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New York Supreme Court

Appellate Division—First Department

Appellate Case No.: 2023-03409

LEHMAN BROTHERS INTERNATIONAL (EUROPE)
(in Administration),

Plaintiff-Appellant,

– against –

AG FINANCIAL PRODUCTS, INC.,

Defendant-Respondent.

BRIEF FOR PLAINTIFF-APPELLANT

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PRELIMINARY STATEMENT

This is a half-billion dollar dispute about how to interpret and apply the ISDA Master Agreement, considered by courts to be the "most important standard market agreement used in the financial world." Supreme Court (Crane, J.S.C.) misinterpreted and misapplied this market-standard contract by permitting Defendant-Respondent AG Financial Products, Inc. ("AGFP") to adopt a never-before-used and wholly subjective method to value credit default swaps ("CDS") that defied commercial reality—turning a $500 million liability into a $20 million gain. The decision conflicts with well-settled New York contract law, which imposes an objective standard of reasonableness; violates the law of this case, including this Court's decision in an earlier appeal; and puts New York at odds with every leading federal and foreign court decision interpreting the ISDA Master Agreement. This Court should correct Supreme Court's error, which upsets settled rules governing the multi-trillion dollar CDS industry, denies Plaintiff-Appellant Lehman Brothers International (Europe) (in administration) ("LBIE") its contractual rights, dramatically departs from market value, and confers a massive windfall on AGFP at LBIE's expense.

CDS are derivative contracts: Their value and payment obligations derive from other financial instruments (like bonds) referenced in the CDS. A buyer (here, LBIE) pays fixed premiums for protection against losses on those underlying

instruments; a seller (here, AGFP) makes payments in the event those instruments suffer losses. Between 2006 and 2008, LBIE and AGFP entered into 28 CDS (the "Transactions"). LBIE paid AGFP millions of dollars for protection against default on $5.7 billion of American subprime mortgages, British residential mortgages, and corporate loans.

AGFP gambled that it could generate additional revenue by selling these Transactions, hoping that losses were relatively unlikely to arise. That was a bet AGFP was clearly losing when it terminated the Transactions in July 2009, yet it simply refused to pay. The global financial crisis in 2008 and 2009 caused huge losses to the pools of mortgages and loans underlying the Transactions, leaving AGFP facing the risk of large payouts on $5.7 billion of protection it had wrongly assumed posed almost no chance of coming due. And unlike many contracts, the ISDA Master Agreement's "no fault" or two-way payment provision required AGFP to reasonably and in good faith calculate its "loss" or "gain" resulting from this termination. If it calculated a loss, it could seek repayment from LBIE. If it calculated a gain, it would owe LBIE that amount.

By all objective measures, removing *$5.7 billion* in potential liability for suddenly very shaky loans was a massive gain to AGFP. If AGFP had followed New York law and standard industry practice it would have valued the Transactions using contemporaneous market prices, which indicated that AGFP owed $485

million to LBIE. If AGFP had used its own internal mid-market values, it would have determined that AGFP owed over $400 million to LBIE. And if AGFP had used its own valuation model but simply relied on market-consensus projections, it would have determined that AGFP owed LBIE nearly $300 million for just two of the 28 Transactions.

Instead, AGFP used an unprecedented, subjective and self-serving valuation methodology to determine that it not only owed *zero* to LBIE, but somehow was owed over *$20 million*. In other words, AGFP claimed that it had sold protection at the height of the market when risk was low, terminated that protection at the bottom of the market when risk was high, but suffered a *loss* by tearing up billions in potential liabilities. This defied logic and was a clear breach of contract.

During a five week bench trial, LBIE introduced evidence of the contemporaneous value ascribed to these Transactions, relying on widely-used objective indicators of market prices. AGFP and its experts, meanwhile, failed to identify any alternative market values and failed to identify a single prior example of any CDS market participant that had used AGFP's subjective methodology to value terminated trades. AGFP's sole witness regarding its calculation freely admitted that it was based on subjective projections by AGFP's insurance affiliate that were at odds with the market consensus.

Had Supreme Court applied the objective standard of reasonableness this Court required when rejecting a prior interlocutory appeal by AGFP, A9527-28 (*Lehman Bros. Int'l v. AG Fin. Prod., Inc*., 168 A.D.3d 527 (1st Dep't 2019)), it would have been skeptical of AGFP relying on its own conveniently rosy projections. AGFP's unmatched optimism was both plainly self-interested—it was on the "protection" side of every CDS it entered and thus had every incentive to downplay future losses—and impossible to square with AGFP's actual business decision to stop selling any CDS like these, at any price, months before termination. Despite those facts, Supreme Court uncritically accepted AGFP's valuation without regard to prevailing market practice and market prices. This was unprecedented, contradicted this Court's interlocutory ruling, and nullified the bargain that LBIE and AGFP had struck on these Transactions.

Supreme Court's decision rests on three fundamental errors, each independently warranting reversal. *First*, Supreme Court's determination that market prices were "irrelevant" is completely at odds with New York contract law and a well-developed international body of law interpreting the same ISDA Master Agreement. It also conflicts with this Court's rejection of the same argument on the prior interlocutory appeal.

Second, Supreme Court contradicted New York law by failing to apply an objective standard of reasonableness to AGFP's valuation, which this Court

previously held should be judged against market practice. Trial evidence established decades of industry practice in which counterparties to derivatives contracts—regardless of their business objectives or individual forecasts—uniformly value terminated CDS consistent with their market price. Supreme Court relied on an erroneous reading of the ISDA Master Agreement, and on a legally irrelevant and factually inaccurate view of the market and AGFP's role in it, to justify its departure from all precedent and prior practice.

Third, Supreme Court compounded its errors by holding that AGFP's methodology and result were reasonable, a decision that cannot be reconciled with the evidence. Supreme Court overlooked the fact that AGFP presented *no evidence at all* regarding its methodology for 26 of the 28 Transactions, but instead offered only hearsay testimony that some unnamed employees at one of AGFP's affiliates determined that those Transactions had less than a 50% chance of incurring losses, and on that basis alone assumed there would be zero future losses. As for the remaining two Transactions, Supreme Court acknowledged that AGFP had projected far fewer future payments to LBIE—amounting to *hundreds of millions of dollars less*—than anyone else was projecting at the time, but somehow concluded that this massive discrepancy was "insufficient to amount to being legally unreasonable."

These legal errors, and others discussed below, warrant reversal of the judgment relating to the termination value of the Transactions, and entry of judgment in favor of LBIE for $485 million based on the unrebutted market value of the Transactions established at trial.

STATEMENT OF QUESTIONS PRESENTED

1. Did AGFP breach its contractual obligation to calculate Loss in an objectively reasonable manner under the ISDA Master Agreement when it valued the Transactions at $20.6 million in its favor when the market value of the Transactions was $485 million in LBIE's favor?

Answer of Supreme Court: Supreme Court incorrectly answered "No."

2. Did AGFP breach its contractual obligation to calculate Loss in an objectively reasonable manner when it valued the Transactions in a manner that deviated from the uniform or highly consistent industry practice?

Answer of Supreme Court: Supreme Court incorrectly answered "No."

3. Did AGFP breach its contractual obligation to calculate Loss in an objectively reasonable manner when it valued the Transactions based on subjective assumptions that were either wholly unsupported by record evidence or contradicted by every independent projection in the record?

a. Answer of Supreme Court: Supreme Court incorrectly answered "No."

STATEMENT OF THE CASE

A. The Parties

LBIE was the Europe-based operating arm of Lehman Brothers, one of the world's leading financial companies before its bankruptcy in September 2008. A702-03.[1] At the time of Lehman's bankruptcy, LBIE was party to tens of thousands of CDS trades. A708-09. As a dealer, LBIE was both a buyer and seller of CDS, in effectively equal amounts. A710-11.

AGFP was created to sell CDS that its insurer affiliate, Assured Guaranty Corp. ("AGC"), was legally prohibited from selling. A1359-60; A1698; A8841, A8843.

B. The Parties' ISDA Master Agreement

The Transactions were executed pursuant to a 1992 ISDA Master Agreement, a standard-form agreement published by the International Swaps and Derivatives Association ("ISDA"). A39; A7133; A7157. The ISDA Master Agreement "serves as the contractual foundation for more than 90% of derivatives transactions globally." *Matter of Lehman Bros. Holdings Inc. v. Intel Corp.*, 2015 WL 7194609 *1 n.1 (Bankr. SDNY, Sept. 16, 2015) ("*Intel*"). It is "probably the most important standard market agreement used in the financial world," and must "be interpreted in a way that serves the objectives of clarity, certainty and predictability." *Anthracite*

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[1] Citations beginning with "A" are to LBIE's Appendix filed with this appeal.

Rated Invs. (Jersey) Ltd. v. Lehman Bros. Finance S.A., [2011] EWHC 1822 (Ch) [114] (Eng.) (quotation marks and citation omitted).

The ISDA Master Agreement provides that following an "Event of Default," such as a party's bankruptcy, the Non-defaulting Party "may" terminate all outstanding transactions and calculate "Payments on Early Termination." A7140-41. If the parties select "First Method," only the Non-defaulting Party can receive such a payment. Most participants in the derivatives market, including AGFP and LBIE here, selected "Second Method," which requires payment to be made to the party for whom the derivative contract had become more valuable by the time of termination—known as being "in-the-money"—regardless of whether it was also the defaulting party. *See Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd*, 452 B.R. 31, 35 (Bankr. S.D.N.Y. 2011) ("*Ballyrock*"); A366-67; A856-57; A7141-42, A7147; A7160.

Section 6(e)(i) of the ISDA Master Agreement provides two standard options for determining the required termination payments: "Market Quotation" and "Loss." A7141-42. Market Quotation values terminated trades based on price quotations from at least four "leading dealers in the relevant market." A7141-42, A7148; A7160, A7169. Market Quotation was "by far, the most common" choice among derivatives counterparties, and is what AGFP and LBIE selected. A372. Attempts to determine a Market Quotation often failed, however, because requests for

quotations were viewed as a "pricing exercise" and not as true opportunities to trade. A377-79; A3707-10; A5388.

