EXHIBIT 57

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

LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration),

Plaintiff,

- against -

AG FINANCIAL PRODUCTS, INC.

Defendant.

Index No. 653284/2011
Justice Marcy S. Friedman

PLAINTIFF'S MEMORANDUM IN OPPOSITION TO DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

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Plaintiff Lehman Brothers International (Europe) (in administration) ("LBIE") respectfully submits this memorandum in opposition to the motion for summary judgment filed by Defendant AG Financial Products, Inc. ("AGFP").

PRELIMINARY STATEMENT

AGFP's motion for summary judgment is based on a fundamental fallacy – that simply because AGFP had discretion under the Loss provision of the ISDA Master Agreement to calculate the credit default swap termination payments due between the parties, then virtually any calculation by AGFP would, as a matter of law, comply with the contractual requirement that the amounts be "reasonably determine[d]." Contrary to AGFP's arguments, there are deep-seated factual disputes that preclude summary judgment in this case. Not only is the particular calculation methodology applied by AGFP in conflict with standards established in case law and long-standing market practice applying the Loss provision, but the specific calculations performed by AGFP are rife with flawed and unsupported assumptions. The discovery record, including thorough expert analyses of the transactions, strongly supports LBIE's position that AGFP's calculation methodology and calculations are, in fact, patently unreasonable; at a minimum, the record reflects many disputed factual issues which preclude summary judgment.

The timing of the termination of the transactions in light of the collapse of the credit markets in 2008 underscores the chicanery of AGFP's motion. The transactions, by which AGFP sold protection to LBIE on various credit instruments, were entered into between 2005 and early 2008, most at a time when credit markets were healthy and stable. However, when AGFP chose to terminate the transactions after the onset of the crisis, it asserted that the value of the transactions had accrued *in its favor* and that LBIE should make a termination payment *to it*. AGFP's motion seeks a ruling that its calculations are reasonable as a matter of law, although its

demand that LBIE make a termination payment to it – rather than vice-versa – is completely counterintuitive given the drastic market movement against AGFP's position in the trades.

AGFP's motion is not only factually illogical, it is also based on an erroneous application of the Loss provision of the ISDA Master Agreement. Cases interpreting the Loss provision in the U.S., the U.K. and Canada (all jurisdictions cited by AGFP) hold that a calculation of Loss should broadly reach the same result as if the transactions were valued based on the Market Quotation methodology, which is based on price quotes obtained from the market. This "cross-check principle" is consistent with the structure of the ISDA Master, which provides that the parties use Loss as a fallback methodology only if a valuation cannot be fixed under Market Quotation, and it has been recently endorsed by the U.S. Bankruptcy Court in New York in *Lehman Brothers Holdings Inc. v. Intel*, a case cited by AGFP. AGFP's methodology – and its summary judgment motion – ignore this key principle and rely on a methodology that AGFP allegedly employs in setting insurance reserves for regulatory purposes without regard to any market quotes, market data or market-derived values.

AGFP's motion further argues that its methodology is "reasonable" as a matter of law notwithstanding that it squarely conflicts with widespread market practice on how Loss is calculated. During discovery, LBIE furnished both factual and expert evidence that for decades market participants have calculated Loss based on the "replacement cost" of the transactions – in other words, using market price quotes or market data to determine the value of the transactions at the time of termination. Specifically, LBIE proffered four expert witnesses whose opinions consistently describe this practice. Their views are aligned with the position that ISDA itself articulated in 2000 – the same year that LBIE and AGFP executed their ISDA Master Agreement – that "Loss is replacement cost. If I were to get rid of this transaction by replacing it, what

would it cost?" In fact, two of LBIE's experts, former senior executives at monoline insurers like AGFP, testified that monolines were aware of this market practice regarding Loss and regularly negotiated modifications to the Loss provision when they wished to avoid a market-based calculation of the termination payment.

In response, AGFP provided no factual or expert evidence whatsoever of market practice and has not identified a single instance ever when a party has calculated Loss in the self-serving way that AGFP did here. AGFP could have chosen to seek revisions to the Loss provision in its ISDA Master with LBIE, but it did not do so, and it should be held to the application of Loss followed consistently in the marketplace. Considering market practice is appropriate under the circumstances here, where the reasonableness of AGFP's calculation must be analyzed and the methodology used by AGFP is unprecedented and results in an implausible outcome.

While LBIE believes that summary judgment would be appropriate in its favor, it recognizes the serious disputes between the parties regarding whether AGFP's calculation methodology and particular calculations were "reasonably determine[d]" and whether AGFP acted "in good faith," as expressly required by the ISDA Master Agreement. For these reasons, LBIE respectfully submits that AGFP's motion for summary judgment should be denied.

BACKGROUND

A. The Parties' Agreement and the Transactions

Between 2005 and early 2008, LBIE and AGFP entered into 28 credit default swap ("CDS") transactions (the "Transactions"), through which LBIE purchased credit protection on particular asset-backed securities (the "Reference Obligations"). Joint Statement of Undisputed

Material Facts ("Joint Stip.") ¶ 1; Ex. 1,[1] Rahl Rep. ¶¶ 14-16. For each Transaction, LBIE agreed to make regular payments to AGFP ("Fixed Payments"), and AGFP agreed to make periodic payments ("Floating Payments") to LBIE in the event that the referenced security ("Reference Obligation") failed to pay interest or principal. Ex. 1, Rahl Rep. ¶¶ 14-16.

- Two "ABX Transactions" executed in 2007 referenced the ABX indexes, which are themselves CDS referencing 20 residential mortgage-backed securities backed by subprime residential mortgages originated in 2006. The ABX indexes are tradeable indexes with official closing prices published at the close of each trading day by Markit Group, Ltd., and they remained liquid despite the downturn in the credit markets. Joint Stip. ¶ 2; Ex. 2, Niculescu Rep. ¶ ¶ 11, 18.
- Twelve "CLO Transactions" referenced particular collateralized loan obligations ("CLOs") which are securitized products backed by pools of high-yield corporate loans. Joint Stip. ¶ 2; Ex. 2, Niculescu Rep. ¶ 11.
- Fourteen "UK RMBS Transactions" referenced residential mortgage-backed securities issued in the United Kingdom. Joint Stip. ¶ 2; Ex. 2, Niculescu Rep. ¶ 11.

The Transactions were governed by a single common master agreement between LBIE and AGFP, dated April 7, 2000, which consisted of two interrelated documents – the ISDA Master, a standard-form template published in 1992 by the International Swaps and Derivatives Association ("ISDA"), and the "Schedule" that amended and supplemented the terms of the ISDA Master. Joint Stip. ¶ 3; Ex. 1, Rahl Rep. ¶ 17. Each of the Transactions was further documented by a written confirmation, which set forth a "notional amount" (the amount of credit protection LBIE was purchasing from AGFP) and a maturity date specifying the point at which the parties' payment obligations would cease. Joint Stip. ¶ 3; Ex. 1, Rahl Rep. ¶ 16; Ex. 2, Niculescu Rep. ¶ 12.

[1] Citations in the form "Ex. __" refer to the exhibits to the Affirmation of James H.R. Windels, dated April 8, 2016, submitted with LBIE's opposition to AGFP's motion.

