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New York Supreme Court

APPELLATE DIVISION — FIRST DEPARTMENT

Lehman Brothers International (Europe) (in administration),

Plaintiff-Respondent,

– against –

AG Financial Products, Inc.

Defendant-Appellant.

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PRELIMINARY STATEMENT

Defendant-Appellant AG Financial Products Inc. ("Assured")[1] was a party to 28 credit default swap transactions with Plaintiff-Respondent Lehman Brothers International (Europe) ("Lehman International") under a 1992 ISDA Master Agreement with monoline-specific terms (the "Agreement"), which required Lehman International to make periodic fixed payments to Assured in exchange for Assured's obligation to make so-called "floating payments" to Lehman International in the event of any shortfalls in principal or interest payments on the underlying securities referenced by the credit default swaps (the "Underlying Securities").

Assured properly terminated the transactions in July 2009 based on Lehman International's insolvency. To determine what payments were owed as a result of the early termination, the Agreement required Assured, as the Non-defaulting Party,[2] to conduct a Market Quotation auction to solicit real, executable bids for replacement transactions from other market participants. Because the auction, which the lower court held was conducted in good faith and reasonably designed, resulted in no such bids, the Agreement thereafter gave Assured broad discretion to choose a method for calculating its Loss in connection with the terminated

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[1] AG Financial Products Inc., together with its affiliate, Assured Guaranty Corp., is referred to herein as "Assured."

[2] Capitalized terms have the meaning provided under the Agreement or otherwise herein.

transactions. The Agreement explicitly provided a menu of choices for Assured to compute its Loss, including the "loss of bargain" approach that Assured followed here, and expressly stated that Assured "need not" reference quotations of market prices (even if such quotations had been available) in making its calculation. Here, the results of the auction undisputedly showed that there were no real market prices for the terminated transactions that could even have been referenced.

This appeal concerns the lower court's error in denying Assured's motion for summary judgment by holding that there were triable issues of fact as to whether Assured abused its discretion (1) by determining its Loss based on its loss of bargain, measured by the fixed payments it would have received and the present value of the expected future floating payments it would have paid if the Agreement had continued to completion, and without reference to market price quotations for replacement transactions (where no executable price quotations or actual replacement transactions existed), and (2) by using its own ordinary course of business loss model to calculate the expected future floating payments. As set forth below, the lower court erred as a matter of law on both issues by not granting summary judgment to Assured, including by failing to give effect to the express, unambiguous terms of the Agreement based primarily on Lehman International's incompetent and irrelevant evidence regarding purported custom and practice, and by not granting appropriate deference to Assured's choices for calculating its Loss,

the reasonableness of which was confirmed by overwhelming, undisputed evidence.

Specifically, the lower court erred by failing to recognize that the express, unambiguous terms of the Agreement allowed Assured, in the absence of executable bids for replacement transactions, to use a "loss of bargain" approach to compute its Loss, which Assured did by determining the net amount that would have been owed if the parties had continued to make all payments required under the Agreement through its completion (the "Payment Model"). This approach mirrored the parties' respective obligations under the Agreement. It was error for the lower court to hold on the basis of Lehman International's purported custom and practice evidence that a triable question of fact was raised as to whether Assured should have instead used a pricing model that generated hypothetical market quotations based on the market prices of the Underlying Securities (or proxies thereof) (the "Pricing Model"), in order to estimate the price of a hypothetical replacement transaction unavailable in the real world.

Further, in questioning the appropriateness of the loss of bargain methodology that Assured used, the lower court also failed to apply the properly deferential standard of review, which requires only that the approach Assured took was rational. There is no factual dispute that it was. Indeed, none of Lehman International's purported custom and practice evidence or expert testimony

challenged the appropriateness of the approach Assured chose if the goal was to solve for Assured's own loss of bargain rather than for the theoretical cost of a hypothetical replacement transaction. While conceding the approach Assured took "appear[ed] on its face to be a reasonable method for calculating the value to Assured of the Terminated Transactions," (Record on Appeal ("R.") 79) (emphasis omitted), the lower court, nevertheless, held it could not conclude it was reasonable for Assured to assume no possibility of replacement transactions that could mitigate its loss. But the record is clear that Assured did not "assume" there were no replacement transactions; it properly looked for and found no such transactions when it conducted the Market Quotation auction that the Agreement required. The Agreement then explicitly entitled Assured to calculate its Loss without referring to market quotations.

Rewriting the Agreement, as Lehman International urges, to require the use of a Pricing Model to calculate the value of a hypothetical replacement transaction would give Lehman International a windfall benefit it could not have obtained had it not defaulted. Moreover, based on the inputs of such a model, it would effectively impose on Assured a *post facto* obligation to insure the market value of the Underlying Securities, an obligation it did not—and, as a monoline insurer,

could not under applicable insurance law—undertake.[3]

Finally, the lower court also erred in holding there were triable issues of fact as to whether Assured abused its discretion in calculating its Loss when it used the same predictive Payment Model it generally used in its business—including for financial and statutory reserve reporting to the SEC and insurance regulators—to determine the likely future floating payments in respect of the Underlying Securities it insured. There has been no suggestion that Assured manipulated its model in any way to improve its outcome in this case. It was plainly reasonable and not an abuse of discretion or bad faith for Assured to predict future floating payments by relying on the same model that it used for multiple business and regulatory purposes and that was vetted for reasonableness by its regulators and outside auditors, including by the same major accounting firm that acts as Lehman International's liquidator in this case. This is especially true because Lehman International's expert criticized only certain of the underlying assumptions used in Assured's Payment Model—not the model's outputs—and Lehman International's own contemporaneous predictive models yielded essentially the same results as Assured's Payment Model. See infra at 16-17.

[3] Monoline insurers like Assured cannot guarantee market value, but only future cash flows on a pay-as-you-go basis. See (R. 238-39); see also N.Y. Ins. Law § 6904(d) (McKinney 2018).

QUESTIONS PRESENTED

1. After the Market Quotation auction, which the lower court held Assured conducted properly and in good faith, produced no bids, was Assured contractually entitled to calculate its Loss based on its loss of bargain and without reference to non-executable market quotations or other hypothetical market prices?

   a. The lower court said no and found a triable issue of fact primarily based on purported custom and practice evidence regarding the allegedly common use of hypothetical market price quotations in calculating Loss, even though the Agreement authorized the loss of bargain approach Assured used and explicitly provided that Assured need not determine its Loss by referencing market prices.

2. To justify Assured's methodology in determining Loss, was it sufficient that the approach Assured chose rationally and reasonably reflected <u>its</u> own loss of bargain?

   a. The lower court said no and held that there was a triable issue of fact as to whether Assured should have mitigated Lehman International's alleged loss by considering market conditions and the possibility of replacement transactions, even though the court found Assured

complied with its contractual obligation to conduct a Market Quotation auction, which yielded no executable bids.

3. Was Assured's calculation of Loss reasonable where the calculation was based on the same financial model it used generally in its business, public financial reporting and calculation of insurance regulatory reserves?

   a. The lower court said no and held that Lehman International's expert raised triable issues of fact, even though the expert only challenged some of the assumptions used in Assured's model and not the outputs, which were consistent with those produced by Lehman International's own contemporaneous models.

STATEMENT OF THE CASE

A. The Parties

Assured is a New York-based monoline insurer that, as part of its business, provides guarantees on a variety of financial instruments. Lehman International was an international financial services firm and the primary European broker-dealer for its parent company, Lehman Brothers Holdings Inc. Lehman International filed for insolvency protection and entered into administration in the United Kingdom on September 15, 2008.[4]

[4] PricewaterhouseCoopers was appointed by the High Court Chancery Division of England and Wales to administer Lehman International's estate in insolvency.

B. The Transactions

Assured and Lehman International entered into 28 credit derivative transactions between 2005 and 2008 in which Lehman International purchased credit protection from Assured on senior tranches of various asset-backed securities (the "Transactions").[5] Fourteen Transactions referenced prime UK residential mortgages ("UK RMBS"); twelve Transactions referenced US corporate loans and debt obligations ("CLOs"); and two Transactions referenced subprime US residential mortgages ("ABX") (together, the "Underlying Securities").

When the parties entered into the Transactions, all of the Underlying Securities were AAA-rated senior notes. This was consistent with Assured's business model as a monoline to underwrite to a zero-loss standard, in which the risk of credit loss was extremely remote, and to hold its position in transactions through their maturity.

C. The Terms Of The Agreement Include A Number Of Non-Standard Monoline-Specific Provisions

The Transactions are governed by a standard-form contract entered into by the parties on April 7, 2000, based on a template published in 1992 by the International Swaps and Derivatives Association ("ISDA") (a "1992 Master

[5] The parties also entered into nine transactions that are not currently at issue, having been dismissed from this case at an earlier stage. See (R. 128).

Agreement") and a schedule thereto, along with separate confirmations for each Transaction (together, the "Agreement"). The Agreement provided that Lehman International would periodically make fixed payments to Assured in exchange for credit protection from Assured—in the form of floating payments—should there be shortfalls by the obligors in principal or interest payments on the Underlying Securities.

