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To be Argued by:
ANDREW J. ROSSMAN
(Time Requested: 15 Minutes)

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.

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PRELIMINARY STATEMENT

AGFP's brief, like Supreme Court's decision, simply ignores the fact that no other party has ever demanded to be *paid* for terminating billions of dollars of its exposure to risky loan defaults in the middle of a global financial crisis. AGFP was an extreme outlier, the only credit default swap (CDS) counterparty to sell protection on subprime mortgages before the Great Recession and then claim that these contracts were assets, rather than liabilities. As Justice Friedman observed, "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 on the Underlying Securities." A74. The market reflected this obvious point: The $5.7 billion in default protection that AGFP sold to LBIE was worth $485 million—*to LBIE*. Internally, AGFP agreed: Its own books valued the Transactions at $438 million—*to LBIE*. But when it came time to calculate Loss under a no-fault provision in an industry-standard contract, AGFP discarded all objective market data in favor of its own subjective and conveniently self-serving projections that valued the Transactions at $20.7 million—to *AGFP*.

This case raises the question whether New York law blesses the commercially untenable idea that a party can unilaterally transform financial instruments that the market says are a half-billion-dollar liability into a multi-million-dollar asset. It does not, because New York applies an objective standard of reasonableness, and the only

objectively reasonable result here—the only one that followed industry practice and was built on market data—is a substantial payment *from* AGFP *to* LBIE.

Supreme Court's contrary conclusion reflects multiple reversible errors, none of which AGFP's brief rehabilitates.

First, Supreme Court wrongly disregarded New York damages law and the consistent rulings of every court to interpret the ISDA Master Agreement, both of which hold that a loss-of-bargain must be consistent with market values. Instead, Supreme Court ruled that market values were "irrelevant."

Second, Supreme Court wrongly countermanded this Court's mandate to consider market practice evidence to determine objective reasonableness. Instead, Supreme Court disregarded uniform industry practice demonstrated by unrebutted expert testimony from several industry experts and hundreds of market-value closeouts by other market participants.

Third, Supreme Court wrongly refused to hold AGFP to an objective standard even within its own methodology. Instead, Supreme Court granted AGFP judgment on its counterclaim even though AGFP undervalued the Transactions by hundreds of millions of dollars compared to every other market participant, and even though AGFP failed to present *any* evidence of how it had valued 26 of the 28 Transactions.

Unable to deny Supreme Court's fundamental errors, AGFP offers a series of irrelevancies to justify its idiosyncratic and market-defying valuation, none of which

justifies affirmance. AGFP does not even claim that its valuation was objectively reasonable or consistent with market prices (it was not, *see infra* 14-17); instead, it argues that its valuation should be judged in light of its own party-specific circumstances and views—an argument this Court rejected on interlocutory appeal, yet Supreme Court accepted. AGFP does not claim that its valuation was consistent with industry practice (it was not, *see infra* 10-14); instead, it cites the same handful of hearsay articles and legal treatises cited by Supreme Court, none of which endorses its novel approach, while disregarding the actual evidence showing a consistent use of market values for calculating Loss. And AGFP does not claim that its valuation methodology had ever been used by any other ISDA counterparty (it had not, *see infra* 10, 23-30); instead, it argues that its methodology was reasonable because AGFP's affiliate was a monoline insurer who thought of CDS like insurance policies—a contention that is legally irrelevant and would invite all market participants to assign their own subjective values to derivative trades.

The decision below sets both New York's objective reasonableness standard and the interpretation of the most widely-used financial contract in the world on a destabilizing path. It should be reversed. This Court should enter a judgment of $485 million in favor of LBIE, or, in the alternative, vacate the judgment and instruct Supreme Court to issue a decision that considers market pricing and applies an objective standard of reasonableness.

ARGUMENT

I. AGFP IGNORES SUPREME COURT'S DISREGARD OF BINDING PRECEDENT REQUIRING A MARKET VALUATION

AGFP does not square Supreme Court's post-trial decision with New York contract law that defines "loss of the bargain" using "the fair market value of the property," *White v. Farrell*, 20 N.Y.3d 487, 494 (2013) (quoting 25 Williston on Contracts § 66:80 (4th ed.)), or decades of decisions establishing that an ISDA "Loss," when used as a fallback methodology as it was here, "is calculated using the mark-to-market value of the parties' swap positions." *Lehman Bros. Special Financing Inc. v. Bank of Am., N.A.*, 553 B.R. 476, 485 (Bankr. S.D.N.Y. 2016). Instead, AGFP invites the Court to sidestep all precedent and treat this case as unique. Respondent's Brief ("Resp.") 28-32. But despite claiming special status as an affiliate of an insurance company, AGFP identifies no principled basis to single it out for special treatment—a demand that would gut the objective reasonableness protection built into "probably the most important standard market agreement used in the financial world," which should "be interpreted in a way that serves the objectives of clarity, certainty and predictability." *Anthracite Rated Invs. (Jersey) Ltd. v. Lehman Bros. Finance S.A.*, [2011] EWHC 1822 (Ch) [114] (Eng.) (cleaned up).