After a CDS is executed, the value of the agreed-upon payment streams changes, as market conditions for the underlying Reference Obligation change. Ex. 1, Rahl Rep. ¶ 20. At any given point in time, a transaction may be "in the money" for one party if the market reflects an increase in the value of the payment streams it has contracted to receive since inception of the transaction, while the other party may be "out of the money" as the value of the payment streams it has contracted to receive has decreased. *Id.* The process of determining the cost at any particular time to replace an existing equivalent CDS in the market is referred to as "marking to market." During the relevant period, AGFP established a Mark-to-Market Review Committee to determine and monitor AGFP's view of the market value of the company's derivatives transactions, including its CDS. As explained by the Chair of the Committee to AGFP's senior officers, declines in the ABX indexes during the financial crisis would lead to declines in value of the company's CDS selling credit protection on those indexes. Ex. 3 at AG00370597-98; Ex. 4, Repetto Dep. 48:13-15. As the credit risk of the ABX indexes increases, reflected in the decreasing price level of the indexes, the cost of purchasing an equivalent amount of credit protection would be substantially higher than the price agreed at the inception of the transactions. Ex. 1, Rahl Rep. ¶¶ 35, 106-107.

A CDS may terminate prior to the scheduled maturity date if an Event of Default occurs as prescribed in the ISDA Master.[2] In addition, ten of the CLO Transactions included Additional Termination Events, which AGFP referred to as "ATEs," that gave LBIE the right to terminate the transactions if AGFP's parent company failed to maintain specified credit ratings. In either case, when one party triggers an Event of Default or an ATE, the "Non-defaulting Party" "may

[2] Ex. 5, 6/30/2009 10-Q at 18 ("The unrealized gains and losses on credit derivatives will reduce to zero . . . unless there is a payment default on the exposure or early termination.").

close out the position and is not obliged to make future contractual payments . . . . However, the underlying contracts must be settled depending on the MtM [mark-to-market] value at the time of default," regardless of which party triggered the default.[3]

The ISDA Master includes several methods to calculate the amount payable on early termination. LBIE and AGFP agreed to use the "Second Method and Market Quotation" approach, which requires the Non-defaulting Party (here, AGFP) to determine a Market Quotation for replacing the terminated transactions by soliciting bids from dealers in the market for the price at which they would step into the shoes of the Defaulting Party (here, LBIE). Only if Market Quotation "cannot be determined or would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result," should the termination payment be calculated by the "Loss" method. Ex. 7, 1992 ISDA Master (definition of "Settlement Amount"). Section 14 defines "Loss" as the:

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

Id. (emphasis added). As discussed below, the use of Loss as a fallback to Market Quotation reflects that the two methodologies are intended to result in broadly similar calculations of the termination payment owed between the parties.

[3] Ex. 6, Jon Gregory, *Counterparty Credit Risk: The New Challenge for Global Financial Markets* 23 (2010).

B. <u>Lehman Enters Bankruptcy</u>

On September 15, 2008, LBIE's parent company, Lehman Brothers Holdings, Inc. ("LBHI"), filed for bankruptcy protection in New York, and LBIE entered into administration by order of the High Court, Chancery Division of England and Wales. Joint Stip. ¶ 4. Both of these events constituted Events of Default under the ISDA Master, and the vast majority of LBIE's counterparties promptly terminated their CDS with LBIE on that basis. Ex. 8, Viegas Decl. ¶ 18; Ex. 9, Copley Dep. 33:6-13.

As its business focused on selling credit protection, AGFP faced significant losses on numerous positions as the financial crisis deepened. In particular, AGFP was acutely aware of the risk that it might be required to make substantial payments on its CDS portfolio. Within days of the Lehman bankruptcies, ratings agencies began pressuring AGFP about whether its CDS with LBIE were "in or out of the money," whether it would "have to make a payment" to LBIE as a result, AGFP's "[p]otential liabilities associated with termination of the swaps" and "[a]ny actions taken by Lehman to monetize existing MTM gains on the [] swaps." Ex. 10 at AG00066113-14; Ex. 11 at AG00064957. The ratings agencies understood what was plainly obvious – the rapid collapse of the credit markets had caused the Transactions to become deeply in the money to LBIE.

The ratings agencies' concerns were well founded. By January 2009, AGFP was reporting that it was getting "absolutely destroyed" by the plummeting ABX indexes, reflecting the crisis in the subprime housing market, Ex. 12 at AG00345541, and AGFP's internal "CDS Exposure by Counterparty" for March 2009 listed the Transactions as being nearly $300 million in LBIE's favor, Ex. 13 at AG00030977. Realizing the risks it was facing, AGFP hired a fleet of law firms and consultants: AGFP's privilege logs produced in this action list withheld or

redacted communications between AGFP and thirteen different law firms, resulting in more than 4,000 of its relevant communications being withheld in discovery. Exs. 14-17 (privilege logs).

In January 2009, the U.S. Securities and Exchange Commission ("SEC") sent comment letters to AGFP inquiring about the prospect of termination payments on its CDS. In response, AGFP represented that the "settlement amounts . . . would be based upon the current market value of the contracts at the time of their termination." Ex. 18, Letter from Robert B. Mills to Jim B. Rosenberg, Senior Assistant Chief Accountant, Div. of Corp. Fin., U.S. S.E.C. (Jan. 23, 2009) at 4. Having seen its credit rating downgraded and fearing the increasing possibility of massive termination payments to its CDS counterparties, AGFP launched a company-wide initiative to remove ATEs from its CDS portfolio, as they represented the most immediate risk that could cause AGFP's counterparties to terminate their CDS. Ex. 19 at AG00020639. AGFP's management dictated that the company "can't do any trades with the banks with ATEs unless these are retrospectively removed." Ex. 20 at AG00071666, 670. For some counterparties, AGFP ultimately agreed to post tens of millions of dollars of collateral to remove the ATEs. Ex. 19 at AG00020639; Ex. 5, 6/30/2009 10-Q at 22.

As part of these efforts, AGFP and its outside counsel retained Zolfo Cooper LLP ("Zolfo"), a financial restructuring firm, to attempt to negotiate a consensual termination of the Transactions on the pretense that AGFP was conducting "an internal housekeeping exercise" in connection with acquiring another monoline insurer. Ex. 21 at LBIE_AGFP_000200007182. After Zolfo initially proposed that the parties terminate the Transactions without any payments between them, LBIE explained that given market movements, the Transactions were "heavily in its favor." Ex. 22, Copley Decl. ¶ 12. In July 2009, unable to reach agreement on a consensual termination, AGFP proposed that LBIE agree to remove the ATEs from the CLO Transactions,

due to concerns that LBIE would terminate the trades in the event of further downgrades. *Id.* ¶ 11. LBIE declined this proposal.

C. Termination of the July 2009 Transactions

On July 23, 2009, ten months after LBHI filed for bankruptcy and LBIE entered administration, AGFP sent LBIE a notice designating an Early Termination Date under the ISDA Master, stating that LBHI's bankruptcy and LBIE's September 2008 order of administration constituted Events of Default under the Agreement. Joint Stip. ¶ 5. Although LBIE was the Defaulting Party and, as such, could not propose a termination payment for the Transactions or act on any bids, in late July it solicited indicative price quotes from several large CDS dealers in an attempt to assess their value. Citigroup provided indications for the vast majority of the Transactions at a total value of nearly $300 million.[4] Nomura, which provided indications for all of the Transactions, placed their value between $482.9 million and $620.9 million, depending on the counterparty's credit rating at the time.[5] While AGFP criticizes the reliability of indicative quotes in its motion, AGFP itself used indicative quotes from similar broker-dealers to value the CDS in its portfolio in its quarterly disclosures to investors filed with the SEC throughout 2009. Ex. 4, Repetto Dep. 69:9-70:16; Ex. 26 at AG00054753.