Importantly, the Agreement contains a number of non-standard terms, consistent with Assured's monoline status. First, the Transactions were subject to a "pay-as-you-go" settlement structure, under which payments on any interest shortfalls were due on a periodic basis, while payments on any principal shortfalls were generally not due until the final maturity of the Transactions, ranging from 7 to nearly 58 years out.[6] Second, Assured's exposure under the Agreement was limited to any such shortfalls, as Assured did not guarantee the market prices of the Underlying Securities. Third, Assured was not required to post collateral in connection with the Transactions.

[6] For the ABX Transactions, Assured potentially could have been required to make floating payments before final maturity in the event of underlying mortgage defaults resulting in the value of the collateral being less than the outstanding principal amount of the applicable Underlying Securities.

D. The Agreement Provides A Right Of Early Termination In The Event Of Default And Requires The Non-Defaulting Party To Calculate A Termination Amount

Under the Agreement, if either party defaults based on a number of enumerated events, including insolvency, the Non-defaulting Party is permitted to terminate the Transactions and has the exclusive right to calculate the termination amount, which, depending upon the circumstances, may be owed by the Defaulting Party to the Non-defaulting Party, or vice versa.

The Parties elected the "Second Method and Market Quotation" approach in the event of early termination. Pursuant to this provision, the Non-defaulting Party must first attempt to calculate the termination amount using the "Market Quotation" method, which requires seeking quotations from leading dealers in the relevant market to step into the shoes of the Defaulting Party for an executable replacement transaction. The Agreement provides that, "[i]f fewer than three quotations are provided, it will be deemed that the Market Quotation . . . cannot be determined." (R. 334-36).

If Market Quotation cannot be determined, the Agreement requires the Non-defaulting Party to calculate its "Loss" using any of the approaches enumerated in the Loss definition, which in its entirety states:

> "Loss" means, with respect to this Agreement or one or more Terminated Transactions, as the case may be, and a party, the Termination Currency Equivalent of an 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). Loss includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication, if Section 6(e)(i)(1) or (3) or 6(e)(ii)(2)(A) applies. Loss does not include a party's legal fees and out-of-pocket expenses referred to under Section 11. A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable, as of the earliest date thereafter as is reasonably practicable. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets.

(R. 341) (emphasis added).

E. Lehman International Defaulted On The Agreement, And Assured Exercised Its Right Of Early Termination As The Non-Defaulting Party

Lehman International triggered an event of default under the Agreement in 2008 when it entered into administration in the United Kingdom. Lehman International's default deprived Assured of the benefit of its bargain, namely Assured's contractual entitlement to receive periodic fixed payments for each Transaction through maturity from a counterparty not subject to an insolvency proceeding in return for Assured's pay-as-you-go commitment to cover any principal and interest shortfalls on the Underlying Securities that actually occurred.

Accordingly, Assured exercised its contractual rights and terminated the Transactions in July 2009.

F. Assured Conducted A Robust Market Quotation Auction, But Was Unable To Obtain Any Executable Quotations For Replacement Transactions

As the Non-defaulting Party, Assured was required to conduct an auction under the Market Quotation method to attempt to obtain at least three executable bids for replacement transactions from leading market dealers. Despite Assured's good-faith efforts in conducting a robust auction process, Assured did not receive a single bid. Assured's expert, Dr. Craig Pirrong, provided an unchallenged opinion that Assured's inability to obtain bids from counterparties "was a result of a lack of appetite in the market for these products, combined with market concerns regarding monoline credit risk." (R. 999) (emphasis added). The absence of bids is also consistent with Lehman International's own internal assessment of the Transactions, as well as its inability to novate or obtain executable bids.

First, shortly after certain of the UK RMBS Transactions were executed, Lehman's Global Head of Valuation Control, Neeraj Chopra—described by a Lehman International employee as "one of the most technically able valuation experts within product control," (R. 1069)—instructed his colleagues to create a modified formula to value those Transactions because "the valuation formula Lehman generally applied to credit default swaps on asset-backed securities . . .

was not an appropriate model to value the Assured Transactions because it did not adequately account for the unique characteristics of the transactions." (R. 1077- 078). These unique characteristics included that Assured was not required to post collateral, and that its payments on most principal shortfalls were not due until the maturity of the Transactions. Chopra also noted the significance of "correlation risk," or wrong-way risk, in valuing the Transactions. Specifically, because the Underlying Securities on which Assured provided credit protection were so highly rated, they were unlikely to require substantial payments by Assured except in a severe and prolonged economic crisis. The correlation risk was that in the event of such a crisis, Assured's required payments across its business might be so widespread that it could not make those payments owed on the Transactions. See (R. 980).

Second, the Lehman International liquidators' own internally prepared valuation analysis explicitly acknowledged that the monoline-specific terms in the Agreement "significantly diminish the value of these contracts." See (R. 1081). They concluded that "[t]he adjusted value of these CDS Contracts is therefore a fraction of any estimate based on standard terms and the appetite for other market counterparts to take over these is severely limited." Id.; see also (R. 1088-089). This view is further reflected in a June 2009 email between then-Joint Administrators of the Lehman International estate, stating that the value of the

Transactions, even if successfully novated, was only between $10 million and $15 million in Lehman International's favor.[7] See (R. 1809-812).

Third, Lehman International's own predictive loss models in 2009 showed that the risk to Assured of having to make payments on the Transactions due to principal or interest shortfalls on the Underlying Securities was very low. As a result, Lehman International attempted to create a "structural assignment" that would allow it to take advantage of the disconnect between the low likelihood of actual defaults on the Underlying Securities and the large theoretical mark-to-market value of credit default swaps with standard terms on those same securities. (R. 1115-122). Lehman International explicitly described the structure as "[a]llow[ing] for the crystallisation of mark to market on contracts that have remote default risk. [Lehman International] will . . . receive this money to the extent that either the Credit Insurer [i.e., Assured] does not default, or the assets do not default – this is a high probability scenario." (R. 1116). In other words, Lehman International's own contemporaneous models predicted the same "remote" risk of principal and interest shortfalls on the Underlying Securities as did Assured.

Fourth, Lehman International also attempted to solicit executable bids on the

[7] Lehman International unsuccessfully attempted to novate the Transactions in late 2008 and early 2009. See (R.1099; R. 1109).

Transactions in July 2009 from traders at four banks with which it had relationships, but without disclosing that Assured was the counterparty. See (R. 1147; R. 1157). Lehman International did not receive any such bids. (R. 1175). Instead, it received only non-binding indicative (i.e., non-executable) bids from three banks (two of which provided only partial bids) with caveats, including that they were not executable, that the quoted prices might be "completely inaccurate" and "might differ substantially" depending on the identity of the protection seller, and that legal documentation had not been reviewed nor had necessary approvals been obtained. See, e.g., (R. 1184; R. 1188; R. 1191-192).[8]

Finally, Lehman International itself used the same Payment Model approach as Assured. Specifically, in negotiating a settlement with its own U.S. affiliate Lehman Brothers Special Financing, Inc. ("LBSF") following its insolvency, Lehman International took the position that a portfolio of hedging transactions it entered into with LBSF that mirrored the Transactions in this litigation (the "Back-to-Back Transactions") should be valued using the same approach that Assured used to determine its Loss on the Transactions and arrived at a nearly identical

[8] The language the banks used here underscores that these so-called indicative bids do not provide a reliable basis for valuing an asset. Accord (R. 1031-032) ("An indicative bid, by definition, is merely an indication of pricing; it is not a price at which the bidder is willing to actually transact. Indicative bidders have little or no incentive to make commercially reasonable bids because they incur no cost or risk when bidding inaccurately, nor do they receive any benefit from bidding accurately. . . .In addition, indicative bidders generally do not take into account counterparty credit risk, which is a key determinant of the value of bespoke CDS transactions[.]").

valuation. (R. 1821-822; R. 1813-816). Lisa Summerfield, co-lead of the Lehman International team responsible for negotiating with LBSF, stated in an email to the LBSF lead negotiator in early 2010 that Lehman International valued the Back-to-Back Transactions at zero and rejected LBSF's attempt to use a Pricing Model to claim a much higher valuation. She wrote that the Back-to-Back Transactions are "a highly structured position that could be valued in multiple ways. A zero valuation results from using a predictive model approach, looking at expected losses over the lifetime of the trade and this is our assessment of the value at 12/12 . . . . [W]e do not think [a mark-to-market valuation] is a valid basis of valuation in the circumstances, particularly given that no market participants were willing or able to provide a valuation of these positions . . . ." (R. 1815).

