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

LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration), Plaintiff, v. AG FINANCIAL PRODUCTS, INC., Defendant.	Index No. 653284/2011 Justice Melissa A. Crane

PLAINTIFF'S PRE-TRIAL BRIEF

QUINN EMANUEL URQUHART & SULLIVAN LLP
51 Madison Avenue, 22nd Floor
New York, New York 10010
(212) 849-7000

Attorneys for Plaintiff Lehman Brothers International (Europe) (in administration)

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PRELIMINARY STATEMENT

The value of a credit default swap is its market price.

That simple proposition is a basic principle of New York contract law. It is the well-established practice under the standard-form contracts at issue, which have enabled a robust, international market by standardizing the process of using market prices to determine value upon termination. And it was central to the bargain that Plaintiff Lehman Brothers International (Europe) (in administration) ("LBIE") struck with Defendant AG Financial Products, Inc. ("AGFP") when they entered into a no-fault ISDA Master Agreement that required the parties to settle terminated trades based on their market value, regardless of which party terminated.

As trial will establish, AGFP acted contrary to New York law, market practice, and the specific bargain that it struck by valuing dozens of credit default swaps ("CDS") as assets when in fact they were liabilities. Before the 2008 financial crisis, the parties had entered into 28 CDS trades with a face value of ***$5.6 billion*** that made AGFP liable for any losses on a group of residential mortgage and corporate loan securities. When the housing and financial markets collapsed, the trades became extremely valuable to LBIE and a massive liability to AGFP. LBIE filed for administration on September 15, 2008, giving AGFP the option to terminate the trades. When AGFP chose to terminate in July 2009, the trades had a market value of ***$577.9 million in favor of LBIE***. AGFP ignored this market value and the conditions that compelled it, instead claiming that the trades were ***$11.8 million in AGFP's favor***.[1] Rather than compensate LBIE based on the current value of the trades as the contract required, AGFP sought millions for itself.

AGFP reached this self-serving result by repeatedly ignoring market data and standard market practice for valuing financial instruments, substituting its own self-serving predictions of

[1] In July 2019, AGFP revised this to $7.6 million due to a calculation error. JX-35. Citations are primarily to trial exhibits, which the parties can re-provide to the Court if helpful.

how the trades might perform, an estimate meant for insurance reserves, but never for CDS valuation. For 26 of the 28 trades, AGFP did not run any model or even review the trades, but simply assumed it would have to make ***no*** payments for the life of these risky trades. That assumption was wildly at odds with the market, where prices reflected the obvious fact that CDS trades against residential mortgage and corporate debt securities had become far more valuable to the protection buyer than the seller. For the remaining two trades, AGFP ignored readily available market prices, instead generating its own model-based calculation that either used outdated market data from before the financial crisis or no identifiable source of data at all.

Trial will reveal just how extreme and unreasonable AGFP's valuation of these CDS trades was. The parties' contractual relationship is defined by a standard-form contract with well-understood termination provisions. ***AGFP cannot identify any other market participant that has ever calculated a CDS termination payment the way it did***. Accepting AGFP's contention that it was entitled to value CDS trades using its own subjective, idiosyncratic, and undisclosed predictions would rob LBIE of its bargain and create precedent that would undo the uniformity and predictability that have allowed the global CDS market to function.

If AGFP had used market prices to value its CDS trades, it would have found they were over half a billion dollars in LBIE's favor. If AGFP had used market data in its reserves valuation, it again would have found they were hundreds of millions of dollars in LBIE's favor. It was only by using *both* an improper methodology never before used to value CDS *and* a set of subjective, market-contradicting assumptions that AGFP was able to value a $577.9 million liability at $11.8 million ***in the wrong direction***.[2] That financial alchemy was at odds with New York law, contrary to the well-understood standards of the industry, and a breach of contract.

[2] AGFP's Statement of Calculation also demands of $13.0 million in unpaid premiums. JX-34 at 5. This amount was overstated by $0.6 million. JX-44 (Niculescu Supp.) ¶ 88.