If Market Quotation cannot be performed or would not produce a commercially reasonable result, the terminated trades must instead be valued using the "Loss" method. A32; A7148. Loss is the amount the Non-Defaulting party "*reasonably determines in good faith* to be its total losses and costs (*or gain* ...)" on the terminated trades. A7147 (emphasis added). Loss must be calculated "as of the relevant Early Termination date, or, if that is not reasonably practicable, as of the earliest date thereafter that is reasonably practicable." A7147. The contract provides that 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." A7147. It does not, however, permit parties to ignore market prices entirely. A62; A67. Though Market Quotation was the most frequently selected valuation methodology, the infrequency of receiving enough quotes to complete that process meant Loss was the most common valuation methodology that LBIE's counterparties actually used. A829; A8509-17.

While AGFP and LBIE could have negotiated for a different termination provision that did not require market-based valuations—as AGFP had done for other

CDS it sold to LBIE[2]—they did not do so for these Transactions. A374; A2547; A7141-42; A7160; A7208-7587; A8435, A8437.

C. LBIE's Purchase Of Credit Protection From AGFP

The 28 Transactions in this case were CDS, in which LBIE agreed to pay a series of fixed premium payments totaling approximately $34 million in exchange for AGFP's agreement to cover up to $5.7 billion in potential losses (such as shortfalls in principal or interest payments) on various referenced financial instruments. A1547-48. The Transactions fall into three categories:

ABX. The two Transactions with the greatest disputed value referenced an instrument known as the ABX index, which was created by market data company Markit Partners ("Markit") to track the performance of the US subprime housing market. AX-80. Markit published prices for the ABX index every trading day and was considered the benchmark for valuing the ABX. A1280; A8551; *see, e.g.*, A8771. The parties executed these Transactions in February 2007, with AGFP agreeing to pay principal and interest shortfalls up to a total of $500 million. A7598-600; A9295.

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[2] AGFP and LBIE amended the termination provisions for nine other CDS trades which allowed AGFP to terminate those trades in December 2008 on a "walkaway" basis, with no further payment obligation for either party. A374; A861; A998; A7120-21; *see also* A22, A27-28. LBIE is not appealing the portion of the judgment relating to the December 2008 trades.

UK RMBS. Another 14 Transactions referenced residential mortgage-backed securities ("RMBS") backed by pools of British residential mortgages. A352-53; A1212-13; A1993. In return for LBIE's fixed payments, AGFP agreed to cover principal and interest shortfalls up to $4.1 billion. A7598-600; A9339.

CLOs. Eleven Transactions referenced collateralized loan obligations ("CLOs"), instruments backed by pools of risky "high-yield" commercial loans. A1215; A2004-07. AGFP agreed to cover payment shortfalls up to $1.1 billion. A7598-600; A9345.[3]

D. The Financial Crisis Made Defaults More Likely—Increasing The Value Of The Transactions For LBIE

When LBIE and AGFP entered these 28 Transactions between August 2005 and May 2008, a default by any of the underlying reference instruments was considered unlikely. A1874; A7602; A8500-51; A9314. During the following months and years, however, the global economy was devastated by the Great Recession, which was largely fueled by a collapse in the subprime housing market. A3045-46; A6320. "Seventeen trillion dollars in household wealth evaporated within 21 months." A6320. By July 2009, home prices in the United States had dropped by about a third, leaving sub-prime borrowers owing, on average, 40% more than the value of their homes. A4896-97; A6320; A9307. Meanwhile,

[3] AGFP also sold LBIE one CDS referencing a collateralized debt obligation ("CDO"), the valuation of which is not materially disputed. A602; A1252.

unemployment was rising to new heights. A4986-88; A6320; A8690.

Many subprime borrowers fell behind on their mortgage payments: of the loans backing the two ABX trades, 44% had not been paid for at least three months, and a record 20% were defaulting each year, giving lenders the right to foreclose. A9309-10; A9315. With home prices so low, the sale of foreclosed homes generated, on average, only a quarter of the value of the mortgages they secured. A1867-68. The instruments backed by the subprime mortgages included in the ABX index, which all originally had AAA ratings, had almost all been downgraded; by July 2009, 38 of the 40 instruments referenced by the ABX were rated "junk" or worse, meaning that they were at serious risk of default. A9314. The financial crisis also hit the British homeowners whose mortgages backed the UK RMBS trades and the businesses whose loans backed the CLO trades. A1993-95; A4894-95; A8791; A9335.

Unsurprisingly, this massive economic deterioration led to a dramatic rise in the cost to buy CDS on the ABX, UK RMBS, and CLO securities—and a corresponding rise in the value to the buyer of CDS purchased at pre-crisis prices. A8551; A8786; A8806-10; A9302. In June 2008, AGFP internally estimated that the 28 Transactions had a mid-market value of $216 million in LBIE's favor.

A8848.[4] By September 2008, AGFP's estimate increased to $270 million, and by the end of 2008, it had risen to over $400 million, still only a fraction of the total $5.7 billion risk that AGFP faced. A8849-50; A3155.[5] As the economy faltered and the risk of default grew, the Transactions became massive liabilities for AGFP and, correspondingly, hugely valuable to LBIE. Accordingly, their termination logically represented a loss for LBIE and a gain for AGFP.

E. AGFP Terminates The Transactions And Calculates Loss Without Reference To Market Values

On September 15, 2008, LBIE entered bankruptcy administration in the U.K. A8277. Pursuant to the ISDA Master Agreement, this gave AGFP the right (but not the obligation) to terminate the trades. A7140-41. Each of LBIE's 76 other counterparties with similar trades valued their terminated CDS consistent with market values. A824-26; A845-46; A8507-18.

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[4] A "mid-market" price is the mid-point between the price at which a buyer is willing to buy and the seller is willing to sell. A879.

[5] Supreme Court disregarded AGFP's internal accounting valuations based on its erroneous conclusion that market prices were irrelevant. A108. For accounting purposes, AGFP separately adjusted these mid-market valuations purportedly to account for its own creditworthiness, but it has not relied on those valuations in this litigation and did not include an adjustment for creditworthiness in its calculation of Loss. In any event, a party's creditworthiness is irrelevant to a determination of contract damages or a calculation of Loss. *See, e.g.*, *Am. List Corp. v. U.S. News & World Report, Inc.*, 75 N.Y.2d 38, 44-45 (1989); *Peregrine Fixed Income Ltd. v. Robinson Dep't Store Public Co.*, [2000] EWHC 99 (Comm.) [30] (Eng.).

In December 2008, AGFP terminated nine CDS that are *not* at issue here; these nine CDS had special terms allowing for a "walkaway" termination, with no payment owed for future value, which AGFP elected to use. *See* note 3, *supra*. If, as AGFP now claims, the Transactions were valuable to AGFP, its decision to terminate these nine similar CDS on a walkaway basis made no sense. AGFP's decision to walk away from these trades demonstrates that AGFP understood that it owed money to LBIE on these terminated trades.

AGFP did not have a similar "walkaway" right for the Transactions at issue here, so AGFP left them in place for months to avoid realizing the massive losses it would incur upon termination. Further, AGFP refused to permit LBIE to transfer (or "novate") the Transactions to another counterparty. A875; A895. In fact, AGFP refused to even pursue novation unless LBIE agreed to amend the terms of the Transactions in AGFP's favor. A8466-67. When LBIE refused to amend the terms, AGFP promptly terminated the Transactions, preventing an opportunity for LBIE to achieve novation. A8466-67; A7589. Supreme Court erroneously excluded this evidence of AGFP's refusal to novate the Transactions, which was admissible both because it was not offered as an admission of liability and because AGFP's president testified that AGFP *was* willing to novate without condition, opening the door to impeachment evidence establishing the opposite. A3201, A3213, A3225-26.

Having terminated the trades, AGFP—which had no experience valuing terminated derivatives trades—engaged consultants to perform an auction in September 2009 to fulfill the requirements of the Market Quotation valuation process. A6729. As was common, prospective participants recognized the auction as a pricing exercise rather than a *bona fide* effort to execute trades. A4672-73; A4698-99; A9222. Only three banks agreed to participate, and the auction did not generate any bids. A2910.

AGFP thus "fell back" to the Loss methodology. A7594. This time it chose *not* to employ consultants, despite having no experience calculating Loss, relying instead on an employee who had never read the ISDA Master Agreement and did not know his calculations were used for that purpose. A1529. Nor did AGFP calculate Loss by reference to its own internal mid-market valuation—$438 million in LBIE's favor as of June 2009 (A8852)—or to available evidence of market values.

Instead, relying on assumptions its affiliate AGC made as part of a regulatory reserving process in the insurance industry,[6] AGFP calculated Loss by determining the value of the fixed payments LBIE would have owed over the remaining life of the trades, and then subtracting the payments AGFP subjectively assumed it would have had to make over the same period. A7594-95.

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[6] A process that explicitly does not apply to the valuation of derivatives. *See infra* Part II.C.

Because AGC did not take a reserve on any of the UK RMBS, CLO, or CDO Transactions, AGFP concluded that it would never have to make *any* payments to LBIE, despite the monumental increase in risk that had occurred since the Transactions were originally executed. A7598-7600; A1562.

For the two ABX trades, AGFP estimated its future payment obligations using a "handful of assumptions" that were not based on any "third-party market data or benchmark," or assumptions used by other market participants, or any governing "policy or procedure," or any "calculations [or] mathematical formula[e]." A1590-92. Instead, AGFP based its assumptions on the subjective personal beliefs of members of its Reserve Committee, supposedly discussed in off-the-record conversations, regarding future economic trends. *Id.*

Based on these subjective assumptions, AGFP projected that had it not elected to terminate the trades, it would have only had to pay LBIE $24 million out of a potential payment obligation of $500 million on the two ABX Transactions, despite the collapse of the subprime housing market, and that it would not have had to pay a single dollar on nearly $5.2 billion in potential payment obligations on the UK RMBS and CLO/CDO Transactions. A7598-7600. Netted against the future fixed payments LBIE would have owed, AGFP calculated a value of $20.6 million *in its own favor*. A7600, A7604.

