination of the July 2009 Transactions set forth in the parties' agreement. AGFP's partial motion seeks dismissal of only LBIE's first and third causes of action.

With regard to the first cause of action, the facts alleged in LBIE's complaint substantiate this claim, and there is no basis for dismissal of this claim as a matter of law. LBIE entered administration (a United Kingdom analogue to bankruptcy) on September 15, 2008, and the parties began to discuss either novation or settlement of the transactions soon after. In the midst of these negotiations, and without communicating with the LBIE team engaged in the discussions, AGFP purported to terminate the nine December 2008 Transactions on a highly technical basis which AGFP relied upon to avoid its contractual liability to LBIE. While LBIE does not dispute that AGFP operated within the corners of its agreement with LBIE, LBIE alleges that AGFP did so with the purpose and effect of depriving LBIE of its contractual benefits. AGFP's argument in its motion that the terminations did not breach an express provision of the agreement misses the point, as New York courts have repeatedly recognized that this argument, if accepted, would excise the implied covenant of good faith and fair dealing from every contract. Assuming LBIE's allegations are true for purposes of this motion, LBIE has clearly stated a claim for breach of the covenant against AGFP.

With regard to the third cause of action, in July 2009, AGFP terminated the remaining 28 July 2009 Transactions, citing LBIE's entry into administration – which occurred nearly a year earlier – as an Event of Default. The parties' agreement required AGFP to calculate a termination payment by applying the "Market Quotation" methodology – *i.e.*, by obtaining quotations from leading broker-dealers in the relevant market on or as soon as practicable after the termination date for the terminated transactions. Only if fewer than three quotations were provided or where the quotations would not produce a commercially reasonable result could AGFP calculate the termination payment using the alternate "Loss" methodology. As alleged in the complaint, AGFP was determined to avoid paying LBIE the money it owed and intentionally acted to bypass the Market Quotation methodology by waiting months to solicit quotations, and then constructed the bidding process to fail by imposing unreasonable bidding procedures to discourage the submission of quotations. AGFP then proceeded to violate the express terms of the parties' agreement by improperly calculating Loss and claiming, contrary to any logical valuation of the transactions in light of the market collapse, that LBIE owed it millions of dollars on the transactions.

LBIE's complaint challenges AGFP's conduct regarding the July 2009 Transactions in two ways: in the second cause of action, LBIE alleges that AGFP breached its contract with LBIE in terms of how to calculate the termination value of the July 2009 Transactions; and in the third cause of action, LBIE alleges that AGFP's conduct in engineering the bidding process violated the implied covenant of good faith and fair dealing.

The Court should reject AGFP's argument that LBIE's claim for breach of the implied covenant with respect to the July 2009 Transactions duplicates its claim for express breach of contract. The latter rests on whether AGFP's use and calculation of Loss complied with the express terms of the parties' agreement, while the former focuses on AGFP's manipulative conduct leading to its assertion that it was entitled to use the Loss method of calculation. Although LBIE cannot recover on both claims, where, as here, they are pleaded in the alternative, claims for breach of the covenant of good faith and for breach of contract are not duplicative and can proceed together to trial.

Accordingly, and as set forth in further detail below, LBIE respectfully submits that the Court deny AGFP's motion to dismiss the first and third causes of action of the complaint.

BACKGROUND

A. The Parties' Agreement and the Transactions

This lawsuit arises out of 37 credit derivative transactions, each referring to underlying bonds or securities, executed between LBIE and AGFP. These transactions were governed by a single common contract between LBIE and AGFP dated as of April 7, 2000 (the "Agreement")[1], which consists of two interrelated documents – the "Master Agreement," a template published in 1992 by the International Swaps and Derivatives Association, and the "Schedule" that amended and supplemented the terms of the Master Agreement. Each of the 37 transactions was further documented by a written confirmation.

The Agreement has terms governing its termination and any payments upon early termination. It provides that a party may terminate the transactions upon the occurrence of an "Event of Default" (Master Agreement § 6(a)), one of which is a party's becoming "subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets." (Master Agreement § 5(a)(vii)(6).)

By selecting the so-called "Second Method," the parties agreed that any payment upon early termination would be made without respect to which party experienced the Event of Default. In other words, if the Non-defaulting Party enjoyed a gain on the terminated transactions, the Non-defaulting Party would be required to pay that amount to the Defaulting Party. (Master Agreement § 6(e)(i)(3).) As AGFP concedes, the parties also agreed in Part 1(f) of the Schedule that any early termination payment would be calculated in accordance with

[1] LBIE entered into the Agreement with ACE Capital RE Overseas Ltd., which, on December 11, 2001, novated its rights and obligations under the Agreement to AGR Financial Products Inc., now called AGFP.