FACTUAL BACKGROUND[3]

A. LBIE And AGFP's Contracts And CDS Trades

In their simplest form, credit default swaps are financial contracts in which one party agrees to make regular "fixed" payments in exchange for its counterparty's commitment to make "floating" payments in the event that a specified "reference" security fails to pay interest or principal.[4] CDS are often referred to as credit "protection," as they protect the "fixed" payer, or protection buyer, against shortfalls in the payments or recoveries on the security referenced in the contract. At the trade's start, "the aggregate scheduled payment obligations of the parties are, loosely speaking, seen to be of equal value," but as the referenced securities become more or less likely to default over time, "the transaction will normally become an asset to one of the parties and a liability to the other, so, if the transaction is closed out before the end of the term, one of the parties will incur a loss and the other will experience a roughly equal gain."[5]

In 1992, the International Swaps and Derivatives Association ("ISDA") published a template Master Agreement that parties could use to standardize the terms of their trades. The ISDA Master Agreement's widespread adoption brought certainty and uniformity to the global industry, making CDS a well-understood and liquid financial instrument.[6] Trillions of dollars in derivatives trades are documented using standard-form ISDA Master Agreements.[7]

LBIE and AGFP are two of the thousands of participants in the CDS market. LBIE is a

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[3] Unless otherwise noted, this Factual Background derives from the Court's July 8, 2018 Decision/Order on Summary Judgment, Dkt. 156; *available at* 110 N.Y.S.3d 218 (Table), the Joint Statement of Undisputed Material Facts, Dkt. 136, and the Court's March 12, 2013 Decision/Order on AGFP's Motion to Dismiss, Dkt. 31; *available at* 969 N.Y.S.2d 804 (Table).

[4] JX-36 (Rahl Rpt.) ¶¶ 14-16; *see also In re Credit Default Swaps Antitrust Litig.*, 2016 WL 2731524, at *1 (S.D.N.Y. Apr. 26, 2016) ("[A] CDS is a derivative whose value depends on the value of an underlying debt instrument.").

[5] Dkt. 471 (A. Gooch & L. Klein, *Documentation for Derivatives* (2002)) at 222-23.

[6] JX-36 (Rahl Rpt.) ¶¶ 40-41, 103; JX-37 (Rahl Reb.) ¶¶ 4, 9-12.

[7] Bank for International Settlements, *Statistical release: OTC derivatives statistics at end December 2019* (2020), https://www.bis.org/publ/otc_hy2005.pdf.

UK company, now in bankruptcy administration, that made up part of Lehman Brothers, one of the world's leading investment banking and trading firms before its 2008 collapse. AGFP is an entity formed for the purpose of participating in the CDS market; its corporate parent, Assured Guaranty Corporation ("AGC"), is a monoline insurer that cannot legally buy or sell CDS.[8] Unlike insurance policies, CDS do not require the protection buyer to have an "insurable interest" in the underlying security, can trigger payments based on events "beyond the scope of risks that can be guaranteed by [a financial guaranty insurance] policy,"[9] and—critically to this dispute—are valued and accounted for based on market prices.[10]

Between 2005 and 2008, AGFP and LBIE entered into a number of CDS trades, including the 28 at issue. In each trade, AGFP sold credit protection, and LBIE bought that protection. Fourteen trades referenced prime UK residential mortgage securities ("UK RMBS"), eleven referenced U.S. corporate loan securities ("CLO"), one referenced U.S. collateralized debt obligations ("CDO"), and two referenced indices of subprime US residential mortgage securities ("ABX"). The total notional value of these trades was $5.6 billion.[11]

As is market standard, each LBIE-AGFP CDS trade is governed by three documents that collectively comprise a single agreement. In April 2000, the parties entered into both a standard-form ISDA Master Agreement[12] and a Schedule[13] in which they chose among different options presented in the ISDA template. Then, when they entered into each individual CDS trade, they

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[8] *See* New York State Dep't of Fin. Servs., Circular Letter No. 19, Sept. 22, 2008 at 3, https://www.dfs.ny.gov/insurance/circltr/2008/cl08_19.htm (entities like AGFP "offer certain contract terms that cannot be legally included in policies issued directly by a [insurers]").

[9] *Id.*

[10] *See* Dkt. 508 (Fin. Accounting Stds. Bd., *Statement of Financial Accounting Standards No. 133— Accounting for Derivative Instruments and Hedging Activities*, June 1998 ("FAS 133")) ¶¶ 4, 281.

[11] JX-41 (Niculescu Rpt.) ¶ 13.

[12] JX-01 (1992 ISDA Master Agreement) & JX-02 (signature page).