G. In The Absence Of Replacement Transactions, Assured Calculated Its Loss In Adherence To The Terms Of The Agreement

Assured chose to determine its Loss based on its "loss of bargain," as the contractual definition of Loss expressly entitled it to do. Specifically, Assured used a Payment Model whereby it added the amount of unpaid fixed payments that Lehman International owed at the time (approximately $13 million) and the present value of the fixed payments that Lehman International would have been required to pay to Assured over the remaining duration of the Transactions (approximately $35 million). It then deducted the floating payments Assured expected to pay to Lehman International based on future shortfalls in principal or interest payments

on the Underlying Securities (approximately $23 million). (R. 835-45). To determine expected future floating payments, Assured used the same model it used in its ordinary course of business, as well as for public reporting purposes and for the calculation of its required reserves as a regulated financial guaranty insurance company. This model and its assumptions were carefully vetted both internally, by senior management, and externally, by its auditors and regulators.

This calculation yielded a net termination amount payable by Lehman International to Assured of approximately $24.8 million, see (R. 962 n.58), which was reflected in the statement Assured delivered to Lehman International (the "Statement of Calculations"). Assured's projections of expected floating payments on the Underlying Securities have proven to be substantially accurate. See (R. 248-49).

H. Lehman International's Hypothetical Computer Pricing Model Did Not Produce Results Consistent With Real World Pricing

Because Lehman International was also unable to secure replacement transactions, its expert, Dr. Peter Niculescu, instead constructed a Pricing Model that solved for theoretical replacement transaction values by using hypothetical market pricing of the Underlying Securities (rather than pricing of executable replacement transactions) as its key input. Critically, Dr. Niculescu's Pricing Model does not even rely on the actual Underlying Securities in large part, but rather employs a multitude of proxies and manipulations derived from other

securities. See, e.g., (R. 964-65) (describing that the market pricing for CLOs is not based on the Underlying Securities, but on manipulation of at least eight sets of assumptions); id. (explaining that nearly half of the UK RMBS benchmarks are not the Underlying Securities, but proxy securities with materially different terms).

Dr. Niculescu's Pricing Model projected that in a hypothetical world, a counterparty should have been willing to pay somewhere between $215 million and nearly $500 million to assume Lehman International's contractual posture.[9] These numbers, however, bear no relation to the real world or Lehman International's own views regarding what any real-world counterparty would pay. First, Dr. Niculescu admitted that had any market participant actually entered into a replacement transaction based on his computer price modeling, it would have lost hundreds of millions of dollars. See (R. 1792-793) ("Q. If they had used the market prices that you used . . . to calculate the values in this column, they would have been out $450 million as of today, correct? . . . A. That's right."). Second, as noted, Lehman International's internal assessment was that the Transactions had no real value to Lehman International. See supra at 16-17.

[9] The upper end of the range assumes no counterparty risk.

I. The Purported Custom and Practice Evidence

In support of its claim that the established market practice was to use market quotations or a Pricing Model to determine the theoretical value of a replacement transaction, Lehman International offered the testimony of a number of purported expert witnesses and the purported evidence of how other claimants in its insolvency proceedings and those of its own affiliate chose to calculate their losses. Critically, Lehman International did not present any custom and practice evidence related to loss calculations by monoline insurers. Its monoline experts, Evy Adamidou and Cynthia Parker, both testified that they had no experience calculating a termination amount under the Loss provision and that they were unaware of a monoline insurer ever calculating Loss using a Pricing Model. See (R. 4709-710; R. 4720-721). While Lehman International's principal expert, Leslie Rahl, opined that a Loss calculation should always be based on either a market price or a reasonable estimation of a replacement transaction, (R. 3123), those views diverge from ISDA's position, as set forth in the amicus briefs ISDA filed in the U.S. Lehman bankruptcy, on how the Master Agreement should be interpreted. See (R. 1503) ("ISDA Amicus") ("Loss was not intended to be a one-size-fits-all provision, and its misinterpretation as such would rob the provision of the important freedom it is intended to convey.").

Furthermore, in support of a claimed industry norm of using a Pricing Model to generate termination amounts, Ms. Rahl's expert report, along with the Declaration of Eduardo Viegas (the "Viegas Declaration"), merely provide examples of how various other claimants (largely investment banks or hedge funds) in the Lehman International insolvency proceedings calculated their losses.[10] See (R. 3110; R. 3410-412). However, neither Ms. Rahl's expert report nor the Viegas Declaration purports to disclose in any detail the actual methodologies used by counterparties or provides any indication that their contracts were based on the 1992 version of the ISDA Master Agreement. Plainly, none of these parties had contracts with the monoline-specific terms included in the Agreement. One need look no further than the rampant litigation by various Lehman affiliates in the wake of their insolvency to see the true range of approaches that their counterparties have employed.[11]

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[10] It is hardly surprising that investment banks would use the same pricing models to establish their claims against the U.S. Lehman entities that they used to value collateral-posting requirements under their agreements. However, there was no such collateral-posting obligation under Assured's Agreement.

[11] See, e.g., Lehman Bros. Holdings v. Intel Corp. (In re Lehman Bros. Holdings Inc.), No. 08-13555 (SCC), 2015 WL 7194609, at *10 (Bankr. S.D.N.Y. Sept. 16, 2015) (disputing Loss determination based on initial transaction costs); see also Am. Adv. Compl. and Objs. to Claims, Lehman Bros. Holdings Inc. v. Credit Suisse AG et al., No. 13-01676 (SCC) (Bankr. S.D.N.Y. Mar. 17, 2017), ECF No. 43 (alleging improper determination of Close-Out calculations); Third Am. Compl. and Claims Obj., Lehman Bros. Holdings Inc. et al. v. Citibank et al., No. 12-01044 (SCC) (Bankr. S.D.N.Y. Dec. 9, 2014), ECF No. 99 (challenging valuation methodology, including trade-by-trade approach and use of bid-offer spread); First Am. Adv. Proc. Compl., Lehman Bros. Holdings Inc. et al. v. Daiwa Sec. Cap. Mkts Co., Ltd., No. 15-01431 (SCC) (Bankr. S.D.N.Y. Mar. 4, 2016), ECF No. 5 (arguing that market quotations received pursuant to

The failure of Lehman International and its affiliates contributed greatly to the 2008 financial crisis, which resulted in the substantial decline in the market trading values of virtually all securities, including even the highest-rated securities. Adoption of Lehman International's Pricing Model approach would give Lehman International a windfall recovery in this case based on market conditions created in part by its own default.

J. Proceedings to Date

In November 2011, Lehman International brought this action against Assured in the New York Supreme Court Commercial Division, alleging breach of contract and breach of the implied covenant of good faith and fair dealing related to the manner in which Assured conducted the Market Quotation auction and calculated its Loss. Assured has successfully obtained dismissal on two of the three counts in the Complaint thus far: Count I (relating to a subset of transactions with unique contractual terms) was dismissed in the lower court's partial grant of Assured's motion to dismiss the Complaint in March 2013. Count III (relating to the Market Quotation auction) was dismissed in the lower court's partial grant of Assured's summary judgment motion in July 2018. In dismissing Count III, the lower court found that no one was willing to enter into executable replacement

an auction could not be used to determine the Non-defaulting Party's loss because that party did not actually enter into a replacement transaction).

transactions with Assured at any price despite Assured's good faith and reasonable efforts to solicit bids from numerous third parties. (R. 55-58).

All that currently remains before this Court is Count II, in which Lehman International alleges that Assured breached the Agreement by failing to determine its Loss "reasonably and in good faith." The lower court denied summary judgment on this Count, finding triable issues of fact meriting a bench trial. It is from this decision that Assured now appeals.

ARGUMENT

I. THE LOWER COURT ERRED IN HOLDING THAT ASSURED'S DECISION TO MEASURE ITS LOSS BY CALCULATING ITS "LOSS OF BARGAIN" RATHER THAN BY THE THEORETICAL COST OF REPLACEMENT TRANSACTIONS RAISES A TRIABLE ISSUE OF FACT

In granting summary judgment on Count III of the Complaint regarding Assured's auction, the lower court expressly found that there were no executable bids available to Assured to replace the Transactions. It also concluded on Count II that the "Loss provision . . . by its terms affords the Non-[d]efaulting Party the discretion to make the determination as to whether use of market prices to calculate Loss is appropriate in a particular case." (R. 68). Nonetheless, the court denied Assured summary judgment on Count II regarding its Loss calculation because Assured did not account for the possibility of entering into replacement transactions in determining its Loss or use market prices to estimate the price of a

fictional replacement transaction. Specifically, the court held: "The failure of the Market Quotation auction in this case does not necessarily mean that Assured was unable to replace the Transactions in the market, or that the price of a replacement transaction is impossible to estimate[.]" (R. 74).

The lower court's suggestion that Assured failed to account for the possibility of executable replacement transactions is erroneous because, as noted above, there is no evidence in the undisputed record to show that any executable replacement transactions or market quotations for such transactions were available to Assured, as the lower court itself found earlier in its opinion with respect to the auction. (R. 55-58). Indeed, Lehman International does not argue otherwise, but instead relies for its Pricing Model approach on a computer model that uses hypothetical market pricing of the Underlying Securities (or in many cases, proxies or assumptions based on unrelated securities) as its critical input to calculate the theoretical price of hypothetical replacement transactions. But that entirely hypothetical calculation of a theoretical value produced a fictional price at which no real market participant was willing to transact. In other words, the lower court premised its decision about the failure to consider replacement transactions on a completely speculative circumstance that both its ruling on the auction

and Lehman International's own arguments demonstrate was contradicted by the undisputed facts in the record.