AGFP's claim that Justice Friedman already discarded New York damages law on summary judgment, Resp. 28-30, misconstrues that decision and the contract.

The ISDA Master Agreement 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." A6103. This contract term grants nothing more than *approval* to use one particular *source* of market evidence (dealer quotes) in determining Loss. It does not give AGFP a license to ignore all prevailing market data, of which there are many sources. Both the reasonableness requirement in the contract and the reference to "loss of bargain," A6103, establish market values as the commercial benchmark, with exceptions only in extraordinary circumstances, such as where a market is closed or a currency discontinued. Justice Friedman correctly recognized that this sentence was "an acknowledgement that there may, within this broad universe of transactions, be situations in which calculation of Loss using market prices may not be possible or would be unreasonable." A61. She further ruled "that a Non-Defaulting Party's Loss (however calculated) should generally be within the range of what the market would pay for a replacement transaction." A68.

There may be situations in which specific sources of market prices are unavailable—although that was not the case here, where daily prices for the ABX Transactions were quoted on a Bloomberg screen, *see infra* 14-15—but in such cases the *objective* of finding a market value remains the same. *See Credit Suisse First Boston v. Utrecht-Am. Fin. Co.*, 84 A.D.3d 579, 580 (1st Dep't 2011) (if "value

cannot be readily discerned at the time of breach, the factfinder may determine 'hypothetical market value' based on expert testimony"); *In re Am. Home Mortg. Hldgs. Inc.*, 411 B.R. 181, 192 (Bankr. D. Del. 2009) (even where assets "are not readily valued by reference to a market," "[e]very valuation methodology has as its goal the determination of value, which, by definition, means [its] sale price").

AGFP's attempt to distinguish this case from New York decisions involving "loss of bargain" (Resp. 30) only establishes how universally this principle applies. AGFP points to no case holding that market value only applies to certain types of assets, and identifies no decision calculating damages based on one party's subjective view. And AGFP entirely ignores the New York and English cases that uniformly interpret "Loss" to reflect market price. Appellants' Brief ("Br.") 31, 33-34, 47 (collecting cases).

The *Devonshire* and *Intel* cases AGFP cites, Resp. 29, 35-37, 48-49, strongly support adherence to objective market values. In *Devonshire*, the trial court calculated "Loss" using a cash-flow model with no risk premium added to bring its results in line with market value, just like AGFP did here for the ABX trades. *Barclays Bank PLC v Devonshire Tr.*, 2011 ONSC 5008 (Can.) ("*Devonshire I*"). But this was reversible error. On appeal, the higher court held that calculating Loss using a model without a risk premium—again, as AGFP did here—"did not value the loss of bargain in relation to the CDS" since the risk premium "constitutes a

significant component of the price of a CDS." *Barclays Bank PLC v Devonshire Tr.*, 2013 ONCA 494 (Can.), ¶¶ 283-84 ("*Devonshire II*").[1] AGFP's need to invoke a *reversed* trial court decision to find an analogue to the methodology Supreme Court blessed here proves the error.

As to *Intel*, AGFP ignores that the calculating party there did not calculate Loss based on "loss of bargain," but rather sought restitution for failure to deliver shares. *Matter of Lehman Bros. Hldgs. Inc. v. Intel Corp.*, 2015 WL 7194609, *22 (Bankr. S.D.N.Y. Sept. 16, 2015). The bankruptcy court, Chapman, J., held that this key difference allowed "Loss" to diverge from market value in that specific circumstance, but not in others. Indeed, the *Intel* court even ruled that Loss and Market Quotation "are intended to lead to the same result when measuring an Early Termination Payment based on loss of bargain." *Id.* at *17. *Intel* thus supports LBIE, not AGFP.

AGFP's reliance on monoline insurance business practices is factually and legally irrelevant. AGFP is not a monoline insurance company, and this contract is not in any way monoline-specific. Br. 37-39; *infra* 11. AGFP's only business is

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[1] AGFP attempts to distinguish *Devonshire* on the basis that it involved a default by the protection seller rather than the protection buyer (Resp. 37 n.7), but it omits that the parties in that case—unlike the parties here—had amended the terms of their ISDA Master Agreement to allow for asymmetric termination payments, rather than the standard no-fault provisions at issue here. *Devonshire I*, 2011 ONSC 5008 (Can.), ¶¶ 328-30.

entering CDS trades, an activity New York's regulators *prohibit* insurers from doing. A1698; A2733; A8841. And when AGFP's monoline-affiliated peers wanted to avoid a market-based valuation under the ISDA Master Agreement, they negotiated to amend the standard termination provisions. Br. 21. LBIE and AGFP did not make any such amendments. Br. 9-10.

Business models are irrelevant to loss-of-bargain damages, which "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) (applying New York law) (quotations omitted). Business models of non-party guarantors are even more irrelevant. *See City of N.Y. v. Clarose Cinema Corp.*, 256 A.2d 69, 71 (1st Dep't 1998) (a guaranty "is independent and by its terms stands alone").