[13] JX-02 (Schedule).

documented it with a Confirmation that confirmed the trade's economic details, any trade-specific terms, and that the trade would otherwise be governed by the parties' ISDA Master Agreement and Schedule.[14] These contracts are governed by New York law.[15]

Unlike many contracts, a party's default is not a breach of an ISDA Master Agreement, but instead gives the "Non-defaulting Party" the right to terminate the trades. If a party exercises that right, it must calculate a termination payment called a "Settlement Amount." The standard-form ISDA Master Agreement presents multiple options from which the parties may choose for how to calculate and exchange that payment. Like most CDS parties, LBIE and AGFP selected "Second Method," sometimes referred to as a two-way provision.[16] Unlike the "First Method," in which the party that defaulted has no claim for payment, if a Non-defaulting Party *gains* by terminating a "Second Method" trade —for example, by eliminating a payment liability—it must pay that gain to its in-the-money counterparty, notwithstanding that counterparty's default.

LBIE and AGFP also elected to use the "Market Quotation" methodology to calculate the Settlement Amount, which was again the market-standard choice. This strictly mechanical process requires the Non-defaulting Party to obtain quotations from leading CDS dealers for the price they would pay, or would have to be paid, to enter into a trade to replace the one that was terminated. If fewer than three quotations were provided, the parties agreed that the "Loss" methodology would apply as a fallback. Under the Loss methodology, the Non-defaulting Party "reasonably determines in good faith … its total losses and costs … ***or gain*** … including any loss of bargain … as of the relevant Early Termination Date."[17] Under this approach, a Non-

[14] JX-05 through JX-32 (Confirmations).

[15] JX-02 at 11.

[16] JX-02 at 4 (selections); *see also* JX-01 at 9-10, 15-16 (methodology definitions).

[17] JX-01 at 15 (methodology definition).

defaulting 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."

B. AGFP's Termination, Failed Auction, And Valuation

After AGFP and LBIE entered into the trades at issue between August 2005 and May 2008, a global financial crisis cratered housing and credit markets. On September 15, 2008, the crisis forced LBIE into administration—an English form of insolvency, and a default under the ISDA Master Agreement. As a result, AGFP (and every other entity trading with LBIE under an ISDA Master Agreement) had the right to terminate open CDS trades. While the vast majority of LBIE's counterparties terminated their trades in September 2008,[18] AGFP did not. Instead, in a calculated effort to minimize its massive obligation to LBIE, AGFP chose to terminate and value its CDS trades with LBIE in multiple steps over the course of more than a year.

First, in December 2008, AGFP terminated nine CDS trades no longer at issue. A bargained-for provision in these nine trades gave AGFP a right to avoid the Market Quotation and Loss valuation methods; AGFP could instead "walk-away" without any future obligations in either direction. If AGFP actually believed its CDS trades with LBIE were valuable assets, as it claims to, using this "walk-away" methodology inexplicably left millions of dollars on the table.

Then, for the 28 CDS trades that did not give AGFP the contractual right to "walk away," AGFP sought to avoid having to pay LBIE their obvious and substantial market value. In a July 2009 presentation to LBIE, AGFP leveled a thinly-veiled threat: Pre-judging that the mandated Market Quotation methodology "cannot be operated in this case," AGFP pronounced that "the Loss method must be used," and that AGFP had already "considered the value of the Swaps" and

[18] LX-156 (spreadsheet of counterparty valuation dates and amounts).

"determined that there is no Loss due to default."[19] When LBIE refused to bow to this threat and simply tear up trades that were hundreds of millions of dollars in its favor, AGFP sent a July 23, 2009 notice terminating the trades.

Although AGFP was tasked with valuing the CDS trades, LBIE sought indicative quotes from leading dealers establishing the trades' enormous value. Nomura placed their value between $482.9 million and $620.9 million in LBIE's favor, depending on the counterparty's credit rating.[20] Citigroup provided quotes on just part of the portfolio that equated to a value of at least $295 million in LBIE's favor.[21] It is no surprise that the trades were a substantial asset to LBIE and liability to AGFP. Prices for the two ABX trades—which account for over half of the amount in dispute—had increased by over $300 million since their execution in February 2007.[22] Daily trading prices showing this massive shift were readily available, including to AGFP.[23]

In September 2009, pursuant to the "Market Quotation" process, AGFP conducted an auction open only to bidders that had already signed a Master Agreement with AGFP and agreed to provide executable bids that AGFP could accept or reject in its sole discretion.[24] Of the 12 dealers AGFP contacted, only three met AGFP's pre-conditions, and none submitted a bid.[25] Having failed to obtain the required number of quotations, AGFP was then required to calculate a termination payment pursuant to the "Loss" provision.