That the Transactions were deeply in the money to LBIE is hardly surprising. By July 2009, the ABX indexes had declined by more than 60% since the ABX Transactions were executed in early 2007, reflecting the market's assessment of the rapidly deteriorating creditworthiness of the underlying subprime RMBS. Ex. 1, Rahl Rep. ¶¶ 106-07. It cannot be

[4] Ex. 23 at LBIE_AGFP_000200009095; Ex. 24 at LBIE_AGFP_000200009096.

[5] Ex. 25 at LBIE_AGFP_000200002285-88. While LBIE did not reveal that the quotes were for CDS with AGFP, the information it provided made it clear that the counterparty was AGFP. Ex. 1, Rahl Rep. ¶ 111.

seriously disputed that in July 2009 LBIE would have had to pay much more to receive the same level of credit protection on the ABX indexes than it paid before the credit crisis began. *Id.*

D. AGFP's Market Quotation Auction

More than a month after it terminated the Transactions, AGFP began the process of obtaining a Market Quotation, as required by the ISDA Master. AGFP engaged Henderson Global Investors ("Henderson") to "'design and execute' an auction of the Transactions 'intended to satisfy the ISDA Market Quotation process' set forth in the" ISDA Master. Joint Stip. ¶ 6. However, as its head of structured products candidly testified, Henderson had never conducted an auction intended to satisfy the "market quotation requirements of the ISDA Master Agreement." Ex. 27, Irvine Dep. 32:20-33:7.

As a result, some of the cumbersome and ambiguous bidding procedures caused confusion among the prospective bidders. AGFP insisted on a threshold requirement that any prospective bidder have an existing ISDA Master in place with AGFP – limiting the universe of bidders to its existing CDS counterparties. Ex. 28, Henderson Rep. at 4. This requirement excluded Nomura, as it "[would not] be able to turn around an ISDA fast enough to meet [AGFP's] deadline." Ex. 29 at CTRL00002049.

This condition was also difficult to reconcile with AGFP's Bidding Procedures Letter, non-negotiable and imposed on all bidders, which stated that AGFP was soliciting bids "on the same terms . . . as the CDS Transactions that existed between AGFP and LBIE." Ex. 28, Henderson Rep. at 19. Contemporaneous documents show that prospective bidders were confused by AGFP's bidding procedures, as it was unclear whether they would be stepping into existing transactions governed by the terms of LBIE's ISDA Master with AGFP or executing new trades pursuant to the terms of their own existing ISDA Masters with AGFP. For example,

Deutsche Bank declined to bid because its "lawyers are having some problems . . . as we are essentially signing up to an agreement that does not mirror the current ISDA master a[g]reement we have with Assured." Ex. 30 at CTRL00001969. Barclays believed, in spite of AGFP's bidding procedures, that "[t]o the extent we won in the auction (on any or all swaps), we would face AGFP under our pre-existing ISDA terms." Ex. 31 at BARC_00000003. Barclays ultimately declined to bid for that reason. *Id.*

E. AGFP's Unreasonable Calculation of Loss

On October 16, 2009, AGFP delivered to LBIE a "Statement of Calculations" stating that it was unable to determine a Market Quotation for any of the Transactions and setting forth a purported calculation of Loss. Ex. 32 at AG00074394-97. AGFP represented that it calculated Loss for each Transaction "by subtracting the expected aggregate Floating Payment amounts . . . from the present value of Fixed Amounts which would have come due on such Transaction." *Id.* at AG00074397. To project the expected Floating Payment amounts, AGFP "assessed the likelihood of the occurrence of . . . Floating Payments using the same methodology used by it in determining regulatory reserves for the quarter ending September 30, 2009 by AGFP's Credit Support Provider, Assured Guaranty Corp." *Id.* at AG00074398. AGFP projected that only the two ABX Transactions would require any Floating Payments and that those payments would total only $23.4 million. AGFP subtracted that amount from the $35.2 million it believed it would have received in Fixed Payments after the termination date and the $13 million it asserted had come due between LBIE's entry into administration and the July 23, 2009 termination date and claimed that LBIE owed it over $24 million. *Id.* at AG00074397-98. AGFP's calculations did not take into account any market prices, market data or other market-derived information, which would have resulted in a value heavily in LBIE's favor.

LBIE's experts, with decades of combined experience in the derivatives market acting for monoline insurers, large financial institutions, and on behalf of ISDA itself, have unequivocally stated that they have never seen Loss calculated in the way AGFP did it here. Ex. 1, Rahl Rep. ¶ 29, Ex. 33, Niculescu Rebuttal Rep. ¶ 4; Ex. 34, Parker Rebuttal Rep. ¶¶ 22-23; Ex. 35, Adamidou Rebuttal Rep. ¶ 13. Nor have AGFP and its experts identified any instance in which Loss has ever been calculated in this manner before. Ex. 36, Prager Dep. 240:22-241:16; Ex. 37, Schozer Dep. 293:19-294:6; Ex. 38, Goldin Dep. 105:11-20; Ex. 39, Pirrong Dep. 16:2-8.

ARGUMENT

Summary judgment is warranted only where it "clearly appear[s] that no material and triable issue of fact is presented." *Ramsammy v. City of New York*, 216 A.D.2d 234, 236 (1st Dep't 1995). The movant's "burden is a heavy one," *William J. Jenack Estate Appraisers & Auctioneers, Inc. v. Rabizadeh*, 22 N.Y.3d 470, 475 (2013), and "[t]his drastic remedy should not be granted where there is any doubt as to the existence of such issues, [] or where the issue is arguable." *Pirrelli v. Long Island R.R.*, 226 A.D.2d 166, 166 (1st Dep't 1996). Summary judgment is particularly inappropriate where, as here, the motion requires a finding that a party acted "reasonably." *See Jones v. Cmty. Bank of Sullivan Cty.*, 306 A.D.2d 679, 680-81 (3d Dep't 2003) (reversing summary judgment and holding that "[w]hether a bank acts in accordance with reasonable commercial standards generally presents a question of fact").

Moreover, as AGFP's counsel has written, "litigation of contractual disputes under the 1992 Master Agreement is likely to give rise to a 'battle of experts' concerning the propriety of each party's respective calculations and the underlying methodologies." 6 Thomas J. Maloney, Carmine D. Boccuzzi, & Roger A. Cooper, *Bus. & Com. Litig. Fed. Cts.* § 70:59 (Am. Bar Ass'n, 3d ed. 2015). As is the case here, "[c]onflicting expert affidavits raise issues of fact and

credibility that cannot be resolved on a motion for summary judgment." *Bradley v. Soundview Healthcenter*, 4 A.D.3d 194, 194 (1st Dep't 2004).

I. Whether AGFP "Reasonably" Applied the Loss Provision Raises Numerous Material Issues of Fact.

AGFP's core argument is that, as the Non-defaulting Party, its calculation of Loss is entitled to such substantial deference that none of the many factual issues disputed by the parties should preclude summary judgment. AGFP ignores that the discretion afforded a Non-defaulting Party under an ISDA Master is "limited," *Portland Regency, Inc. v. RBS Citizens, N.A.*, Civ. No. 2:12-CV-408-DBH, 2015 U.S. Dist. LEXIS 34771, at *20 (D. Me. Mar. 20, 2015), and courts routinely reject the Loss determinations of Non-defaulting Parties.[6] *See Australia New Zealand Banking Grp. Ltd. v. Societe Generale* [2000] CLC (CA) 833 [¶¶ 15-16] (Eng.); *Brittania Bulk plc (in liquidation) v. Pioneer Navigation Ltd.*, [2011] EWHC (Comm) 692 [¶¶ 9-11, 56] (Eng.); *Pioneer Freight Futures Co. v. TMT Asia Ltd.*, [2011] EWHC (Comm) 778 [¶¶ 110, 118] (Eng.); *Barclays Bank plc v. Devonshire Tr.*, [2013] O.J. No. 3691 [¶ 285] (Can. Ont. C.A.).

