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

PRETRIAL MEMORANDUM OF DEFENDANT AG FINANCIAL PRODUCTS INC.

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Defendant AG Financial Products Inc.[1] submits this memorandum pursuant to the Court's request for supplemental briefing regarding the factual and legal questions remaining for trial.

PRELIMINARY STATEMENT

This is a straightforward contract dispute about whether Assured reasonably determined the amount owed between the parties after LBIE defaulted on the parties' agreement. Under that agreement, the parties entered into credit default swaps, which were essentially a form of insurance for potential nonpayment on certain securities. Here, LBIE agreed to make premium payments to Assured in exchange for Assured agreeing to make payments to LBIE for shortfalls, if any, on interest and principal payments for those securities. The transactions differed from what LBIE itself has described as standard credit default swap transactions because, as was typical with credit default swaps involving insurers like Assured, the parties here agreed to limit Assured's obligations to insuring shortfalls as they came due over the life of the transactions (a period of more than 40 years in some cases). As a result, Assured was not required to make payments or post collateral to LBIE based on changes in the market prices of the insured securities. There is no dispute that LBIE defaulted by filing for insolvency and ceasing to make its premium payments to Assured, and that Assured was within its rights to terminate the agreement based on LBIE's default and then to reasonably determine the amount owed to either party.

The parties' agreement includes an agreed-upon damages provision, which provides that the non-defaulting party will be compensated for its losses as is standard under New York law. If the non-defaulting party receives a gain as a result of the termination, it is required to pay that

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[1] AG Financial Products Inc. ("AGFP"), together with its affiliate, Assured Guaranty Corp. ("AGC"), is referred to herein as "Assured." Lehman Brothers International (Europe) (in administration) is referred to herein as "LBIE."

amount to the defaulting party. Initially, as required by the contract, Assured held an auction with major financial institutions to see what, if anything, they would be willing to pay to take LBIE's place in the terminated transactions, but there were no bids. Where no bids are received, the contract provides for Assured, as the non-defaulting party, to calculate its "Loss" as a result of LBIE's default. The contract expressly defines "Loss" as the amount Assured "reasonably determines in good faith to be its total losses and costs (or gain) . . . including any loss of bargain." Assured calculated its loss of bargain to be approximately $20 million—which consists of the lost premium payments that LBIE owed Assured over the life of the contract, reduced by the expected payouts Assured calculated it would have to make during that time—and Assured seeks to recover that amount through its counterclaim here. LBIE, on the other hand, contends that Assured's determination was unreasonable, that it obtained a gain of hundreds of millions of dollars by terminating the transactions, and that it owes LBIE that amount.

Based on Justice Friedman's prior rulings—which upheld the reasonableness of Assured's auction, dismissed all but one of LBIE's claims and substantially narrowed the sole remaining claim—the primary issue left to be decided at trial is whether Assured's determination of its Loss was done reasonably. The plain language of the contract and the evidence show that Assured's methodology and calculation were objectively reasonable.

Assured followed the letter of the contract in determining its Loss, selecting "loss of bargain"—one of the approaches that is expressly identified in the contract—as the basis for its determination. Assured then reasonably calculated its loss of bargain by estimating the amounts that each side would have owed the other over the life of the transactions if LBIE had not defaulted. Assured's estimates used the amounts it had recorded in its books based on the

procedures and models it used in the ordinary course of its business, which were subject to extensive review by Assured's senior management, its actuary and its independent auditor. *See infra* 13-14.

LBIE's case hinges on the Court finding that Assured's "loss of bargain" approach was unreasonable and that the *only* reasonable way for Assured to determine its Loss was to use the market prices at which the transactions could be replaced in the market. Decision/Order at 24-25, NYSCEF Doc. No. 156 (July 2, 2018) (the "D/O"). Because the evidence shows that no replacement transactions were available, LBIE further contends that Assured was required to use market inputs and a model to formulate a hypothetical price that market participants would theoretically pay to enter into replacement transactions with Assured. But the contract expressly rejects that notion, stating that Assured, as the non-defaulting party "may (*but need not*) determine its Loss by reference to quotations of relevant rates or prices." *See infra* 13, 20; *see also* D/O at 23 (emphasis added). And there is nothing in the Loss provision requiring a party to determine the hypothetical value of a purely theoretical replacement transaction.

LBIE's sole support is its purported industry custom and practice evidence, with which it attempts to import into the parties' agreement a requirement that Assured calculate its Loss based on a hypothetical price generated by a model using market inputs. Not only is this an improper attempt to rewrite the unambiguous terms of the contract, but LBIE also fails to satisfy the clear requirements under New York law that custom and practice evidence must be both fixed and notorious at the time the parties entered into the contract. The evidence LBIE has proffered could not possibly satisfy those requirements because it pertains to contracts that post-date the parties' agreement. And it relates to credit derivative contracts with standard terms, in which the

parties had agreed to make payments or post collateral based on market prices (which Assured never agreed to). *See infra* 20-21.