"Market Quotation," which requires the Non-defaulting Party to obtain quotations from leading dealers in the relevant market, known as "Reference Market-makers," to step into the shoes of the Defaulting Party for a replacement transaction or transactions.[2] (Master Agreement § 14 (definition of "Market Quotation"); Mot. at 12.) Only if Market Quotation "cannot be determined or would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result," should the termination payment be calculated by the "Loss" method. (*Id.* (definition of "Settlement Amount").) Section 14 of the Master Agreement defines "Loss" as the:

> amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from any of them).

B. <u>Termination of the December 2008 Transactions</u>

On September 15, 2008, LBIE entered into administration by order of the High Court Chancery Division of England and Wales. (Compl. ¶ 22.) Following the commencement of LBIE's administration, LBIE and AGFP engaged in regular and productive discussions exploring

[2] More specifically, Market Quotation requires the Non-defaulting Party to solicit quotations from "four leading dealers in the relevant market." (Master Agreement § 14 (definition of "Reference Market-makers").) These Reference Market-makers are asked to provide quotations for an amount that they would pay or be paid to enter into a replacement transaction "that would have the effect of preserving for [the Non-defaulting Party] the economic equivalent of any payment or delivery" expected under the transactions terminated by the Event of Default. (*Id.* (definition of "Market Quotation").) If more than three quotations are obtained, the Market Quotation will be the average after eliminating the high and low quotations. If exactly three quotations are obtained, the Market Quotation will be the middle of the three quotations, and if three quotations cannot be provided, "it will be deemed that the Market Quotation . . . cannot be determined." (*Id.*)

a mutually beneficial novation or commutation of the 37 Transactions under the Agreement. (*Id.*)

In the middle of these discussions, AGFP sent to LBIE nine "Notices of Failure to Deliver Reports," dated November 13, 2008, which alleged that with respect to nine of the 37 Transactions, LBIE had failed to provide AGFP with monthly trustee reports relating to the underlying reference obligations. (Zutshi Aff. Ex. 12.) In a letter dated December 23, 2008, AGFP terminated the December 2008 Transactions on that basis, declaring the occurrence of an Additional Termination Event (as defined in the confirmations documenting the December 2008 Transactions). (Zutshi Aff. Ex. 13.) The confirmations for the December 2008 Transactions provide for a separate termination payment calculation that effectively bypasses the relevant provisions in the Agreement. Pursuant to the confirmations governing these transactions, upon the occurrence of an Additional Termination Event, instead of paying an amount in accordance with the Agreement (*i.e.*, Market Quotation), LBIE would owe to AGFP an "Accrued Fixed Payment Amount," which consists of the accrued and unpaid premiums that LBIE owes to AGFP as of the Early Termination Date. (Zutshi Aff. Ex. 4.) On October 7, 2009, AGFP delivered a valuation statement for the nine December 2008 Transactions, in which AGFP stated that LBIE owed it $3,960,319.86. (Compl. ¶ 26.)

AGFP sent these notices and terminated the December 2008 Transactions *without* requesting the information directly from the LBIE personnel engaged in the parties' discussions. Indeed, AGFP could easily have obtained these reports from other sources. (Compl. ¶ 24.)

C. <u>Termination of the July 2009 Transactions</u>

Seven months later, AGFP sent to LBIE a notice, dated July 23, 2009, designating an Early Termination Date under the Agreement, stating that LBHI's bankruptcy and LBIE's

September 2008 order of administration constituted Events of Default under the Agreement. (Zutshi Aff. Ex. 14.) Accordingly, AGFP designated July 23, 2009, as the Early Termination Date for the 28 July 2009 Transactions that had not been terminated in December 2008. This notice did not explain why AGFP waited nearly a year after LBIE's administration to designate an Early Termination Date.

AGFP delivered valuation statements for the July 2009 Transactions in October 2009, (Compl. ¶ 28) but provided no explanation as to why it sent these valuation statements nearly three months after the Early Termination Date, in light of the Agreement's requirement that the party calculate the termination payment "on or as soon as reasonably practicable following the occurrence of an Early Termination Date." (Master Agreement § 6(d)(i).)