As discussed below, AGFP's motion raises a host of factual issues disputed between the parties and their experts, including whether AGFP's Loss calculation methodology was reasonable and in good faith; the nature of market practice regarding the calculation of Loss and the extent of AGFP's departure from market practice; whether AGFP's status as a monoline insurer justifies consideration of a different market practice (Mot. at 25-27); the state of the derivatives market at the time the Transactions were terminated and the reliability of the parties'

[6] AGFP relies on foreign precedents that interpret the ISDA Master, *see* Mot. at 21-22 (arguing based on English case law), and cites to a recent decision of the U.S. Bankruptcy Court which itself relies on English and Canadian cases. *See Lehman Bros. Holdings Inc. v. Intel Corp.*, No. 08-13555 (SCC), 2015 WL 7194609, at *15, n. 90 (S.D.N.Y. Sept. 16, 2015); *see also Associated Bulk Trading, Inc. v. Lyondell Petrochemical Co.*, No. 89 Civ. 2853 (JFK), 1990 U.S. Dist. LEXIS 10200, at *9 (S.D.N.Y. Aug. 7, 1990) (interpretation of standard form contracts by English courts constitutes "persuasive" though "not binding" authority). A compendium of foreign decisions cited in this opposition is being provided with LBIE's opposition to AGFP's motion.

respective replacement cost valuations (*id.* at 25-27); whether the results of AGFP's auction process bears on the appropriateness of its calculation methodology and the feasibility of a replacement cost approach (*id.* at 26-28); and whether the many assumptions used by AGFP in performing its specific numerical calculation of Loss were unduly optimistic and unreasonable. LBIE submits that these disputed issues, at a minimum, preclude a finding that as a matter of law AGFP's determination of Loss was made "reasonably" and "in good faith."

A. Whether AGFP's Calculation of Loss Is Reasonable and in Good Faith Is Inherently Factual and Requires Consideration of Market Practice.

The ISDA Master states that "Loss means . . . an amount [the Non-defaulting Party] ***reasonably determines in good faith*** to be its total losses and costs (or gain in which case expressed as a negative number)" (emphasis added). Under New York law, "the phrase 'reasonably determines' suggests that the parties intended a standard of objective reasonableness to apply." *Christie's Inc. v. SWCA, Inc.*, 22 Misc. 3d 380, 383-384 (Sup. Ct. N.Y. Cty. Sept. 12, 2008); *MBIA Ins. Corp. v. Patriarch Partners VIII, LLC*, 842 F. Supp. 2d 682, 704 (S.D.N.Y. 2012) (same). As the First Department has held, "[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered." *Hoag v. Chancellor, Inc.*, 246 A.D.2d 224, 231 (1st Dep't 1998). Consideration of market practice is appropriate "for the permissible purpose of providing guidelines for the unexplained term, 'unreasonably withheld.'" *Id.* In the context of the UCC, courts have held that the term "commercially reasonable" has a "lack of further particularization" and "invites consideration of accepted business practices." *Bankers Tr. Co. v. J. V. Dowler & Co.*, 47 N.Y.2d 128, 134 (1979).

Courts have recognized the particular importance of consistency in market practice with respect to the ISDA Master. The Second Circuit has held that courts must look to "the

background customs, practices, and usages of the credit derivatives trade" in order to "assess ambiguity in the disputed CDS contracts." *Eternity Global Master Fund Ltd. v. Morgan Guar. Tr. Co.*, 375 F.3d 168, 173 (2d Cir. 2004) (internal quotation marks omitted). The court explained that even the standard form ISDA Master "may be ambiguous when applied to one set of facts but not another,"[7] and reversed summary judgment because the trial court "took no submissions on the customs and usages of the credit derivatives industry." *Id.* at 179, 181; *see also Graffman v. Espel*, 1998 WL 55371, at *5 (S.D.N.Y. Feb. 11, 1998), *aff'd sub nom. Graffman v. Doe*, 201 F.3d 431 (2d Cir. 1999) (denying summary judgment because whether defendants met "reasonable commercial standards" is an issue of fact). This approach accords with ISDA's purpose to "standardize market practices and documentation and to enhance the operation and efficiency of the derivatives market." Ex. 1, Rahl Rep. ¶ 41; *see also Eternity Global Master Fund*, 375 F.3d at 173-74 (same).

The principal case cited by AGFP for its position that market practice should not be considered holds just the opposite. AGFP cites the First Department's decision in *AG Capital Funding Partners, L.P. v. State St. Bank and Tr. Co.*, 10 A.D.3d 293, 295 (1st Dep't 2004), for the proposition that the ISDA Master should be applied "without resort to extrinsic evidence" such as industry practice. *See* Mot. at 17. However, the Court of Appeals reversed the First Department on this very point, overturning dismissal on the basis that the "allegations of industry practice give support to [the] claim." *AG Capital Funding Partners, L.P. v. State St. Bank & Tr. Co.*, 5 N.Y.3d 582, 594 (2005).

[7] Here, AGFP's application of the Loss provision is so unprecedented and so contrary to market practice that the "reasonably determines" requirement of the ISDA Master has, in effect, been rendered ambiguous. *See* Ex. 40, Jeffrey Golden, *Interpreting ISDA terms: when market practice is relevant, as of when is it relevant?*, *Cap. Mkts. L. J.* 299, 305 (2014) ("That is where market practice first becomes relevant; it is through the filter of a market practice understanding that a term can be deemed ambiguous.").

Finally, AGFP repeatedly cites to extrinsic evidence regarding the meaning of the Loss provision, including (1) the alleged market practice of monoline insurers, which it claims is different than that of others in the derivatives market; (2) the 1992 ISDA user guide; (3) an amicus brief filed by ISDA in the *Intel* case; and (4) an expert report submitted in *Intel* by Professor Jeffrey Golden on the drafting history of the ISDA Master. (Mot. at 4, 8, 18-19, 25.) Moreover, in the *Intel* decision cited by AGFP, the court considered numerous examples of extrinsic evidence, including ISDA publications and expert testimony. *Intel*, 2015 WL 7194609, at *11-*12. For the foregoing reasons, extrinsic evidence, including relating to market practice, is appropriate for the Court to evaluate AGFP's interpretation and application of the Loss provision to the Transactions.[8]

B. Application of the "Cross-Check Principle" Is Inherently Factual.

Directly relevant to assessing whether Loss has been "reasonably determine[d]," courts have considered the structure of the ISDA Master Agreement and the close interplay between the Market Quotation and Loss provisions. Because Loss is utilized as a fallback to Market Quotation – which by definition seeks to determine the replacement cost of the terminated transaction in the market – courts have held, under what is termed the "cross-check principle," that a determination of Loss should achieve broadly the same result as Market Quotation. *See Brittania Bulk* ¶ 44 ("it would be very odd if the two payment measures were not intended to

[8] Professor Golden strongly endorses the use of market practice to interpret the ISDA Master. He argues that the agreement was left "incomplete by necessity ***with the expectation that general and sometimes ambiguous provisions will be interpreted consistent with market expectation***." *See* Ex. 40, Golden, *supra* note 7, at 299 (emphasis added). Where, as here, "a market participant is taking a position that has never been taken previously in the long history of the ISDA Master Agreement, and there is clear evidence of market participants having consistently taken a different position on the same or similar facts, that is usually a very good indication that the participant's position is contrary to the industry's understanding of how the provision in question is meant to operate." *Id.* at 302. In "instances in which the drafters recognized that it was both necessary and beneficial to paint with a broader brush . . . we did so with the expectation that any ambiguities would be resolved by market participants in a commercially reasonable manner." *Id.* at 303.