Fundamentally, LBIE ignores the overwhelming evidence that Assured did not receive any gain as a result of the termination and that the transactions had no real-world value to LBIE, including because of the differences between the agreed-upon economic terms of the transactions here and the standard terms of the credit default swaps LBIE traded with other counterparties. Among the many reasons that its claim fails, the following are key:

First, LBIE's claim in this litigation that the transactions were objectively worth hundreds of millions of dollars to it cannot be reconciled with the results of the auction that Assured conducted to seek bids from other market participants to enter into replacement transactions with Assured. Ten leading global financial institutions participated in that auction, which Justice Friedman has already held was well designed and robustly conducted. But not one market participant was willing to pay even a dollar to step into LBIE's shoes in the transactions. *See infra* 11-12.

Second, in the months leading up to Assured's termination, LBIE itself tried to find a third party willing to pay LBIE to step into its shoes in the transactions. Those efforts failed. *See infra* 9-10. Neither Assured nor LBIE were able to obtain a single firm quotation showing what any third-party would actually pay to assume LBIE's position in the transactions at issue.

Third, from September 2008, when LBIE defaulted, through July 2009, when Assured ultimately terminated the transactions, senior LBIE personnel recognized in candid internal communications that the transactions had little to no real-world value for LBIE precisely because the modifications agreed upon by LBIE and Assured differentiated these transactions from standard credit default swaps. *See infra* 9.

Fourth, shortly before filing this suit, LBIE itself took the position that transactions essentially identical to those at issue here could be valued based on the same "loss of bargain" methodology that LBIE attacks Assured for using and that the transactions had no value under that approach. Not only does this evidence contradict LBIE's claim that there was a uniform market practice of valuing transactions based on market prices, but it also shows that LBIE itself believed it was reasonable to value nearly identical transactions based on expected losses over the life of the transactions—which is precisely what Assured has done here. *See infra* 15-16.

Fifth, LBIE argues that Assured's calculation is wrong because the Transactions were "in the money" to LBIE. That is, LBIE contends that deterioration during the financial crisis in the market prices of the insured securities demonstrates that the value of the transactions to LBIE should have been estimated at hundreds of millions of dollars. This ignores that the modified terms of the transactions did not require Assured to make payments based on market prices. Additionally, during the financial crisis, the decline in the market prices of the insured securities was not a reliable indicator of expected shortfalls in interest and principal payments on those securities. To the contrary, market prices reflected a number of factors that had nothing to do with the long-term performance of those securities, including much more limited demand for those securities after the collapse of Lehman. *See infra* 23-24.

Finally, we now know how the Transactions have actually performed since the termination: that performance shows that Assured's estimates of its total losses over the life of the Transactions were remarkably accurate, further confirming the reasonableness of Assured's approach. Even if LBIE could somehow show that Assured did not reasonably determine its Loss, LBIE would still bear the burden of establishing that the hypothetical pricing model used by its expert provides a stable foundation for estimating Assured's gain. The actual performance

of the transactions highlights that LBIE's calculations are divorced from reality and that LBIE's approach would impose an improper penalty on Assured as the non-defaulting party. *See infra* 17.

In sum, the evidence amply demonstrates that Assured reasonably determined its Loss and that the approach LBIE advocates is contrary to the parties' agreement, controlling law and the factual record.

FACTUAL OVERVIEW

I. The Origin and Terms of the Transactions

Between 2005 and 2008, LBIE and Assured entered into 37 credit default swaps ("CDS"). 28 of these transactions are still at issue here (the "Transactions").[2] The terms of each Transaction are set out in an individual "Confirmation," and all of the Transactions are governed by a "Master Agreement" template published in 1992 by the International Swaps and Derivatives Association ("ISDA"), along with a customized schedule (altogether, the "Agreement").[3] Through the Transactions, LBIE purchased credit insurance from Assured on various securities (the "Underlying Securities"), which are referred to in the Agreement as "reference obligations," including AAA-rated senior tranches of asset-backed securities collateralized by prime UK residential mortgages ("UK RMBS"), US corporate loan and debt obligations ("CLOs") and portfolios of twenty asset-backed securities collateralized by subprime US residential mortgages ("ABX").

The parties agreed to two important modifications to the Transactions that made them different from most other standard CDS. First, in exchange for LBIE, as the insurance buyer,

[2] LBIE asserted a single claim for breach of the implied covenant of good faith and fair dealing with respect to the other nine transactions, which Assured terminated on a separate basis, but the Court dismissed that claim in its entirety in its decision dated March 15, 2013.

[3] The Agreement and schedule thereto were executed on April 7, 2000.

agreeing to make periodic premium payments to Assured (the "Fixed Payments"), Assured, as the insurance seller, agreed to pay LBIE for shortfalls, if any, in interest or principal payments on the Underlying Securities when due (the "Floating Payments"). The fact that Assured was only required to make Floating Payments in the amount of actual shortfalls in interest or principal payments as they came due over the life of the Underlying Securities is referred to as a "pay-as-you-go" structure.[4] Second, the parties agreed that Assured would not be required to post any collateral in connection with the Transactions.

In contrast, in many CDS, if there is a payment shortfall or other default with respect to the underlying security, the seller agrees to make an immediate payment to the buyer based on the decline in the market price of the underlying security. Additionally, parties to standard CDS typically agree to post collateral on a daily or periodic basis in an amount determined by reference to the market price of the underlying securities. In those cases, the typical CDS seller would be required to post collateral based on a decrease in the market price of the underlying securities. These provisions make it easier for an investment bank, like LBIE before its insolvency, to trade in and out of CDS contracts.