This error was compounded by the court's further conclusion that:

> Assured has not shown that the last sentence of the Loss provision must be read as effectively removing the issue of use of market prices from the analysis of a Non-[d]efaulting Party's reasonableness and good faith.

(R. 69). Here, the lower court ignored the plain language of the Agreement granting Assured broad discretion and flexibility to determine its Loss, particularly the provision stating that Assured "may (but need not)" calculate its Loss in reference to market quotations. Instead, the court wrongly relied on Lehman International's purported custom and practice evidence to find that Assured's decision to determine Loss without reference to market quotations, which this record uniformly shows did not exist, necessarily raises a triable issue of fact regarding whether Assured acted reasonably. Such evidence, if ever appropriate, is improper where, as here, it is used to subvert the Agreement and vary its express, unambiguous terms.

A. Assured Cannot Be Required To Use Market Quotations In Its Loss Calculation Because, As The Court Correctly Found, There Were No Executable Bids Available

The lower court's finding that there was a triable issue of fact regarding whether Assured reasonably decided not to determine its Loss based on the value of possible replacement transactions cannot be reconciled with the court's

unchallenged holding disposing of Count III of the Complaint. In dismissing Count III, the court held that, despite Assured's good faith efforts to locate a replacement transaction, no executable bids were available, and because no one was willing to enter into actual replacement transactions with Assured at any price, no Market Quotation could be determined. (R. 55-58; R. 341-42) ("Market Quotation" definition). In so holding, the lower court specifically relied on testimony from Assured's expert Dr. Pirrong that Assured's inability to obtain executable bids from counterparties was due to "a lack of appetite in the market for these products, combined with market concerns regarding monoline credit risk." (R. 52-53) (quotation omitted). The court noted that this opinion from Dr. Pirrong was "supported by detailed reasoning, and by communications between Reference Market-makers and Assured or its agents concerning the auction." (R. 53).

On this record, it is clear that there were no executable bids available to Assured in the market. This was confirmed not only by Assured's price-discovery as a result of its reasonably conducted Market Quotation auction, but also by Lehman International's own failed efforts to find a party to whom it could novate the Agreement and its own failed auction attempt. Dr. Pirrong's uncontested explanations for why the Transactions had no real-world value to Lehman International further confirms that no one was willing to pay even a fraction of the hypothetical replacement value that Lehman International nonetheless claims is the

appropriate measure of its loss (and Lehman International's loss is not at issue here).

Critically, there is no inconsistency between Assured's hold-to-maturity business model and its agreement to determine its losses or gains in the first instance based on the Market Quotation method. If there had been an executable bid, Assured could have accepted it, entered into replacement transactions with the bidder, and continued to hold the new contract to maturity. If a bidder had agreed with Lehman International's position in this litigation that there was a substantial possibility of future floating payments, the bidder would have offered to make a payment to enter into replacement transactions with Assured, and that amount could have been turned over by Assured to Lehman International. However, as the lower court found, no one was willing to assume Lehman International's position in the Transactions for any amount.

B. When Market Quotation Could Not Be Determined, The Agreement Expressly And Unambiguously Authorized Assured To Select A Loss of Bargain Approach To Determine Its Loss

The Agreement provides that, in the event Market Quotation cannot be determined, the Non-defaulting Party is required to calculate its "Loss." (R. 342) ("Settlement Amount" definition). The terms of the Loss provision unambiguously grant Assured, as the Non-defaulting Party, the exclusive right to determine its

Loss in connection with the Transactions, and the flexibility to choose—at its sole discretion—how to calculate that amount through a variety of approaches.

First, the provision defines the Non-defaulting Party's Loss as the "amount that party reasonably determines in good faith to be <u>its</u> total losses and costs." (R. 340-44) (emphasis added). Second, the Loss definition provides that the Non-defaulting Party may, "at [its] election . . . but without duplication," choose from among various approaches to make that determination, including "<u>loss of bargain</u>," "cost of funding," and "loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position." <u>Id.</u> (emphasis added). Third, the final sentence of the Loss definition states: "A party may (<u>but need not</u>) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets." <u>Id.</u> (emphasis added).

In accordance with these provisions, Assured elected to determine its Loss based on its loss of bargain. Assured did not attempt to reference market quotations for replacement transactions not only because it did not need to do so under the Agreement, but also because no such executable bids existed, as the undisputed record shows. It also did not attempt to determine the theoretical cost of a non-existent replacement transaction by reference to the market value of the

Underlying Securities (or proxies thereof), including because Assured did not—and could not—insure the market value of the Underlying Securities.[12]

In Lehman Brothers Holdings v. Intel Corp., the Bankruptcy Court administering the Chapter 11 case of Lehman International's U.S. affiliates held that the Loss provision under the 1992 Master Agreement is intended to give the Non-defaulting Party flexibility to determine its Loss in whatever manner it reasonably and in good faith decides is appropriate, and concluded that

> [o]n the face of the ISDA Master's definition of "Loss," [the Non-defaulting Party] has broad discretion in determining its Loss, so long as its methodology is reasonable and in good faith. . . . Further, there is nothing in the text of the definition of Loss that explicitly mandates any particular calculation method or otherwise modifies the plain meaning of that first sentence of the definition – that the [N]on-defaulting [P]arty is permitted to calculate its loss reasonably and in good faith.

No. 08-13555 (SCC), Adv. No. 13-01340, 2015 WL 7194609, at *10 (Bankr. S.D.N.Y. Sept. 16, 2015). The Intel court rejected an argument by the U.S. Lehman entities, very similar to the one Lehman International makes here, that the counterparty was required to use market quotations and prices to determine its Loss. The court further found that "the ISDA User's Guide [for the 1992 Master Agreement] makes clear that Loss is intended to provide parties flexibility in

[12] Market prices are not a proxy for the likelihood of default, but instead reflect multiple supply and demand considerations, including market sentiment towards an entity or a particular class of securities. See, e.g., (R. 955).

selecting a method to calculate their Early Termination Payments." Id. at *11. Notably, ISDA filed an amicus brief in the Intel case to confirm that Loss was "crafted . . . to allow flexibility in the determination of the Non-[d]efaulting Party's loss following early termination. Any reasonable, good faith calculation consistent with applicable law comports with the Loss definition." (R. 1502-503).

C. Lehman International Cannot Subvert The Agreement's Plain Meaning Through Purported Custom And Practice Evidence

The lower court expressly recognized that "the ISDA Master Agreement is not ambiguous to the extent that it provides that Loss need not be calculated using market quotations in every case." (R. 66). Nevertheless, because it also found that the Agreement "is ambiguous as to whether Loss, under the circumstances of this case, was 'reasonably determine[d],'" id., the court permitted purported custom and practice evidence to show Assured could not have reasonably determined its Loss other than by reference to market prices. The court reasoned that Assured had not indisputably justified its decision not to use market prices to estimate the value of a hypothetical replacement transaction in determining its Loss. Specifically, the court held "Assured has not shown that the last sentence of the Loss provision must be read as effectively removing the issue of use of market

prices from the analysis of a Non-[d]efaulting Party's reasonableness and good faith" and

> [w]here, as here, evidence is submitted that there may be a uniform or highly consistent practice of calculating Loss in a particular manner under similar circumstances, and the Non-[d]efaulting Party deviates from that practice, that deviation raises a genuine question of fact as to the Non-[d]efaulting Party's reasonableness or good faith in calculating Loss.

(R. 69, R. 71).

In so holding, the court erred. There is no way to reconcile this holding with the contractual provisions entitling Assured to calculate "its loss," to choose "at its election" to employ a "loss of bargain" methodology, and to choose not to determine its Loss by reference to market prices. The court's interpretation turns the Loss provision on its head, expressly contradicting the terms of the Agreement and varying those terms by adding a new contractual requirement: that Assured must, in addition to showing the Market Quotation auction resulted in no executable bids, also make an affirmative showing that its decision not to use market prices was "reasonable." The Agreement imposes no such requirement. The court's imposition of this requirement is particularly improper here because the undisputed record shows that no executable bids for replacement transactions were available.

Even if custom and practice evidence were ever relevant to ascertain whether Loss was determined in a reasonable and good faith manner, it cannot be

used to deprive Assured of its express contractual right to calculate Loss based on its loss of bargain and without reference to market prices. The lower court's discussion of whether another related term in the Loss definition, "reasonably determines," was a "specialized or unexplained term" is therefore not only incorrect but also entirely irrelevant here. None of Lehman International's purported custom and practice evidence suggests that Assured acted unreasonably by using a Payment Model if its goal was to solve for its loss of bargain rather than the hypothetical value of non-existent replacement transactions. The purported custom and practice evidence cannot be used to vary the other express, unambiguous terms of the Loss definition, which expressly permit Assured to determine its Loss based on its loss of bargain.