achieve broadly the same result"); *Intel*, 2015 WL 7194609, at *15 ("Loss and Market Quotation are, although different formulae, aimed at achieving broadly the same result, so that outcomes derived from one may be usefully tested by way of cross-check by reference to the other.") (quoting *Anthracite Rated Invs. (Jersey) Ltd. v. Lehman Bros. Fin.*, [2011] EWHC (CH) 1822 [¶ 116(1)] (Eng.)); *see also ANZ* ¶ 15; *Brittania Bulk* ¶ 44; *Pioneer Freight Futures* ¶ 98; *Fondazione Enasarco v. Lehman Bros. Fin. S.A.*, [2015] EWHC (CH) 1307 [¶ 28] (Eng.).[9]

The recent decision of the U.S. Bankruptcy Court in *Intel* endorsed the cross-check principle and held that "Loss and Market Quotation are intended to produce Early Termination Payments in broadly similar amounts when measuring the loss of payments or deliveries due after the Early Termination Date." *Intel*, 2015 WL 7194609 at *18. The court described the cross-check principle as "well[ ]reasoned" and one that has "hardened into hornbook law in the context of contracts for which deliveries or payments were to be made *after* the Early Termination Date." *Id.* at *16 (emphasis in original).[10]

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[9] The cross-check principle is consistent with New York law that contractual provisions should not be interpreted and applied in a way that would lead to inconsistent results. *See James v. Jamie Towers Hous. Co.*, 294 A.D.2d 268, 269 (1st Dep't 2002), *aff'd*, 99 N.Y.2d 639 (2003) ("As a matter of law, we should adopt the construction of the contract that reasonably harmonizes these provisions and avoids the inconsistency.").

[10] In *Intel*, the parties entered into a share repurchase agreement documented on an ISDA Master providing that on August 29, 2008, Intel would provide Lehman Brothers OTC Derivatives Inc. ("LOTC") with $1 billion worth of Intel stock in return for $1 billion of collateral; and on September 29, 2008, LOTC would return a number of Intel shares based on an agreed-upon formula in return for the collateral. Because of the Lehman bankruptcies, LOTC was unable to deliver the Intel shares on September 29, 2008, and Intel terminated the transaction. Intel's position was that because of LOTC's delivery failure, Intel should be permitted to keep the $1 billion of collateral rather than receive the market value of Intel shares which were never delivered, and the court agreed. The court drew a fundamental distinction between transactions terminated *after* performance was already past due (and delivery had failed) and transactions terminated *before* performance was completed and where the valuation of future payment streams was required. In the latter context – which is precisely the case with the AGFP-LBIE Transactions – the cross-check principle was logical and has "hardened into hornbook law." While the *Intel* court held that Loss provides flexibility to the Non-defaulting Party, the court never suggested that this flexibility is so broad that it swallows the requirement of reasonableness and, to the contrary, in the context of transactions terminated before performance was complete, the court confirmed the propriety of using the cross-check principle in evaluating determinations of Loss by Non-defaulting Parties.

AGFP's assertion that its calculation of Loss was reasonable because it represented its "loss of bargain" (Mot. at 16, 17, 19) was rejected by the English court in *Anthracite*, which held that Loss "reflects the principle . . . that where damages are sought for loss of bargain . . . then, subject only to the availability of a market for the obtaining of a replacement contract, the cost of such a replacement contract as at the breach date is likely to prove the most reliable yardstick for measuring . . . loss of bargain." *Anthracite* ¶ 117; *see also Musick v. 330 Wythe Ave. Assocs., LLC*, 41 A.D.3d 675, 676 (2d Dep't 2007) ("The measure of damages for loss of bargain is the difference between the contract price and the market value of the property at the time of the breach . . . ."). Likewise, the ruling in the *Devonshire* case squarely rejected the type of discounted cash flow methodology used by AGFP, holding that it reflected "a misunderstanding of the loss of bargain component of Loss," and that any reasonable calculation of Loss must take into account the "market implied estimate of projected losses, or 'risk premium' that is part of the cost of purchasing credit protection" that AGFP chose to ignore here. *Devonshire* ¶¶ 282-289.[11] In short, "(i) because Market Quotation is intended broadly to reflect the loss of bargain and (ii) Loss includes the non-defaulting party's loss of bargain, the two measures are intended to lead to the same result." *Intel* at *17.

Application of the cross-check principle to the circumstances of this case is an inherently factual exercise. To grant AGFP's motion, the Court would be required to resolve complex factual disputes, including what an appropriate market-based valuation of the Transactions would

[11] The court noted that Barclays purchased credit protection in CDS form before the financial crisis caused the market price of credit protection to soar and was entitled to receive that loss of bargain. *Devonshire* ¶ 284. Because the Canadian government formally shut down the market for the underlying instruments on which the CDS were based, making it impossible to obtain market quotes to calculate a replacement cost, the appellate court held that a market risk premium should be included in the Loss calculation to replicate the impact of market risk that was missing from the cash flow methodology. By excluding this risk premium, the court held that the trial judge only "valued the likely loss to be suffered in the underlying portfolios; he did not value the loss of bargain in relation to the CDSs." *Id.* ¶¶ 282-284.

be and whether AGFP's Loss calculation methodology leads to broadly the same result – all of which will be necessary to determine the reasonableness of AGFP's actions and consistency with the cross-check principle.

C. Market Practice Is to Determine Loss Using a Replacement Cost Approach and, at the Least, Raises Factual Issues as to Whether AGFP's Calculation Was Reasonable.

The record shows that AGFP's calculation of Loss was contrary to well-established market practice which, at a minimum, precludes a finding that AGFP calculated Loss reasonably and in good faith. Expert reports and testimony established the following:

- Leslie Rahl, a former ISDA board member and a member of the ISDA Committee responsible for drafting the original ISDA Master Agreement, stated in her expert report on behalf of LBIE that "[i]n [her] experience a calculation of 'Loss' pursuant to the ISDA Master Agreement is based either on a market price or a good faith and commercially reasonable approximation of a price at which the transaction could be replaced in the market." Ex. 1, Rahl Rep. ¶ 58-59. Ms. Rahl, who has analyzed and valued thousands of CDS in her thirty years as a leader in the derivatives market, stated unambiguously: "I have never seen a party to an OTC derivatives transaction calculate the 'Settlement Amount' of a terminated transaction using economic forecasts, as AGFP has done here. AGFP's approach is thus inconsistent with market practice." *Id.* ¶ 29.

- Dr. Peter Niculescu, who ran the Capital Markets division of Fannie Mae and global fixed income strategy at Goldman Sachs, concurred that "[m]arket practice uses the cost of a replacement transaction to determine 'Loss.'" Ex. 33, Niculescu Rebuttal Rep. ¶ 4.

- Dr. Evy Adamidou and Cynthia Parker, who were senior executives at monoline insurers responsible for CDS transactions, both agreed that it is "standard market practice in the derivatives market" that Loss requires a replacement cost approach. Ex. 34, Parker Rebuttal Rep. ¶ 23; Ex. 35, Adamidou Rebuttal Rep. ¶ 13.

- In contrast, AGFP's experts disclaimed expertise in market practices for calculating Loss. *See* Ex. 39, Pirrong Dep. 10:3-8 (denying expertise "in market practice regarding how to value derivative transactions pursuant to the loss provision of the 1992 ISDA master agreement"); Ex. 38, Goldin Dep. 103:8-22 (denying expertise "in any aspect of the loss provision of the ISDA master agreement"); Ex. 36, Prager Dep. 239:20-240:17 ("I'm not here today specifically to talk about the ISDA master or loss calculations broadly under any ISDA master."). AGFP's experts were unable to cite ***a single example*** of a party calculating Loss in the way that AGFP did.