Although "falling back" to Loss was commonplace, AGFP's lopsided and arbitrary

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[19] LX-90 at 11.

[20] LX-76 (Nomura indications).

[21] LX-75 (Citigroup indications).

[22] JX-36 (Rahl Rpt.) ¶¶ 106-07; JX-41 (Niculescu Rpt.) ¶¶ 38-39, Exh. 6.

[23] JX-40 (Bruce Rpt.) ¶¶ 44-50.

[24] Dkt 312 (CTRL00002049) (Nomura was unable "to turn around an ISDA fast enough to meet [AGFP's] deadline."); JX-34 at 3-4 (describing AGFP's Market Quotation process, including requirement that bidders agree to submit binding quotations).

[25] JX-34 (Statement of Calculations) at 7.

methodology defied all market conventions. AGFP added up all the "fixed" payments it expected to receive over the duration of the trades, then calculated the future "floating" payments it expected to pay not using market data, but instead the idiosyncratic predictions its corporate parent made for an entirely different purpose—setting insurance policy reserves. Insurance reserves are a facially improper way to value CDS trades, as they *do not purport to be a valuation*. Instead, they only record a reserve if a loss is more than 50% likely;[26] a 49% chance of a huge payout, although obviously relevant to an asset's value, is ignored entirely. Moreover, while AGFP portrays this methodology as employing a discounted cash-flow model, in most cases no "model" was run at all: For 26 of the 28 trades, AGFP simply assumed a string of zero projected losses, reflecting its parent's subjective judgment that insurance policies related to such trades did not require a reserve.[27] The two ABX trades, on the other hand, were subjected to the reserve cash-flow model, which AGFP's parent itself has described as "an inherently subjective process involving numerous estimates, assumptions and judgment by management."[28] AGFP projected that those two trades—valued by the market at $329 million to LBIE due to the deterioration of the underlying subprime mortgages[29]—would require just $23 million in future "floating" payments.[30] AGFP subtracted this artificially reduced figure from the "fixed" amounts it projected LBIE would owe and sent LBIE a bill with an $11.8 million valuation.

C. Procedural History

[26] Rosenblum Tr. 137:10-17 ("And more importantly, it has to be -- has to be probable, and by probable I mean, there's a 50 percent chance that the event will occur that will lead to a loss. So if it was a 20 percent chance that the event would occur in our scenarios that would lead to a loss, there would be no loss reserve under a statutory basis."); Rosenblum Supp. Tr. 39:12-16, 116:10-22, 120:15-121:5.

[27] Rosenblum Supp. Tr. at 16:16-20:25; 21:24-22:20; JX-44 (Niculescu Supp.) ¶ 64.

[28] LX-115 (Assured Guaranty Ltd., Form 10-K (2008)) at 61.

[29] JX-41 (Niculescu Rpt.) ¶¶ 39-40 & Exh. 7.

[30] JX-34 (Statement of Calculation) at 10.

AGFP's valuation of its CDS trades was an extreme outlier among the valuations submitted by LBIE's other CDS counterparties, and it deprived LBIE of hundreds of millions of dollars of value that properly belonged to the administrated estate and its stakeholders. LBIE therefore sued in November 2011.

In July 2018, the Court granted summary judgment regarding AGFP's actions in conducting the failed Market Quotation auction, but denied AGFP's summary judgment motion with respect to the calculation of Loss. The Court ruled that "an ***objective standard of reasonableness*** applies to a contractual provision requiring performance of an obligation in a reasonable manner."[31] The Court went on to identify some of the evidence relevant to determining whether AGFP breached that objective standard, including "evidence of departure by Assured, as the Non-Defaulting Party, from ***standard industry practice*** [which] is a factor, among others, to be considered in assessing its reasonableness and good faith in calculating Loss."[32] The Court also recognized that "[i]t would make no sense to hold as a matter of law that, because the Market Quotation process was unsuccessful, Assured was free to adopt a methodology that results in a termination payment completely divergent from the cost of replacing the Transactions."[33] AGFP appealed and the First Department affirmed, citing the same authority supporting consideration of LBIE's evidence "that defendant's calculations were not reasonable under the circumstances."[34] This trial follows.