Even if AGFP were allowed to invoke its affiliate's insurance business model, A8843, it defies commercial logic to claim AGFP can terminate its CDS trades years early, but still extract over $35 million in expected future payments from LBIE, as Supreme Court ordered here. A7594. It is tantamount to cancelling a homeowner's insurance policy at the moment flames reach the door and then charging the homeowner for years of future premiums. AGFP cannot take a "heads I win, tails you lose" approach to contract rights, in which it is an insurer for purposes of

eliminating its future risk but a derivatives market participant for purposes of keeping its future reward.

This Court should uphold the uniform expectation that "loss-of-bargain" is measured by market value, and reverse Supreme Court's decision to the contrary.

II. AGFP FAILS TO EXCUSE SUPREME COURT'S DISREGARD FOR EVIDENCE OF MARKET PRACTICE, WHICH VALUED THE TRADES AT $485 MILLION IN LBIE'S FAVOR

Supreme Court acknowledged that Loss must be calculated in a "commercially reasonable" manner. A77; A79, A87; A98; *see* 4E N.Y. Prac., Com. Litig. in N.Y. State Courts §114:39 (4th ed.) ("NY Practice"). This objective standard of reasonableness requires a methodology and result that are consistent with the "accepted business practices" that "actually govern the members of a business" and thus "reflect a practical wisdom born of accumulated experiences." *Bankers Tr. Co. v. J. V. Dowler & Co.*, 47 N.Y.2d 128, 134 (1979). Supreme Court should have applied this objective standard to AGFP's actions, taking into account "industry norms" as this Court directed, but it did not. A9527-28 (citing *Hoag v. Chancellor Inc.*, 246 A.D.2d 224, 230-31 (1st Dep't 1998). Instead, Supreme Court erred by ruling that the voluminous evidence of market practice was "irrelevant." A107; Br. 19-24, 35-48.

Unable to cite any market practice evidence supporting its calculation, AGFP again seeks to recharacterize the objective standard of reasonableness as a subjective

one. It extracts language from a negligence case and the Restatement of Torts to the effect that reasonableness requires consideration of "all of the particular circumstances of the case." Resp. 32 (quoting *Bethel v. New York City Transit Auth.*, 92 N.Y.2d 348, 353 (1998) (quoting Restatement (Second) of Torts § 283, comment c)). But the relevance of "particular circumstances" does not justify a focus on AGFP's supposed idiosyncrasies without consideration of standard industry practice. AGFP advanced the same argument before, contending in its interlocutory appeal that its actions "should be evaluated under a deferential standard of rationality." A9407; A9418-19. This Court rejected that argument then, and should reject it again. A9527-28.

AGFP's brief does not point to any evidence that any party to an ISDA Master Agreement has *ever* calculated Loss in the manner it did here. Br. 44-48. Instead, AGFP merely adopts Supreme Court's erroneous ruling, contending that the evidence does not establish a uniform market practice, that market prices were not available for the trades at issue, and that market prices are in any case irrelevant. Each argument fails.

A. Trial Established A Uniform Industry Practice Of Valuing CDS Using Market Prices And Market Data

The objective standard of commercial reasonableness required Supreme Court to consider whether AGFP's calculation of Loss was consistent with "a uniform or highly consistent practice of calculating Loss in a particular manner under similar

circumstances." A64. Supreme Court committed legal error by discarding industry practice entirely by concluding it could not "ever work to approximate Assured's Loss." A105. AGFP does not address this legal error. Instead, AGFP focuses on Supreme Court's related (and equally erroneous) ruling that the trial evidence did not establish a "uniform" practice. Resp. 33-41.

As set forth in LBIE's opening brief, the evidence regarding market practice was voluminous, uniform, and one-sided. Br. 44-48. It included:

- Testimony from five experts (including AGFP's expert, Mr. Cohn) that it is standard practice to value CDS in the ordinary course and upon termination using market pricing. Br. 20-25. AGFP complains that these experts "performed no systematic study or analysis," Resp. 33, but LBIE's experts had collectively traded and valued tens of thousands of derivatives, and supported their opinions with specific evidence. A346-A350, A918, A1191-1197, A1355, A1365-A1367, A1857-1858. In contrast, AGFP presented *no* examples of parties calculating Loss as it did here.

- Documentary evidence that LBIE's many counterparties on the same type of CDS trades uniformly valued those trades consistent with market pricing. A808-09; A824-26; A832-46; A8507-18. As a dealer, LBIE bought and sold CDS to every type of market participant, and all but AGFP agreed that the buyer of protection on asset-backed securities purchased before the Great Recession and terminated during it was owed money. Br. 22, A8509. AGFP contends that this highly probative evidence is "irrelevant" because its trades had "materially different terms," specifically whether the counterparty was required to post collateral, and whether the trades permitted "physical settlement." Resp. 38-39 (citing A4091-92, A6619-24). But collateral only affects *where* a creditor can obtain payment; it does not affect *the amount of the debt*. Br. 45, n.9. And physical settlement—which was not even a term of the ABX or UK RMBS trades—had "no material economic significance." A2308-11.