Market practice as described by LBIE's experts is corroborated by the manner in which numerous other counterparties have terminated their CDS with LBIE. Since LBIE entered administration 62 counterparties have terminated hundreds of CDS with LBIE referencing asset-backed securities (like the Reference Obligations here) and, acting as the Non-defaulting Party, calculated Loss (or "Close-out Amount," its equivalent under the 2002 ISDA Master Agreement[12]). Ex. 8, Viegas Decl. ¶ 22. In consistent fashion, each of the 62 determined Loss (or its equivalent) using market-derived data to calculate a replacement cost for the transactions. *Id.* ¶¶ 20-22. For CDS on the ABX indices, LBIE had entered into 171 CDS with other counterparties, and the settlement amounts proposed by the counterparties were within a close range of LBIE's market-derived values for nearly all of them. For CDS on reference obligations beyond asset-backed securities, LBIE agreed to termination payments with nearly 600 counterparties, and the settlement amounts proposed by those counterparties either matched or fell within a modest variance of LBIE's internal valuations which had been calculated using market-derived data. *Id.* ¶¶ 24-28.[13] There is only one conclusion that can be drawn from the numerous instances when LBIE's counterparties calculated Loss: Market practice was uniformly to determine the replacement cost of the terminated transactions using market-derived data.

This evidence of market practice is consistent with published views across the derivatives market that Loss requires a determination of the replacement cost of the terminated transactions. In 2000, the same year when LBIE and AGFP executed their ISDA Master, ISDA's Senior Director for Policy stated ISDA's interpretation of Loss in no uncertain terms: "Loss is

[12] Close-Out Amounts "are often referred to as mark-to-market or MTM amounts." *Banco Espirito Santo, S.A. v. Concessionaria Do Rodoanel Oeste S.A.*, 100 A.D.3d 100, 105, 105 n.5 (1st Dep't 2012).

[13] *See* Affirmation of James H.R. Windels at ¶¶ 58-62.

replacement cost. If I were to get rid of this transaction by replacing it, what would it cost?" Ruth W. Ainslie, *Symposium: Industry Perspective,* 5 Fordham J. Corp. & Fin. L. 14, 20 (2000).

Likewise, the Derivatives Claim Settlement Framework approved by the U.S. Bankruptcy Court in the Lehman bankruptcy matter requires the use of market prices to generate a replacement cost to determine Loss. Ex. 1, Rahl Rep. ¶¶ 86-87. Similarly, the European Financial Markets Lawyers Group convened a symposium to discuss the calculation of close-out amounts for CDS in September 2009 – just when AGFP was calculating Loss for the Transactions. That group advised its members that the "[d]iscretion of the non-defaulting party [is] advisable but limited by . . . [t]he need to use market data and third party quotations, if available and valid." Ex. 41, European Financial Markets Lawyers Group, *EFMLG Symposium on Standard Market Documentation: Calculation of Close-Out Amounts*, at 17.

AGFP has cited to no equivalent evidence in support of the reasonableness of its Loss calculation methodology, let alone evidence so definitive as to warrant summary judgment.[14]

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[14] AGFP suggests that the absence of bids during its auction process indicates that a market-based valuation of the Transactions was infeasible. Mot. at 27. LBIE submits that this is not the case and at the very least raises an issue of disputed fact. Attempts to apply the Market Quotation process during the financial crisis frequently failed, not because a market-based valuation was infeasible, but rather because dealers were reluctant to spend the significant time and resources necessary to analyze and prepare a bid when there was little chance the bid would result in an actual replacement transaction. Ex. 42, Rahl Rebuttal Rep. ¶ 79; Ex. 43, Niculescu Dep. 294:5-12; Ex. 44, Silvie A. Durham, *Terminating Derivatives Transactions* (Oct. 2009) ch. 5, p. 9 ("One of the major issues with market quotation is the inability to procure market quotations when market quotations are most needed. . . . Dealers were so busy dealing with issues arising from the credit crisis that began in 2008 or the liquidity crises in 1997 and 1998 that requests for market quotations . . . were ignored."). Additional questions of fact are raised regarding whether AGFP's failure to obtain bids in its auction was a result of the confusing and onerous bidding process it implemented. *See infra* Section III. Moreover, internal memoranda from AGFP and the testimony of its employees make clear that there was an available market for the Transactions. Ex. 26 at AG00054773 (quarterly memorandum from AGFP's Mark to Market Committee concluding that because "the ABX Index is still an actively traded and published Index as of Q2 '09, . . . an exit market for these CDS products exists"); Ex. 45, Rosenblum Dep. 181:17-182:4 ("exit market" for CDS existed).

D. AGFP's Status as a Monoline Does Not Alter the Meaning of the Loss Provision.

AGFP's argument that monoline insurers should be governed by a different set of rules in calculating Loss is meritless. At a minimum, whether this assertion is true is factually disputed by the parties and their experts, and there is substantial evidence that monolines, like other market participants, understood Loss to require a replacement cost calculation.

The only two experts in this action who have actually been employed by monolines have opined that monolines "understood that according to the terms of the ISDA Master Agreement," Loss would be "calculated on a mark-to-market basis unless the monoline negotiated a different calculation." Ex. 34, Parker Rebuttal Rep. ¶ 22; Ex. 35, Adamidou Rebuttal Rep. ¶¶ 13, 18, 19. Ms. Parker, former Head of Global Derivatives at Ambac who served on a number of ISDA working groups, and Dr. Adamidou, who served in senior capacities in the derivatives groups at two monolines, both testified that monolines sought to modify their ISDA Masters by negotiating bespoke provisions in lieu of Market Quotation and Loss "that allowed the monoline to 'walk away' if its counterparty incurred an Event of Default." Ex. 34, Parker Rebuttal Rep. ¶¶ 22-24; Ex. 35, Adamidou Rebuttal Rep. ¶¶ 28-29. AGFP's experts have done nothing to rebut these opinions, nor can they. ISDA Masters executed by monolines and produced in discovery include walkaway provisions in place of standard Market Quotation and Loss provisions. Ex. 34, Parker Rebuttal Rep. ¶¶ 29-31. AGFP itself followed the same practice, modifying an ISDA Master with a major bank to override Loss in situations where, as here, its counterparty defaulted. Ex. 46 at AG00069915-16. LBIE's experts and AGFP's own practices raise an issue of fact regarding a central tenet of AGFP's position on summary judgment and in the case as a whole – that monolines followed a different set of rules in applying Loss.

Moreover, in correspondence regarding its public filings required under the U.S. securities laws, AGFP told the SEC that "settlement amounts payable in the event of [an early] termination would be based upon the current market value of the contracts at the time of the termination." Ex. 18, Letter from Robert B. Mills to Jim B. Rosenberg, Senior Assistant Chief Account, Div. of Corp. Fin., U.S. S.E.C. (Jan. 23, 2009) at 4. AGFP cautioned regulators about the "[r]isk of mark-to-market termination payments" with respect to its CDS, Ex. 47, Mem. from Cristie March to File, "Meeting with Assured Guaranty regarding Dodd-Frank Act Title VII Rulemaking" (Sept. 7, 2010) at 5, and one of its managing directors warned of the possibility that AGFP might have to "make a mark to market payment" upon early termination of a CDS. Ex. 48 at AG00374765. AGFP's CFO testified that the company was advised "that if ATE provisions were triggered [its] counterparties would calculate termination payments using a mark to market approach." Ex. 49, Mills Dep. 162:6-12.