As a result of the agreed-upon deviations from standard CDS terms, the market prices of the Underlying Securities were irrelevant to Assured's bargain. Unlike a typical CDS seller, Assured only insured against actual shortfalls in interest and principal payments as they came due. And in most cases, because of the long term of the Underlying Securities, principal payments on these securities would not be due for between 10 and more than 40 years. Assured, like other financial guaranty or "monoline" insurance companies, wrote the Agreement this way

[4] In fact, principal payments were due only at the very end of the life of the Underlying Securities (which could be as late as 2056), and only for two of the 28 Transactions could even a portion of the principal become due earlier as a result of implied write-downs. Defendant's Memorandum in Support of Its Motion for Summary Judgment at 5 n.7, NYSCEF Doc. No. 137 (Feb. 22, 2016) ("Def.'s Summary J. Mem.").

so that the economics of the Transactions would be consistent with its business model more generally. Whether it provides insurance through a financial guaranty or CDS contract, Assured's business model is to maintain that insurance coverage (and continue receiving premiums) for the full term of the contract, which is also referred to as "holding to maturity." Assured does not and cannot trade in or out of its CDS contracts, unlike investment banks or other investors who may do so with regularity.[5] The modifications to the Agreement here protected Assured from having to make any market-based payments on the Transactions, and allowed Assured to collect premium payments through the full term of the security.

II. Fall 2008 Through Spring 2009—LBIE's Default and Its Failed Attempt to Novate

On September 15, 2008, LBIE filed for insolvency protection in the United Kingdom and entered into administration, with PricewaterhouseCoopers ("PwC)" serving as administrator. From that time on, LBIE stopped making the Fixed Payments to Assured that were due under the Agreement. Both LBIE's entry into administration and its failure to pay the amounts it owed constituted events of default under the Agreement and entitled Assured to terminate the Transactions at its discretion.

Before Assured terminated the Transactions, LBIE had discussions with Assured in the fall of 2008 in which LBIE raised the possibility of assigning the Transactions to another party. Ex. 1, Email Correspondence from A. Pickering to F. Cuccovillo dated November 10, 2008.[6] Assured did not object to LBIE assigning its side of the Transactions to a new creditworthy

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[5] LBIE has argued that AGFP was merely an affiliate of an insurance company, but was not itself an insurance company. That argument misses the mark. As was typical for CDS issued by monoline insurance companies, AGC issued a financial guaranty policy insuring any payments due to LBIE by AGFP under the Transactions. This insurance policy is expressly incorporated into the Agreement, and AGC is identified in the Agreement as AGFP's credit support provider. As a result, AGC was the real party-in-interest, as LBIE's own internal documents confirm. *See* Defendant's Reply in Further Support of Its Pre-Trial Memorandum at 4-5, NYSCEF Doc. No. 673 (November 15, 2019).

[6] Unless specifically stated otherwise, all exhibits referenced herein are attached to the Affirmation of Ryan S. Redway in Support of the Pretrial Memorandum of Defendant AG Financial Products Inc., dated May 24, 2021.

counterparty through novation, and decided to hold off on exercising its contractual right to terminate the Transactions. Such a novation would have allowed Assured to preserve the benefit of its bargain by holding onto the Transactions through maturity.

Following the discussions about a potential novation, LBIE asked two of its experienced traders, Juan Quintas and Francesco Cuccovillo, to conduct an analysis of the value of the Transactions, and they prepared a detailed memo in November 2008 setting out that analysis. Ex. 2, Assured Guarantee-LBIE Swap Exposure Valuation and Alternatives. The memo explained that the "MtM [mark-to-market] value of these positions could be substantial if they had been documented under standard CDS terms," but that "there are two big issues that significantly diminish the value of these contracts." *Id.* at 1. These issues included the pay-as-you-go structure and absence of collateral posting as a result of the Transactions "not [being] documented under standard ISDA confirmation terms, but rather under a heavily modified version." *Id.* The memo concluded that "[t]he adjusted value of these CDS Contracts is therefore a fraction of any estimate based on standard terms and the appetite for other market counterparts to take over these is severely limited." *Id.* It also concluded that if the Transactions were held to maturity, as the parties had agreed, they would have almost no value to LBIE. *Id.* at 2. As a result, the memo recommended that LBIE attempt to "extract" value by pursuing a potential "contract assignment"—in other words, looking for a third-party willing to pay LBIE to step into LBIE's shoes in the Transactions. *Id.* at 3.

Over the following months, LBIE attempted to novate the Transactions, but these efforts failed. LBIE was unable to find any entity—a bank, a broker-dealer, or one of their clients—willing to step into LBIE's shoes. *See* Def.'s Summary J. Mem. at 14-15. After Mr. Quintas left LBIE and began working at Nomura in December 2008, LBIE attempted to broker a deal with

Nomura, but Nomura also could not find any clients who were interested. LBIE even tried to novate by using what it called a "structured repackaging solution," in which it would create a special purpose vehicle to hold the Transactions as "off-balance sheet" assets while issuing CDS on the same Underlying Securities with standard terms (essentially transforming these CDS into more standard CDS), but that effort also failed. Ex. 2, Assured Guarantee-LBIE Swap Exposure Valuation and Alternatives at 3; *see also* Ex. 3, Rioja Finance: Summary of Indicative Terms and Conditions.

