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New York Supreme Court

APPELLATE DIVISION—FIRST DEPARTMENT

Lehman Brothers International (Europe) (in administration),

Plaintiff-Respondent,

– against –

AG Financial Products, Inc.

Defendant-Appellant.

REPLY BRIEF OF DEFENDANT-APPELLANT

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PRELIMINARY STATEMENT

In its opening brief, Assured demonstrated that the Supreme Court erred in denying Assured summary judgment on Lehman International's sole remaining breach of contract claim where Assured had determined its Loss based on its loss of bargain as expressly permitted by the parties' Agreement.[1] Specifically, the Supreme Court erred by:

> (1) holding that irrelevant and inadmissible purported custom and practice evidence could impose an obligation on Assured to reference non-executable market quotations or other hypothetical market prices in its Loss determination, despite the express language in the Loss definition to the contrary;
>
> (2) questioning Assured's purported failure to mitigate Lehman International's loss by taking into account market conditions and the possibility of replacement transactions, even though it is undisputed that there were no replacement transactions available to Assured; and
>
> (3) questioning Assured's calculation of its Loss based on a financial model Assured generally used in its business, public financial reporting, and calculation of insurance regulatory reserves based solely on an expert's challenge to some of the model's underlying assumptions—but not its output—and despite evidence of the reasonableness of the results generated by Assured's model, including the fact that Lehman International's own contemporaneous Payment Model produced the same results.

Rather than responding to these points and attempting to defend the decision below, Lehman International's opposition brief ("Opp'n") largely ignores or rewrites the Supreme Court's opinion and repeatedly invokes the words

[1] Capitalized terms not defined herein have the meaning ascribed to them in Assured's opening brief on appeal ("Opening Br.").

“reasonable” and “good faith” as if they were magical talismans against summary judgment. Specifically, Lehman International ignores and attempts to re-litigate the Supreme Court’s non-appealed decision granting Assured summary judgment with respect to Count III of the Complaint, which held that Assured had made a good-faith attempt to find potential replacement trades through its reasonably designed Market Quotation auction that failed simply because there were no actionable bids. Lehman International also abandons the “ambiguity” rationale that the Supreme Court actually relied on to justify its consideration of purported custom and practice evidence to evaluate whether Assured reasonably determined its Loss. Instead, Lehman International attempts to support the Supreme Court’s decision by advancing a new factual narrative based on “facts” that are not only irrelevant but also unsupported by any admissible evidence in the record. Finally, and critically, Lehman International’s new legal analysis ignores the plain meaning of the Loss definition, which explains what steps Assured needed to take to act “reasonably” and in “good faith” as required by the Agreement.

For these and the other reasons set forth below, Lehman International’s opposition fails to support the existence of any of the purported triable issues of fact that the Supreme Court found. Accordingly, the Supreme Court’s decision should be reversed and the case remanded for entry of judgment in Assured’s favor

dismissing Count II with prejudice and awarding Assured the full amount sought in its counterclaim.

ARGUMENT

I. ASSURED WAS ENTITLED TO DETERMINE ITS LOSS BASED ON ITS LOSS OF BARGAIN AND WITHOUT CONSIDERING MARKET PRICES AS A MATTER OF LAW

A. The Agreement Unambiguously Authorized Assured's Approach To Calculating Its Loss

As Assured showed in its opening brief, the Supreme Court wrongly concluded based on purported custom and practice evidence that Assured's decision to determine its Loss based on its "loss of bargain" without reference to non-executable market quotations or other hypothetical market prices raised a triable question of fact. Assured cannot be required to determine its Loss based on market quotations or other hypothetical market prices for theoretical replacement transactions because the Agreement expressly authorizes Assured to determine Loss based on its loss of bargain and to do so without reference to market prices. (Opening Br. at 26-29).

Lehman International offers no plausible alternative interpretation of this contractual language, which it concedes is unambiguous. (Opp'n at 30). Instead, it urges an unsupported and illogical reading, arguing that the Loss definition permits a Non-defaulting Party to exercise these express contractual rights only if it can establish that doing so was reasonable under the circumstances. (Id.) Moreover,

Lehman International argues that the Non-defaulting Party must show that its election of one of the several alternative approaches for determining Loss explicitly authorized by the Agreement was consistent with how other parties have determined their Loss in other situations. (Id.)

There is no textual support for Lehman International's position. The Agreement plainly places no limitation on the Non-defaulting Party's express right "not" to "determine its Loss by reference to [market] quotations." Nor does the Agreement say that the Non-defaulting Party may choose to determine its Loss based on its loss of bargain only if it can establish that doing so is reasonable in light of custom and practice in the market or other circumstances. Rather, the Agreement explicitly authorizes several different, alternative approaches for determining Loss, each of which is presumptively reasonable. Where a party chooses the loss-of-bargain approach, the separate references to "reasonableness" and "good faith" in the Loss definition simply mean that the specific steps taken for calculating loss of bargain and the calculation itself must also be reasonable—although these provisions cannot require anything expressly excluded by the Agreement.