In sum, the application of contractual provisions, especially in standard form agreements, does not turn on the identity of a contracting party. To the contrary, a standard form agreement "is interpreted wherever reasonable as treating alike all those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing." *See* Restatement (Second) of Contracts § 211(2) (1981). Here, AGFP executed an ISDA Master with no modification to the standard terms governing payment upon termination of the CDS, which, as LBIE has shown, required use of the replacement cost of the transactions. AGFP's position that a market practice existed under which monolines could act differently is contrary to the factual record and at least raises factual disputes precluding summary judgment.

E. LBIE's Settlement Negotiations with LBSF <u>Are Inadmissible and Irrelevant.</u>

AGFP argues, based on a misreading of a single e-mail, that an employee of LBIE conceded the reasonableness of AGFP's Loss calculation in the context of negotiations between LBIE and its U.S. affiliate over so-called "back-to-back transactions" by which LBIE transferred risks relating to its CDS to Lehman Brothers Special Financing ("LBSF"). Mot. at 28-30. AGFP is wrong for at least three reasons.

First, the e-mail is inadmissible under CPLR 4547 which provides that "[e]vidence of any conduct or statement made during compromise negotiations" with respect to "a claim which is disputed as to either validity or amount of damages shall be inadmissible as proof of liability." AGFP concedes that the e-mail was sent during negotiations to resolve LBIE's claim filed in LBSF's bankruptcy proceedings. Mot. at 29. The employee who wrote the e-mail testified that this exchange occurred in the midst of "hard negotiations," Ex. 50, Summerfield Dep. 178:14-25, which is precisely the type of communication CPLR 4547 was enacted to protect. *See 82 Retail LLC v. Eighty Two Condo.*, 117 A.D.3d 587, 589 (1st Dep't 2014) (internal quotation marks omitted) ("CPLR 4547 and well-settled judicial policy preclude the introduction of evidence of settlement negotiations to prove either liability or the value of the claims.").

Second, the statements are irrelevant. The back-to-back transactions discussed in the e-mail were governed by a separately negotiated Side Letter between LBIE and LBSF that passed "all risks under [the transactions between LBIE and its counterparties] to LBSF." Ex. 51 at LBIE_AGFP_001900000040. Accordingly, LBIE owed LBSF "only to the extent LBIE actually receives that settlement amount from its client." *Id.* At the time of the email, AGFP was asserting that it owed nothing to LBIE as a result of the termination of the Transactions, and

accordingly LBIE's position in its negotiations with LBSF was that under the Side Letter LBIE's claim against LBSF should mirror AGFP's claim against LBIE, at least until LBIE actually received some payment from AGFP. Ex. 50, Summerfield Dep. 189:7-24.

Finally, if anything, the manner in which the back-to-back transactions were ultimately settled between LBIE and LBSF underscores the unreasonableness of AGFP's Loss calculation. Ms. Summerfield testified that in her view LBIE's claim against LBSF was reduced by around $700 million as a result of the back-to-back transactions mirroring the LBIE-AGFP Transactions, *id.* 224:8-19, reflecting LBIE's belief that a similar amount should be payable by AGFP to LBIE.

II. Whether the Internal Projections Used by AGFP Were Made "Reasonably" and "in Good Faith" Is Factually Disputed.

Beyond the unreasonableness of its overall methodology, the assumptions used by AGFP in performing its calculation of Loss were deeply flawed and unfounded. In projecting losses on the ABX indices as a basis to calculate Loss on the ABX Transactions, AGFP used a series of assumptions about the performance of the underlying pools of subprime residential mortgages, including the rate at which the mortgages would default, the extent of loss upon default, and the rate at which the subprime borrowers would prepay their mortgages.[15] Ex. 33, Niculescu Rebuttal Rep. ¶ 200; Ex. 52 at AG00346863. All of these assumptions were unduly optimistic and have been proven to be flatly wrong, raising serious questions about the reasonableness of AGFP's Loss calculation on the ABX Transactions.

In a prior litigation before Justice Kapnick, AGFP's expert (Harrison Goldin) submitted a report on behalf of a group of banks that purchased credit protection from a monoline insurer (MBIA) on asset-backed securities similar to those underlying the AGFP-LBIE Transactions.

[15] AGFP proffers no evidence in its motion or in the extensive factual record in this case about the reasonableness of the assumptions it used to project losses on the other categories of Reference Obligations.

Mr. Goldin opined that MBIA's loss projections were misleading, unreliable, and unreasonable because they suffered from many of the same fundamental flaws as AGFP's projections do in this case. Ex. 53, Goldin *MBIA* Aff. In the *MBIA* matter, Mr. Goldin directly contradicted a core position maintained by AGFP here – that monolines' internal modeling assumptions for projecting losses for their statutory reserves are presumptively reasonable. As Mr. Goldin testified in *MBIA*, the reasonableness of one party's loss projections must be judged by reference to those of other market participants: "That third parties have independently estimated losses is highly relevant to an assessment of the appropriateness of loss reserve projections." *Id.* ¶ 36.

In performing its calculations, AGFP steadfastly ignored third-party loss estimates. As analyzed by LBIE's expert Dr. Niculescu, each of AGFP's assumptions was significantly more optimistic than those used by other market participants, including other monolines, and the "*combination* of AGFP's assumptions . . . resulted in projected losses to the underlying mortgages (and hence, losses to the ABX Transactions themselves) that were far below those of other major market participants." Ex. 33, Niculescu Rebuttal Rep. ¶ 200. AGFP's optimism that the subprime crisis would quickly dissipate and the housing market would return to pre-crisis strength was not shared by other market participants and has proven to be incorrect.

Specifically, AGFP's assumptions were unreasonable in the following respects:

- <u>Loss Severity Assumptions.</u> AGFP's loss severity assumptions were highly optimistic, particularly when compared with those of other market participants. Ex. 33, Niculescu Rebuttal Rep. ¶ 200. To project statutory loss reserves for the second quarter of 2009, AGFP used three scenarios, an optimistic case, a base case and a pessimistic case, in which its loss severity assumptions were 50%, 60%, and 70%, respectively. Ex. 54 at AG00053901-02. By July 23, 2009, the actual, observable loss severity for mortgages underlying the two ABX Transactions was 74%, higher than even AGFP's most pessimistic case during the prior quarter. Ex. 33, Niculescu Rebuttal Rep. ¶¶ 217-219. Inexplicably, AGFP ignored real world loss severity and modified its assumptions *downward*, projecting loss severity to begin dropping to either 40% or 50% after one year. *Id.*; Ex. 52 at AG00346887. AGFP points to no other market participant who was

projecting loss severities to drop so quickly (if at all), and market participants at the time shared a view that loss severities would remain close to 70% or higher for the foreseeable future. Ex. 33, Niculescu Rebuttal Rep. ¶ 227 & Ex. 40. AGFP's bullish assumption was wrong – loss severities for the ABX Transactions have continued to rise, and remain above 80%. *Id.* ¶ 273.

- Default Assumptions for Delinquent Borrowers. AGFP's default assumptions were equally flawed. AGFP first relied on liquidation rates for the subprime mortgages whose borrowers were already delinquent, with different rates for five different delinquency buckets. *Id.* at ¶ 279 & Ex. 46. As analyzed by Dr. Niculescu, each of these assumptions was more optimistic than those of broker-dealers, ratings agencies, and other monoline insurers. *Id.* ¶¶ 289-290 & Ex. 48. The best illustration of the unreasonableness of AGFP's assumptions is that it assumed that 15% of subprime borrowers whose mortgages were already in foreclosure would somehow not default. *Id.* AGFP points to no other market participant who shared its view.