- Documentary evidence showing that the largest banks in the CDS market used market prices or replacement trades when terminating their trades. A8344-45, 8375; A1355-56; A1971-72. AGFP again contends that this evidence of market practice is "irrelevant," including because it ostensibly permitted a "subjective valuation," Resp. 38, but the cited document says no such thing and simply contains a boilerplate reservation of rights. A8336.

- A widely published report from industry leaders—including ISDA—acknowledging 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*." A7836. AGFP simply ignores this language. Resp. 34.

- The SEC filings of AGFP's parent company, which acknowledged that "[i]f a credit derivative is terminated, the Company could be required to make *a mark-to-market payment* as determined under the ISDA documentation," and that 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). AGFP contends that this statement only applied where its counterparty terminated. Resp. 39-40. But the statement makes no such distinction, nor would one make sense given that a "market practice for derivative contracts" necessarily applies to the derivatives market *as a whole*.

Supreme Court's conclusory assertion that this evidence "came nowhere close to proving a uniform market practice" cannot stand, particularly in the absence of *any* competent contrary evidence. AGFP's witnesses, for example, did not contest the existence of a uniform practice to value terminated CDS using market pricing. Mr. Rosenblum "had no opinion about what would be the appropriate approach" for valuing trades under an ISDA Master Agreement and was not even aware that the trades were being valued for that purpose. A1524-A1528. Mr. Schozer "was never

involved in a Loss calculation" before this case and had "never seen how someone else calculated Loss under an ISDA." A3051. Mr. Prager admitted he was "not an expert in market practice for calculating Loss under an ISDA Master Agreement," something he had never done himself. A4176-A4177. Dr. Pirrong admitted that he was "not offering an opinion in this case as to the reasonableness or good faith of AGFP's loss calculation," and "not offering an opinion on whether the loss calculation was consistent with market practice under the ISDA Master Agreement." A4640-A4641. The only AGFP witness with *any* relevant experience—the attorney Mr. Cohn—admitted that he advised market practitioners to "look at the market price" when calculating Loss, because when trades are terminated under the ISDA Master Agreement "the in-the-money party receives the mark-to-market value upon close-out, even if that party is in default." A3696, A7132.

In response, AGFP relies on the same few hearsay and irrelevant secondary sources cited by Supreme Court. Resp. 33-41. AGFP cites two hearsay treatises that undermine its position by advocating market inputs to determine value even where there is no "available market." Br. 46-47 & n.10. It cites three hearsay articles analyzing supposed market dislocation, but none addresses market practice for calculating Loss. Br. 46. It cites ISDA, but fails to acknowledge (let alone rebut) ISDA's recognition that parties "choose Market Quotation, and if it fails, resort to Loss," when they "desire Market Quotation or 'roughly the same result.'" Br. 32.

And it cites the testimony of two of LBIE's experts in other cases, without acknowledging that in both cases the experts sought to calculate a market value. Br. 47-48.

Supreme Court erred by disregarding voluminous evidence of industry norms, *Hoag*, 246 A.D.2d at 230-31, instead holding AGFP to a subjective standard of reasonableness.

B. Market Prices Were Available For All Of The Transactions

AGFP contends that even if industry practice mandated consideration of market prices, prices were not available in July 2009. Resp. 41-47. Supreme Court erroneously adopted this view, A78, but the evidence shows otherwise.

1. The ABX Transactions Were Worth $329 Million Based On Published Pricing

The two most significant Transactions in this litigation reference Markit's ABX index, which tracked the performance of subprime mortgages. As Supreme Court acknowledged, "Markit published official prices for the ABX trades at the close of every trading day." A80. Market participants, including AGFP, used Markit's official prices to value ABX trades in the ordinary course. A9200; A1305. Contrary to AGFP's characterization, no "model" is required to calculate the value of ABX trades—and LBIE's experts did not need to construct any "model"—because one may simply consult the published price. A1299-A1300; A9328.

AGFP's own contemporaneous accounting memoranda recognized that "the ABX Index is still an actively traded and published Index," A9200, which was confirmed by evidence of at least seven banks offering to buy and sell ABX trades on July 23, 2009. A8771-85.

Indeed, evidence at trial established that AGFP regularly valued the Transactions for accounting purposes at levels consistent with Markit's prices. Only when calculating Loss did AGFP select a wildly different valuation:

Date	Markit Published Price[2]	AGFP Valuation[3]	Difference (%)
6/30/2008	$203,750,000	$204,100,000	0.17%
9/30/2008	$197,825,000	$198,250,000	0.21%
12/31/2008	$277,325,000	$275,000,000	0.84%
3/31/2009	$362,425,000	$370,000,000	2.09%
6/30/2009	$352,614,828	$352,500,000	0.03%
7/23/2009	**$328,915,632**	**$24,214,686**	**92.64%**

AGFP's use of market prices in the ordinary course disproves Supreme Court's erroneous conclusions that market prices were unavailable, inapplicable due to supposed "bespoke" terms or "structural protections," or unreliable due to supposed "market dislocation." In fact, AGFP valued *these very trades* using market pricing until it was time to calculate Loss. Then, and only then, did AGFP abandon market prices for a subjective loss reserve methodology. Br. 48-49.