In any event, Lehman International does not—and cannot—dispute that no executable bids for replacement transactions were available to Assured. (Opening Br. at 24-26). Even under Lehman International's mistaken reading of the Loss

definition, there had to be some circumstances where it would have been appropriate for Assured to determine its Loss without reference to market quotations—and it is hard to imagine a stronger case for doing so when, as here, there are none available.

Aside from offering this plainly erroneous interpretation of the Loss definition, Lehman International makes three futile attempts to invent a new triable issue of fact as to Assured's contractual right to determine its Loss as it did.

First, Lehman International improperly zeroes in on three words in the 242-word Loss definition and argues that summary judgment is not appropriate solely because the Agreement required Assured to determine its Loss "reasonably" and in "good faith." (Opp'n at 25-29). Not every determination of "reasonableness" or "good faith," however, requires a trial; a trial is required only where the party opposing summary judgment identifies specific admissible evidence that creates a genuine material dispute as to whether the other party has acted "reasonably" or in "good faith"—which Lehman International has failed to do. The cases on which Lehman International purports to rely do not hold otherwise. Guidance Enhanced Green Terrain, LLC v. Bank of Am. Merrill Lynch, 45 N.Y.S.3d 392, 395 (1st Dep't 2017) (reversing grant of motion to dismiss where neither party addressed issue of reasonableness); Good Hill Master Fund L.P. v. Deutsche Bank AG, 46 N.Y.S.3d 33, 37 (1st Dep't 2017) (affirming decision after trial, without opining on

suitability of summary judgment, and excluding market practice evidence because contract language governed); Samson Lift Techs., LLC v. Jerr-Dan Corp., 33 N.Y.S.3d 168, 169 (1st Dep't 2016) (affirming denial of summary judgment on "reasonable commercial efforts" clause only where opposing party raised a dispute of material fact); Homayouni v. Paribas, 660 N.Y.S.2d 413, 416 (1st Dep't 1997) (reversing summary judgment, not on reasonableness grounds, but on the issue of whether the party accepted the contract or made a counteroffer). Indeed, in dismissing Count III, the Supreme Court already ruled that there was no genuine factual dispute about Assured's good faith in conducting the Market Quotation auction. (R. 58).

Second, despite not appealing the Supreme Court's dismissal of Count III, Lehman International attempts to re-litigate the fact that Assured attempted in good faith to locate a replacement transaction through a Market Quotation auction, in order to manufacture a triable issue of fact as to the good faith of Assured's Loss determination. Specifically, Lehman International asserts that Assured "pledge[d] not to make cash payments to Lehman" (Opp'n at 36);[2] expressed its belief that

[2] Lehman International argues that Assured delayed exercising its right to terminate the Transactions in recognition that termination would result in a payment to Lehman International. (Opp'n at 9). However, Lehman International's inferences as to why Assured terminated the Transactions when it did cannot supplant the fact that the termination itself was a proper exercise of Assured's contractually granted authority. See (R. 121-22 (dismissing claims because it was undisputed that "the transactions were terminated in compliance with [the bargained-for termination] provision")).

any Market Quotation auction would fail (id.); and conducted its Market Quotation auction "according to restrictive conditions" (id. at 41). Yet these factual assertions cannot raise a material triable issue of fact because they are irrelevant to the issue on appeal here, namely, whether the Loss definition expressly authorized Assured to determine Loss based on its loss of bargain, and without reference to market prices. In any event, there is no admissible evidence to support Lehman International's conclusory assertions, which the Supreme Court properly rejected. Indeed, the first two statements Lehman International cites were made in confidential settlement negotiations with Zolfo Cooper LLP and Assured pursuant to a non-disclosure agreement;[3] accordingly, under CPLR § 4547, such evidence is inadmissible both on summary judgment and at trial.[4] See Anita Terrace Owners, Inc. v. Goldstein Assocs. Consulting Eng'rs, PLLC, 2013 N.Y. Slip Op. 51150(U), at *10 (Sup. Ct. Queens Cty. 2013) ("[Defendant]'s submission of plaintiff's letter

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[3] Indeed, Lehman International repeatedly references mischaracterized evidence obtained during confidential settlement negotiations with Zolfo Cooper LLP and Assured. See, e.g., (Opp'n at 10-12, 15). In particular, Lehman International cites a PowerPoint presentation that was attached to an email clearly stating "please find attached our initial discussion document setting out the basis for settlement." (R. 3503 (emphasis added)). Further, the first substantive page of the PowerPoint itself confirms that it was sent by Zolfo Cooper LLP, which had "been engaged by AG to facilitate settlement of the Swaps held with LBIE." (R. 3510 (emphasis added)).