III. Summer 2009—Assured's Termination and LBIE's Indicative Bids

By the summer of 2009, it was becoming clear to Assured that LBIE was unlikely to find a substitute counterparty. So in early June 2009, Assured re-engaged with LBIE in discussions about a potential settlement of the Transactions, but those discussions proved unsuccessful. As a result, on July 23, 2009, Assured gave LBIE notice that it was exercising its contractual right to terminate the Transactions based on LBIE's default. Def.'s Summary J. Mem. at 6.

Even as LBIE negotiated with Assured in the weeks before the termination, LBIE's contemporaneous documents reflect that it was simultaneously preparing a plan to "challeng[e] [Assured's] valuation" in the event of a termination. *See* Ex. 4, Email Correspondence between D. Swanson and H. Merriman dated July 22, 2009. As part of that litigation strategy, LBIE solicited quotes from Mr. Quintas (the former LBIE trader who was at this time working at Nomura), as well as from traders at Citibank, JPMorgan and Barclays. Based on its concern that no one would "give [] a firm quote," LBIE decided to "just ask for [a] quote, without specifying firm or indicative," *id*; and also redacted or omitted key information about the Transactions, including that Assured was the counterparty. Not one firm bid resulted from this process. Def.'s Summary J. Mem. at 15.

Mr. Quintas responded "on the terms indicated below I won't quote. You are asking for firm bids." Ex. 5, Email Correspondence from D. Swanson to B. Radicopoulos dated August 3, 2009. When told by LBIE to "respond with whichever qualification you require," he provided LBIE with a heavily caveated bid in which he pretended not to know the identity of the counterparty despite having conducted a detailed analysis of these same Transactions for LBIE just months earlier.[7] *Id.* Conveniently for LBIE, the prices in Mr. Quintas's "indicative" bid were divorced from his prior analysis, which had concluded that the adjusted value of the Transactions was "a fraction of any estimate based on standard terms." *See, e.g.*, Ex. 2, Assured Guarantee-LBIE Swap Exposure Valuation and Alternatives. In the end, LBIE only obtained two additional partial, non-binding bids that were similarly caveated. *See* Def.'s Summary J. Mem. at 15.

IV. The September 2009 Market Quotation Auction

The Agreement provided that, in the event of an early termination, a termination payment would be calculated using what is called "Second Method and Market Quotation." Def.'s Summary J. Mem., Ex. 7. Under Market Quotation, Assured, as the Non-Defaulting Party, was required to seek price quotations for executable bids for replacement transactions from leading market dealers. *Id.* Assured followed this contractually required approach by engaging a highly regarded investment advisory firm, Henderson Global Investors ("Henderson"), to conduct and run a Market Quotation auction to solicit bids. Henderson approached more than a dozen of the largest financial institutions in the world, each with a broad client base. In advance of the

[7] In this bid, Mr. Quintas said that "the generic AAA and A counterparties assumed in the quotes are too broad an assumption, and therefore prices might differ substantially once we know the exact identity of our potential source of protection." Ex 5, Email Correspondence from D. Swanson to B. Radicopoulos dated August 3, 2009. He also highlighted that the bids were "not firm," that "none of these are actionable," and that "[t]his is not an offer or invitation to trade." *Id.* The other three banks included near-identical caveats with their indicative bids.

auction, Henderson provided the bidders with access to a data room containing all relevant documentation and information about the terms of the Transactions (including that Assured would be the counterparty). Ten financial institutions, each with experience in the markets for RMBS and CLOs, as well as related CDS, ultimately agreed to participate in the auction, which was held in London on September 16, 2009. Not one submitted a single bid on any of the Transactions.

The Court has already held that Assured's Market Quotation auction was reasonably and appropriately designed and diligently conducted, that "neither the design nor the implementation of the auction were a reason for the lack of bids," and that "designing and carrying out the auction differently would not have resulted in [Assured] receiving sufficient bids to determine a Market Quotation under the 1992 ISDA Master Agreement." D/O at 8 (quoting Pirrong Rep. at 1). In support of this holding, the Court detailed several independent reasons why there was no appetite among market participants to submit bids on the Transactions at the time of the auction, including limited demand for the Underlying Securities, *id.* at 11, and concerns that if such high-quality securities experienced significant defaults, a monoline insurer like Assured might also be at risk of defaulting. *Id.* at 9-10. The difficulty of modeling this correlation risk, also sometimes referred to as "wrong-way risk," and the high costs of hedging against this risk, made it unlikely that a counterparty would be willing to pay Assured to enter into replacement transactions, particularly in light of "the absence of collateral posting and the back-ending of Assured's payment obligations" under the Agreement. *Id.*

The fact that none of the bidders, which included many of the most sophisticated financial institutions in the world, were willing to pay any amount to enter into LBIE's shoes in the Transactions is also consistent with LBIE's inability to novate the Transactions and with

LBIE's contemporaneous and candid internal assessments which recognized that at most the real-world value of the Transactions to LBIE would not exceed $10-15 million. *See* Ex. 6, Email Correspondence between P. Copley and S. Pearson dated June 30, 2009; *see also* Ex. 2, Assured Guarantee-LBIE Swap Exposure Valuation and Alternatives.