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[31] Dkt 156 (Summary Judgment Decision) at 21

[32] *Id.* at 28 (emphasis added); *see also id.* at 22 (quoting *Hoag v. Chancellor, Inc.*, 246 A.D.2d 224, 230-31 (1st Dep't 1998) for the proposition that "evidence of industry practice" is admissible "'for the permissible purpose of providing guidelines for an unexplained term,'" in this case "objectively reasonable").

[33] *Id.* at 30.

[34] Dkt. 354 (Order on Appeal) *available at* 168 A.D.3d 527, 528 (1st Dep't 2019).

ISSUES PRESENTED AT TRIAL

I. UNDER NEW YORK LAW, THE LOSS-OF-BARGAIN VALUE OF A FINANCIAL INSTRUMENT IS ITS FAIR MARKET VALUE

It is common ground among LBIE and AGFP that the calculation of the 28 CDS trades' value should be judged "using a 'loss of bargain' approach."[35] There is similarly no dispute that the termination payment provisions are, in the words of AGFP's expert Joshua Cohn, meant to reflect "generally applicable New York law on contract damages."[36] As trial will establish, however, AGFP's subjective valuation methodology, divorced from market pricing, is fundamentally at odds with the contract law principles it invokes. New York law is clear that the loss-of-bargain value for a financial asset like a CDS is set by the market, and the market was clear that *these* CDS were worth hundreds of millions to LBIE. *St. Lawrence Factory Stores v. Ogdensburg Bridge & Port Auth.*, 13 N.Y.3d 204, 207 (2009) ("the 'benefit of its bargain'" is the "difference between the agreed-upon price of the property and its market value").

It is black-letter law that where a breach of contract results in "the deprivation of an item with a determinable market value, the market value at the time of the breach is the measure of damages." *Cole v. Macklowe*, 64 A.D.3d 480, 480 (1st Dep't 2009); *see also, e.g.*, *White v. Farrell*, 20 N.Y.3d 487, 494 (2013) ("'[T]he generally accepted measure of damages is the difference between the contract price and the fair market value of the property at the time of the breach.'") (quoting 13 Lord, Williston on Contracts § 66:80 (4th ed.)); *Sharma v. Skaarup Ship Mgmt. Corp.*, 916 F.2d 820, 825 (2d Cir. 1990) ("It is also fundamental that, where the breach involves the deprivation of an item with a determinable market value, the market value at the time of the breach is the measure of damages."). Objective, third-party market data prevails over

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[35] *See, e.g.*, Dkt. 468 (AGFP's Methodology Br.) at 1, 3, 6, 7, 13.

[36] JX-47 (Cohn Rpt.) ¶ 15.

subjective, personal views: "When a defendant's breach of contract deprives a plaintiff of an asset, the courts look to compensate the plaintiff for the 'market value' of the asset 'in contradistinction to any peculiar value the object in question may have had to the owner.'" *Schonfeld v. Hilliard*, 218 F.3d 164, 178 (2d Cir. 2000) (quoting John D. Calamari & Joseph M. Perillo, *The Law of Contracts* § 14-12 (3d ed. 1987)).

These bedrock principles of New York law apply with particular force to the contracts in this case, in which LBIE and AGFP agreed to use the "Market Quotation" and "Second Method" payment methodologies. By choosing "Market Quotation," the parties agreed that they would look to the market to define the payment—just as New York law provides.[37] And by choosing "Second Method," the parties agreed that a Non-defaulting Party had a right to terminate, but not to a windfall, as it had to pay over any market-defined gain from the termination. As New York law recognizes, an "opinion of fair market value must represent not only the seller's viewpoint, but also the buyer's, since value in the market place reflects both influences." *Boyce v. Soundview Tech. Grp., Inc.*, 464 F.3d 376, 388 (2d Cir. 2006) (quotation omitted).

Trial will establish that if AGFP had applied these basic principles of New York law when it "chose to calculate its Loss by using a 'loss of bargain' approach,"[38] it would have valued the 28 CDS trades as a valuable asset to LBIE and massive liability to AGFP. LBIE's expert Dr. Peter Niculescu will testify that market prices for the referenced securities[39] are

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[37] *See Lehman Bros. Holdings Inc. v. Intel Corp.* ("*Intel*"), 2015 WL 7194609, at *17 (Bankr. S.D.N.Y. Sept. 16, 2015) ("[T]he court first concluded, based on Section 6(e)(iv) of the 1992 ISDA Master Agreement, that the payment called for by Market Quotation 'is intended broadly to reflect the loss of bargain.'") (quoting *Peregrine Fixed Income Ltd. v. Robinson Dep't Store Public Co.* [2000] EWHC 99 (Comm) [28] (Eng.)).