[4] While the evidence produced through settlement discussions was available to Lehman International because CPLR § 4547 does not apply to discovery, see, e.g., In re Town of Waterford v. N.Y. State Dep't of Envtl. Conserv., 906 N.Y.S.2d 651, 659 (3d Dep't 2010), aff'd, 18 N.Y.3d 652 (2012), the evidence is nonetheless inadmissible at the summary judgment stage under that rule.

. . . the sum and substance of which is an offer of settlement or to compromise is stricken from this motion for summary judgment pursuant to CPLR [§] 4547."); see also J.A.O. Acquisition Corp. v. Stavitsky, 745 N.Y.S.2d 634, 642-43 (Sup. Ct. N.Y. Cty. 2001), aff'd, 739 N.Y.S.2d 821 (1st Dep't 2002) (refusing to grant partial summary judgment on the basis of statements made during attempt by parties to settle their differences).

Third, despite conceding that the Loss definition is unambiguous (Opp'n at 30), Lehman International argues that the Supreme Court's consideration of purported custom and practice evidence for the purpose of assessing whether Assured calculated its Loss "reasonably" and in "good faith" was proper because those terms lack "particularization," and that the Supreme Court did not consider this evidence for the improper purpose of changing plain contractual terms. (Id. at 28-32). This argument fails for several reasons.

As a preliminary matter, Lehman International's description of the decision below is demonstrably false. Although it claims that the Supreme Court "found that the Master Agreement is not ambiguous as to the Non-[d]efaulting Party's discretion to decide whether and how to consider market evidence" (Opp'n at 30 (citing R. 71) (emphasis omitted)), the court explicitly stated that "the ISDA Master Agreement . . . is ambiguous as to whether Loss, under the circumstances of this case, was 'reasonably determine[d].'" (R. 66). That actual ruling was in

error. (Opp'n at 29-30). Rather than defend that holding, Lehman International ignores it and defends a decision the Supreme Court never made.

Lehman International's argument that the terms "reasonable" and "good faith" "lack . . . particularization" is also without merit. (Opp'n at 27-28). Indeed, the Loss definition provides extensive, explicit guidance on what is intended by these terms, which Lehman International simply ignores because the contractual language directly undermines its position. Specifically, the Loss definition makes clear that the Non-defaulting Party may choose to determine "its" Loss based on its "loss of bargain," without reference to market quotations, even when they are available. Assured's choice to do exactly that—in a situation where executable market quotations were undisputedly <u>not</u> available—is plainly reasonable as a matter of law. The Court need not—and cannot—consult additional, extrinsic "guidelines" that contradict express contractual rights to make that determination. (Opening Br. at 32-33 (citing <u>Hoag v. Chancellor, Inc.</u>, 677 N.Y.S.2d 531, 537-38 (1st Dep't 1998)).

In other words, Lehman International's purported custom and practice evidence cannot, as a matter of law, be used to interpret "reasonableness" in a manner contrary to the plain language of the Agreement. (Opp'n at 25-29). Lehman International claims that Assured was unreasonable in failing to consider market prices because there is a consistent market practice of doing so. The plain

language of the Agreement, however, explicitly provides that "[a] party may (but need not) determine its Loss by reference to quotations of relevant rates or prices." (R. 340-44 (emphasis added)). Even the Supreme Court concluded on this point that "the Loss provision could not be clearer." (R. 67). The purported custom and practice evidence that Lehman International attempts to rely on here would thus vary the explicit language providing that Assured need not rely on market prices. Such use of custom and practice evidence is plainly impermissible under New York law. (Opening Br. at 32 (citing MBIA Ins. Corp. v. Countrywide Home Loans, Inc., 39 Misc.3d 1220(A), at *24 (1st Dep't 2013))).

Accordingly, because Lehman International has not meaningfully disputed that (1) the unambiguous language of the Agreement expressly authorized Assured to determine "its" "loss of bargain" without reference to market quotations and (2) no actionable quotations for replacement transactions were, in any event, available to Assured, the Supreme Court erred in relying on purported custom and practice evidence to interpret and effectively nullify the plain contractual language.

B. Lehman International's Custom And Practice Evidence Is Both Inadmissible And Incompetent

Even if this Court were to decide that reliance on market practice evidence to interpret the terms of the Agreement were justified as a matter of law, the market practice evidence put forth by Lehman International is both inadmissible and incompetent, and therefore cannot create a material dispute of

fact. See Zuckerman v. City of New York, 49 N.Y.2d 557, 560 (1980) (recognizing that "the party opposing the [summary judgment] motion must demonstrate by admissible evidence the existence of a factual issue requiring a trial of the action" (emphasis added)).