V. Assured's October 2009 Calculation of Loss

The Agreement directs that "[i]f fewer than three quotations are provided," as was the case here, "it will be deemed that the Market Quotation… cannot be determined.'" Def.'s Summary J. Mem. at 6 (quoting Agreement § 14). In that case, Assured as the Non-Defaulting Party must use the "Loss" method to calculate the termination payment. Loss is defined as follows:

> "Loss" means, with respect to this Agreement or one or more Terminated Transactions, as the case may be, and a party, the Termination Currency Equivalent of **an amount that party reasonably determines in good faith to be its total losses and costs** (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, **including any loss of bargain**, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from any of them). Loss includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication, if Section 6(e)(i)(l) or (3) or 6(e)(ii)(2)(A) applies. Loss does not include a party's legal fees and out-of-pocket expenses referred to under Section 11. A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable, as of the earliest date thereafter as is reasonably practicable**. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets.**

Id. (emphasis added). After summary judgment, the primary question remaining for trial is whether Assured's calculation of its Loss was reasonable and done in good faith.

Assured calculated Loss as follows: first, it added up the unpaid and future Fixed Payments that LBIE would have owed to Assured over the life of the Transactions and determined the present value of those payments—approximately $48.8 million. Next, Assured

used its existing processes and models (the same ones used in its ordinary course of business, and subject to thorough and independent vetting, including by its actuary, board and auditors) to estimate the interest and principal shortfalls that the Underlying Securities would experience over the life of the transactions. Assured determined the present value of the expected Floating Payments it would have owed LBIE to be approximately $28.1 million. This replicated the bargain Assured made: that it would receive premium payments from LBIE, and that it would make Floating Payments in the event that the Underlying Securities actually experienced shortfalls. The result was a net termination amount of approximately $20.7 million payable by LBIE to Assured. *See* Defendant's Pre-Trial Memorandum at 4, NYSCEF Doc. No. 468 (Sept. 21, 2019) ("Def.'s 2019 Pretrial Mem."). This calculation was remarkably close to LBIE's own pre-litigation calculation of the value of the Transactions if they continued through maturity. *See* Ex. 2, Assured Guarantee-LBIE Swap Exposure Valuation and Alternatives at 2. In short, Assured determined its "loss of bargain"—as the Agreement expressly provides—based on the parties' actual economic obligations under the terms of the Transactions, and using its ordinary-course procedures and models.

VI. LBIE Sues, Claiming Assured Owes It $1.4 Billion Dollars, While Valuing Nearly Identical Transactions at Zero

Instead of paying the amount it owed Assured as a result of its default, LBIE filed the current action in November 2011, claiming that Assured actually gained $1.4 billion from the termination of all the transactions under the Agreement and seeking damages in that amount. To calculate its claim, LBIE has no actual replacement transactions to rely on, which Assured could have entered into to preserve its bargain. Rather, LBIE's claimed damages are hypothetical and speculative, based on a model its litigation expert designed for this case, in which the expert tries to estimate the cost of theoretical replacement transactions based on market prices of some of the

Underlying Securities or, where such prices were unavailable, based on proxies. The Court's dismissal of two of LBIE's claims has drastically reduced LBIE's original damages claim, and the valuation models put forward by its litigation expert now support a claim of approximately $200 million before interest.[8] Neither its original demand nor its reduced expert valuation, however, take into account the evidence that no real-world market participant was willing to pay even a dollar to step into LBIE's shoes on the Transactions, as demonstrated by LBIE's failed efforts to novate and Assured's robust Market Quotation auction.

Meanwhile, just months before filing this suit, LBIE took the position that nearly identical transactions to those here could reasonably be valued using an expected loss methodology like Assured used and that the resulting value was zero. Historically, LBIE hedged the Transactions with Assured by entering into a series of back-to-back transactions on the same Underlying Securities (the "Back-to-back Transactions") with its U.S. affiliate, Lehman Brothers Special Financing Inc. ("LBSF"), on terms identical to those of the Transactions between Assured and LBIE. In the Back-to-back Transactions, LBIE took Assured's position by agreeing to make payments to LBSF for shortfalls, if any, on interest and principal payments for the referenced securities, and LBSF took LBIE's position by agreeing, in exchange, make premium payments to LBIE. In December 2008, LBSF terminated the Back-to-back Transactions, and from late 2010 through early 2011, LBIE and LBSF engaged in discussions over how to calculate the amount of the resulting termination payment. In those negotiations, LBIE argued for the same approach for determining "loss of bargain" that Assured used here. Lisa

[8] LBIE has also argued that it should not have to adjust its calculation of damages to account for the specific modifications to the Agreement that the parties agreed upon, resulting in a claim of approximately $500 million, but that argument is contradicted by the sworn deposition testimony of its own experts. *See* Plaintiff's Methodology Brief at 15-17, NYSCEF Doc. No. 469 (Sept. 21, 2019); Defendant's Opposition to Plaintiff's Methodology Brief at 18-19, NYSCEF Doc. No. 637 (Oct. 30, 2019) ("Opposition to Methodology Brief").