[38] Dkt. 468 (AGFP's Methodology Br.) at 1.

[39] As the Court has already ruled, the value of the CDS trades had to be "determined 'as of the relevant Early Termination Date,' not years later using hindsight." Dkt. 156 at 36 (quoting JX-01 (1992 ISDA Master Agreement) at 15). This matches the principle that measuring damages with "the application of hindsight [is] contrary to New York law." *Kaminsky v. Herrick,*

available and reliably documented.[40] For example, in addition to emails from major banks every day quoting where they would buy and sell the ABX indices, third party data provider Markit published daily closing mid-market prices for the indices, which are inversely proportional to the market prices and values of CDS protection on those indices.[41]

Markit also published daily closing prices for standard CDS on UK RMBS, and JP Morgan published both mid-market prices for CLOs and a CDS basis that connects the prices of the underlying reference CLOs to the price of CDS protection on them.[42]

Using those reliable, widely-used market values, Dr. Niculescu calculates that the mid-

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Feinstein LLP, 59 A.D.3d 1, 11 (1st Dep't 2008); *see also UBS Secs. LLC v. Highland Cap. Mgmt. L.P.*, No. 650097/2009, Dkt. 641 at 29 (Sup. Ct. N.Y. Cty. Nov. 14, 2019) (Friedman, J.) ("New York courts reject damage awards based on what the actual economic conditions and performance were in light of hindsight.").

[40] JX-41 (Niculescu Rpt.) ¶¶ 18-20, 36, 53-54, 58, 82-83.

[41] JX-40 (Bruce Rpt.) Exhs 2 & 3; *see* JX-41 (Niculescu Rpt.) Exh. 6; JX-36 (Rahl Rpt.) Exh. 2; LX-107 (AG00370599) (ABX quotes); LX-113 (Markit ABX.HE Historical Dataset).

[42] JX-41 (Niculescu Rpt.) at ¶¶ 18-20, 36, 53-54, 58, 82-83.

market value[43] of the trades was $577.9 million—$328.9 million for the ABX Transactions, $112.0 million for the CLO and CDO Transactions, and $137.0 million for the UK RMBS Transactions, all in LBIE's favor.[44] There is no meaningful dispute about mid-market price in public markets as of July 23, 2009. AGFP's experts have only proposed a single $16.6 million modification to Dr. Niculescu's mid-market calculation[45]—and even that minor proposed adjustment is disputed and incorrect. Dr. Niculescu's reliable application of published mid-market prices is consistent with contemporaneous evidence from Nomura, which valued the CDS trades at $482.9 to $620.9 million, and Citigroup, which valued a subset at a minimum of $295 million.[46] As the Court noted at Summary Judgment, "[i]t cannot be disputed that, at the time of the terminations at issue, the financial crisis had significantly increased the prospect of shortfalls in timely interest and ultimate principal payments on the Underlying Securities."[47]

"The value of assets for which there is a market," such as the ABX indices, captures "the discounted value of the stream of future income that the assets are expected to produce." *Sharma*, 916 F.2d at 825-26 (holding that "the market value at the time of the breach," not projected lost profits, "is the measure of damages"). A reasonable market-based approach could not reach any conclusion *other than* that these CDS trades were massively in-the-money to the

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[43] Mid-market values are halfway between the highest "bid" that a buyer is offering to pay for particular credit protection and the lowest "offer" that a seller is offering to accept. JX-41 (Niculescu Rpt.) ¶ 15 n.3.

[44] JX-44 (Niculescu Supp.) ¶ 52, Ex. 7. Dr. Niculescu's largely unchallenged methodology finds further support in New York law, under which even if "the fair market value of the asset … cannot be readily discerned at the time of breach, the factfinder may determine 'hypothetical market value' based on expert testimony." *Credit Suisse First Boston v. Utrecht-Am. Fin. Co.*, 84 A.D.3d 579, 580 (1st Dep't 2011).