First, Lehman International points to the testimony of its experts that "monoline insurers were aware of the market practice of considering market valuation when calculating Loss and regularly negotiated modifications to the Loss method when they wished to avoid a market-based calculation." (Opp'n at 32). However, it is undisputed that these individuals conceded they had no experience with a monoline (or any other party) calculating a termination amount under the Loss provision and had never seen an Agreement similar to the one at issue here. (R. 4709-710; R. 4720-721). Further, they acknowledged their opinions were based solely on private, bilateral agreements between other parties that were executed after the Agreement at issue here—agreements of which Assured would have had no knowledge. Compare (R. 348-62 (ISDA Schedule) (executed on April 7, 2000)) with (R. 3822-823 (Parker report) (referring to agreements dated December 2000, March 2001, and August 2006)) and (R. 3834-845 (Adamidou report) (providing no specific dates for general statement that monolines knew of mark-to-market practice)).

Second, Lehman International points to nine other Assured trades that were negotiated with alternative provisions to demonstrate that Assured was aware of the market practice of marking-to-market. (Opp'n at 32). Those provisions merely gave Assured alternative bases for terminating those nine transactions, and permitted it to do so on a walk-away basis, thereby avoiding disputes over Loss calculations. That Assured sought to protect itself in this way against the type of costly litigation against which it is defending itself here is not relevant to the issues in this appeal, let alone sufficient to create a triable issue of fact.

Third, Lehman International points to the settlement framework developed by its U.S. affiliates after its 2008 bankruptcy, in which a majority of these affiliates' counterparties (which were other financial institutions, not monoline insurance companies) relied upon market information. (Opp'n at 19-20). But Lehman International does not dispute that, under New York law, for industry practice to have any weight, the parties must be aware of that practice and intend to follow it at the time of entering into the contract. (Opening Br. at 34-39).[5] Such

[5] Instead, Lehman International suggests that Assured's arguments regarding whether parties were aware of the purported custom and practice at the time of contracting "are not responsive to the actual ruling on appeal," because the lower court purportedly "did not consider extrinsic evidence to vary contract terms but instead to assess whether triable issues existed as to Assured's breach of those terms." (Opp'n at 32). As discussed supra, Lehman International misreads the opinion below; accordingly, the issue of whether the parties could have referred to its purported custom and practice evidence when contracting is relevant to assessing whether the lower court erred in considering it.

facts are therefore irrelevant as a matter of law because they post-date the Agreement at issue, and could not conceivably inform what Lehman International and Assured specifically intended years earlier when they entered into their Agreement. Moreover, Lehman International has no response to Assured's argument that those ad hoc settlements have never been accepted as precedent by any court, including the Lehman bankruptcy court. (Opening Br. at 36-37).[6] Finally, no reasonable factfinder could conclude that Lehman International's anecdotal evidence overrides the position adopted by ISDA, the industry group that publishes the form of agreement used in this case, in the Intel case, which was that "Loss was not intended to be a one-size-fits-all provision, and its misinterpretation as such would rob the provision of the important freedom it is intended to convey." (Id. at 19 (quoting R. 1503)).

Ultimately, Lehman International is correct that "the parties sharply dispute the strength and import of the market practice evidence in the record," but it fails to confront that Assured disputes that evidence because of its legal irrelevance and insufficiency. Extrinsic evidence like Lehman International's purported custom and practice evidence cannot vary the express terms of the parties' Agreement, and, even if it could, there is no reason to believe that the parties were aware of, or

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[6] Lehman International's new counsel is also counsel to the U.S. affiliates in the Lehman bankruptcy, and thus plainly could have challenged this fact were it not true.

intended to contract in reference to, an industry practice of marking-to-market. Thus, it was error for the Supreme Court to rely on such evidence of industry practice to find a triable issue of fact.

II. ASSURED USED AN INHERENTLY REASONABLE APPROACH TO CALCULATE ITS LOSS OF BARGAIN

As Assured showed in its opening brief, the Supreme Court also erred in finding triable issues of fact as to whether Assured should have mitigated Lehman International's loss by considering market conditions and the possibility of replacement transactions. This was erroneous for two reasons: *first*, because Assured's approach reasonably reflected its own loss of bargain, both because it satisfied a deferential rationality standard of review and because it was consistent with New York damages law; and *second*, because the Supreme Court found that Assured fully complied with its contractual obligation to conduct a Market Quotation auction, which yielded no executable bids, and which established that there were no possible replacement transactions to consider. (Opening Br. at 24-26; 43-53). In response, Lehman International makes four arguments: (1) a deferential standard of rationality does not apply (Opp'n at 33-37); (2) New York damages law is irrelevant (id. at 43-45); (3) the failure of the Market Quotation auction does not "conclusively demonstrate[] the unavailability of market-based pricing information" (id. at 41-42); and (4) the cross-check principle raises a triable

question regarding the reasonableness of Assured's methodology and result (id. at 45-49). None of these arguments has merit.