AGFP thus ignored its own internal mid-market valuations and all contemporary third-party evidence, and instead claimed that it had been deprived of $20.6 million when it tore up nearly $5.7 billion in potential payment liabilities tied to subprime mortgages and other vulnerable instruments at the height of the global financial crisis.

F. The Proceedings Below

1. Pre-Trial Procedural History

AGFP was the only seller of protection on mortgage-backed CDS that claimed it was owed money by LBIE. A8507-18; A916-17. LBIE, who had paid out hundreds of millions of dollars on CDS where it had sold protection, sued AGFP for breach of contract in November 2011 in order to protect its contractual rights and recover the true value of the Transactions. A112.

Pre-trial proceedings resolved LBIE's claims relating to AGFP's termination of nine trades in December 2008, A36, and the design and execution of the Market Quotation auction, A51.

Justice Marcy Friedman, who presided over the case from 2012 until her retirement prior to trial in 2020, denied AGFP's summary judgment motion with respect to AGFP's Loss calculation. A51-75. Noting that it could "not be disputed that, at the time of the terminations at issue, the financial crisis had significantly increased the prospect of shortfalls in timely interest and ultimate principal

payments," Justice Friedman found a triable issue regarding whether AGFP's calculation of Loss had been reasonable. A74. Justice Friedman ruled that AGFP's conduct was subject to "an *objective* standard of reasonableness" pursuant to which "industry norms may appropriately be considered" and "evidence of departure by [AGFP], as the Non-Defaulting Party, from standard industry practice" must be "considered in assessing its reasonableness and good faith in calculating Loss." A54-65.

Justice Friedman rejected AGFP's argument that the failure of the Market Quotation method justified its decision to ignore market values entirely when calculating Loss. Citing the well-established "cross-check" principle that Market Quotation and Loss should lead to "broadly the same result," Justice Friedman reasoned that "[i]t would make no sense to hold as a matter of law that, because the Market Quotation process was unsuccessful, [AGFP] was free to adopt a methodology that results in a termination payment completely divergent from the cost of replacing the Transactions." A67.

2. AGFP's Unsuccessful Summary Judgment Appeal

AGFP appealed only the portion of Justice Friedman's summary judgment decision finding a triable issue regarding AGFP's reasonableness and good faith in calculating Loss. A9370–71; A9407–9419. AGFP argued, *inter alia*, that (i) Justice Friedman erred in adopting an objective standard of reasonableness; (ii) because the

Market Quotation auction had failed, Justice Friedman erred in ruling that market values were relevant; (iii) evidence of industry custom and practice was irrelevant to the reasonableness of AGFP's calculation; and (iv) the "cross-check" principle should not apply. A9358-9423. This Court rejected each of AGFP's arguments and unanimously affirmed the appealed parts of Justice Friedman's decision, emphasizing the relevance of industry practice:

> Despite the discretion afforded to [AGFP] under the parties' agreements to calculate its loss after the agreements had been terminated, [LBIE] raised an issue of fact as to whether [AGFP]'s loss calculation was reasonable and in good faith as required by the agreements. The court properly considered [LBIE]'s evidence, including expert reports, in support of its claim that [AGFP]'s calculations were not reasonable under the circumstances (*see Hoag v Chancellor, Inc.*, 246 AD2d 224, 230-231 [1st Dept 1998]).
>
> We have considered [AGFP]'s remaining arguments and find them unavailing.

A9527-28, *available at* 168 A.D.3d 527, 528 (1st Dep't 2019) (Renwick, J.P., Manzanet-Daniels, Gische, Mazzarelli, Kahn, JJ.). This decision cleared the way for trial.

3. The Trial

After the original trial date was adjourned because of the pandemic, Justice Friedman retired, and in March 2021 the case was reassigned to Justice Crane, who conducted a five-week bench trial starting in October 2021. A287-5494.

At trial, there was extensive, unrebutted evidence of a uniform or at least highly consistent industry practice of valuing CDS—both in the ordinary course, and

when calculating termination payments under the ISDA Master Agreement—by reference to market value.

a. <u>Expert Testimony Confirms Uniform Market Practice</u>

Four expert witnesses with substantial industry experience each testified to a uniform practice of valuing terminated CDS by reference to market values.

Graham Bruce, formerly Global Head of Structured Credit Trading at Commerzbank and the only trial witness to have traded CDS in 2009, testified that it was standard industry practice to value CDS using a "hierarchy of inputs": (i) market prices for identical trades (Level 1); (ii) market prices for similar trades (Level 2); or (iii) model-based prices using market-based inputs or market-standard assumptions (Level 3). A1276-78; A1334-35; A9296. Mr. Bruce demonstrated that Level 1 and Level 2 market prices were available to AGFP for each of the Transactions as of July 2009. A1308; A1315-16; A1319-21; A1495-96; A9297-302. He also testified that each of the CDS at issue were regularly traded in 2009. A1207-08; A1214-16. Mr. Bruce confirmed that he had "never seen an insurance regulatory reserve approach used for valuing a derivative for any purpose whatsoever." A1380.

Leslie Rahl, a former member of ISDA's board who has been involved with roughly "a hundred separate terminations" governed by the ISDA Master Agreement involving "tens of thousands of transactions," A343; A346-49; A416-17, testified that until this case she had never "been involved in a matter where a party disputed

whether loss, when calculated as a fallback from a failed market quotation, should reach a market-based result," A385.

Evy Adamidou, who negotiated ISDA Master Agreements for insurance company affiliates like AGFP, detailed how those companies "understood very well that the standard provision of the ISDA Master Agreement would lead to a Mark-To-Market termination of the credit default swaps." A2358; A2375; A2378-79.[7] Her testimony was corroborated by evidence of other ISDA Master Agreements—including one executed by AGFP itself—featuring "heavily customized Loss definition[s]" to avoid the use of market values. *See e.g.*, A8269 (AGFP-Deutsche Bank ISDA); A8255, 8257 (LBIE-Ambac ISDA); A8435, 8437 (LBIE-FSA ISDA).

And Dr. Peter Niculescu, an economist who held leadership roles at Goldman Sachs and Fannie Mae, testified based on his involvement in the valuation of roughly 50,000 terminated derivatives trades governed by ISDA Master Agreements that it was "uniform consensus market practice" that Loss and Market Quotation would arrive at broadly the same result—the market value of the terminated transaction. A2041-42; A1854-58; A2037-39. In Dr. Niculescu's words, "there's been a universal understanding and universal application that when a market price is available, even if Market Quotation fails, that the fallback to Loss needs to be based

[7] "Mark-to-market" means to mark (value) the trades at a market price. A1275.

on that market price." A1951.

b. Other Counterparties Follow Industry Practice

Additional testimony and documentary evidence demonstrated that LBIE's other counterparties valued their trades consistent with market prices. Eduardo Viegas, who oversaw LBIE's efforts to reach agreements with LBIE's counterparties regarding the valuation of terminated CDS, testified that when LBIE entered administration, it faced 76 non-AGFP counterparties on 643 CDS trades referencing instruments similar to those at issue here. A730; A798. LBIE was the protection buyer in 296 of those trades, and the protection seller in 347. A8507. Regardless of the counterparties' business models, their subjective views about the future, and the details of their contracts with LBIE, the evidence was uniform. When LBIE was the protection buyer, the 76 non-AGFP counterparties paid LBIE the trade's market value upon termination; and when LBIE was the protection seller, LBIE paid market value. A808-09; A824-26; A832-46; A8507-18. The sole outlier was AGFP.

The evidence also showed that LBIE's U.S. affiliates and their major bank counterparties agreed to value tens of thousands of terminated CDS based on either actual replacement trades or market prices as of the relevant early termination date. A8344-45, 8375; A1355-56; A1971-72. Dr. Niculescu testified that this agreement represented a "market standard" that was used "uniformly" to value other derivatives subject to valuation by a wide variety of market participants. A1971-72; A2038.

This uniform market practice is unsurprising as it conforms with New York law and the standard ISDA closeout provisions.

c. __Major Market Participants, Including AGFP, Acknowledge Industry Practice__

The evidence further showed that industry leaders and AGFP's own parent entity recognized the standard industry practice of valuing terminated derivatives by reference to market value. Just one month before LBIE entered administration, the Counterparty Risk Management Policy Group ("CRMPG"), a diverse group of derivatives industry leaders (including banks, hedge funds, major law firms, and ISDA itself), published a comprehensive report—commonly called "CRMPG III"—which considered in detail the "challenges of closing out a major market participant" under the ISDA Master Agreement. A7836. Assessing current industry practice, the report concluded that there was "general agreement that in determining close-out amounts *market inputs should be used unless doing so would produce a commercially unreasonable result*." *Id*. (emphasis added).

Similarly, AGFP's parent entity Assured Guaranty Ltd. ("AGL") repeatedly acknowledged the existence of a standard market practice for the valuation of CDS trades on termination. In its 2008 10-K filing with the Securities and Exchange Commission ("SEC"), AGL disclosed:

> If a credit derivative is terminated, the Company could be required to make *a mark-to-market payment* as determined under the ISDA documentation. … The process for determining the amount of such

payment is set forth in the credit derivative documentation and *generally follows market practice for derivative contracts*.

A7770 (emphasis added). AGL understood that this market practice would also apply even if AGFP was the Non-defaulting Party. A May 2008 presentation to AGL's Board of Directors acknowledged that "if *the counterparty* defaults[,] [m]ark-to-market may apply." A8819 (emphasis added). In a presentation to the SEC in September 2010, AGL again acknowledged that a "[r]isk of *mark-to-market termination payments* exists." A8839 (emphasis added).

d. **<u>AGFP's Witnesses Do Not Establish A Contrary Market Practice</u>**

AGFP presented three expert witnesses and two fact witnesses, but none of them had *ever* traded CDS, and none of them had *any* experience valuing CDS trades upon termination beyond AGFP's termination of the trades with LBIE. *See, e.g.*, A1525; A1527; A2762-63; A2894-95; A3049-51; A3470-73; A4176-77; A4640-41; A4708-09.