Summerfield, co-lead of the LBIE team responsible for this negotiation, told LBSF that "our assessment of the value" of the back-to-back transactions was "zero" based on "a predictive model approach, looking at expected losses over the lifetime of the trade." Ex. 7, Email Correspondence from L. Summerfield to R. Geraghty dated February 22, 2011. Although LBIE takes the position in this case that the Transactions should be valued by reference to market prices, what LBIE told LBSF was that market references were not "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 . . . ." *Id.*. Grant McPherson, who managed the LBIE team responsible for reconciling derivatives between LBIE and other Lehman affiliates, confirmed in his sworn deposition testimony that LBIE valued the back-to-back transactions using the same approach as Assured, and stated that LBIE's rejection of a market price-based valuation was "credible," "defensible," "reasonable" and not done "in bad faith." Ex. 8, McPherson Dep. at 132:3-134:8.[9] LBIE has moved *in limine* to exclude evidence related to the back-to-back transactions on the grounds they are settlement discussions, but as we show in our brief in opposition, even if some of this evidence were considered settlement communications (which it is not), the evidence falls squarely within an exception to CPLR § 4547. Defendant's Memorandum in Opposition to Plaintiff's Motion in Limine No. 2 to Exclude Evidence of Settlement Negotiations, NYSCEF Doc. No. 593 (Oct. 30, 2019).

[9] LBIE has also objected to certain of this evidence as hearsay. In their Memorandum of Law In Opposition to Defendant's Motion in Limine to Overrule Hearsay Objections, NYSCEF Doc. No. 605 (Oct. 30, 2019), it also wrongly attempts to cast the discussions surrounding LBIE's back-to-back transactions as irrelevant; the statements demonstrating that LBIE advanced a methodology identical to Assured's Loss calculations in its discussions with LBSF goes to the very issues to be decided here and plainly fall within the speaking agent exception to hearsay. *See also* Defendant's Memorandum of Law in Support of its Motion to Overrule Hearsay Objections Based on the Speaking Agent Exception to Hearsay, NYSCEF Doc. No. 396 at 3-4 (Sept. 20, 2019) (discussing admissions from LBIE's senior agents and employees that demonstrate that the valuation assumptions and calculations used by LBIE in its back-to-back negotiations with LBSF were identical to Assured's internal valuation methods and calculations.).

VII. The Reasonableness of Assured's Calculation is Confirmed by the Actual Performance of the Securities

We now know how the securities underlying the Transactions actually performed, and that performance further confirms the reasonableness of Assured's determination: 26 of the 28 Transactions made timely interest payments and have now repaid all principal owed without experiencing a single shortfall, as Assured predicted. *See* Def.'s Summary J. Mem. at 26. The remaining two Transactions (the ABX indices) have experienced shortfalls that are only slightly larger than what Assured's ordinary-course models estimated in 2009 (the total difference is less than one percent of the notional value of the Transactions). In other words, the actual performance of the Transactions is consistent with Assured's calculations, as well as with LBIE's own internal estimates of how the Transactions would perform in November 2008, Ex. 2, Assured Guaranty-LBIE Swap Exposure Valuation and Alternatives, and the valuation LBIE put forward for the Back-to-back Transactions in February 2011, Ex. 7, Email Correspondence between L. Summerfield and R. Geraghty, dated February 22, 2011. In stark contrast, the performance of the Transactions cannot be reconciled with the model created by LBIE's litigation expert for this case, which projected the opposite of what actually happened, with estimated Floating Payments due LBIE from the Transactions of more than $500 million. *See* Def.'s Summary J. Mem. at 26.

<u>QUESTIONS REMAINING FOR TRIAL</u>

After summary judgment, the critical question remaining for trial is whether Assured's determination of its Loss as a result of LBIE's default was done reasonably.[10] *Lehman Bros. Int'l v. AG Fin. Prod., Inc.*, 168 A.D.3d 527, 528, 90 N.Y.S.3d 530, 531 (1st Dep't 2019). The

[10] The Court has already ruled that there was no genuine issue of fact about Assured's good faith in conducting the Market Quotation auction and locating a replacement transaction, and dismissed LBIE's implied covenant of good faith and fair dealing claims arising out of Assured's termination of the Transactions. *See* D/O at 14.

standard for reasonableness requires the Court to consider whether the actions taken by Assured are those of a reasonable Non-defaulting Party in Assured's position based on the facts and circumstances facing Assured at the time of its decision. Def.'s 2019 Pretrial Mem. at 4-5. To recover on its claim, LBIE, as the plaintiff, has the burden of proving that Assured did not reasonably calculate its Loss.