A. A Deferential Standard Of Rationality Is Required

Lehman International does not dispute that the English courts that have considered this issue apply a rationality test, nor does it dispute that such a test is consistent with ISDA's objective to prevent every single Loss calculation from being second-guessed in costly litigation. See Lehman Bros. Holdings v. Intel Corp. (In re Lehman Bros. Holdings Inc.), No. 08-13555 (SCC), 2015 WL 7194609, at *12 (Bankr. S.D.N.Y. Sept. 16, 2015) (recognizing the "considerable advantages given to the [N]on-defaulting [P]arty," in furtherance of "the marked reluctance to allow second guessing of a party that determines a settlement amount" (quoting Professor Golden)); see also Simon Firth, Derivatives: Law and Practice 11-153 (2018) (explaining that the Agreement "reflects the fact that, where discretion is given to a party, it is that party which is the decision-maker, rather than the court"). Lehman International instead argues that the rationality standard is contrary to New York law because New York law requires an "objective standard" of reasonableness. (Opp'n at 33). But this misconstrues the rationality standard. There is nothing subjective in that standard, which simply prohibits Assured from reaching a determination that no objectively reasonable person in the same position could reach. (Opening Br. at 46). Nor is this standard

uncommon under New York law. See, e.g., People v. Dunbar, 24 N.Y.3d 304, 317 (2014) (applying "[n]o reasonable person in the position" standard to clarity of Miranda warning regardless of subjective confusion); Security Police & Fire Prof'ls of Am. Ret. Fund v. Mack, 940 N.Y.S.2d 609, 614 (1st Dep't 2012) (applying "no reasonable person in the directors' position" standard to decisions by executives challenged as corporate waste without reference to subjective intent).

Lehman International also unconvincingly claims that a deferential rationality standard is contrary to the language of the Agreement because other terms of the Agreement purportedly "grant one party unfettered discretion," and the Loss definition is not one of them. (Opp'n at 34-35). But Assured has never claimed it has "unfettered discretion," nor does the rationality standard provide for unfettered discretion.

Finally, Lehman International contends that the court in Intel did not actually endorse a deferential rationality standard because it did not use the word "rational." (Opp'n at 34). Yet, even without using that word, the court made clear that it was applying a similarly deferential standard to evaluate the reasonableness of Intel's Loss calculation by explicitly recognizing that "there is no single 'correct' methodology for calculating Loss." Intel, 2015 WL 7194609, at *19. This is further confirmed by the court's analysis and ultimate ruling granting summary judgment to Intel dismissing Lehman's challenge to the reasonableness

of Intel's Loss calculation. The Supreme Court's decision not to apply an appropriately deferential standard, regardless of what one calls it, was indisputably a departure from the Intel precedent.[7]

B. Lehman International Does Not Dispute That Assured's Approach To Determining Loss Was Consistent With New York Damages Law

Lehman International also challenges Assured's argument that, even if a deferential rationality standard did not apply, Assured's loss of bargain approach would still be reasonable because it is consistent with New York damages law. Importantly, however, Lehman International does not dispute that Assured's cash-flow methodology was consistent with New York damages law; instead, it claims merely that New York damages law is inapplicable because the election of a "Second Method" valuation is a "'fundamental departure' from common law damages." (Opp'n at 44). This argument fails. The Second Method provision in the Agreement is a modification of ordinary New York damages law in that it allows for the possibility that Loss may be a negative number, resulting in a

[7] Lehman International's claims that the Intel court did not apply such a rationality standard are belied by Lehman International's own counsel's recognition that the decision below was a serious, novel departure from prior precedent, including, specifically, Intel. See Davis Polk & Wardwell, Davis Polk Defeats Summary Judgment Motion on Behalf of Lehman Bros. Int'l Europe (July 13, 2018), available at https://www.davispolk.com/news/davis-polk-defeats-summary-judgment-motion-behalf-lehman-brothers-international-europe (last visited Nov. 9, 2018) ("Justice Friedman's decision is particularly significant given that the only other U.S. case to analyze the Loss provision, [Intel], largely held that the Loss provision gave the [N]on-defaulting [P]arty significant discretion to calculate its Loss.").

payment to the breaching party.[8] But the Second Method provision has no other relevance to how a party's loss of bargain is measured. Lehman International can point to nothing in that provision or elsewhere in the Agreement to contradict the notion that a party's loss of bargain should be calculated based on the benefit of the bargain that it would have received under the contract in the event there had been no breach, which is precisely how Assured determined its loss of bargain here. (Opening Br. at 50-52).

C. There Can Be No Triable Issue Of Fact On The Reasonableness Of Assured Not Considering Replacement Transactions When It Is Undisputed That No Such Replacement Transactions Existed

Lehman International's miscellaneous arguments as to why the Supreme Court did not err in concluding that Assured should have mitigated Lehman International's loss by considering replacement transactions are unavailing.