Notwithstanding the court's assertion that the 1992 Master Agreement is a "highly specialized standard-form commercial contract," (R. 64 n.10), the particular phrase at issue, "reasonably determines," is not itself specialized. The case law does not support the proposition that a common phrase in a contract otherwise containing specialized provisions requires the consideration of extrinsic evidence. Rather, the specialized terms must themselves be the subject of interpretation in order for extrinsic evidence to be appropriate. Cf. Law Debenture Trust Co. of N.Y. v. Maverick Tube Corp., 595 F.3d 458 (2d Cir. 2010) (citation omitted).

In any event, the use of a "specialized or unexplained term" does not permit the court to rewrite other unambiguous language in the contract. This Court, in Ashwood Capital, Inc. v. OTG Management, Inc., 948 N.Y.S.2d 292, 298 (1st Dep't 2012), rejected the concept that a phrase "[without] reasonable alternative meaning" could be rendered ambiguous by other language in the contract based on the plaintiffs' "mere assertion . . . that contract language means something other than what is clear." Id. (quotation omitted). Further, New York law is well-settled that where, as here, "the plain language is clear, there is no ambiguity and thus no need to resort to extrinsic evidence," MBIA Ins. Corp. v. Countrywide Home Loans, Inc., 39 Misc.3d 1220(A), at *24 (1st Dep't 2013), including "evidence of custom or industry practice [that would] subvert the agreement's plain meaning," id. (quoting AG Capital Funding Ptrs., L.P. v. State St. Bank and Trust Co., 781 N.Y.S.2d 88, 90 (1st Dep't 2004)).

None of the cases on which the lower court relies suggests otherwise. The lower court cites to this Court's decision in Hoag v. Chancellor, Inc., 677 N.Y.S.2d 531 (1st Dep't 1998) to justify its reference to custom and practice evidence to interpret the phrase "reasonably determines." However, this Court's holding in Hoag does not support use of such evidence in interpreting a self-contained, contextually determined contractual provision, such as the Loss definition here. The contract at issue in Hoag provided that a percentage of incentive fees would be

distributed to employees with consent, and that such consent "shall not be unreasonably withheld," but it gave no context as to what would constitute reasonable bases to withhold consent. Id. at 534. This Court allowed extrinsic evidence after determining it "was not [offered] for the improper purpose of interpreting or varying an agreement without ambiguity, . . . but for the permissible purpose of providing guidelines for the unexplained term, 'unreasonably withheld.'" Id. at 537-38.

In stark contrast, here, Lehman International sought—and the lower court allowed—use of its purported custom and practice evidence to rewrite the unambiguous provision in the Agreement that Assured "need not" determine its Loss by reference to market prices. Moreover, unlike the "unexplained term" in Hoag, the Agreement here includes a nearly 250-word definition of Loss detailing the parameters under which a Non-defaulting Party may reasonably determine its Loss. (R. 341).

Finally, the court also cited a handful of cases for the proposition that "the question of what is reasonable may require consideration of the facts and surrounding circumstances in the case." (R. 65). Assured does not dispute this basic tenet. However, as described above, none of the evidence Lehman International proffered relates to the reasonableness of Assured's calculation. Rather, it seeks to show solely that Assured should not be permitted to choose the

loss of bargain approach in the first place, and is therefore improper.

i. *The Evidence Offered By Lehman International Is Also Incompetent Because It Does Not Show A Fixed and Notorious Usage When The Parties Entered Into The Agreement*

As this Court has established, "[o]ne who seeks to use trade usage to define language or annex a term to a contract must show either that the other party to the contract is actually aware of the usage, or that the existence of the usage in the business to which the transaction relates is so notorious that a person of ordinary prudence in the exercise of reasonable care would be aware of it." Reuters Ltd. v. Dow Jones Telerate, Inc., 662 N.Y.S.2d 450, 454-55 (1st Dep't 1997); see also SR Int'l Bus. Ins. Co. v. World Trade Ctr. Props., LLC, 467 F.3d 107, 134 (2d Cir. 2006) (citation omitted).

Here, the fact that ISDA itself has expressed the view in the U.S. Lehman bankruptcy that there is no requirement that a Non-defaulting Party calculate its Loss in any specific way under the 1992 ISDA Master Agreement, including absolutely no requirement that it use a method that relies on market prices, should alone be dispositive that no such notorious custom or practice exists. See supra at 26. In any event, evidence of whatever approach claimants may have taken to calculate their losses in the U.S. Lehman bankruptcy proceedings cannot be relevant. As this Court made clear in Reuters, custom and practice evidence cannot influence the construction of a contract unless it "raise[s] a fair presumption

that it was known to both contracting parties and that they contracted in reference thereto." Id. at 454 (citations omitted) (emphasis added). That is not the case here at all. As the lower court acknowledged, the Viegas Declaration involved derivative terminations "since entering Administration" in September 2008 in private contracts to which Assured was not a party. (R. 71). But Assured and Lehman International entered into the 1992 Master Agreement and schedule in April 2000 and executed the individual Transactions between 2005 and early 2008, well before Lehman International's entry into administration on September 15, 2008. (R. 3084, R. 3086). No reasonable factfinder could determine that Assured and Lehman International "contracted in reference" to a purported custom that post-dates the contract formation. Accord Reuters Ltd., 662 N.Y.S.2d at 454. For the same reason, the supposed "noteworthy example of counterparties using market prices to calculate Loss," relied upon heavily in the expert report of Ms. Rahl and also cited by the lower court, is similarly defective since it relates to "when the U.S. Lehman Brothers entities filed for bankruptcy in 2008" and thereafter. (R. 70).

Moreover, extrinsic evidence cannot establish a fixed and notorious trade usage if it "ha[s] no connection to the parties' dealings." Building Serv. Local 32B-J Pension Fund v. 101 Ltd. P'ship, 51 N.Y.S.3d 31, 33 (1st Dep't 2017). Lehman International's evidence cannot establish that Loss was calculated "in a

particular manner under similar circumstances" to this case, (R. 71), because unlike the parties in the precedents Lehman International cites, the parties here had contracts with monoline-specific terms and no history of using such valuations in posting collateral, as the Agreement had no collateral-posting requirement.

The so-called Lehman framework detailed in Ms. Rahl's expert report and referenced above was a one-time negotiated settlement involving "thousands of derivative transactions" between the "Big Banks," a defined group comprising thirteen international banks and their affiliates, and the U.S. Lehman entities. (R. 1552-554). No monoline insurer was party to the confidential negotiations or to the settlement. (R. 967-68). Moreover, the framework explicitly acknowledged that the parties were voluntarily foregoing arguments regarding valuation of derivatives to achieve settlement. Id. Lehman International cannot identify any case in the U.S. Lehman bankruptcy (or in any other court) citing the Lehman framework compromise as a precedent for limiting how a Non-defaulting Party calculates its Loss, even against Lehman.[13] This evidence thus has no probative

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[13] Additionally, the parties to the Lehman framework entered into a mutual agreement in 2008, entitled the Close-Out Amount Multinational Agreement ("CMA"), which "had the effect, in general terms, of replacing the 1992 provisions for close-out and settlement amounts on early termination with the re-drafted provisions of the 2002 edition of the Master Agreement." Lehman Bros. Int'l (Europe) (in administration) et al. v. Lehman Bros. Fin. S.A., [2012] EWHC 1072 (Ch), 2012 WL 1469111 ¶ 16, rev'd in part on other grounds [2013] EWCA 188 (Civ), 2013 WL 617550.

value whatsoever with respect to Assured's calculation of its Loss under the Agreement.

Similarly, as discussed above, the assertion by another of Lehman International's experts, Dr. Niculescu, that market practice is to use replacement transactions to determine Loss is irrelevant given that the undisputed facts establish there were no replacement transactions available to Assured. See supra at 19. Dr. Niculescu's attempt to calculate theoretical market prices for a hypothetical replacement transaction using a computer model largely based on proxies and assumptions derived from unrelated securities in no way establishes a fixed and notorious usage in the industry to calculate Loss through such a theoretical construct. Indeed, Dr. Niculescu acknowledged that his Pricing Model generated a theoretical value for the Transactions much greater than any actual market participant would be rationally willing to pay to step into Lehman International's shoes. See id. Lehman International's speculative expert testimony as to what someone might theoretically pay for these positions is insufficient as a matter of law to defeat Assured's summary judgment motion. See, e.g., Ramos v. Howard Indus., Inc., 10 N.Y.3d 218, 224 (2008) ("An expert's affidavit—offered as the only evidence to defeat summary judgment—must contain sufficient allegations to demonstrate that the conclusions it contains are more than mere speculation and would, if offered alone at trial, support a verdict in the proponent's favor."

(citations omitted)); Clough v. Szymanski, 809 N.Y.S.2d 707, 709 (4th Dep't 2006) (concluding that "[t]he speculative affidavit of plaintiff's expert containing alternative explanations concerning the manner in which the accident occurred is insufficient to defeat the [summary judgment] motion" (internal quotation omitted)).