[2] A8567-A8583; A8627-A8659; A1299-A1300; A9302; A9328-A9333.

[3] A8848-A8852; A1825-A1827. The figure for July 23, 2009 reflects AGFP's Loss calculation. A7598; A7604; A9302.

2. The UK RMBS And CLO Transactions Were Worth $172 Million Based On Published Pricing

Trial evidence also established that market pricing was available for the UK RMBS and CLO Transactions, that AGFP relied upon these published prices when valuing the trades in the ordinary course, and that AGFP recognized in 2009 that dealers were "still selling protection on [these] asset classes." A9199; A1214-A1216.

Supreme Court acknowledged that Markit "regularly published prices for the mortgage-backed securities underlying [the UK RMBS] trades throughout 2009." A80. As with the ABX trades, AGFP used Markit to value its UK RMBS portfolio in the ordinary course. A1311-A1316; A8807. Dr. Niculescu used Markit's published levels as of July 23, 2009 to determine that the UK RMBS trades were worth $76 million in LBIE's favor. A9340.

Trial also demonstrated that CLO prices were published by JPMorgan. A1319-A1321; A8791. This was the same pricing source that AGFP itself used to value its CLO positions in 2009. A9185. Far from calculating prices "out of whole cloth," A106, Dr. Niculescu used this same source to determine that the CLO positions were worth $96 million to LBIE. A9347.

Dr. Niculescu's market-based valuation of the 28 Transactions at $485 million in LBIE's favor[4] was largely consistent with AGFP's own market-based ordinary course valuation of $438 million as of June 30, 2009. AGFP consistently valued the Transactions as having substantial value *to LBIE* for at least a year prior to termination, but selected an entirely different calculation when determining Loss:

Date	**AGFP Valuation of the Transactions[5]**
6/30/2008	$215,903,625
9/30/2008	$270,478,148
12/31/2008	$403,543,398
3/31/2009	$489,714,380
6/30/2009	$437,909,535
7/23/2009	**($20,663,300)**

AGFP only cites its $216 million valuation from June 2008, Resp. 42-43—and even that outdated, pre-crisis figure is hundreds of millions of dollars in LBIE's favor. AGFP never explains how it could value the Transactions in its own books using market pricing for GAAP accounting, yet take the litigation position (erroneously adopted by Supreme Court) that market pricing was unavailable.[6]

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[4] This amount includes approximately $13 million in Unpaid Amounts.

[5] A8848-A8852; A1825-A1827. The figure for July 23, 2009 reflects AGFP's Loss calculation. Resp. 23.

[6] AGFP also asserts without citation that Supreme Court questioned Dr. Niculescu's credibility. Resp. 44. The Decision contains no adverse credibility findings about any of LBIE's witnesses.

3. The Failure Of Market Quotation Did Not Render Market Prices "Unavailable"

AGFP repeats Supreme Court's erroneous assertion that AGFP's failure to obtain bids during the Market Quotation process in September 2009 shows that market prices were unavailable in July 2009. Resp. 41-42, 49. Justice Friedman firmly rejected this argument:

> It would make no sense to hold as a matter of law that, because the Market Quotation process was unsuccessful, Assured was free to adopt a methodology that results in a termination payment completely divergent from the cost of replacing the Transactions. The parties appear to agree that Market Quotation auctions often fail to produce replacement transactions, even in liquid markets. . . . The failure of the Market Quotation auction in this case does not necessarily mean that Assured was unable to replace the Transactions in the market, or that the price of a replacement transaction is impossible to estimate for purposes of applying the cross-check principle.

A67. This Court affirmed Justice Friedman's ruling on appeal, and should reverse Supreme Court's trial decision to the contrary. Br. 36-37.

AGFP's argument contradicts the structure and purpose of the ISDA Master Agreement, which specifically anticipates that Market Quotation might fail, requiring parties to calculate Loss instead. A7148 (definition of "Settlement Amount"). It does not state or imply that in such a case, the trades are worth nothing, which would make "Loss" essentially meaningless. *Id*; A3710-A3711. The undisputed evidence at trial was that the Market Quotation method failed the vast

majority of the time, yet market participants consistently assigned market values to their trades. Br. 36.

AGFP cites a series of emails from prospective auction participants, Resp. 19-20, but Supreme Court properly ruled that these documents are inadmissible hearsay. A5541-43. The only relevance of the Market Quotation auction is that it failed, requiring AGFP to conduct an objectively reasonable and good faith Loss calculation. The auction is otherwise legally and factually irrelevant.

4. AGFP's Refusal To Permit A Novation Did Not Render Market Prices "Unavailable"

AGFP also cites the fact that LBIE and AGFP did not novate the trades. Resp. 16-17. Supreme Court properly did not rely on the lack of a novation in its Decision, A82, and this Court should disregard it as well.