D. <u>AGFP Bypasses the Agreement's Selection of Market Quotation</u>

AGFP acknowledged that the parties had agreed to calculate the amount due upon the occurrence of an Early Termination Date pursuant to the Market Quotation methodology. Its valuation statement noted that it had "contacted" 12 Reference Market-makers in an attempt to determine Market Quotations for the July 2009 Transactions but that no Reference Market-maker submitted a bid.[3] AGFP also disclosed that it required all 12 Reference Market-makers to execute and return a confidentiality agreement and agree to bidding procedures imposed unilaterally by AGFP. AGFP represented that only three of the 12 Reference Market-makers agreed to abide by these procedures, and none of the three Reference Market-makers elected to submit a quotation. On that basis, AGFP concluded that it was "not able to determine a Market Quotation for any of the Terminated Transactions," and proceeded to determine the Loss for

[3] Notably, KPMG, which was engaged by AGFP to run the auction process, did not select Henderson Global Investors Limited as auction advisers until over a week after the July 23, 2009, Early Termination Date, and did not engage Henderson until late August.

each of the July 2009 Transactions. Significantly, AGFP did not begin to solicit the quotations required for Market Quotation until almost two months *after* it had already decided to calculate the amount due in relation to the July 2009 Transactions using the Loss methodology. (Compl. ¶ 29.)

E. <u>AGFP's Unreasonable Calculation of Loss for the July 2009 Transactions</u>

As established by market practice, Loss is intended to return the parties to their respective positions at the time when the contract was terminated. (Compl. ¶ 30.) Thus, Loss is ordinarily determined by referring to the market value of the terminated transactions as of the Early Termination Date – or, stated differently, the cost of replacing or re-establishing the economic equivalence of the terminated transactions. As a result, Loss and Market Quotation typically yield similar results. (Compl. ¶ 31.)

Instead of adhering to market practice and expectations, AGFP calculated Loss not based on market valuations but rather based on an internal regulatory accounting calculation which follows a peculiar methodology of present valuation of the positions. By calculating the purported present value of all payments that AGFP expected to receive from LBIE during the entire term of each of the July 2009 Transactions and subtracting from it the sum of all payments it purportedly determined that it would likely have to pay to LBIE during the term of each Transaction, many of which have maturity dates as late as 2033 and 2040, AGFP took the position that LBIE owed it over $24 million. (Compl. ¶¶ 32-33.)

AGFP's internal methodology is *not* what the Agreement provided for, and *not* what the market would expect as a basis for calculating the termination amounts for the Transactions. LBIE's preliminary analysis, based on market data that would ordinarily be expected to be applied in settlements of this nature, indicates that AGFP owes LBIE approximately $1.4 billion. (Compl. ¶ 37.)

On November 28, 2011, LBIE commenced this action, alleging that AGFP's pretextual termination of the December 2008 Transactions violated the implied covenant of good faith and fair dealing, that AGFP's Loss calculation in respect of the July 2009 Transactions breached the Agreement, and that AGFP's course of conduct preceding its valuation of the July 2009 Transactions breached the implied covenant of good faith and fair dealing.

ARGUMENT

On a motion to dismiss pursuant to CPLR 3211, the "pleading is to be afforded a liberal construction." *Arnav Indus. v. Brown, Raysman, Millstein, Felder & Steiner, LLP*, 96 N.Y.2d 300, 303 (2001). The Court "must take the allegations asserted within a plaintiff's complaint as true and accord plaintiff the benefit of every possible inference, determining only whether the facts as alleged fit within any cognizable legal theory." *Samiento v. World Yacht Inc.*, 10 N.Y.3d 70, 79 (2008). Under this liberal standard, the court must deny the motion to dismiss if it determines that the plaintiff is "entitled to relief on any reasonable view of the facts stated." *Campaign for Fiscal Equity, Inc. v. State of New York,* 86 N.Y.2d 307, 318 (1995).

I. AGFP'S TERMINATION OF THE DECEMBER 2008 TRANSACTIONS VIOLATED THE COVENANT OF GOOD FAITH AND FAIR DEALING

AGFP's argument that compliance with the technical terms of a contract insulates it as a matter of law from liability based on the covenant of good faith and fair dealing (Mot. 14-18) rests on an unnecessarily cramped interpretation of the covenant[4] and is contrary to well

[4] Indeed, AGFP's narrow view of the implied covenant of good faith and fair dealing is demonstrated by its citation to *Cohen v. Nassau Educators Fed. Credit Union*, 37 A.D.3d 751 (2d Dep't 2007), *affirming* 12 Misc. 3d 1164A (Sup. Ct. Nassau County 2006), which affirms a

established law. (Mot. at 16-18 (citing cases)). In fact, it is well settled that looking only to the express terms of a contract is insufficient, since "breach of the implied covenant does not depend on the existence of any breach of an express provision of [an agreement]." *Wallace v. Merrill Lynch Capital Servs., Inc.*, 10 Misc. 3d 1062A (Sup. Ct. N.Y. County 2005). Contrary to AGFP's argument, "New York courts have repeatedly affirmed that a party may be in breach of an implied duty of good faith and fair dealing . . . *when it exercises a contractual right* . . . to deprive the other party of the fruit of its bargain." *Gross v. Empire Healthchoice Assur., Inc.*, 16 Misc. 3d 1112A (Sup. Ct. N.Y. County 2007) (emphasis added).