Finally, the testimony of Lehman International's other experts, Ms. Parker and Ms. Adamidou, is based solely on their personal experiences as senior executives at two other monoline insurers and does not establish a "uniform and unvarying" practice for all monolines. Simply put, Ms. Parker and Ms. Adamidou are not competent to provide custom and practice evidence regarding the calculation of Loss. Both testified they have no actual experience calculating Loss under a 1992 Master Agreement. (R. 140; R. 4709-710; R. 4720-721). And their testimony is not supportive of Lehman International's position, as both admitted that a Non-defaulting Party is not required under the definition of Loss to take into account market prices. See (R. 1388; R. 4722-723).

Lehman International, as the party seeking to introduce evidence of custom and practice, has the burden of demonstrating the prior existence of such trade usage. See SR Int'l Bus. Ins. Co., 467 F.3d at 135. Lehman International did not meet its burden based on the incompetent and irrelevant evidence submitted. Thus, even if it were offered for a proper purpose and not to vary the express terms of the

Agreement, Lehman International's purported custom and practice evidence should have been rejected because "no reasonable factfinder could find that such a custom existed" on this basis. Id.; see Law Debenture, 595 F.3d at 469-70 (affirming the rejection of custom and practice evidence at the summary judgment stage).

ii. *The So-Called "Cross-Check" Principle If Properly Applied Supports Assured's Position*

The lower court erred when it held that the Pricing Model used by Lehman International's expert or the indicative bids solicited by Lehman International could be used to "cross-check" Assured's Loss calculation. The cross-check principle was developed by the English courts for circumstances that are exactly the opposite of those presented here: to ensure that the use of market quotations to calculate a termination payment under the Second Method and Market Quotation approach did not produce an unreasonable result contrary to actual, real-world losses. See Peregrine Fixed Income Ltd. v. Robinson Dep't Store Pub. Co. Ltd., [2000] C.L.C. 1328, [1339]. The stated theory behind this principle is that "where Market Quotation produces a result . . . far removed from that which would be produced by the use of the Loss measure . . . . it is possible to say with some confidence that the result [of the Market Quotation] is commercially unreasonable by the standards of the Agreement." Id.[14] Here the court flipped the principle on

[14] In this respect, the cross-check principle is not materially different from New York law that requires—in order for a liquidated damages clause to be an enforceable agreement and not an

its head to require that Assured's Loss calculation be "checked" against a Market Quotation to evaluate the reasonableness of the calculation. (R. 74). In so holding, the court again directly contravened the last sentence of the Loss definition, which requires that Assured "need not" use market prices in determining Loss. (R. 340-44). However, if applied in such a way, the cross-check principle would actually support Assured's calculation because the Market Quotation auction yielded no executable bids, which is consistent with Assured's position that the Agreement had negative value to Lehman International.

Moreover, the lower court overlooked that none of the cases on which it or Lehman International relies involved "cross-checking" the reasonableness of a Loss calculation based on a Payment Model against a hypothetical value yielded by a Pricing Model. There is simply no precedent for this. Nor are indicative bids a reliable proxy for market prices, and such bids by definition are not a substitute for replacement transactions. This is widely recognized in the courts and throughout the industry. See Lehman Bros. Fin. SA (In Liquidation) v. Sal. Oppenheim Jr. & Cie. KGAA, [2014] EWHC 2627 (Comm) ¶ 16, 2014 WL 3671646 ("[It is] entirely plain that [the Replacement Transaction] is intended to

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unenforceable penalty—that the Non-defaulting Party calculate damages in a manner that the parties reasonably believe will approximate the Non-defaulting Party's Loss. See, e.g., JMD Holding Corp. v. Cong. Fin. Corp., 4 N.Y.3d 373, 379 (2005).

be . . . a ‘live quotation,’ i.e. one capable of being taken up there and then.”); see also Fondazione Enasarco v. Lehman Bros. Fin. SA, [2015] EWHC 1307 (Ch) ¶ 56 (noting that the reference in the Loss definition to “quotation of relevant rates and prices from one or more leading dealers in the relevant markets” does not refer “to something less than real offers at which dealers were willing to contract on the day of the quotation”).

The indicative bids that Lehman International solicited were plainly not probative of what any counterparty would have actually paid to enter into a replacement transaction with Assured. The undisputed facts show that, before Assured delivered its Statement of Calculations, Lehman International first sought executable bids, which it could not obtain, and then indicative bids on the Transactions from peer investment banks, without disclosing Assured’s identity as the protection seller. Lehman International received only three sets of indicative bids—two of which were only partial bids, all of which included numerous caveats, and none of which were executable. See supra at 15-16.

Indeed, one of the bids was provided by a former Lehman International trader, Juan Quintas, who had been responsible for valuing the Transactions at Lehman International in 2008 and unsuccessfully attempted to novate them to a third party before joining Nomura. Still, Mr. Quintas expressly refused to provide an executable bid on the Transactions and gave only an indicative bid rife with

caveats, purporting not to know the identity of the counterparty to the Transactions. See (R. 1183-186). The fact that Mr. Quintas claimed not to recognize the very portfolio he was previously responsible for at Lehman International was pure gamesmanship and reflective of the fact that this was a sham accommodation bid not made by an independent bidder. Accord The High Risk Opportunities Hub Fund Ltd. (In Liquidation) v. Credit Lyonnais, No. 600229/00, 2005 WL 6234513, at *6 (Sup. Ct. N.Y. Cty. July 6, 2005) (rejecting reliance on bids tainted by lack of independence in light of information provided to bidders by party seeking such bids).

In short, by their own terms and express disclaimers, the indicative bids cannot reasonably be a substitute for an actual replacement transaction, nor can they be a relevant metric against which to evaluate the reasonableness of Assured's Loss calculation. Any "significant discrepancy between the indicative bids and Assured's Loss calculation," (R. 75), is thus legally and factually irrelevant and cannot create a triable issue in this case.

II. THE LOWER COURT ERRED IN FINDING A TRIABLE ISSUE OF FACT AS TO THE REASONABLENESS AND GOOD FAITH OF ASSURED'S DETERMINATION OF ITS LOSS OF BARGAIN

A. The Lower Court Departed From The Weight Of Authority, Which Establishes That Assured's Loss Calculation Should Be Evaluated Under A Deferential Standard Of Rationality

The lower court improperly imported an "objective standard of reasonableness" to evaluate Assured's Loss calculation, and concluded that it could not assess whether Assured "reasonably determined" its Loss under this standard without considering evidence of industry norms. (R. 65). Notably, the lower court actually conceded that the method Assured used to calculate its Loss "appears on its face to be a reasonable method for calculating the value to Assured of the terminated Transactions." (R. 79) (emphasis added). The lower court should have ended its analysis there. Not doing so was a clear departure from the weight of authority, which establishes that courts should apply a deferential test of rationality and uphold a Loss determination under the 1992 Master Agreement unless it is "a determination which no reasonable [N]on-defaulting [P]arty could come to." Enasarco, [2015] EWHC 1307 (Ch) ¶ 53. As discussed below, this deferential approach, first set forth in an English line of cases, was endorsed and imposed against U.S. Lehman entities in Intel, which applied New York law. It is also

consistent with commentary by ISDA and the industry at large. See, e.g., (R. 1502-503).

i. *The Non-Defaulting Party's Loss Calculations Should Be Afforded Significant Discretion And Deference By The Courts*

The Intel court endorsed as a "general rule" that a Non-defaulting Party should be given significant discretion and deference in calculating its Loss. The court, quoting one of the principal drafters of the 1992 Master Agreement, Professor Jeffrey Golden, stated that

> [a] second commercial objective . . . in drafting the ISDA standard-form documents was mitigating the risk of fact-specific disputes and the attendant risk of protracted litigation . . . . [f]or example, the wide discretion afforded the [N]on-defaulting [P]arty (discussed throughout this report), the considerable advantages given to the [N]on-defaulting [P]arty, and the marked reluctance to allow second guessing of a party that determines a settlement amount can only be understood if market interest in 'certainty' and the perceived difficulties encountered in otherwise discovering facts and confirming consensus in a global marketplace are fully appreciated . . . . Setting specific fixing times or prices was not the game. Neither was searching for the 'correct' or 'perfect' (or even 'best') answers. The goal was to stay within acceptable parameters based on the particular objectives of the parties. In 1992, this goal was reflected in the general terms of reasonableness and good faith. Assuming an outcome based on these principles, an early termination determination was expected to be conclusive. Whether a different result might also have been reached was irrelevant. The drafters intended to build into the definition of Loss a contractual privilege for the [N]on-defaulting [P]arty to make its own determination, and we assumed that the situations when a court would interfere with the exercise of that contractual discretion would be extremely limited.