Testimony by AGFP's sole market practice expert, Joshua Cohn, supported LBIE's position. He conceded that it was "common" practice for parties to reference market prices when terminating derivative trades, A3656, and said he would advise clients "to look at the market price," A3696. Mr. Cohn also admitted advising market practitioners in 2009 that under the ISDA Master Agreement's Second Method—which LBIE and AGFP selected here—"the in-the-money party receives

the mark-to-market value upon close-out, even if that party is in default." A7132. Neither he nor any other witness identified a *single* instance in which an ISDA counterparty calculated Loss using an insurance loss reserve model.

e. **LBIE Demonstrated That The Transactions Were Worth $485 Million At Termination**

In addition to this evidence of industry practice, Dr. Niculescu presented a market valuation of the 28 Transactions. For the two ABX Transactions, the valuation "was very straightforward" because "Markit simply publishes the prices. … So we just looked it up." A1954; A8583; A8659; A9333. For the fourteen UK RMBS Transactions, Dr. Niculescu was likewise able to use prices published by Markit, with some simple adjustments to account for certain changes the parties had made to the payment terms of the trades. A1995-96; A2000-01; A8807; A9340. For the nine CLO Transactions, Dr. Niculescu applied a standard valuation methodology using the same sources of market data that AGFP itself used for its internal accounting. A2010-11; A8791; A9347. Altogether, Dr. Niculescu calculated that the 28 Transactions were worth $485 million to LBIE as of the Early Termination Date of July 23, 2009. A1952-53; A2044; A9325.[8]

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[8] This valuation includes approximately $13 million in Unpaid Amounts, which reflect unpaid premiums and interest on those unpaid premiums. A7602. Dr. Niculescu's valuation also includes an adjustment (favorable to AGFP) to reflect the likely transaction costs a party would incur when purchasing the CDS. Dr. Niculescu calculated that, excluding these transaction costs, the mid-market value of the Transactions was $578 million in LBIE's favor. A9325.

Dr. Niculescu also testified that if AGFP had valued the ABX Transactions using the assumptions about the performance of the underlying mortgages that independent third parties had at the time, rather than the subjective and one-sided assumptions its insurer affiliate had adopted, AGFP would have generated a valuation of, on average, $305 million just for those two ABX Transactions. A9320; A7620; A8677-78; A8704; A8744; A1943-48; A9357; A5098-99.

4. The Decision After Trial

In its Decision After Trial, Supreme Court acknowledged that Justice Friedman had "found an issue for trial" because AGFP "did not use market prices in calculating its own loss" and thus that the issue to be tried was "whether Defendant AG Financial Products, Inc's [] calculation of the 'Loss' on 28 Credit Default Swaps ('CDS') was objectively reasonable and made in good faith under the parties' ISDA Master Agreement as of the July 23, 2009 termination date.'" A76 (alteration in original) (citation omitted). This was the decision's first and only reference to the "objectively reasonable" standard.

In its decision, Supreme Court made a number of interrelated and erroneous rulings that are the subject of this appeal. *First*, Supreme Court held that market values were "irrelevant" to AGFP's calculation of Loss, based on its misinterpretation of the ISDA Master Agreement and New York law, as well as its mistaken finding that "the markets" were "dislocated." A97-103, 107-08. These

errors are addressed in Part I below.

Second, disregarding the extensive fact and expert testimony recited above, Supreme Court ruled that LBIE had not demonstrated a "uniform market practice to value utilizing only market prices." A103-06. In doing so, Supreme Court failed to hold AGFP to an objective standard of reasonableness as required by New York law and the law of this case. These errors are addressed in Part II below.

Third, Supreme Court ruled that AGFP had "demonstrated *prima facie* that its [Loss] calculations were reasonable and in good faith." A108-11. As to the ABX Transactions, Supreme Court conceded that AGFP's valuation deviated from the projections of other market observers by "hundreds of millions of dollars," but nonetheless concluded that this massive discrepancy was "insufficient to amount to being legally unreasonable." Regarding the UK RMBS and CLO Transactions, Supreme Court did not identify any competent evidence supporting the reasonableness of these calculations—because AGFP did not present any—and instead expressly relied on evidence regarding AGFP's valuation of the ABX Transactions. These errors are addressed in Part III below.

After judgment was entered, LBIE timely noticed its appeal. A12.

STANDARD OF REVIEW

This Court has plenary authority to review Supreme Court's findings of law and fact pursuant to CPLR 5501. "[I]t is well settled that as to the review of a

judgment following a nonjury trial, [the Appellate Division's] authority is as broad as that of the trial court and that as to a bench trial [the Appellate Division] may render the judgment it independently finds warranted by the facts, taking into account in a close case the fact that the trial judge had the advantage of seeing the witnesses." *Matter of State of New York v. Jesus H.*, 176 A.D.3d 646, 647 (1st Dep't 2019) (quotations omitted).

"An appellate court's resolution of an issue on a prior appeal constitutes the law of the case and is binding on the Supreme Court, as well as on the appellate court … [and] operates to foreclose reexamination of [the] question absent a showing of subsequent evidence or change of law." *Kenney v. City of New York*, 74 A.D.3d 630, 630-31 (1st Dep't 2010) (quotation omitted).

ARGUMENT

I. SUPREME COURT MISAPPLIED NEW YORK LAW AND MISINTERPRETED THE ISDA MASTER AGREEMENT IN FINDING MARKET VALUES IRRELEVANT

It is undisputed that AGFP "did not use market prices in calculating its own loss." A76. Indeed, Supreme Court's central ruling was that "the worth of the Transactions in the market is utterly irrelevant to Assured's Loss." A107. That statement is wrong under New York law, the law of this case, and the cases that have interpreted the ISDA Master Agreement. The portion of the judgment relating to the Transactions should be reversed, and judgment entered in favor of LBIE for $485

million—the market value of the Transactions as of the date of termination.

A. Loss Of Bargain Is Determined By Reference To Objective Market Prices

AGFP has consistently argued, including to this Court on the earlier appeal, that its Loss calculation "is entirely consistent with New York contract law on 'loss of bargain.'" A9416. It was not. Both New York and other leading commercial courts interpreting the ISDA Master Agreement have firmly established that "loss of bargain" is measured by reference to market price. By deliberately disregarding market prices, AGFP breached the agreement.

In New York, "[w]hen a defendant's breach of contract deprives a plaintiff of an asset, the courts look to compensate the plaintiff for the market value of the asset in contradistinction to any peculiar value the object in question may have had to the owner." *Schonfeld v. Hilliard*, 218 F.3d 164, 178 (2d Cir. 2000) ("*Schonfeld*") (applying New York law) (quotations omitted). Loss of bargain damages measure "the difference between the contract price and the fair market value of the property at the time of the breach." *White v. Farrell*, 20 N.Y.3d 487, 499 (2013) (quoting 25 Williston on Contracts § 66:80 (4th ed.)). As this Court has explained, where a party seeks compensation for "'the deprivation of an item with a determinable market value, the market value at the time of the breach is the measure of damages.'" *Cole v. Macklowe*, 64 A.D.3d 480, 480 (1st Dep't 2009) (quoting *Sharma v. Skaarup Ship Mgt. Corp.*, 916 F.2d 820, 825 (2d Cir. 1990) (applying New York law)).

Courts look to the market value because it best "reflects the market's estimate of the present value of the chance to earn future income, discounted by the market's view of the lower future value of the income and the uncertainty of the occurrence and amount of any future property." *First Fed. Lincoln Bank v. United States*, 518 F.3d 1308, 1317 (Fed. Cir. 2008) (citing *Schonfeld*, 218 F.3d at 176). Even where market prices cannot be directly observed, a "hypothetical market value based on expert testimony" serves the "objective that a party seeking recovery for breach of contract is entitled to be made whole as of the time of the breach." *Credit Suisse First Bos. v. Utrecht-Am. Fin. Co.*, 84 A.D.3d 579, 580 (1st Dep't 2011) (quotations omitted); *see Sharma,* 916 F.2d at 826 ("Measuring contract damages by the value of the item at the time of the breach is eminently sensible and actually takes expected lost future profits into account.").

These principles have been consistently applied in cases involving the valuation of CDS. *See, e.g.*, *UBS Sec., LLC v. Highland Capital Mgmt, L.P.*, NYSCEF No. 650097/2009, Doc. No. 641, at 20 (Sup. Ct. N.Y. Cty. Nov. 14, 2019) (Decision and Order After Trial) (rejecting results of CDS auction 11 days after breach in favor of $470 million internal mark-to-market valuation as of the date of breach) (citing *Sharma*, 916 F.2d at 825); *The High Risk Opportunities Hub Fund Ltd. v. Lyonnais*, 2005 WL 6234513, at *8 (Sup. Ct. N.Y. Cty. July 6, 2005) (determining Loss using the parties' internal market-based value for the trades).

Moreover, federal and foreign courts interpreting the ISDA Master Agreement have consistently held that the market value of a derivative is the proper measure of Loss under Second Method. *See Lehman Bros. Special Financing Inc. v. Bank of Am., N.A.*, 553 B.R. 476, 485 (Bankr. S.D.N.Y. 2016) ("*Lehman Bros. Special Financing*") (holding that "under Loss and using Second Method" "a termination payment is calculated using the mark-to-market value of the parties' swap positions"); *Ballyrock*, 452 B.R. at 35 ("Second Method . . . provides for an early termination payment to be made to the in-the-money party regardless of whether that party is in default"); *Anthracite*, [2011] EWHC 1822 (Ch) [117] ("where damages are sought for loss of bargain … the cost of [a] replacement contract as at the breach date is likely to prove the most reliable yardstick for measuring the claimant's loss of bargain"); *Lehman Brothers Finance, S.A. v. Sal. Oppenheim Jr.& CIE. KGAA*, [2014] EWHC 2627 (Comm.) [39-45] (Eng.) (using market prices to value terminated transactions under an ISDA Master Agreement).