It is undisputed that AGFP never provided "a binding consent to novate the trades." A875. AGFP wanted to eliminate, not replace, its exposure to risky mortgage-backed securities which had caused the demise of nearly all other monoline insurers. A4801-A4805. Thus, AGFP enacted rules in September 2008 prohibiting new CDS transactions of the type at issue here, A8967-A8981, and it seized on the opportunity to walk away from other trades with LBIE in December 2008 based on a technical default, A27-A28.[7]

[7] This argument also rests entirely on Supreme Court's improper exclusion of evidence showing that AGFP prohibited a novation from occurring unless LBIE

5. Derivatives Markets Were Not Dislocated

AGFP suggests that market pricing was not truly "available" because of "dislocation"—a supposed difference between available market prices and the "true" value of the Transactions. *See* Resp. 26-27, 36, 46-47. This argument is legally irrelevant and contradicted by the record. Br. 39-42. Market prices on the CDS trades at issue were widely available, including to AGFP, which relied on them to value these CDS in the ordinary course. *Supra* 14-17. Moreover, prices were *not* dislocated in July 2009; neutral third-party projections of future losses on the assets underlying the CDS trades matched the market price. Br. 25, 41. AGFP's suggestion that market prices were dislocated because they did not match *AGFP's* subjective loss projection assumptions is just an example of circular reasoning and is inconsistent with the law of the case that Loss must be determined in an *objectively* reasonable manner.

Even if markets were "dislocated," New York law does not permit discarding determinable market prices in favor of a party's subjective view. "[W]here the breach involves the deprivation of an item with a determinable market value, the market value at the time of the breach is the measure of damages." *Sharma v. Skaarup Ship Mgmt. Corp.*, 916 F.2d 820, 825 (2d Cir. 1990) (applying New York

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first agreed to unilaterally modify the trades to make them more favorable to AGFP. Br. 14.

law); *see also Am. Home*, 411 B.R. at 192 (even where markets are dislocated, "the purpose remains the same—to determine as accurately as possible what the sale price would be, i.e., price discovery").

6. LBIE Never Agreed With AGFP's Valuation

Unable to find *any* support for its valuation, AGFP claims that LBIE itself considered the Transactions to be worthless. Resp. 15, 45. AGFP primarily cites a one-off memo that a single LBIE employee prepared in October 2008 following discussions with AGFP. *See generally* A7852-7854. Supreme Court observed at trial that this document was "of little utility" since it merely represented one employee's "impressions." A967. There is no dispute that it was not created in the ordinary course, predated AGFP's calculation by nearly a year, reflected undisclosed or erroneous assumptions regarding the trade terms, and was never approved by LBIE management. A932; A971-A972; A1134-A1136; A1141. Still, it assigned the Transactions a market value between $230 million and $1.3 billion in LBIE's favor. A7853.

Supreme Court properly gave this document and the other hearsay documents AGFP cites no weight. A108. AGFP's reliance on such materials reveals the absence of admissible support for the decision below.

C. Market Prices Were Relevant to AGFP's Calculation of Loss

AGFP argues that regardless of a uniform industry practice or the availability of market prices, LBIE's "hypothetical" calculation of the market value of the Transactions was nevertheless "irrelevant." Resp. 47-49. That is wrong as a matter of law, and Supreme Court's adoption of that argument was plain legal error.

First, AGFP contends that Supreme Court properly considered the "actual terms of the Transactions" which AGFP claims were "[u]nlike the vast majority of CDS." Resp. 47-48. In fact, the ABX trades were documented under standard terms, while the UK RMBS trades varied only with respect to the *timing* of certain payments owed, and the CLO trades varied only in allowing for physical settlement—an economically immaterial term. A2002-A2003; A5259; A2308-A2311. And while neither party was required to post collateral based on daily changes in market price, that only affected the *location* of the funds to satisfy the amount owed on early termination; it did not affect the *amount*. Br. 45, n.9. None of the "actual terms of the Transactions" imposed materially different payment obligations on AGFP as compared to every other market participant—which is precisely why AGFP relied on market prices when calculating the fair value of the Transactions in the ordinary course. *Supra* 14-17. Any structural protections were a known feature of the Underlying Securities themselves and already taken into account by all market participants in their pricing.

Second, AGFP contends that the cross-check principle—that "a Non-Defaulting Party's Loss (however calculated) should generally be within the range of what the market would pay for a replacement transaction," A67—is inapplicable because the Market Quotation process failed. Br. 48-49. But this misrepresents the cross-check principle, and as discussed above, Justice Friedman properly rejected this argument on summary judgment, and this Court affirmed over AGFP's appeal. Br. 18-19.

Here, the trial evidence established that market prices were available for each of the Transactions, and that AGFP's Loss calculation undervalued the Transactions by nearly *half a billion dollars* compared to its own internal mid-market valuation. Supreme Court erred by ruling that a Loss valuation that wiped out the entire market value of the Transactions was nonetheless reasonable.