Intel at *12 (citing Golden) (emphasis added). The U.S. Lehman entities warned in Intel, as Lehman International does here, of the "wild uncertainty and unpredictability" of permitting flexibility and discretion in calculating Loss. Id. (citation omitted). However, the Intel court rejected this position, explaining that "[s]uch hyperbole is misplaced" and concluding that "the drafters desired the certainty that [a Loss calculation], once determined, would be conclusive and legally enforceable – not necessarily the certainty that [Loss] would be calculated in a particular way."[15] Id. (citing Golden).

While the lower court acknowledged that the 1992 Master Agreement was designed to create certainty and predictability in the market, (R. 64-65 n.10), and even quoted portions of the above excerpt from Professor Golden, (R. 69 n.12), the court erroneously adopted Lehman International's claim that there existed a "market consensus" to use market prices in determining Loss, and sought to evaluate the "objective" reasonableness of Assured's Loss calculation within that context. (R. 64-65 n.10).

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[15] Another leading commentator described the "[c]ircumstances in which the court will intervene" in a Non-defaulting Party's Loss calculation as follows:

> The requirement to act reasonably is, in effect, a requirement to act rationally. . . . [T]he court will not intervene unless the result is one that no reasonable decision-maker could have come to. This reflects the fact that, where a discretion is given to a party, it is that party which is the decision-maker, rather than the court. The court's role is merely to ensure that the discretion has not been abused.

Simon Firth, Derivatives: Law and Practice 11-153 (2018).

ii. *English Precedent Establishes A Standard Of Rationality For Loss Calculations Under The 1992 Master Agreement*

English precedent clearly distinguishes between the 1992 Master Agreement and the 2002 Master Agreement because of the unique contractual language and purposes of each standard-form agreement: the former providing for a permissive standard of "rationality," and the latter imposing an "objective" standard of "commercial reasonableness."[16]

Like Intel, which found that the Loss definition grants broad discretion to the Non-defaulting Party under New York law, English courts have consistently held that the phrase "reasonably determines in good faith" in the 1992 Master Agreement requires only that the determining party must not reach "a determination which no reasonable [N]on-defaulting [P]arty could come to." Enasarco, [2015] EWHC 1307 (Ch) ¶ 53; see also Peregrine, [2000] C.L.C. 1328, [1340]) ("[A court] should not regard any act done by [the Non-defaulting Party] honestly and in good faith as unjustified or involving a breach of contract unless it is clear that the belief in which he acted was flawed."). In other words, "in considering whether the [N]on-defaulting [P]arty has 'reasonably determined' its

[16] English law, while not controlling, is nevertheless instructive as the only body of law other than New York expressly provided for under the Governing Law and Jurisdiction of the 1992 Master Agreement. (R. 339-40); see also (R. 64-65 n.10) (noting that "New York and England [are] the two forums most commonly called upon to interpret the [ISDA Master] Agreement"). The lower court cited English law for propositions relating to the interpretation of the 1992 Master Agreement. See (R. 64-65 n.10, R. 78).

Loss, that party is not required to comply with some objective standard of care as in a claim for negligence . . . It is essentially a test of rationality." Enasarco, [2015] EWHC 1307 (Ch) ¶ 53. There is no evidence to suggest Assured lacked an honest belief that the calculation measure it employed was appropriate. This is confirmed by Assured's use of the same measure across the board for multiple business purposes, including to calculate reserves and to satisfy its regulators.

This interpretation of the 1992 Master Agreement has been confirmed by later decisions contrasting the 2002 Master Agreement, where the Non-defaulting Party's calculation is reviewed under a standard of "objective" reasonableness. See, e.g., Lehman Bros. Int'l (Europe) (in administration) et al. v. Lehman Bros. Fin. S.A. [2012] EWHC 1072 (Ch) ¶ 48, 2012 WL 1469111, *9 rev'd in part on other grounds [2013] EWCA 188 (Civ), 2013 WL 617550. This distinctive treatment is based on the language of the "Close-Out Amount" provision in the 2002 Master Agreement, which replaced the Market Quotation and Loss provisions of the 1992 Master Agreement. In determining the termination amount owed between the parties under the "Close-Out Amount" provision, the Non-defaulting Party is required to "act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result." Int'l Swaps and Derivatives Ass'n, User's Guide to the ISDA 2002 Master Agreement at 3 (2003).

A recent English case, Lehman Brothers Special Financial Inc. v National Power Corp., [2018] EWHC 487 (Comm), explained the difference in the applicable standards for the 1992 and 2002 Master Agreements. As that court observed, the adoption of the "Close-Out Amount" provision in the 2002 Master Agreement to replace the Loss and Market Quotation provisions of the 1992 Master Agreement was a "material" change between the forms.[17] Id. ¶ 76. The court held that, while the 2002 Master Agreement explicitly "requires the Determining Party to use procedures that are, objectively, commercially reasonable in order to produce, objectively, a commercially reasonable result[,]" id. ¶ 81 (emphasis added), the Loss provision in the 1992 Master Agreement merely "requires rationality," or that a party "must not arrive at a determination which no reasonable [N]on-defaulting [P]arty could come to." Id. ¶¶ 74-75.

[17] Among the material changes to the 2002 Master Agreement, the 2002 version expressly elaborated that "[c]ommercially reasonable procedures used in determining a Close-out Amount" include "information from internal sources . . . of pricing or other valuation models that are, at the time of the determination of the Close-out Amount, used by the Determining Party in the regular course of its business in pricing or valuing transactions between the Determining Party and unrelated third parties that are similar to the Terminated Transaction." Int'l Swaps and Derivatives Ass'n, User's Guide to the ISDA 2002 Master Agreement app. at 4 (2003). The 2002 Master Agreement thus explicitly contemplated that an internal valuation model used in the ordinary course of business—such as Assured's Payment Model—would be presumed to be commercially reasonable and entitled to deference.

iii. *The Lower Court Disregarded The Weight Of Authority And Relied On Inapposite And Distinguishable New York Law*

The lower court disregarded this weight of authority and instead relied on a handful of inapposite New York cases that do not even involve ISDA agreements.[18] For example, Christie's Inc. v. SWCA, Inc., 867 N.Y.S.2d 650, 653 (Sup. Ct. N.Y. Cty. 2008), involved a "satisfaction clause[]" in a letter agreement setting forth terms for the sale of a sculpture, requiring the court to decide whether the clause called for an objective standard of reasonableness or an "honest, albeit unreasonabl[e]" determination. Id. at 654. Such case law regarding conditions precedent to a satisfaction clause is irrelevant to interpreting the discretion granted in an ISDA damages provision. MBIA Insurance Corp. v. Patriarch Partners VIII, LLC, 842 F. Supp. 2d 682, 711 (S.D.N.Y. 2012), involved the interpretation of a contractual provision requiring the "use of commercially reasonable efforts" (emphasis added), which the court concluded imputed an objective standard. If anything, MBIA is consistent with the English precedent described above that

[18] The lower court dealt with Enasarco only in a footnote, dismissing the standard as "apparently made in dicta, and, in this court's opinion, . . . overbroad and inconsistent with New York law." (R. 69 n.12). As just set forth, Enasarco is among a line of English cases consistently applying this standard. Furthermore, contrary to the lower court's assertion, Enasarco is entirely consistent with Intel, which applied New York law in interpreting the Loss provision of the 1992 ISDA Agreement. Notably, the lower court quoted favorably the unequivocal language in Intel that there is "nothing in the text of the definition of Loss that explicitly mandates any particular calculation method," and that "the [N]on-defaulting [P]arty is permitted to calculate its loss reasonably and in good faith." (R. 67). In light of this, the lower court's determination that Enasarco was inconsistent with New York law was incorrect.

interpreted the explicit importation of "commercial" reasonableness in the 2002 Master Agreement.

In contrast, consider this Court's decision in Good Hill Master Fund L.P. v. Deutsche Bank AG, 46 N.Y.S.3d 33 (1st Dep't 2017), which did involve the interpretation of an ISDA Master Agreement. In Good Hill, this Court held that the lower court properly awarded certain prejudgment interest to Good Hill under the relevant provisions of the 2002 Master Agreement. Id. at 38. In so doing, the Court rejected Deutsche Bank's argument that Good Hill could have obtained a more favorable rate. Quoting the specific contractual language, which provided that the default rate shall be certified "without proof or evidence of any actual cost," the Court concluded that, "[w]hile the resulting judgment is large relative to the original award, this is no reason to depart from the legal principle that contracts must be enforced according to the language adopted by the parties." Id. at 39 (internal quotation omitted). The Loss definition, which explicitly grants Assured the right to calculate Loss as it did here, must likewise be enforced as written.

B. In Any Event, Assured's Loss Of Bargain Methodology Satisfies Any Standard Of Review Because It Is Consistent With The Express Requirements Of The Contract As Well As New York Damages Law

Notwithstanding that the lower court imported an incorrect standard of review, Assured's Loss methodology also plainly meets an objective reasonableness standard because (1) it was an exercise of Assured's express rights

under the Agreement, (2) it is consistent with New York law on damages, and (3) in valuing the Back-to-Back Transactions that mirrored the Transactions at issue here, Lehman International itself used the same approach that Assured used to determine its Loss and arrived at a nearly identical valuation.