B. By Selecting Market Quotation And Second Method, The Parties Chose A Market-Based Valuation Method

Reference to market price is not only a requirement of New York law, it is precisely what the parties agreed to do. In their ISDA Master Agreement, LBIE and AGFP agreed (1) to calculate the Settlement Amount by first looking to leading dealers to price the CDS (Market Quotation); (2) to pay the "in-the-money" party the value of the CDS, regardless of which party had defaulted (Second Method); and

(3) not to otherwise alter the industry-standard terms for calculating the Settlement Amount. A374; A7141-42, 7148; A7160, 7169. All of these choices call for a market valuation, and Supreme Court's assertion that AGFP's "'loss of bargain' … had nothing to do with market prices" is contradicted by the unambiguous contractual terms and cases interpreting them. A100.

First, by selecting Market Quotation as the default valuation method, LBIE and AGFP agreed that a market valuation provided the best, most accurate binding value for any terminated trades. A366-67; A375-76. As ISDA itself has recognized—in a brief authored by AGFP's own expert, Joshua Cohn—parties "choose Market Quotation, and if it fails, resort to Loss," when they "desire Market Quotation or 'roughly the same result.'" Amicus Brief for ISDA at 15, *Lehman Bros. Holdings Inc. v. Intel Corp.*, No. 08-13555 (SCC), Adv. Proc. No. 13-01340, Dkt. 57-1, (Bankr. S.D.N.Y. Jan. 20, 2015). Choosing Market Quotation provides contracting parties with "*ex ante* certainty" regarding the basis of any payment to be made on early termination. *Id*.

Second, by selecting Second Method, the parties agreed that an "early termination payment [would] be made to the in-the-money party regardless of whether that party is in default." *Ballyrock*, 452 B.R. 31, 35 n.9; *Lehman Bros. Special Financing*, 553 B.R. at 485 (under Second Method and Loss, "if . . . the reference [instrument] underlying a Swap had decreased in value over the lifetime

of the Swap, [the protection buyer] would be entitled to a termination payment on account of its interest in that Swap" regardless of whether that party had defaulted); *Intel*, 2015 WL 7194609, at *6 n.46 ("Second Method … allows each party to receive the benefit of its bargain, without regard to which party was the defaulting party.").

Third, while parties that wish to avoid a market-value based termination payment could negotiate alternative termination methods, as LBIE and AGFP did for the nine trades terminated in December 2008, LBIE and AGFP selected the market-standard methods of Second Method, Market Quotation, and Loss for the 28 Transactions. A374; A2547; A2549; A7141-42; A7160.

C. Supreme Court Disregarded "Hornbook Law" And Law Of The Case That Loss Should Approximate A Market Price

Courts applying the 1992 ISDA Master Agreement have recognized that reference to market prices is inherent in the structure of the agreement itself. Under the "cross-check principle," a doctrine first developed in England that has since "hardened into hornbook law," Market Quotation and Loss are "intended to lead to the same result when measuring an Early Termination Payment based on loss of bargain." *Intel*, 2015 WL 7194609, at *16-17.

> Given that [the Agreement] expressly contemplates that, if a Market Quotation cannot be determined or would not produce a commercially reasonable result, the fallback position will be a calculation of Loss, it would be very odd if the two payment measures were not intended to achieve

> broadly the same result, in terms of the payments that have to be made either way . . . .

Britannia Bulk plc [in liquidation] v. Pioneer Nav. Ltd., [2011] EWHC 692 (Comm) [44] (Eng.); *see* A8242 (User's Guide to the 1992 ISDA Master Agreement) (explaining that Market Quotation and Loss are both intended to reflect "the future value of the Terminated Transactions").

Supreme Court acknowledged that application of the cross-check principle is law of the case: "The summary judgment decision in this case held . . . 'a Non-Defaulting Party's Loss (however calculated) should generally be within the range of what the market would pay for a replacement transaction.'" A76 (quoting Justice Friedman's Decision, A67). Yet Supreme Court declined to apply the cross-check principle, stating that it was "not at all clear to this court why" it should do so. A107. But the "why" has been well explained, including by Justice Friedman, and following this Court's rejection of AGFP's interlocutory appeal, it was not within Supreme Court's power to disregard the cross-check principle when evaluating the reasonableness of AGFP's Loss calculation. *See Kenney*, 74 A.D.3d at 630-31; *Holloway v. Cha Cha Laundry, Inc.*, 97 A.D.2d 385, 386 (1st Dep't 1983) ("once an issue is judicially determined … it is not to be reconsidered by judges or courts of coordinate jurisdiction in the course of the same litigation").

D. Supreme Court's Disregard Of Market Values Rested On A Series Of Fundamental Legal Errors

Disregarding these well-settled legal principles, Supreme Court ruled that market prices and market values were "irrelevant" to AGFP's Loss calculation. None of Supreme Court's various reasons support its erroneous conclusion.

1. The ISDA Master Agreement Did Not Permit AGFP To Ignore Market Value

Supreme Court ruled that market prices were irrelevant to AGFP's Loss calculation on the erroneous basis that "the ISDA Master Agreement … specifically stated that Assured 'need not' consider market prices in [its Loss] calculation." A78. The ISDA Master Agreement says no such thing. The language Supreme Court relied on does not refer to all market prices or values, but only one particular source of pricing information: quotations from leading dealers. Thus, it provides that "[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," A7147 (emphasis added). There are myriad pricing sources. By making dealer quotations a specifically permissible, though not required, source, this sentence does not license parties to disregard market values entirely when calculating Loss.

ISDA has explained that this sentence was intended to allow a party to value terminated derivatives using dealer quotes even if those quotes were "not necessarily in accordance with the technical requirements set forth in Market Quotation."

A8241-42. Moreover, Justice Friedman rejected AGFP's argument on Summary Judgment that the cited provision "must be read as effectively removing the issue of use of market prices from the analysis of a Non-Defaulting Party's reasonableness and good faith," A62. Supreme Court improperly disregarded this law of the case and misinterpreted the contract when it adopted AGFP's erroneous interpretation of the Loss provision.

2. AGFP's Failure To Value The Transactions Using Market Quotation Did Not Render Market Values Irrelevant

Supreme Court also wrongly ruled that "once [AGFP's Market Quotation] auction failed … market prices were not relevant to determining Assured's 'Loss.'" A84. Nothing in the ISDA Master Agreement supports this conclusion; in fact, the cross-check principle runs directly counter to it. *See supra* Part II.C. Extensive evidence at trial showed that the Market Quotation method routinely failed—and that Non-Defaulting Parties invariably calculated Loss, as a fallback, on the basis of market values. A828-31; A8507-18.

Not a single court interpreting the ISDA Master Agreement has ever held that the failure of the Market Quotation method renders market prices irrelevant. In fact, as Justice Friedman ruled on summary judgment, "[i]t would make no sense to hold as a matter of law that, because the Market Quotation process was unsuccessful, [AGFP] was free to adopt a methodology that results in a termination payment completely divergent from the cost of replacing the transactions." A67. AGFP

challenged this determination on appeal, arguing that market prices were irrelevant due to the failure of the Market Quotation process. A9370; A9389-94. This Court rejected that argument, A9527-28, and Supreme Court erred by nonetheless adopting it. *See J-Mar Serv. Ctr., Inc. v. Mahoney, Connor & Hussey*, 45 A.D.3d 809, 809, (2d Dep't 2007) (appellate court's prior determination that party's arguments were "without merit" was law of the case and required reversal of lower court's contrary order)).

3. AGFP Is Not A "Monoline Insurer," And Its Business Model Is Irrelevant To The Determination Of Loss

Supreme Court further erred in ruling that "market prices would [not] be relevant anyway" because "Assured is a monoline insurer" that "did not insure the value of the Transactions" but only "their payment flow as payments became due." A78. LBIE's counterparty is not "Assured," it is AGFP. A364; A7591-7596; A7173-77. AGFP is not a monoline insurer; it does not write financial guaranty insurance contracts. A1698; A8841. It exists *only* to enter into CDS trades, which an insurance company is prohibited from doing. A1698; A8845 (New York State Dep't of Fin. Servs., *Circular Letter No. 19*, Sept. 22, 2008). Under New York law, a "'[c]redit default swap' … does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business." N.Y. Ins. Law § 6901(j-1). As a distinct legal entity created to participate in the CDS market and *only* the CDS market, AGFP cannot now invoke the business

interests of its affiliates to shield itself from the legal consequences of its own activities. *See Estevez v. SLG 100 Park LLC*, 215 A.D.3d 566, 568 (1st Dep't 2023) ("Corporate entities may not discard their separate nature when it becomes inconvenient and yet retain all the advantages that it brings."). Supreme Court's failure to distinguish between AGFP and its insurance affiliates was plain error.

Moreover, even taking into account the business model of a "monoline insurer," which AGFP was not, would still not make market values irrelevant to the determination of Loss. Loss-of-bargain damages "compensate the plaintiff for the 'market value' of the asset *in contradistinction to any peculiar value the object in question may have had to the owner*." *Schonfeld*, 218 F.3d at 178 (emphasis added and citation omitted). The value of an asset is not calculated only by reference to one party's view; instead, an "opinion of fair market value must represent not only the seller's viewpoint, but also the buyer's, since value in the market place reflects both influences." *Boyce v. Soundview Tech. Grp., Inc.*, 464 F.3d 376, 388 (2d Cir. 2006) (quotation omitted); *see People v. Collier*, 22 N.Y.3d 429, 435 (2013) (under New York law, a "defendant's subjective interpretation of the agreement does not control").

Supreme Court did not cite any authority suggesting that an industry-standard contract can have a different meaning at different times depending on the subjective business interests of the contracting parties—let alone the business interests of non-

party affiliates. Such a rule would wreak havoc among commercial contracting parties who would, at a stroke, lose any expectation of certainty in the meaning of the agreements they had signed. Supreme Court's factually and legally erroneous ruling should be reversed.

4. Purported "Dislocation" In The Financial Markets Was Legally Irrelevant And Factually Incorrect

Supreme Court also erred in dismissing market values on the basis that "the markets were dislocated, with trading values on these Securities substantially lower than their actual worth." A84. This conclusion was wrong as a matter of law, because market dislocation does not render market prices irrelevant under New York law. It was also factually incorrect, because the trial record does not support a finding that market prices were dislocated or that trading prices were different from the "actual worth" of the Transactions.