I. Assured Reasonably Calculated Its Loss

The plain language of the Agreement supports the reasonableness of Assured's determination of the termination amount. Because the Market Quotation auction did not result in any bids, the Agreement granted Assured the right to make that determination based on the Loss definition. The Loss definition grants Assured, as the non-defaulting party, broad discretion to determine "*its* total losses and costs" based on a methodology of *its* choice. D/O at 24. The definition explicitly identifies several different potential approaches from which Assured could choose, including "loss of bargain," "cost of funding," or losses incurred in "terminating, liquidating, obtaining or reestablishing any hedge or related trading position." *Id.* at 14-15. And it specifically states that "[a] party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets." *Id.* at 15. Based on the plain language of this definition, Justice Friedman previously held that "the Loss provision could not be clearer in stating that a party 'may (but need not)' calculate Loss using market quotations of rates or prices. The phrase 'need not' is not a technical or specialized term which is, or could be, rendered ambiguous by evidence proffered by LBIE." *Id.* at 23-24. The Court went on to reason that the "Loss provision thus by its terms affords the Non-Defaulting Party the discretion to make the determination as to whether use of market prices to calculate Loss is appropriate in a particular case." *Id.* at 24.

Here, Assured reasonably exercised its discretion by selecting "loss of bargain"—one of the options expressly identified in the Agreement—as the basis for its determination. This meant determining what the agreed-upon terms would have required each party to pay over the life of the Transactions if LBIE had not defaulted. Because the Transactions obligated LBIE to make fixed premium payments to Assured in exchange for payments from Assured in the amount of actual shortfalls as they occurred on the Underlying Securities, Assured calculated the lifetime premium payments that LBIE would owe to it, and subtracted from that total the expected shortfalls that it would owe LBIE.

Assured reasonably determined these expected shortfalls for the Transactions by using the same procedures and models that it used in the ordinary course to monitor its expected losses for transactions across its business. In other words, the numbers Assured used here were ones that had already been generated and were on its books for the Transactions. *See* Def.'s Summary J. Mem. at 23-24. The reasonableness of Assured's approach is further confirmed by the fact that its loss procedures and models were and are the subject of substantial oversight and independent review. *See* Def.'s Summary J. Mem. at 24 n.20. As a publicly listed, regulated insurance company, these models were used for Assured's financial and statutory reserve reporting to the SEC and insurance regulators, and were systematically reviewed by senior management, the Audit Committee, its chief actuary and its independent auditor, PwC. *See Id.* at 25 n.22. Both the chief actuary and the independent auditor have duties of independence that require them to evaluate the reasonableness of management's accounting estimates, including its loss reserves estimates.

II. Assured Was Not Required to Measure Loss by Reference to a Replacement Transaction

LBIE's challenges to the reasonableness of Assured's "loss of bargain" approach are all based on the premise that there is only one objectively reasonable way for a party in Assured's shoes to determine its Loss, and that is based on the real or hypothetical market price of a replacement transaction. This premise is wrong on the law and the facts.

The words of the Loss definition could not be more clear in granting the non-defaulting party discretion and stating that it "need not" determine Loss based on reference to prices or quotations. There is nothing in the text of that definition that supports LBIE's attempt to strip Assured of the "discretion and flexibility" that the Court has already held was granted to it. D/O at 24 (citing *Lehman Bros. Holdings Inc. v. Intel Corp.*, 2015 WL 7194609, at *12). Notably, the Loss definition grants the non-defaulting party the option *not* to use observable quotations even in cases where Market Quotation generated some but fewer than the required number of bids. Indeed, the Agreement even permits the non-defaulting party this option where the bids received "would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result." *See* Def.'s Summary J. Mem., Ex. 7 (definition of Settlement Amount).

Unable to find contractual language to support its position, LBIE relies entirely on experts to interpret (and effectively rewrite) the contract based on purported industry custom and practice. But, even if it were permissible for LBIE to vary the unambiguous terms of the Agreement in this way (and it is not), LBIE does not offer any competent, admissible evidence of a "fixed and notorious" custom and practice supporting the approach it advocates here, which Justice Friedman made clear is a precondition for any such evidence being admissible. *See* D/O at 21 n.10 . As a result, in one of its *in limine* motions, Assured has challenged the admissibility

of all of that evidence. *See* Defendant's Memorandum of Law in Support of Its Motion to Preclude the Introduction at Trial of Inadmissible Custom and Practice Evidence, NYSCEF Doc. No. 413 (Sept. 20, 2019) ("Custom and Practice Memorandum"). As explained in that motion, LBIE has the burden to show that when it entered into the Agreement, a "true market consensus" existed that Loss could only be determined based on the market price of replacement transactions for transactions similar to those here, and that Assured was "actually aware" of this fixed, consensus interpretation of Loss, or that the industry custom of calculating Loss that way was "so notorious that a person of ordinary prudence in the exercise of reasonable care would be aware of it." *See* D/O at 19 (quoting *J.P. Morgan Inv. Mgmt. Inc. v. AmCash Grp. LLC*, 966 N.Y.S.2d 23, 24 (1st Dep't 2013)); *Law Debenture Trust Co. of N.Y. v. Maverick Tube Corp.*, 595 F.3d 458, 466 (2d Cir. 2010). LBIE cannot meet this burden, including because its purported custom and practice evidence did not exist when the parties originally entered into the Agreement, or even when Assured calculated its Loss in 2009. The vast majority of LBIE's purported evidence relates to the private settlement negotiations conducted by LBIE and other Lehman affiliates, which were only made public years later, if at all. Further, the purported evidence relates to standard-term transactions or where the parties had independently agreed to tie their payment obligations to market prices, and not to modified agreements, like those at issue here, with a pay-as-you-go structure and no collateral posting requirements. So however fixed the evidence is with respect to market-price based payment obligations, it has no application here because of the modified terms of the Agreement. *See* Custom and Practice Memorandum.