III. AGFP FAILS TO ESTABLISH THE REASONABLENESS OF ITS LOSS CALCULATION

The ISDA Master Agreement requires a party calculating Loss to reach "a commercially reasonable result," Decision at 23 (quoting *Devonshire I*), which must be consistent with "market convention" and "the realities of the market at the time." NY Practice §114:39.

AGFP's Loss calculation was not consistent with market convention or market reality. AGFP calculated Loss for the two ABX trades using an insurance reserve methodology that permits subjective valuation and has never before been

used to calculate Loss under an ISDA Master Agreement. Br. 48-49. This valuation was based on subjective assumptions regarding the future performance of the underlying subprime mortgages that lacked any contemporary evidentiary support and radically departed from what anyone else was projecting at the time. Br. 49-57. As to the other 26 trades, AGFP advanced *no* competent evidence establishing the use of *any* calculation methodology. Instead, AGFP blithely *assumed* that those 26 trades would never suffer any losses despite the historic downturn in the housing market and broader economy that had dramatically increased risk of default. Br. 58-60.

AGFP does not meaningfully engage with these points of error. Instead, like Supreme Court, it conflates the valuation processes AGFP used by suggesting, incorrectly, that its values for all 28 trades were model-based and subject to extensive internal review, while relying extensively on inadmissible hearsay evidence.

A. AGFP Cannot Establish The Reasonableness Of Its ABX Valuation

To determine whether AGFP's calculation of Loss for the two ABX trades was commercially reasonable, Supreme Court was required to apply an objective standard, taking into account "industry norms." *Hoag*, 246 A.D.2d at 230-31. But AGFP has made no effort to show, either at trial or on appeal, that its valuation was consistent with commercial practice. Instead, AGFP argues that its valuation was

reasonable because it was consistent with its *own* ordinary course practice, a circular argument that would give every party closing out trades under the ISDA Master Agreement unreviewable discretion. Resp. 50.

AGFP's ordinary course valuation showed the Transactions to be a massive asset to LBIE and a corresponding liability to AGFP. *Supra* 14-17. But when calculating Loss, AGFP instead relied on values assigned by its insurer affiliate as part of a reserve process designed for financial guaranty insurance contracts—a fundamentally different type of instrument subject to rules and regulations that expressly *permit* a subjective valuation. Br. 48-49.[8]

Even if this subjective reserve model had been AGFP's "ordinary course" methodology, it was not consistent with industry norms. AGFP cannot identify a *single* instance in which *anyone* used an insurance reserve methodology to value CDS or calculate Loss. At trial, not a single expert—including AGFP's own expert, Mr. Cohn—testified that they had *ever* seen any other counterparty use the methodology AGFP employed here. Br. 20-22, 25.[9]

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[8] AGFP's contention that it had an incentive not to under-estimate future losses gets things backwards. Resp. 50. Unlike LBIE, which both bought and sold CDS and thus had every incentive to value them objectively, AGFP was exclusively a seller and thus stood to benefit by underestimating future losses.

[9] AGFP attempts to characterize its ABX valuation methodology as a "discounted cash flow" methodology akin to those applied by LBIE's experts in unrelated cases. Resp. 20. But in those cases, LBIE's experts applied market inputs to ensure consistency with market pricing. Br. 47-48.

AGFP's ABX valuation was commercially unreasonable for the additional reason that it was premised on a series of outdated assumptions about the underlying subprime mortgages that materially conflicted with all other market participants' contemporaneous projections. Br. 52-55. AGFP seeks to dismiss this critical failure as "nit-picking criticisms." Resp. 55. But under an objective standard, discrepancies between AGFP's subjective assumptions and independent third-party projections are direct evidence of AGFP's unreasonable approach.[10]

Unable to provide specific support for its valuation, AGFP resorts to vagaries, contends that its assumptions were consistent with "observable economic developments" such as supposed "signs of recovery in the housing market [and] programs launched by the Obama administration." Resp. 56. But precisely because any such "economic developments" were "observable," they were equally apparent to, and priced in by, all other market participants as part of the market price. "The value of assets for which there is a market" captures "the discounted value of the

[10] AGFP's defense of its off-market assumptions should be rejected. It claims its loss severity assumption "was in line with the market," Resp. 56 n.12, but the cited testimony addressed *initial* loss severity—an observable historical fact—not *future* loss severities, which only AGFP projected would quickly fall. A4026; *see* Br. 53-54. AGFP contends that whereas JP Morgan projected that 79% of "current" borrowers would default over the lifetime of the ABX trades, AGFP projected 26% only over the next two years, Resp. 56 n.12, but since AGFP projected almost *no* defaults thereafter, its 26% projection was effectively a lifetime rate. A4902-A4903. And AGFP does not contest that its prepayment assumption was not shared by any other market participant. Br. 54.

stream of future income that the assets are expected to produce." *Sharma*, 916 F.2d at 826.