First, it is undisputed that no executable replacement transactions were actually available to Assured. Nor does Lehman International dispute that the absence of any such bids was consistent with its own contemporaneous internal assessment of the Transactions, as well as its own inability to novate or obtain

[8] For example, if Assured had determined that the projected losses for the Transactions were larger than the value of fixed payments owed by Lehman International, the Second Method would have required a payment by Assured to Lehman International. The provision is designed to prevent windfalls and not to undermine New York law damages principles. See Anthony C. Gooch and Linda Klein, Documentation for Derivatives: Annotated Sample Agreements and Confirmations for Swaps and Other Over the Counter Transactions 230 (4th ed. 2002) (explaining that the Second Method reflects the view that "the [Non-defaulting] [P]arty should not be allowed to reap a windfall from a default").

executable bids, and the uncontested opinion of the market, as summarized by Assured's own expert. (Opening Br. at 12-16 (citing R. 1099; R. 1109)).

Second, nothing in the Agreement, or New York law more generally, required Assured to somehow mitigate its loss when there were no available executable replacement transactions. (Id. at 54 (citing cases)). Lehman International makes no effort to address that argument or the underlying law, and entirely ignores the cases on which Assured relies.

Third, the suggestion that Assured should have considered other so-called "market based indicators of value," namely, non-binding indicative bids and the estimates generated by a hypothetical Pricing Model[9] (Opp'n at 41), should be rejected for several reasons. Non-binding indicative bids (and especially the heavily caveated ones solicited by Lehman International here) do not provide a reliable basis for valuing an asset and cannot create a triable issue of fact.[10] (Opening Br. at 15). Similarly, the purported estimates generated by the computer

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[9] Though Lehman International argues that it would have been "in the money" because of the state of the financial market at the time the Transactions were terminated (Opp'n at 49), this argument is irrelevant to Assured's calculation of its Loss as the Non-defaulting Party because Assured never guaranteed market prices. (Opening Br. at 54-55). Accordingly, the "market context surrounding the termination [of the Transactions]" does not raise a triable issue of fact. (Opp'n at 49).

[10] Lehman International's argument that the Loss definition must contemplate consideration of indicative bids because a different provision (Market Quotation) provides for the use of an average of multiple quotes (Opp'n at 41-42) is not only illogical on its face, but also ignores the express language in the Loss definition stating that Assured "need not" determine its loss by reference to market quotations, which would include any indicative bids. (R. 341).

models of Lehman International's expert are a pure fiction and cannot be accepted as a proxy for what anyone in the real world would pay to step into Lehman International's shoes. (Id. at 18). And, above all, Lehman International's suggestion directly contradicts the final sentence of the Loss definition, which provides that "[a] party may (but need not) determine its Loss by reference to quotations of relevant rates or prices." (R. 341 (emphasis added)).

Finally, Lehman International's conclusory assertion that Assured "acknowledged as late as April 2009 that the Transactions were worth hundreds of millions of dollars to Lehman" is not only irrelevant to this issue but unsupported. (Opp'n at 13 (citing SR. 17, SR. 23-24)). Lehman International provides no support for this assertion beyond citing to a single spreadsheet circulated internally referencing "MTM" calculations without any other context. Tellingly, Lehman International omits any mention of relevant testimony in connection with this and other similar spreadsheets because, if it had done so, it would be clear that Assured at times attempted to estimate how its investment bank counterparties might calculate mark-to-market termination values in the hypothetical event that Assured were to default—the opposite situation from the facts of this case. Moreover, the valuation of these CDS contracts under Generally Accepted Accounting Principles bears no relationship to the probability that Assured would have suffered any future losses had the contracts been held to maturity. See (R. 1964) ("The

unrealized gains (losses) on credit derivatives will reduce to zero as the exposure approaches its maturity date, unless there is a payment default on the exposure or early termination.”).

D. The Cross-Check Principle Does Not Raise A Triable Issue Of Fact As To The Reasonableness Of Assured’s Approach

Ironically, despite otherwise arguing that New York law should control, Lehman International contends that the Supreme Court correctly applied the English law “cross-check principle” to find a triable issue of fact, comparing Assured’s Loss calculation to the non-actionable indicative bids that Lehman International solicited, or the fictional estimates generated by its expert’s hypothetical pricing model. (Opp’n at 47).

This argument misses the mark in two ways. *First*, Lehman International cites to cases in which the methods for calculating the Settlement Amount under the ISDA Agreements were the reverse of the method here: the parties chose Loss as the first method of calculating Settlement Amount and Market Quotation as the back-up option. That is exactly the opposite of the circumstances here, where the parties agreed to Market Quotation first and Loss as the back-up, and you only get to Loss when the Market Quotation method fails. Lehman International then selects out-of-context quotes from the cases it cites without otherwise addressing

this fundamental logical flaw.[11]

Second, Lehman International has no response to the fact that the purported indicative bids the Supreme Court pointed to cannot possibly serve as a reliable measure of value, and the estimates generated by the Pricing Model created by Lehman International's expert are completely unrealistic and fictional,[12] not to mention that the express contractual language in the Loss definition does not require consideration of market prices at all. Though Lehman International attempts to create a triable issue of fact regarding the reliability of the indicative bids it obtained (Opp'n at 48), it does not—and cannot—dispute that these indicative bids contained numerous caveats and were not executable. (Opening Br.