[45] JX-49 (Goldin & Prager Reb.) ¶ 55; JX-44 (Niculescu Supp.) ¶ 52 n.86. Notably, none of AGFP's experts endorsed using AGC's internal mark-to-market calculations, which even AGFP ignored when calculating its purported Loss. *See, e.g.*, JX-36 (Rahl Rpt.) ¶¶ 116-24 (detailing methodological failures and absurd results evident in AGC's attempted marks).

[46] LX-76; LX-75.

[47] Dkt. 156 at 37.

protection buyer, a reality that *every other LBIE counterparty* with trades referencing these types of obligations recognized, whether it was in that party's favor or not.[48]

II. UNDER WELL-ESTABLISHED INDUSTRY PRACTICE IN THE CDS MARKETS, AGFP'S "LOSS" CALCULATION HAD TO REACH A FAIR MARKET VALUE

As the Court has ruled, "the ISDA Master Agreement must be read in light of its purpose, which is to promote legal certainty and predictability or market stability when applied to termination of a diverse array of derivative transactions in global markets."[49] The CDS market, comprised of thousands of different counterparties with differing goals and perspectives, could not work if every trade's value depended on idiosyncratic, private determinations of value. Instead of the no-fault basis for settlement that the ISDA Master Agreement imposes, every termination would be an opportunity for a windfall to the terminating party and a penalty to its counterparty, as Non-defaulting Parties with opposite positions would each demand the "discretion" to value offsetting trades in their own favor—exactly what AGFP seeks to do. Parties could not reliably hedge, manage, or even measure their exposure without a baseline agreement that CDS trades are measured by market value, and early terminations would inevitably lead to protracted litigation such as this.

The ISDA Master Agreement required AGFP to perform its valuation "in good faith" and "reasonably" in light of industry practice. The evidence of this practice is overwhelming, and not seriously contested. Industry groups have documented the "general agreement that in determining close-out amounts market inputs should be used unless doing so would produce a

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[48] JX-40 (Bruce Rpt.) ¶¶ 79-86.

[49] Dkt. 156 at 24; *see also Lomas v. JFB Firth Rixson Inc.* [2010] EWHC 3372 (Ch) [53] (Eng.) ("The ISDA Master Agreement is one of the most widely used forms of agreement in the world. It is probably the most important standard market agreement used in the financial world.").

commercially unreasonable result."[50] AGFP's parent company has publicly recognized that "[i]f a credit derivative is terminated, the Company could be required to make a mark-to-market payment as determined under the ISDA" and that "[t]he process for determining the amount of such payment . . . generally follows market practice for derivative contracts."[51] The contemporaneous practices of LBIE's hundreds of CDS counterparties, each of which terminated its trades and calculated values that closely aligned with LBIE's market-based valuations,[52] powerfully demonstrate the uniformity of market practice in valuing CDS trades.

LBIE's experts will testify that it was standard practice in the CDS industry to value trades—both in the ordinary course and upon termination—based on market prices. Graham Bruce, the only expert who was trading CDS in 2008 and 2009, will testify that derivatives counterparties always sought to value CDS trades based on market data.[53] Leslie Rahl and Dr. Niculescu, experts who have worked on the close-outs of tens of thousands of trades under ISDA Master Agreements, will similarly testify that termination payments are uniformly "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."[54] And Dr. Evy Adamidou and Cynthia Parker, the only experts in this case with experience working for monoline insurers like AGC, both agree that such companies "were aware that, when they entered the CDS market, there was already a body of ISDA-related market practice and use of documentation for CDS that would require

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[50] LX-110 (Counterparty Risk Management Policy Group III, *Containing Systemic Risk: The Road to Reform* (August 6, 2008)) at 137.

[51] LX-115 (Assured Guaranty Ltd., Form 10-K (2008)) at 58.

[52] JX-40 (Bruce Rpt.) ¶¶ 79-86; LX-92.

[53] JX-40 (Bruce Rpt.) ¶¶ 19, 38-42.

[54] JX-36 (Rahl Rpt.) ¶ 58; *see* JX-41 (Niculescu Rpt.) ¶¶ 14-15.

mark-to-market payments upon early termination of the transactions."[55] In contrast, none of AGFP's witnesses will testify that they have ever seen a *single instance*, much less an accepted market practice, of using subjective cash-flow projections that contradict available market data to calculate a termination payment.[56]

Under New York law and the law of this case, the parties', industry's, and experts' evidence of "a uniform or highly consistent practice of calculating Loss in a particular manner under similar circumstances" is a key determinant of whether AGFP breached its obligation to calculate "Loss" "reasonably" and "in good faith."[57] As the First Department has ruled, in a decision cited in both the Court's Summary Judgment ruling and the First Department's affirmance, ""[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered." *Hoag*, 246 A.D.2d at 231. Contracts that impose a reasonableness standard do so because "the virtue of its lack of further particularization is that it invites consideration of accepted business practices as a guide[.]" *Bankers Tr. Co. v. J.V. Dowler & Co.*, 47 N.Y.2d 128, 134 (1979). The evidence of those practices establishes AGFP's breach.