Evidence showed that AGFP's subjective model, populated with commercially unreasonable inputs, generated commercially unreasonable results. AGFP projected losses of roughly $24 million on all of the securities protected by the two ABX trades. A7598-A7600. By contrast, Wall Street's leading mortgage research group, Barclays, projected $324 million in losses. Br. 56. If AGFP's affiliate had populated its model with independent third-party data, it would have calculated losses between $270 million and $339 million. A9322.[11]

AGFP embraces rating agencies S&P and Moody's as neutral market observers, but flatly ignores that those entities' loss projections would result in a substantial net payment to LBIE. Expressed as a percentage of the original value of the entire mortgage pool, AGFP's projection shows a 28% loss vs. 30% by Moody's and 32% by S&P. Resp. 57. But even these seemingly small differences have a massive impact on the magnitude of losses on the specific tranche of the CDS that

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[11] Unwilling to defend Supreme Court's conjecture about the motives and conduct of these banks, Br. 56-57, AGFP contends (Resp. 58-59) that "the banks' analyses worked backwards from market prices" and that boilerplate disclaimers indicated possible conflicts of interest. This misinterpretation was rebutted at trial. In fact, the banks presented *both* market-derived *and* projection-based valuations, which were similar because market prices accurately reflected the expected risk of loss at the time. A2089-A2090.

AGFP agreed to protect, a phenomenon well understood in the CDS market.[12] As Supreme Court itself acknowledged, "[t]his discrepancy is significant in that a couple of percentage points makes a difference of *hundreds of millions of dollars*." A109 (emphasis added). And those are the *best* pieces of market data for AGFP, including Moody's outdated March projection. The other rating agency, Fitch, projected much higher losses, and the consensus view of the leading banks was higher still. A9353.

B. AGFP Cannot Establish The Reasonableness Of Its UK RMBS And CLO Valuation

AGFP bears the burden to prove its counterclaim for recovery on the 26 non-ABX trades, A5498-99, yet it utterly failed to establish that it applied a commercially reasonable methodology or reached a commercially reasonable result. AGFP contends that "overwhelming evidence" supports Supreme Court's finding that AGFP had "calculated its Loss for all twenty-eight Transactions using the same ordinary course-of-business model that its surveillance and loss reserving groups used for multiple critical business purposes unrelated to this litigation." Resp. 50. But for 26 of the trades, there was no competent evidence at all.

[12] As an analogy, imagine a 29-foot levee protecting a seaside town. A model that assumes 28-foot waves might project minimal losses; one that expects 32-foot waves will project a disaster.

Like Supreme Court, AGFP relies almost exclusively on the testimony of Ben Rosenblum, the employee responsible for calculating loss reserves for AGFP's insurance affiliate. But Rosenblum admitted at trial that the "Reserve Committee did not go through those [non-ABX] transactions in the third quarter of 2009," and that he therefore did not calculate *any* reserve value for these trades. A1569-72. Instead, solely because a separate set of employees, none of whom testified or were even identified, had assigned those trades an internal 'AAA rating,' AGFP simply *assumed* that those trades would not suffer a single dollar of losses over the next 20 years. *Id.* Rosenblum did not know what analysis—*if any*—had been conducted to determine that all 26 non-ABX trades should be assigned a AAA rating. A1572-73. He did not know what data—*if any*—had been considered when assigning those ratings. A1575. He did not know what scenarios—*if any*—had been considered. A1573-74. He admitted that he "can't point … to any piece of paper or memo or calculation showing the analysis, if any," regarding the valuation of the 26 non-ABX trades. A1575. Yet he conceded that, because AGFP only took a loss reserve "if there was a *probable* loss" on a transaction, meaning "50 percent or greater," the result of these unidentified employees giving the 26 non-ABX trades an AAA rating

was that AGFP *did not attempt to quantify the actual expected loss* for these trades. A1564, A1567.[13]

Aside from this speculative testimony, the only other evidence Supreme Court and AGFP cite are two spreadsheets purportedly reflecting analysis regarding two of the non-ABX trades. Resp. 52-53. Contrary to Supreme Court's erroneous characterization of these spreadsheets as reflecting work "that he performed," A96, Rosenblum admitted that he had not prepared the spreadsheets, did not know who created them, and could not say whether he had even *seen* them in 2009—and also admitted that AGFP had not relied on either spreadsheet in connection with its Loss calculation. A1779; A1829-32.

AGFP did not present testimony from any witness with personal knowledge of the basis for AGFP's determination that the 26 non-ABX trades would suffer no future losses—an assumption grossly at odds with the market value of those trades. *Supra* 14-17. AGFP therefore failed to carry its counterclaim burden to establish the objective and commercial reasonableness of its Loss calculation.

CONCLUSION

The judgment should be reversed, and the Court should enter a judgment of $485 million in favor of LBIE, plus interest. In the alternative, the Court should

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[13] Neither of AGFP's other fact witnesses had any personal knowledge either. A3023; A3843.

vacate the judgment and instruct Supreme Court to issue a decision that considers market pricing and applies an objective standard of reasonableness.

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