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[11] The cross-check cases Lehman International quotes involved a Non-defaulting Party arguing that it could seek to recover premium payments that would have been owed to it without deducting any expected payments it would have owed on the theory that those payments would not be due because of the Defaulting Party's breach. The courts rejected that argument based on the cross-check principle, holding that because the secondary calculation method was an auction that required assuming the agreements would be carried out by both parties, it would be improper to calculate Loss without similarly accounting for the obligations of both parties. See Australia & New Zealand Banking Group Ltd. v. Société Générale, [2000] C.L.C. 833 [CA] ¶ 15 ("Bearing in mind the intention of the loss and market quotation clauses to arrive at broadly the same results, the calculation of loss, or loss of bargain, must proceed on the same basis, that is valuing the transaction according to the nominal value of the payments which would have been required under it, assuming satisfaction of all conditions precedent."); see also Britannia Bulk Plc. (in liquidation) v. Pioneer Nav. Ltd., [2011] EWHC 692 (Comm) ¶ 14.

[12] Indeed, not only were there no replacement transactions available, but Lehman International's expert did not even have direct market information available for all the referenced underlying securities. Compare (R. 1730 (basing ABX mid-market value on "ABX index transactions[]")), with (R. 1737 (basing CLO mid-market calculations on the "difference in spreads between [CLOs] and [CDS referencing the CLOs]")). This contradicts Lehman International's misstatement that "the Transactions all referenced underlying securities or indices from which market-based valuations could readily be derived." (Opp'n at 42).

at 41-42).[13] Accordingly, the cross-check principle is inapplicable as a matter of law and cannot raise a triable issue of fact regarding the reasonableness of Assured's Loss calculation.

III. LEHMAN INTERNATIONAL'S ARGUMENTS CHALLENGING THE REASONABLENESS OF ASSURED'S LOSS CALCULATION ARE UNAVAILING

The Supreme Court's third error was in questioning Assured's reasonableness and good faith in calculating its Loss based on the same financial model it used in the ordinary course of its business, for public financial reporting, and the calculation of insurance regulatory reserves. As Assured demonstrated in its opening brief, this was error because Lehman International's expert only challenged some of the assumptions used in Assured's model and not the outputs, and because the outputs, moreover, were consistent with those produced by

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[13] Lehman International argues that, because Assured agreed that auctions can fail even in liquid markets, the failure of the auction does not necessarily preclude the possibility of a replacement transaction. (Opp'n at 48). But it is undisputed that, not only did the auction fail to generate bids, but Lehman International itself independently tried to solicit replacement transactions and failed. (Opening Br. at 14 (citing R. 1099; R. 1109)). Accordingly, any cross-check would properly occur against a zero-value bid. (Id. at 40).

Lehman International's own contemporaneous models. (Opening Br. at 56-57). Lehman International's arguments to the contrary are unavailing.

A. The Reasonableness Of Assured's Model Is Confirmed By Its Use For Regulatory And Business Purposes

Lehman International does not dispute that Assured used the same loss model to calculate its loss of bargain that it used across the board for regulatory and business purposes. Indeed, the reasonableness and propriety of Assured's loss model had been vetted by both regulators as well as auditors. (Opening Br. at 5). Notably, the administrator of the Lehman International estate, PricewaterhouseCoopers, has served as Assured's independent auditor and signed off on the same model used by Assured to calculate its regulatory loss reserves. See (id. at 7 n.4; 55-56); see also (R. 2389). Lehman International cannot now argue that the same loss model approved by Lehman International's own administrators is somehow unreasonable if used for another purpose.

Moreover, even the 2002 ISDA Master Agreement, which imposes a higher standard of commercial reasonableness, recognizes that the use by the calculating party of the same valuation models it uses in the regular course of business to determine its Close-out Amount is presumptively reasonable. Int'l Swaps and Derivatives Ass'n, User's Guide to the ISDA 2002 Master Agreement at 26-27 (2003) ("The final paragraph of the Close-out Amount definition includes examples of commercially reasonable procedures, including the application of

pricing or other valuation models . . . provided that those models are used by the Determining Party in the regular course of its business in pricing or valuing similar transactions between the Determining Party and unrelated third parties.”).