Under New York law, market value may be determined regardless of market dislocation. "Although it is easier to determine an asset's market value when it is actively traded on a standardized exchange or commodities market, an asset does not lose its value simply because no such market exists." *Schonfeld*, 218 F.3d at 178. As this Court has held, even if "value cannot be readily discerned at the time of breach, the factfinder may determine 'hypothetical market value' based on expert testimony." *Credit Suisse First Bos. v. Utrecht-Am. Fin. Co.*, 84 A.D.3d 579, 580 (1st Dep't 2011). Disregarding this binding precedent, Supreme Court actually

criticized LBIE's expert for "attempt[ing] to calculate a hypothetical market price based on various pricing proxies"—exactly the sort of analysis that is required in such circumstances. A106.

Supreme Court also miscited *In re American Home Mortgage Holdings Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd* 637 F.3d 246 (3d Cir. 2011), for the proposition that AGFP had discretion to "not use market prices." A100. That case made clear that where instruments "are not readily valued by reference to a market," any alternative methodology must still attempt to solve for *market value*: "Every valuation methodology has as its goal the determination of value, which, by definition, means [its] sale price …." 411 B.R. at 192. *American Home*, like New York law and ISDA precedent, makes clear that the value of a financial instrument is its market value, and thus it would be error to accept any valuation methodology that does not even *seek* to find such a market value.

Factually, Supreme Court's unprecedented finding that CDS markets were "dislocated" in July 2009 and that market prices were therefore unavailable or unreliable was unsupported by the record. Supreme Court relied on a hearsay article from AGFP's expert describing markets *in January 2009*, a hearsay press release from the Treasury Department describing markets *in March 2009*, a hearsay report from the Bank of England describing markets *in October 2008*, and a decision from a Canadian court involving administratively-closed markets *in January 2009*. A85-

86 (citing A7130-32; A7122; A6558; *Barclays Bank PLC v Devonshire Trust*, 2011 ONSC 5008 (Can.)). Supreme Court further erred in relying upon unsubstantiated testimony from AGFP's experts, none of whom had experience trading or valuing CDS in 2009, and a hearsay research article written by two professors at U.C. Berkeley. A85-87; A104 (citing A6385). Reliance on this evidence was error. *See, e.g.*, *Vetti v. Aubin Contr. & Renovation*, 306 A.D.2d 874, 875 (4th Dep't 2003) (reversing and ordering new trial where decision was based upon hearsay document and an expert's opinion based on the same).

The only evidence presented at trial measuring supposed "dislocation" in the CDS markets in July 2009 demonstrated that there was none. Neutral third party research departments from top financial institutions projected future losses on the ABX Transactions that closely matched the quoted market prices, reflecting that market pricing was consistent with expected losses. Supra p. 25; A1941–50; A4992–93. On July 23, 2009, at least seven banks were offering to buy and sell ABX CDS. A8771-85. The trial record established that a market did exist for these trades in 2009, market prices were available and published daily for the widely-traded ABX index, and these market prices reflected a value of $485 million in LBIE's favor as of July 23, 2009. *See supra* pp. 24-25. Even AGFP's expert agreed that by "July of 2009, these [market] events we're talking about in September of '08, that the results of those had eased." A3987-88. And in its own accounting

memoranda from September 2009, AGFP expressly acknowledged that "the ABX Index is still an actively traded and published Index." A9200. Finally, AGFP's mid-market valuation of the Transactions was already $216 million in LBIE's favor on June 30, 2008 (A8848), demonstrating that the Transactions were heavily in LBIE's favor even prior to the period of supposed "market dislocation" cited by Supreme Court.

In sum, Supreme Court's disregard of the market value of the Transactions was contrary to New York law and the parties' contract, and should be reversed.

II. SUPREME COURT LEGALLY AND FACTUALLY ERRED BY FAILING TO APPLY AN OBJECTIVE STANDARD OF REASONABLENESS

Even if New York law and decisions interpreting the ISDA Master Agreement did not require consideration of market values in calculating Loss, AGFP's failure to take market values into account was still an unreasonable departure from well-established market practice. As Justice Friedman ruled on summary judgment, and as this Court affirmed on the prior appeal, AGFP's Loss calculation must be reviewed under an *objective* standard of reasonableness that is properly tested through a comparison to standard industry practice.

At trial, LBIE presented extensive evidence of a uniform industry practice of calculating Loss consistent with market values, as detailed above. *See supra* pp. 19-24. Supreme Court nevertheless ruled that LBIE had not proven "uniform market

practice to value utilizing only market prices." A104. To reach that conclusion, Supreme Court defined the relevant industry so narrowly that it turned an objective standard of reasonableness into a subjective one. This was reversible error.

A. This Court Has Held That An Objective Standard of Reasonableness Applies Here

The ISDA Master Agreement defines "Loss" as the "amount [the Non-defaulting Party] reasonably determines in good faith to be its total losses and costs (or gain . . .)." A7147. On summary judgment, Justice Friedman ruled that under New York law "an objective standard of reasonableness applies to a contractual provision requiring performance of an obligation in a reasonable manner." A58 (citing *MBIA Ins. Corp. v. Patriarch Partners VIII, LLC*, 842 F. Supp. 2d 682, 704-05 (S.D.N.Y. 2012); *Christie's Inc. v. SWCA, Inc.*, 22 Misc. 3d 380, 383-84 (Sup. Ct. N.Y. Cty. Sept. 12, 2008)). Applying that objective standard in this case, Justice Friedman concluded that "[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-Defaulting Party deviates from that practice, that deviation raises a genuine question of fact as to the Non-Defaulting Party's reasonableness or good faith in calculating Loss." A64 (emphasis added).

AGFP appealed, arguing that its Loss calculation "should be evaluated under a deferential standard of rationality" and that evidence of industry practice was accordingly irrelevant. A9407; A9418-19. This Court rejected AGFP's arguments

and unanimously affirmed Justice Friedman's decision, holding that Supreme Court "properly considered plaintiff's evidence, including expert reports, in support of its claim that [AGFP's] calculations were not reasonable under the circumstances," A9527-28, and citing *Hoag v. Chancellor Inc.*, 246 A.D.2d 224 (1st Dep't 1998), which held that "[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered," *id*. at 230-31.

B. Supreme Court Failed To Assess AGFP's Calculation Of Loss Against Standard Industry Practice

Given this law of the case, Supreme Court was required to apply an *objective* standard, testing the reasonableness of AGFP's Loss calculation by taking into account evidence of a "uniform or highly consistent" industry practice. Supreme Court resisted this mandate, wrongly suggesting that uniform market practice was irrelevant to AGFP's Loss calculation because of its supposed status "as a monoline insurer" and the supposed "bespoke (monoline specific) terms" of the CDS. A105. AGFP is *not* a monoline insurer—and even if it were, that would be irrelevant as a matter of law, as discussed above. *See supra* Part I.D.3. Nor did the CDS here have "monoline specific terms": the "ABX trades were standard contract trades," executed on the same basis as any ABX CDS, and the minor changes the parties made to the UK RMBS and CLO Transactions could be (and were) easily addressed

through the application of industry-standard valuation techniques. A2002; A5018-19.[9]

By effectively requiring LBIE to prove a uniform practice involving *monoline* insurers with *identical* trades, Supreme Court erroneously narrowed the multi-trillion dollar CDS market to a party of one (AGFP, who was not even a monoline insurer) and replaced an objective standard of reasonableness with a purely subjective one, contrary to this Court's prior decision and New York law.

Supreme Court likewise was incorrect to rule that LBIE "came nowhere close to proving a uniform market practice to value utilizing only market prices." A104. As set forth above (*see supra*, at pp. 19-24), extensive evidence, presented over weeks of trial, showed an industry standard practice to value CDS using market prices. Supreme Court did not address any of this evidence, and the evidence that it did mention does not support its conclusion. In fact, that evidence all reinforces the existence of an industry practice of calculating Loss based on market value, even in the absence of directly observable market prices.

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[9] Supreme Court erred in relying upon trade terms such as lack of collateralization to disregard market values. A105-06. Collateral reduces counterparty credit risk (i.e., the likelihood that one party will not pay what it owes), but is irrelevant to the value of a terminated trade. A362; A1340. AGFP did not factor credit risk into its Loss calculation, A1342, and it is irrelevant as a matter of law. *See Am. List Corp.*, 75 N.Y.2d at 44-45; *Peregrine,* [2000] EWHC 99 [30]. As to the other trade terms, AGFP used standard market sources to calculate a mid-market value for the Transactions at $438 million in LBIE's favor as of June 30, 2009. A8852.

First, Supreme Court cited various reports supposedly showing that "particularly at times of extreme market disarray, there was no consensus on valuation methods," A104. As explained in Part I.D.4 above, there was no such "market disarray" as of the relevant valuation date here. But in any event, the cited reports say nothing about the calculation of Loss under an ISDA Master Agreement; instead, they are simply analyses by third-party observers regarding conditions in a variety of financial markets months or years before the valuation date relevant here. *See* A6385 (October 2009 report about 2006-2008); A6558 (October 2008 report about 2007-2008); A6264 (March 2009 report about 2006-2008). These hearsay reports, which do not actually discuss *any* practice for calculating Loss, cannot rebut LBIE's conclusive market practice evidence.

Second, Supreme Court also cited a January 2009 article in which AGFP's expert Joshua Cohn observed that "(i)n a distorted market, finding an accurate means of calculating damages may be difficult," A7132, and a "learned treatise"[10] discussing valuation where there is no market for an instrument, *see* A6885. But the very same 2009 article suggests, as a "guide" to the calculation of Loss, "reference to neutral third-party indicators of value, such as market prices," A7132, while the cited "learned treatise" suggests that, where there is no "available market," a Non-

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[10] *But see* N.Y. Practice Series, Evidence in New York State and Federal Courts § 8:71 ("In New York . . . [n]o hearsay exception allows for the admissibility of the contents of a treatise for the truth of the matter asserted therein.").

Defaulting Party might instead calculate Loss using a "pricing model" that uses "market inputs to estimate the value of a transaction," A6885.