- Default Assumptions for Current Borrowers. AGFP calculated default assumptions for borrowers current in their mortgage payments by using "[l]oan [p]erformance data . . . for loan behavior in the last 6 months of 2008." *Id.* ¶ 303; Ex. 52 at AG00346882. By September 30, 2009, that data was at least nine months old and predated the brunt of the credit crisis. In *MBIA*, Mr. Goldin criticized MBIA for using loan performance data from late 2008 to project losses in February 2009, opining that any "good faith attempt to project future losses" should do so based on contemporaneous data. "Given what had transpired in the economy in October, November, December 2008, January and February 2009, it is to me unassailable that the data from August 2008 and even before was stale, outdated, incomplete and inaccurate." Ex. 55, Goldin *MBIA* Dep. 197:15-20. AGFP's use of even older data is even more unreasonable here.

- Prepayment Assumptions. AGFP's projections relied on unrealistic assumptions about the extent to which subprime borrowers would prepay their mortgages. In the midst of the subprime crisis, AGFP assumed that prepayments would increase to between 10% and 15% within three years – by 2012. Ex. 33, Niculescu Rebuttal Rep. ¶ 311; Ex. 52 at AG00346885. As other market participants correctly forecasted, prepayments have remained depressed, averaging 2.3% between July 23, 2009 and mid-2015. *Id.* ¶ 325.

While each of these assumptions is unreasonable on its own, the combined effect dramatically understated the extent of projected losses on the ABX Transactions and, in turn, the amount AGFP should have owed LBIE when the transactions were terminated. In the *MBIA* matter, Mr. Goldin testified that economic conditions at the time required the need "to consider the potential for additional and accelerating turbulence in projecting loss reserves in a monoline insurance context." Ex. 55, Goldin *MBIA* Dep. 198:17-24. AGFP failed to do that, and it

projected only 6% losses to the ABX Transactions at the same time that other market participants were projecting losses as high as 72%. Ex. 33, Niculescu Rebuttal Rep. ¶¶ 10, 200 & Ex. 33.

AGFP contends that the subsequent performance of the Reference Obligations validates the reasonableness of its assumptions. Mot. at 26-28. But the ISDA Master requires that Loss be determined "as of the relevant Early Termination Date," not years later using hindsight. In any event, AGFP's projections for the ABX Transactions significantly *underestimated* actual losses. AGFP projected only $23 million in losses for the ABX Transactions. Ex. 32, AG00074401. As of May 2015 (the date the parties exchanged expert rebuttal reports), losses had already reached roughly $44 million, with 85% of the notional amount for the two ABX Transactions *still outstanding* and subject to further losses. Ex. 33, Niculescu Rebuttal Rep. ¶ 89 & Ex. 19. AGFP's current analysis shows that lifetime losses for the ABX Transactions will likely total nearly $80 million, meaning that it now expects that losses will be approximately four times as large as AGFP projected in its Calculation Statement. Ex. 56, ABX Check. At a minimum, there are factual issues about whether AGFP's rosy assumptions and inaccurate loss projections were sufficiently "reasonable" to warrant summary judgment.

III. There Are Factual Issues as to Whether AGFP Conducted Its Market Quotation Auction in Accordance with the Covenant of Good Faith and Fair Dealing.

Numerous factual issues stand in the way of summary judgment on whether AGFP conducted its Market Quotation auction in good faith. A party's good faith, "which necessitates examination of a state of mind, is not an issue that is readily determinable on a motion for summary judgment." *Credit Suisse First Boston v. Utrecht-Am. Fin. Co.*, 80 A.D.3d 485, 487 (1st Dep't 2011) (internal quotation marks omitted).

The pledge to exercise discretion "includes a promise not to act arbitrarily or irrationally in exercising that discretion," *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389 (1995) (internal citation omitted), and whether a party "acted arbitrarily or irrationally under the contract is an issue of fact not proper for summary judgment." *Creative Waste Mgmt., Inc. v. Capitol Envtl. Servs., Inc.*, 429 F. Supp. 2d 582, 610 (S.D.N.Y. 2006). Numerous facts demonstrate that AGFP exercised its discretion "to deprive [LBIE] of the fruit of its bargain," namely, an auction conducted reasonably and in good faith. *Gross v. Empire Healthchoice Assur., Inc.*, 16 Misc.3d 1112(A), 2007 WL 2066390, at *3 (Sup. Ct. N.Y. Cty. July 18, 2007); *see also The High Risk Opportunities Hub Fund Ltd. v. Lyonnais*, No. 600229/00, 2005 WL 6234513 (Sup. Ct. N.Y. Cty. July 6, 2005) (granting summary judgment to Defaulting Party on claim that Non-defaulting Party failed to conduct Market Quotation auction in good faith).

AGFP enlisted Henderson to "design and execute" the auction, even though Henderson had never before conducted an auction to satisfy the Market Quotation requirements of the ISDA Master. *See supra* Part D. Notwithstanding Henderson's lack of relevant experience, neither AGFP nor its counsel provided Henderson with any guidance on whether the auction it designed complied with the terms of the Market Quotation provision. Ex. 27, Irvine Dep. 183:9-184:22. Henderson, in fact, had "no opinion as to whether the result of the auction satisfied" the requirements of the Market Quotation provision. (*Id.* 199:13-200:11.)

The Bidding Procedures Letter had inconsistencies that confused and ultimately deterred prospective bidders. *See supra* Part D. The confusion in the bidding process and requirement that bidders have their own ISDA Masters with AGFP (although the new transactions were supposed to be on the same terms as the AGFP-LBIE Transactions) resulted in the most likely bidder, Nomura, being excluded from the auction. Henderson recognized that the presence of

former LBIE personnel at Nomura familiar with the transactions increased the likelihood that Nomura would bid (*id.* 227:21-228:12) – in fact, Nomura believed the Transactions were worth several hundred million dollars (*see supra* Parts C and D). AGFP ultimately excluded Nomura from the auction, insisting on unrealistic timetables to negotiate an ISDA Master, and leading Nomura to abandon its efforts, as it could not "turn around an ISDA fast enough to meet [AGFP's] deadline." Ex. 29 at CTRL00002049.

Finally, AGFP made clear, in bold letters: "**The Company will decide in its absolute discretion whether or not to accept any bid as the successful bid**." Ex. 28, Henderson Rep. at 23. This caveat caused bidders to question whether taking the time to research and prepare a bid would even be worthwhile. Ex. 31 at BARC_00000003. Dr. Niculescu, who has spent years on trading desks, testified that this requirement would certainly have deterred bidders from taking the time required to bid because "there was no assurance that a transaction would occur, [and] I would be skeptical that my efforts to develop a price would result in meaningful business for my desk." Ex. 43, Niculescu Dep. 294:5-12.

At a minimum, these facts demonstrate that "the parties [have] present[ed] conflicting evidence as to whether [plaintiff] acted 'arbitrarily or irrationally,'" which makes summary judgment inappropriate because this "is precisely the type of factual determination that falls within the province of the jury." *Island Two LLC v. Island One, Inc.*, No. 13 Civ. 02121 (LGS), 2015 WL 1026495, at *10 (S.D.N.Y. Mar. 9, 2015) (internal citation omitted); *see also Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89, 98 (2d Cir. 2007) ("[W]hether particular conduct violates or is consistent with the duty of good faith and fair dealing necessarily depends upon the facts of the particular case, and is ordinarily a question of fact to be determined by the jury or other finder of fact.").

CONCLUSION

For the foregoing reasons, LBIE respectfully requests that the Court deny AGFP's motion for summary judgment.

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