B. Lehman International’s Challenges To The Assumptions In Assured’s Loss Model Fail To Raise A Triable Issue of Fact

Lehman International instead attempts to defend the Supreme Court’s decision that there is a triable issue of fact regarding the reasonableness of the result of Assured’s Loss calculation by mischaracterizing certain of the assumptions used by Assured in its loss reserve methodology. (Opp’n at 51-58). This argument is inherently illegitimate and fails to raise a triable issue of fact, as Lehman International has not offered the output of any alternative model, or even an alternative calculation based on Assured’s model, using what it claims would be more reasonable assumptions. This is especially true because Lehman International misstates the actual impact of the assumptions it challenges on the model’s output. For example, although Lehman International claims that Assured “increased its predicted prepayment rate dramatically (and thereby reduced its projected default payments)” (Opp’n Br. at 55), this element of Assured’s model actually increased its projected losses. Higher prepayment rates decrease Assured’s cushion in the collateral because when borrowers prepay they no longer continue to make interest payments over the life of the mortgages, which would otherwise generate excess spread. (R. 1604 (explaining that, with respect to

mortgage-backed securities, Assured accounted for the possibility that "prepayment rates increase . . . leading to lower recoveries through excess spread"). Additionally, prepayment tends to decrease the number of favorable mortgages in the pool, leaving a higher proportion of unfavorable mortgages in the pool that are more likely to default, and thereby increasing Assured's likelihood of having to pay upon their default. (R. at 1608-09).

Similarly, Lehman International erroneously contends that Assured skewed its economic forecasts in its favor in July 2009. (Opp'n at 53). The undisputed factual record actually reflects that the minor changes that Assured made in its forecasting methodology had no material impact whatsoever on the overall results. (R. 958 (explaining that "while there were some alterations to the assumptions and mechanics between the second and third quarters of 2009, those changes did not materially change the amount of reserves calculated" (citing Rosenblum Dep. 215:10-16)). Moreover, these changes were made across the board for all purposes, and there is no evidence they were done to affect the calculations at issue here. Unsurprisingly, the Supreme Court did not rely on this argument, including because Lehman International does not dispute that these changes in economic forecasting had no material effect on Assured's ultimate calculation of Loss. See (R. 1713-87).

C. Lehman International Used The Same Loss Model To Reach The Same Outcome

In response to evidence that Lehman International's contemporaneous models predicted essentially the same results as the model that Assured used, Lehman International claims that the only reason it valued the back-to-back transactions with its U.S. affiliate Lehman Brothers Special Financing, Inc. at zero is because its "negotiation position with its affiliate was specifically intended to mirror Assured's own litigation position." (Opp'n at 42-43 (citing R. 1815)). Even if true, this explanation does not affect the significance of its admissions. Specifically, Lehman International does not dispute that it fully hedged its exposure to Assured with trades with its affiliate, nor does it contest that in discussing what settlement amount was warranted, Lehman International was in the identical arrangement to Assured's position here. (Opening Br. at 53).

Lehman International also does not dispute that, in an email to its affiliate, Lisa Summerfield, co-lead of the Lehman International team responsible for negotiating with Lehman affiliates, wrote: "For the avoidance of doubt, we remain comfortable that the latest valuation methodologies used are appropriate and our recent settlement proposal is of course based on them. . . . A zero valuation results from using a predictive model approach, looking at expected losses over the lifetime of the trade and this is our assessment of the value at 12/12," and that, with respect to the $1.4 billion valuation, "we do not think [that marking-to-market] is a

valid basis of valuation in the circumstances, particularly given that no market participants were willing or able to provide a valuation of these positions and [Assured itself] value[s] the position as a payable from LBIE to [Assured]." (R. 1815 (emphasis added)). Finally, Lehman International does not dispute that, when asked about this email, one of its witnesses admitted that the approach used was "reasonable," "credible," "defensible," and not done "in bad faith." Id. (citing R. 1838-849).

D. The Reasonableness Of Assured's Model Is Confirmed By Its Actual Performance

Finally, the reasonableness of Assured's calculation has been confirmed by subsequent events. Lehman International does not dispute that the actual losses under the contract, as of May 2015, amounted to $35 million (when present valued as of the date of the termination), rather than the $23 million Assured projected.[14] Those actual losses are far closer to Assured's projections than to Lehman International's initial claim in this case based on its "market models" that Assured should have owed $1.4 billion (R. 97) or even to its expert's subsequent Pricing Model estimates. Although not perfect, Assured's model has proven substantially more accurate than the market-based model Lehman International relies upon.

[14] Lehman International's reference to $44 million did not reflect a present value discount. (R. 248-249 (explaining that "the insured tranches have to date (over five years later) suffered credit losses with a present value (as of the date of Termination) of $35 million")).

Lehman International claims that this actual performance is legally irrelevant. But its desire to escape the reality of the recovery of the global economy, as Assured correctly predicted was highly likely to occur before the far out maturity of the securities, is not supported by any law.

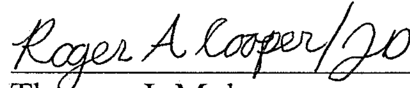
CONCLUSION

For the foregoing reasons, Assured respectfully requests that the Court reverse the Supreme Court's denial of Assured's Motion for Summary Judgment on Count II of Lehman International's Complaint, and remand this case to the Supreme Court for the purpose of dismissing Lehman International's claims with prejudice and granting Assured summary judgment for the full amount of its counterclaims.

Dated: November 9, 2018
New York, New York

Respectfully submitted,

CLEARY GOTTLIEB STEEN &
HAMILTON LLP



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