Third, Supreme Court cited an English case, *Anthracite*, which referenced "valuation and liquidity difficulties affecting hedge fund portfolios" in 2009, A104, but overlooked that court's ruling that the calculation of Loss there should be based on a "replacement transaction quotation"—that is, a market value. [2011] EWHC 1822 (Ch.) [112, 116].

Finally, Supreme Court suggested that two of LBIE's experts, Ms. Rahl and Dr. Niculescu, had "utilized different valuations in other cases," thereby supposedly demonstrating a lack of uniform industry practice. A104. But the *Devonshire* matter in which Ms. Rahl testified involved unique circumstances: specifically, a 17-month standstill that barred either party from exercising its contract rights until months after the trades would ordinarily have been terminated and valued. *Barclays Bank PLC v. Devonshire Trust*, 2013 ONCA 494, para. 45, 232, 269–70 (Can.) ("Devonshire"). Rather than value the trades as of the end of the standstill period, Ms. Rahl considered the conditions at the time termination would have been triggered. *Id.* at 232. To do so, Ms. Rahl performed a discounted cash flow analysis, and then added a "market risk premium" of hundreds of millions of dollars to adjust for the difference between her projection and the market price. *Id.* at 232–239; A392. Although the trial court in *Devonshire* ruled that Loss should include only the

projection value, and not the market risk premium, the appellate court *reversed*, citing Ms. Rahl's testimony and holding that the addition of a market risk premium was necessary to "value the loss of bargain in relation to the CDS." *Devonshire*, 2013 ONCA 494 at 283.[11]

Similarly, Dr. Niculescu testified that although he employed a discounted cash flow model as part of his valuation in the *Solstice* matter, he determined the present value of the instrument at issue by discounting it "at a market rate" in order to generate a market price "[a]s closely as [he] could make [it]." A2312-14. Contrary to Supreme Court's view, *Devonshire* and *Solstice* provide yet more evidence of a uniform practice of valuing derivatives based on market price.

C. Supreme Court Erred In Finding AGFP's Subjective Insurance Reserve Methodology Reasonable

Rather than hold AGFP to an objective standard of reasonableness informed by market practice, Supreme Court permitted AGFP to value the Transactions using an explicitly subjective methodology. A87-91. To calculate Loss, AGFP looked to the amount of reserves taken by its financial guaranty insurer affiliate, AGC, pursuant to Financial Accounting Standard No. 163 ("FAS 163"). A1523; A7591; A1552-53. FAS 163 is an accounting standard applicable to financial guaranty

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[11] Elsewhere in its decision, Supreme Court repeated the *Devonshire* trial court's reversed error by suggesting that a market risk premium was unnecessary here. A102.

insurance products, and it expressly permits insurance companies to use their own *subjective* assumptions for valuation. A8858; A1555-56. Because insurance products are very different instruments from CDS, FAS 163 states on its face that it "*does not apply to … derivatives instruments*" such as the Transactions. A8860-61 (emphasis added). Given this, and the lack of any evidence at trial of any party valuing CDS using this methodology, it was error for Supreme Court to rule that this explicitly subjective methodology was reasonable.

* * *

As Justice Friedman warned, "[j]udicial interpretation of the ISDA Agreement in a vacuum, without any consideration of industry practice, could lead to results that frustrate, rather than promote ISDA's—and the parties'—objectives of certainty and market stability." A57–58. Yet, that is precisely what Supreme Court did at trial, and provides further basis for reversal.

III. SUPREME COURT ERRED IN FINDING AGFP'S LOSS CALCULATION REASONABLE

Supreme Court erred in finding that the methodology AGFP chose and the result it reached were reasonable. For the ABX Transactions, it used a subjective loss reserve model, designed by its insurer affiliate, AGC, that reduced its liability to LBIE by nearly $300 million dollars compared to third party valuations. For the other 26 Transactions, AGFP did not follow any methodology at all—it simply assumed that it was more likely than not that it would never have to pay LBIE a

single dollar in losses on more than $5 billion of risky mortgages and loans. Because these valuations were not objectively reasonable by any standard, the judgment should be reversed even if this Court were to conclude that Supreme Court did not err in finding market values irrelevant (*supra*, Part I) or failing to apply an objective standard of reasonableness consistent with industry norms (*supra*, Part II).

A. Supreme Court Erred In Finding That AGFP's Subjective Valuation Of The ABX Transactions Was Reasonable

Supreme Court erred in finding AGFP's subjective valuation of the ABX Transactions—which differed from comparable third-party valuations by hundreds of millions of dollars—reasonable. It was able to reach that result only by disregarding substantial evidence that AGFP's assumptions about the performance of the underlying subprime mortgages were massively over-optimistic compared to market consensus and by relying on rank speculation about the third parties' supposed motivations in projecting how the ABX would perform at the time.

The two ABX Transactions reference an index tied to the performance of tens of thousands of U.S. sub-prime residential mortgages issued in 2006—the very height of the housing boom that preceded the Great Recession. A1206-07; A1862-63; A1874; A9307. By July 2009, thousands of these mortgages had already defaulted, thousands more were seriously delinquent, and nearly all of the financial instruments underlying the ABX index had seen their credit ratings downgraded from AAA to "junk" status. A9314; A1862-63.

To project future losses on the ABX, AGFP's insurer affiliate, AGC, began by determining how many mortgages in each pool were current on their payments, delinquent, in default, or foreclosed. A8193; A1597-1601. These statistics were available through Intex, an industry-standard loss-projection calculator, and they are not in dispute. A1706-07.

AGC's model also required assumptions regarding the *future* performance of the mortgage pools. Supreme Court mistakenly believed that AGC relied on assumptions or projections supplied by Intex. *See, e.g.*, A78 ("To determine that [future] default rate, Assured relied on data from Intex involving these very mortgages."); A108 ("Assured used actual market data for the specific Transactions at issue, available through Intex, an industry standard platform, to come up with a default rate of 28%").[12] That was a clear error. As AGFP's witnesses explained, Intex is simply a "modeling tool" that starts with historical data and then renders a projection once a user's "assumptions are layered on." A1686-87; A1706-07; A1722-23.

Supreme Court's mistaken understanding that Intex was the *source* of AGC's assumptions fundamentally undermines its conclusion that AGFP valued the ABX

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[12] Supreme Court incorrectly used the term "Default Rate" to refer to a different metric—the percentage of the *value* of each collateral pool backing the ABX reference instruments that was projected to be lost over the lifetime of the ABX trades. *See, e.g.*, A78 ("Assured came up with a 28% default rate."); A90 (same).

CDS reasonably and in good faith. Supreme Court did not understand that AGC, an insurance company incentivized not to predict crushing losses, had created those projections. And the record showed that AGC's four key assumptions were plainly unreasonable.

First, AGC made an unreasonable assumption regarding how likely a current or delinquent mortgage was to default (the "Default Rate" or "Liquidation Rate"). A1596-97; A1601-02; A1605; A8193. Trial revealed that although AGC had access to reports showing the number of mortgages that were current or delinquent, it did not have up-to-date data regarding the rates at which those mortgages had gone on to default. As a result, AGFP based its assumptions on data—never introduced at trial—supposedly reflecting the historical experience of an unidentified group of mortgages as of mid-2008, months before the crisis and a full year before the Early Termination Date. A1728-29. For example, while AGC assumed that only 26% of "current" mortgages would default, ratings agency Fitch projected that 67% would default, while JP Morgan looked at the actual performance of the loans at issue in the six months leading up to July 2009 and projected that fully *79%* of those borrowers would ultimately default. A8677; A9214; A9356.

Second, AGC made an unreasonable assumption regarding *when* those defaults would occur (the "Default Rate Curve"). A1611-13. AGC did not rely on any data, stale or otherwise; it simply assumed that almost all of the (relatively few)

mortgages it projected to default would do so within roughly three years. A1605-06; A1611-13. Because subprime defaults are mostly driven by housing prices and unemployment rates, A4896-97, this amounted to an assumption that—in the throes of the worst financial crisis in living memory, with housing prices down 33% from their peak and unemployment at historic highs—the economy would rapidly return to pre-crisis default levels. A1874; A9307. That was not an assumption shared by others in the marketplace. A2299-300; A8704; A9318.

Third, AGC made an unreasonable assumption regarding how much would be lost on each defaulted mortgage as a percentage of its value (the "Loss Severity"). A1614-22; A9310. Because housing prices had declined so much since 2006, many homes were worth a fraction of their mortgage. A1862-63; A9307. By July 2009, the mortgages at issue were losing roughly 72% of their value following foreclosure. A1945-47; A9321. Yet AGC projected that loss severities would fall to 40% by 2012 and would not rise thereafter. A2266-71; A9317; A9322. No one else projected loss severities to fall so far or so fast; for example, ratings agency S&P projected that loss severity would remain at 70% indefinitely, and JP Morgan projected that severities would rise above 80% by 2012, and would still be above 60% in 2018. A6324; A8744; A9317. Supreme Court misapprehended the record by citing AGC's *initial* Loss Severity rate of 70% (an observable statistic about

current losses on current foreclosures) to defend AGC's *projected future* rate, which AGC alone projected to improve rapidly. A109.

Fourth, AGC made an unreasonable assumption regarding the rate at which borrowers would prepay their mortgages (the "Prepayment Rate"). A1623-24. When subprime mortgages are defaulting at high rates, prepayments reduce the overall risk of loss to a mortgage-backed security, because loans that prepay cannot default. A1935-37. By July 2009, prepayments on subprime mortgages had fallen from 18% to 2%. A9100; A9308. But AGC projected this rate to shoot back up to between 10% and 15% within about 3 years, effectively removing risky mortgages from the pool and thereby decreasing the likelihood of future losses. A1623-24; A9318. Again, all evidence in the record showed that third parties in the markets projected prepayments to remain at their low, near 2%, indefinitely. A1935; A8704; A9318.