As a result, "'[i]n determining whether a party has breached the . . . covenant of good faith and fair dealing, a court must examine not only the express language of the parties' contract, but also any course of performance or course of dealing that may exist between the parties.'" *Tractebel Energy Mktg. v. AEP Power Mktg.*, 487 F.3d 89, 98 (2d Cir. 2007) (quoting 23 Williston on Contracts § 63:22). This standard is consistent with the scope of the covenant more broadly embracing "a pledge that neither party *shall do anything* which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." *ABN AMRO Bank, N.V. v. MBIA Inc.*, 17 N.Y.3d 208, 228 (2011) (emphasis added) (quotation marks omitted).

Thus, courts have routinely rejected AGFP's very argument – that acting consistent with a contract's express terms establishes a legal defense against any breach of the covenant of good faith. In *Richbell Information Services, Inc. v. Jupiter Partners, L.P.*, the defendant contended

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decision that this Court has held to "reflect a short-sighted view of the New York law on this subject." *Gross v. Empire Healthchoice Assur., Inc.*, 16 Misc. 3d 1112A (Sup. Ct. N.Y. County 2007).

that its unlimited veto right in a stockholder agreement precluded the plaintiff's claim for breach of the implied covenant. *See* 309 A.D.2d 288, 301-02 (1st Dep't 2003). In response, the First Department held that this narrow reading of the covenant had "at least two flaws" – first, a claim for breach requires the court to consider "the entire course of conduct," and second, even an unlimited contractual right "may not be exercised solely for personal gain in such a way as to deprive the other party of the fruits of the contract." *Id.* at 302. Thus, the court upheld the denial of defendant's motion to dismiss, since the complaint sufficiently alleged that the defendant "exercised a [contract] right malevolently." *Id.* Likewise, a party may still breach the implied covenant of good faith and fair dealing when its actions are "technically consistent with" the contract, but "do[] away with the 'fruits' of the contract." *Empresas Cablevision, S.A.B. de C.V. v. JPMorgan Chase Bank, N.A.*, 680 F. Supp. 2d 625, 631-32 (S.D.N.Y. 2010).

AGFP's entire argument regarding termination of the December 2008 Transactions is thus misplaced – LBIE is not arguing that AGFP lacked the contractual authorization to terminate the December 2008 Transactions. Rather, examining the parties' course of dealing, the complaint clearly states a claim that the manner and timing in which AGFP terminated the December 2008 Transactions violated the Agreement's implied covenant of good faith and fair dealing. As a threshold matter, "whether particular conduct violates or is consistent with the duty of good faith and fair dealing necessarily depends upon the facts of the particular case, and is ordinarily a question of fact to be determined by the jury or other finder of fact." *Tractebel*, 487 F.3d at 98 (quotation marks omitted); *Merzon v. Lefkowitz*, 289 A.D.2d 142, 143 (1st Dep't 2001) (same).

Here, LBIE has alleged – and, conspicuously, AGFP's motion does not dispute – that: (1) its purported termination came in the midst of ongoing settlement discussions between the parties; (2) it did not once request from its LBIE negotiation partners the information that it was purportedly denied; and (3) this information was readily available from other sources. Indeed, AGFP could have terminated the Agreement on the basis of LBIE's entry into administration and calculated a Termination Amount using Market Quotation or, if necessary, Loss. Instead, to avail itself of a more advantageous termination payment methodology, it pretextually terminated the December 2008 Transactions by citing LBIE's purported failure – in the immediate aftermath of its entry into administration – to deliver certain reports that were otherwise available, including from the LBIE personnel with whom it was meeting regularly. Whether these facts state a claim for breach of the covenant is a factual question, and LBIE has not yet enjoyed the opportunity to take discovery on any of these issues. *See Richbell*, 309 A.D.2d at 303; *In re Kaszirer*, 298 A.D.2d 109, 110 (1st Dep't 2002). There can be no question that AGFP's manipulative termination of the December 2008 Transactions had the effect of denying LBIE the "fruits" of the parties' Agreement. *Cf. Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389 (1995); *see also Zuckerwise v. Sorceron Inc.*, 289 A.D.2d 114, 114-15 (1st Dep't 2001) (denying motion to dismiss claim that termination breached covenant of good faith).