First, the Loss definition provides that the Non-defaulting Party may, "at [its] election . . . but without duplication," choose among various approaches to calculate its loss, including "loss of bargain." (R. 341). Assured's loss of bargain is, by definition, the net total of the present value of the fixed payments Lehman International agreed to make in connection with the Transactions, minus any floating payments Assured would have been required to make if not for the early termination of the Transactions. It is undisputed that Assured agreed to provide credit protection to Lehman International by paying for shortfalls in timely interest and principal when contractually due, in return for regular fixed payments from Lehman International. If Lehman International had not defaulted and the Transactions had continued through maturity, Lehman International would have been obligated to continue making those fixed payments, and Assured would have been obligated to make payments for interest and principal shortfalls, if any. Those obligations are precisely reflected in the Payment Model that Assured used to determine its Loss here. (R. 835-45).

Second, as asserted by ISDA in its Intel amicus brief, "[h]ow one establishes Loss is a matter of fundamental damages principles." See (R. 1505).[19] Assured's approach is entirely consistent with New York contract law on "loss of bargain." See, e.g., Sager v. Friedman, 270 N.Y. 472, 481 (1936) ("The measure of damages which flows from a breach of contract is the difference between the value of what has been received under the contract and the value of what would have been received if the contract had been performed according to its terms."); Boyce v. Soundview Tech. Grp., Inc., 464 F.3d 376, 384 (2d Cir. 2006) (explaining that it is "settled" law "that 'damages for breach of contract should put the [non-breaching party] in the same economic position he would have occupied had the breaching party performed the contract'" (citation omitted)). Indeed, if the agreed-upon remedy provision was not drafted to be consistent with New York damages law, it would be an unenforceable penalty clause.

[19] See also Expert Report of Joshua Cohn, Lehman Bros. Fin. AG v. Aktiebolaget Svensk Exportkredit, Case No. T 5048-12 (Swed. TR 2012) ("Many of the same concepts behind the ISDA Master Agreement's definition of Loss are also reflected in the general New York law of contract damages. This is because the Loss definition in the ISDA Master Agreement is intended to be consistent with these general principles and to provide specific suggestions to swaps participants on how to apply these principles in determining the economic effect on the Non-defaulting Party of a Default under a derivatives contract."); Anthracite Rated Invs. (Jersey) Ltd. v Lehman Bros. Fin. SA, [2011] EWHC 1822 (Ch) ¶ 117 ("The extended definition of Loss in Section 14 of the 1992 Master Agreement nonetheless uses certain words and phrases which were . . . intended to be illuminated by reference to the general common law (or New York law) meaning.").

Third, as discussed above, Lehman International used the same methodology in valuing the Back-to-Back Transactions in which it sold credit protection to LBSF, and arrived at a nearly identical valuation. See (R. 1813-816). Grant McPherson, a Lehman International employee who analyzed the Back-to-Back Transactions, conceded that Lehman International used a Payment Model to value these transactions in its negotiations with LBSF—identical in approach to the methodology used here by Assured—that was "reasonable," "credible," "defensible," and not done "in bad faith." (R. 1838-849). Lehman International cannot assert that Assured's Loss calculation does not meet the reasonableness standard of review when Lehman International itself "reasonabl[y]," "credibl[y]" and "defensibl[y]" put forth a similar model to value mirroring transactions on identical terms.

C. The Lower Court Erred In Suggesting That Assured's Failure To Mitigate Its Loss Raised A Triable Issue Of Fact Where Such Mitigation Was Not Possible In The Absence Of Market Quotations

The lower court questioned the reasonableness of Assured's loss of bargain approach based on Assured's supposed failure to mitigate loss. Specifically, the court perceived a "problem" in that Assured's methodology "assume[d] that there was no possibility of a replacement transaction to mitigate the loss of value that Assured purportedly suffered." (R. 79).

There can be no triable issue of fact on this point given that there were no replacement transactions available to Assured by which to mitigate loss, making this a moot issue. As the Non-defaulting Party, Assured was "obligated to do only what the ISDA Agreement contemplated, namely, terminate the Transactions and calculate the Termination Amount." JPMorgan Chase Bank, N.A. v. Controladora Comercial Mexicana S.A.B. de C.V., Slip Op. 52066(U), at 16-17 (Sup. Ct. N.Y. Cty. Mar. 16, 2010). Here, the undisputed record shows that after terminating the Transactions, Assured attempted to mitigate its damages through the process expressly contemplated by the parties in the Agreement: holding a Market Quotation auction to solicit replacement transactions. Assured had no additional duty to do anything further to try to mitigate damages after its auction resulted in no replacement transactions. See id. (citing Murray v. NYC Transit Auth., 862 N.Y.S.2d 706 (2d Dep't 2008) ("[T]he party injured by a breach . . . was not obligated to use extraordinary remedies or incur extraordinary risk or expense to mitigate damages.").

D. Evidence Of Market Conditions Is Also Irrelevant To The Reasonableness Of Assured's Loss Of Bargain Methodology

The lower court also found that Lehman International raised a triable issue of fact regarding the reasonableness of Assured's Loss calculation by alleging that Lehman International's cost for obtaining credit protection increased based on market conditions in 2009, and thus the Transactions were "in the money" to

Lehman International at the time of Assured's determination. (R. 81-82). While this assertion could potentially be relevant to determining Lehman International's loss of bargain if Assured had defaulted, it is irrelevant to Assured's Loss. Moreover, to the extent this movement reflected a change in market prices of the Underlying Securities, it is also irrelevant because Assured did not guarantee such "market prices," but only provided protection against any shortfalls in interest or principal payments on the Underlying Securities as due.

III. THE LOWER COURT ERRED IN FINDING A FACTUAL QUESTION AS TO THE REASONABLENESS OF ASSURED'S LOSS MODEL, WHICH WAS USED FOR MULTIPLE BUSINESS PURPOSES

The lower court erred in finding a triable issue of fact based on Lehman International's challenges to assumptions in Assured's methodology. For the reasons stated above, the court should have upheld Assured's Loss calculation unless it found there was a triable issue of fact regarding whether Assured reached "a determination which no reasonable [N]on-defaulting [P]arty could come to." Enasarco, [2015] EWHC 1307 (Ch) ¶ 53. In calculating its Loss, Assured used the same Payment Model it used to determine regulatory loss reserves. Consistent with its obligations as a regulated insurance company, Assured maintained an independent loss reserve process subject to multiple layers of oversight, including by Assured's Audit Committee, its Chief Actuary and its independent auditor,

PricewaterhouseCoopers. There could be nothing irrational or unreasonable about Assured proceeding in this way.

Moreover, although Lehman International's expert challenged certain assumptions of Assured's Payment Model, there is no evidence that the model's outputs were unreasonable or skewed to Lehman International's detriment. The lower court thus erred in finding a triable issue of fact based on Lehman International's attempts to pull specific assumptions out of context and characterize them as "objectively" unreasonable. (R. 78). The assumptions must be evaluated in the context of the overall methodology, which has proven itself to be remarkably accurate. (R. 259-63). As Assured's experts, Harrison Goldin and David Prager explained:

> To be sure, a good faith attempt to project future losses need not predict the future precisely; rather, it should do so reasonably and realistically, based on management's informed view of data available contemporaneously. The demonstrated accuracy of the models *post-hoc* validates their reasonableness.

(R. 263).

Critically, Lehman International's experts did not offer any alternative calculation based on a Payment Model that used assumptions they believed were more reasonable. The Court can properly infer that this was because there was no loss model available that would have produced an outcome materially different from the model that Assured used. This conclusion is confirmed by Lehman

International's own contemporaneous valuations of the Transactions using its own payment models in connection with both its attempt to novate the Transactions and its negotiation of the termination of the Back-to-Back Transactions with its own affiliate. See supra at 12, 16-17. As set forth above, Lehman International's models predicted essentially the same results as the model used by Assured. See id. Lehman International has no basis to dispute the factual accuracy of its own documents or witness testimony, and there is no triable issue of fact on this point.

CONCLUSION

For the foregoing reasons, this Court should reverse the lower court's holdings that there were triable issues of fact regarding (1) Assured's decision to determine its Loss based on its loss of bargain rather than by the theoretical cost of replacement transactions that did not exist, (2) the reasonableness and good faith of Assured's determination of its loss of bargain, and (3) the reasonableness of Assured's loss model, which was used for multiple business purposes.

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Respectfully submitted,

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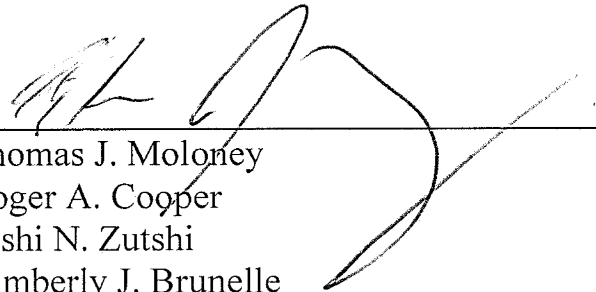

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