AGC was projecting fewer defaults over a shorter period, higher recoveries from foreclosures, and higher voluntary prepayments than anyone else. These subjective and idiosyncratic assumptions built upon one another, and when combined in the Intex modeling software, they predicted that the mortgage pools backing the ABX Transactions would lose just 28% of their original value. A4041; A9357. This was far more favorable to AGFP than any other market observer projected at the time. Barclays, Bank of America, and JP Morgan all published

research reports projecting losses on the ABX index as of July 2009 to be greater than 40% (Barclays as of July 24, 2009, Bank of America as of July 23, 2009, and JP Morgan as of July 9, 2009); ratings agency Fitch projected losses of 39% as of June 12, 2009; and S&P projected losses of 32% as of July 6, 2009.[13] A8813; A8704, A8678; A9213-18; A6325; A9354. Even seemingly small changes to these percentages amount to massive differences As Supreme Court itself acknowledged, "a couple of percentage points makes a difference of hundreds of millions of dollars." A109; *see* A2296.[14]

Supreme Court did not meaningfully engage with these extreme discrepancies between AGC's assumptions and contemporary projections—discrepancies it mischaracterized as mere "quibble[s]." A108–A110. Supreme Court dismissed these third-party projections based on its misapprehension of the factual record. For

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[13] Supreme Court stated that AGFP's 28% loss projection "aligns" with a report by ratings agency Moody's projecting losses of 30%, A95, but the cited report was released in March 2009, *four months* before the valuation date. A6625. In any event, Supreme Court erred in relying upon the rating agency projections because, as the court noted, the rating agencies were severely discredited for "failing to predict the financial crisis." A94

[14] Supreme Court commended AGFP for taking "into consideration that these instruments had significant structural protections," including the "senior tranche, AAA status" of the trades, and claimed that LBIE "never addresse[d] these structural protections." A110. This again misapprehends the record. *All* of these calculations of expected losses (whether made by the rating agencies, investment banks, or LBIE's experts) incorporate those structural protections and the relevant tranche that was covered, and such features have nothing to do with whether AGC reasonably projected the future performance of underlying mortgages.

example, Supreme Court erroneously suggested that because "most of the loans covered only 80% of the home value … 20% could be recovered in a foreclosure," A109-10, ignoring that the mortgages at issue were losing more than 70% of their value on foreclosure *even when accounting for the residual value of the homes*. A1867–68; A4907–08; A9311. Similarly, Supreme Court referred to the instruments underlying the ABX as having "AAA status," A110, when it is undisputed that by July 2009 only *one* of the forty instruments underlying the ABX Transactions was still rated AAA and that all but one of the rest had been downgraded to junk status, A7609.

Supreme Court's error was compounded by its improper disregard for all evidence presented at trial regarding the projections of leading investment banks, including Barclays, JP Morgan, and Bank of America. A93-94. Each of them issued research reports in July 2009 with projections about the precise mortgage pools underlying the ABX index as of July 2009. A8811; A8682; A8673. Barclays—the preeminent mortgage research desk at the time—published projections as of July 24, 2009 that were consistent with available market prices, indicating that the ABX CDS would incur $324 million in losses. A8813.

Supreme Court disregarded this compelling contemporaneous evidence based on unsupported conjecture that New York's major investment banks might have falsely misrepresented their forecasts in their public research reports—sent to

thousands of institutional clients—in order to benefit LBIE or protect their own presumed litigation interests. A78, A83. No such incentives existed, and there is no record evidence that permitted Supreme Court to conclude they did. To the contrary, the banks' research desks had ample legal, regulatory and commercial incentives to publish accurate forecasts in 2009. A4974–79.

Supreme Court speculated that Barclays might nevertheless have knowingly published inaccurate projections—misleading thousands of customers—because Barclays had purchased other parts of Lehman Brothers' defunct U.S. operations, which were no longer connected to LBIE. A93. But again there was no evidence that Barclays stood to gain in any respect from LBIE's recovery from AGFP. Supreme Court's statement that the other investment banks "undoubtedly were already in litigation or were contemplating litigation against their monoline insurers," A95, is likewise without basis; no evidence was presented at trial that any of the banks whose reports were in evidence faced any comparable dispute. "Speculation and surmise are not a substitute for proof," and no proof of the bias Supreme Court conjured was offered at trial. *De Mayo v. Yates Realty Corp.*, 35 A.D.2d 700, 700 (1st Dep't 1970); 8A Carmody-Wait New York Practice with forms 2d § 60:17 ("a finding founded merely on surmise and suspicion constitutes error").

B. Supreme Court Erred In Finding That AGFP Satisfied Its Burden With Respect To The 26 UK RMBS, CLO, And CDO Transactions For Which It Offered No Evidence

Supreme Court further erred by determining that AGFP met its burden with respect to its valuation of the 26 UK RMBS, CLO, and CDO Transactions. For these Transactions, trial evidence demonstrated that AGFP did not run a valuation model or consult any third-party pricing sources; instead, it simply assumed that it would never have to cover a single dollar of losses on more than $5 billion of total exposure at the height of the Great Recession, based solely on the assumption by unnamed employees of its insurance affiliate that those Transactions were less than 50% likely to incur losses. A1548-57; A1560-75; A7598-602. AGFP never introduced any evidence supporting this extreme and illogical valuation. Its total failure of proof means that it cannot recover with respect to these Transactions, and the judgment with respect to these Transactions should be reversed.

It is undisputed that, from the time the parties entered the CDS to the Early Termination Date, the economic prospects for the instruments referenced by all 26 Transactions fell significantly. A9335, 42-43; A8853-57; A9237-55. As Dr. Niculescu explained, by July 2009 "the global financial crisis that began in the United States had spread;" home prices in the United Kingdom were down, while default rates among high-yield collateralized loans were up. A9335; A9342-43; A1993-96; A2005-06; A8808. But AGFP did not present any evidence at trial

regarding whether—let alone how—it took these changing economic conditions into account when determining that the 26 Transactions would suffer zero losses.

Ben Rosenblum, the actuary responsible for calculating AGC's reserves, testified that he did not calculate any reserve on the 26 UK RMBS and CLO Transactions, and that in fact AGC's Reserve Committee had not reviewed those Transactions. A1569-70. Rosenblum testified that a *separate* group of AGC employees, the "Surveillance Group," had made the determination that the Transactions were less than 50% likely to suffer a loss. A1569-71. Rosenblum could not say when the Surveillance Group had made that determination, what information it had considered, or what analysis it had actually performed. A1575. In fact, when Rosenblum attempted to testify to what the Surveillance Group "would have" done, Supreme Court asked: "What about what they actually did? Do you know the answer?" Rosenblum responded: "No." A1572-73.

Despite this total failure of evidence, Supreme Court ruled that AGFP had reasonably valued these 26 CDS using the "discounted cash flow analysis and projections used across its business." A96. In fact, there is no evidence that any discounted cash flow analysis was performed on these Transactions. Supreme Court cited Rosenblum's testimony regarding what it characterized as "the surveillance runs that *he* performed for these assets," *id.* (emphasis added), but as Supreme Court itself had elicited, Rosenblum was not part of the Surveillance Group, did not know

what analysis (if any) it had performed, and had not analyzed these 26 Transactions. A1570-73. Supreme Court stated (without citation) that AGFP "ran its data through Intex, an industry-standard platform for modelling cashflows," and that, "like the ABX [Transactions], the data was for the exact transactions at issue." A97. In fact, no evidence was presented that AGFP valued these 26 Transactions using Intex. Supreme Court seems to have misunderstood testimony about the ABX and assumed that it applied to the other Transactions, when AGFP's witnesses made clear that it did not. *See* A1568–70.[15]

Supreme Court also cited a spreadsheet that purportedly reflected calculations performed by the Surveillance Group for one of these 26 Transactions. A96 (citing A5809). But AGFP did not rely on the spreadsheet in valuing the 26 Transactions. A1829-31.

For all of these reasons, AGFP failed to meet its burden with respect to the 26 Transactions referencing UK RMBS and CLOs/CDOs. Thus, at the very least, judgment should be entered in LBIE's favor as to those Transactions.

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[15] In its analysis of "Assured's Valuation," Supreme Court did not mention these 26 trades *at all*. A108-11.

CONCLUSION

The judgment as to the 28 Transactions should be reversed, and the clerk should be directed to enter judgment of $485 million in favor of LBIE, which represents the market value of the Transactions as of July 23, 2009, plus interest.[16]

Date: September 22, 2023

Respectfully submitted,

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[16] This amount includes approximately $13 million in Unpaid Amounts. LBIE is not appealing the portion of judgment awarding AGFP $3,960,329.86 plus interest for the nine CDS terminated in December 2008.

PRINTING SPECIFICATION STATEMENT

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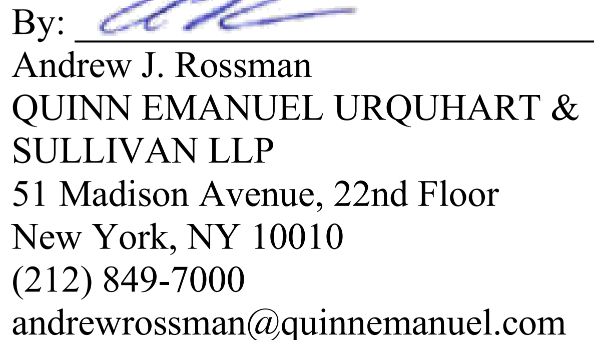
Respectfully submitted,



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STATEMENT PURSUANT TO CPLR § 5531

New York Supreme Court

Appellate Division—First Department

LEHMAN BROTHERS INTERNATIONAL (EUROPE)
(in Administration),

Plaintiff-Appellant,

– against –

AG FINANCIAL PRODUCTS, INC.,

Defendant-Respondent.

1. The index number of the case in the court below is 653284/2011.

2. The full names of the original parties are as set forth above. There have been no changes.

3. The action was commenced in Supreme Court, New York County.

4. The action was commenced on or about November 28, 2011. Issue was joined by filing of a Verified Answer and Counterclaims on or about April 22, 2013. Plaintiff filed a Reply to Counterclaims on or about May 13, 2013.

5. The nature and object of the action is for breach of contract.

6. This appeal is from the Judgment, entered on June 30, 2023.

7. This appeal is on the appendix method.