LBIE also erroneously argues that the requirement to use the market price of a replacement transaction to determine Loss is supported by the cross-check principle, a judge-made doctrine adopted in a handful of foreign cases involving completely different fact patterns.

But even if the Court were to hold for the first time that the cross-check principle applies under New York law, that doctrine does not provide a basis for challenging the reasonableness of Assured's Loss determination here. Cross-check has been applied by foreign courts to test whether bids received in a Market Quotation were reasonable by comparing them against a "loss of bargain" cashflow analysis similar to what Assured conducted here. Opposition to Methodology Brief at 10-11. It has never been applied the other way around to use Market Quotation bids as a reasonableness check on a "Loss" determination, let alone to require testing the reasonableness of a Loss determination based on hypothetical quotations generated by a defaulting party's litigation model, as LBIE advocates. But even if this reverse application were appropriate (and it is not), the results of the Market Quotation here – where no one was willing to pay a dollar to step into LBIE's shoes – are consistent with Assured's determination, and only call into question the reasonableness of LBIE's damages claim. *Id.*

LBIE's attempt to import a requirement to use the market price of a replacement transaction into the Agreement is particularly untenable on the facts of this case because the evidence shows that there were no replacement transactions available, despite independent efforts by both parties to find third parties willing to enter into such transaction. Assured invited leading financial institutions to a well-designed Market Quotation auction, but not a single one was willing to pay even a dollar to enter into a replacement transaction. *See supra* 12-13. And LBIE repeatedly tried to novate or assign the transactions to a third party because it believed that was the best way to "extract" value from the transactions, but again no one was willing to do so. *See supra* 8-11. Even on the eve of termination, as LBIE began preparing a litigation strategy to challenge Assured's determination, it tried and failed to obtain a single binding, actionable bid

from any third party to step into LBIE's shoes. Defendant's Reply Memorandum in Further Support of Its Motion for Summary Judgment at 8-9, NYSCEF Doc. No. 145 (May 9, 2016).

In the absence of any evidence of reliable price quotations for replacement transactions, LBIE instead argues that the only reasonable basis for Assured to determine its Loss was based on hypothetical quotes generated by a model, like the one created by LBIE's litigation expert, that estimates what a market participant should have been willing to pay for replacement transactions based on the market prices of the Underlying Securities, or on proxies in instances where even those prices were unavailable. Those models fail to take into account that there was no one willing to enter into the replacement transaction with Assured, and that this requirement would be inconsistent with the actual terms of the Agreements. Further, LBIE's model itself is based on flawed assumptions that use varied proxies and manipulations, and overvalue the Transactions by not properly taking into account the modified terms of these Transactions. Opposition to Methodology Brief at 17-18. In addition to being contrary to the terms of the Agreement, applicable law, and the evidence, requiring Assured to determine loss by modeling the hypothetical price of a theoretical replacement transaction would be fundamentally unfair because it would require Assured, as the non-defaulting party, to make a substantial payment to LBIE based on a theoretical transaction that Assured could not actually enter into to preserve its bargain.

LBIE's approach is particularly unreasonable here because the "market data" that LBIE's litigation expert relies on from the height of the financial crisis reflected a number of factors that had nothing to do with expected shortfalls over the life of those securities. In particular, there was extensive contemporary economic analysis, including from economists for the Bank of England and the Bank of International Settlements showing that pricing of the relevant securities

here was primarily driven by the limited demand for these securities (including based on the changes in regulatory and tax regimes) and bore little to no relationship to the probability of future defaults. *See* Opposition to Methodology Brief at 11-12. LBIE thus cannot show that the hypothetical prices generated by its model in any way reflect a gain to Assured from terminating the Transactions.

III. Assured's Calculated Loss Was Commercially Reasonable

LBIE's final argument is that, even if Assured was permitted to calculate Loss as it did, the result was nevertheless unreasonable. But all of the contemporaneous evidence confirms the reasonableness of Assured's result. The conclusion that the Transactions did not have value for LBIE is consistent with: LBIE's own internal assessment in November 2008. *See supra* 10; LBIE's February 2011 valuation of the identical back-to-back transactions. *See supra* 16-17; LBIE's inability to novate the Transaction. *See supra* 10-11; LBIE's failure to obtain even a single firm bid for the Transactions. *See supra* 11-12; and the results of the Market Quotation auction, which also did not generate any bids. *See supra* 12-13. Finally, Assured's result is also consistent with the actual performance of the Underlying Securities. *See supra* 17-18; *see also Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, 289 U.S. 689, 698 (1933) ("[Where] [e]xperience is then available to correct uncertain prophecy[,] [th]ere is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within.").

CONCLUSION

For the reasons set forth above, Assured acted reasonably in determining its loss. LBIE seeks a windfall to which it has no right under the clear language of the Agreement. In short, LBIE cannot meet its burden of showing that Assured's determination was objectively unreasonable.

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Respectfully submitted,

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