In sum, here, as in *Richbell*, "[t]hese allegations do not create new duties that negate [AGFP's] explicit rights under a contract, but rather, seek imposition of an entirely proper duty to eschew . . . bad faith . . . in the guise of business dealings." 309 A.D.2d at 302. LBIE has sufficiently pleaded a breach of the implied covenant of good faith and fair dealing.

II. AGFP'S CONDUCT PRECEDING ITS VALUATION OF THE JULY 2009 TRANSACTIONS VIOLATED THE COVENANT OF GOOD FAITH AND FAIR DEALING

AGFP's claim for breach of the duty of good faith and fair dealing with respect to the July 2009 Transactions should not be dismissed as duplicative of its claim for breach of contract.

AGFP is correct that as a general matter a claim for breach of the implied covenant of good faith and fair dealing is redundant where the same conduct is also the predicate for a breach of one of the contract's express terms. (Mot. at 18-19.) Here, however, LBIE has advanced distinct claims for breach of contract and breach of the implied covenant of good faith and fair dealing. LBIE's contract claim turns on whether AGFP violated Section 14 of the Master Agreement by (1) wrongly concluding that Market Quotation could not "be determined or would not [have] (in the reasonable belief of the party making the determination) . . . produce[d] a commercially reasonable result," as set forth in the definition of "Settlement Amount," or (2) failing to calculate Loss "reasonably" and "in good faith," as set forth in the definition of "Loss." (Compl. ¶¶ 45-47.)

In contrast, LBIE's alternative implied covenant claim turns on whether AGFP unreasonably and in bad faith waited nearly a year to cite LBIE's entry into administration as an Event of Default, then waited an additional two months to solicit bids for Market Quotation, and ultimately rigged the Market Quotation auction to fail by imposing unreasonable bidding procedures to discourage the submission of bids. (Compl. ¶ 52.) Thus, even if the Court determines that AGFP did not violate the literal terms of the Agreement, it should find that it has, by its conduct, breached its duty of good faith. *See MBIA Ins. Co. v. GMAC Mortg.. LLC*, 30 Misc. 3d 856, 865 (Sup. Ct. N.Y. County 2010) ("Claims for breach of good faith and fair dealing are not duplicative . . . where claims are not predicated on contractual terms that form the basis for the breach of contract claim."). Likewise, AGFP's contention that both claims seek identical damages is incorrect. As one example, discovery may demonstrate that AGFP's rigged auction prevented the determination of a Market Quotation for some transactions, but not others, leading to different damages flowing from AGFP's breach of the implied covenant. Regardless, at this stage, before any discovery has been produced, any assessment – let alone comparison – of precise damages figures is premature.

Moreover, LBIE properly pleaded these claims in the alternative. As noted above, LBIE has claimed that AGFP breached express provisions of the Agreement that have explicit good faith and reasonableness requirements. (Master Agreement § 14 (definitions of "Settlement Amount," "Loss").) "Whether the covenant of good faith and fair dealing is redundant or inconsistent with the Agreement depends upon the substantive rights and duties conferred by the parties' contract." *IMI Systems, Inc. v. Sterling Software, Inc.*, No. 90 Civ. 2005, 1991 U.S. Dist. LEXIS 14909, at *7 (S.D.N.Y. Oct. 18, 1991). Thus, "where the contract meaning is yet to be determined, a party can continue in both a claim for breach of contract and one for breach of the covenant of good faith and fair dealing." *Fantozzi v. Axsys Techs., Inc.*, No. 07 Civ. 02667, 2008 U.S. Dist. LEXIS 94040, at *22 (S.D.N.Y. Nov. 6, 2008); *see also Hard Rock Cafe Int'l, (USA), Inc. v. Hard Rock Hotel Holdings, LLC*, 808 F. Supp. 2d 552, 567–68 (S.D.N.Y. 2011) (same). A plaintiff is only precluded from recovering on both express and implied contract theories at the same time. *Id.* at 567. AGFP's motion is premature since "New York courts allow the Plaintiff to defer making an election of remedies and damages in cases where there is a dispute over the . . . scope . . . of the putative contract. The Plaintiff is not conceptually precluded from presenting both equitable and contract theories to the factfinder." *Fantozzi*, 2008 U.S. Dist. LEXIS 94040, at *22 (citation and quotation marks omitted).

CONCLUSION

For the foregoing reasons, LBIE respectfully requests that the Court deny AGFP's Motion to Dismiss the First and Third Causes of Action of the Complaint.

Dated: New York, New York
March 9, 2012

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