This evidence is further supported by the "significant body of recent case law [that] has developed in relation to the interpretation and application both of Loss and Market Quotation under the 1992 Master Agreement." *Anthracite Rated Invs. (Jersey) Ltd. v. Lehman Bros. Finance S.A.*, [2011] EWHC 1822 (Ch) [116] (Eng.). These decisions have recognized that the

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55 JX-38 (Adamidou Rpt.) ¶ 34; *see* JX-39 (Parker Rpt.) ¶ 22.

56 Dkt. 486 (Cohn Tr.) at 50:19-20 ("I know of no client that calculated loss in that way."); Dkt. 487 (Prager Tr.) at 240:22-241:16 ("I'm not aware of any instance in which — as we discussed in which the monoline was the non defaulting party and in which there was an invocation of a termination event that led to any calculation of loss."); Dkt. 488 (Goldin Tr.) 105:11-20 ("I'm not aware of any such instance."); Dkt. 489 (Pirrong Tr.) 16:2-8 (Q "Are you aware of any instance where a settlement amount was determined under the loss provision of the 1992 ISDA master agreement without using market prices or incorporating a market risk premium?" A "No, I'm not.").

57 Dkt. 156 (Summary Judgment Decision) at 27.

"Loss" methodology "precisely reflects the principle by then well established at common law, namely that where damages are sought for loss of bargain occasioned by the breach (leading to termination) of a commercial contract 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 the claimant's loss of bargain." *Id.* ¶ 117. They have recognized that "following an Early Termination Date, a termination payment is calculated using the mark-to-market value of the parties' swap positions, as calculated under Loss and using Second Method, meaning that … if, at the time of the Early Termination, the reference obligations underlying a Swap had decreased in value over the lifetime of the Swap, [Lehman] would be entitled to a termination payment on account of its interest in that Swap." *Lehman Bros. Special Financing Inc. v. Bank of Am., N.A.*, 553 B.R. 476, 485 (Bankr. S.D.N.Y. 2016), *aff'd,* 2018 WL 1322225 (S.D.N.Y. Mar. 14, 2018), *aff'd,* 970 F.3d 91 (2d Cir. 2020). And they have repeatedly recognized that attempting to settle a CDS trade using anything other than the reasonable mark-to-market valuation as of termination is a breach of contract. *See, e.g.*, *UBS Secs.*, No. 650097/2009 (Sup. Ct. N.Y. Cty. Nov. 14, 2019) (rejecting CDS auction 11 days after breach in favor of $470 million mark-to-market valuation as of the date of breach).

Courts applying the ISDA Master Agreement have also adopted a "cross-check principle," which "stands for the proposition that a Non-Defaulting Party's Loss (however calculated) should generally be within the range of what the market would pay for a replacement transaction."[58] This is because Market Quotation and Loss are "intended to lead to the same result when measuring an Early Termination Payment based on loss of bargain." *Intel*, 2015 WL

[58] Dkt. 156 (Summary Judgment Decision) at 30.

7194609, at *17.[59] As this Court ruled on summary judgment, "[i]t would make no sense to hold as a matter of law that, because the Market Quotation process was unsuccessful, Assured was free to adopt a methodology that results in a termination payment completely divergent from the cost of replacing the Transactions."[60] This principle applies with particular force where, as here, the parties selected Market Quotation as their primary and preferred payment methodology, thus agreeing that the market's views would control in the first instance.

The same body of decisions interpreting the ISDA Master Agreement also recognizes the import of the parties' choice to select "Second Method," thereby agreeing that an "early termination payment [would] be made to the in-the-money party regardless of whether that party is in default." *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31, 35 n.9 (Bankr. S.D.N.Y. 2011). The purpose of the termination provision is not to punish a defaulting party or grant its counterparty a windfall, but instead to crystallize the market value of the parties' net positions at that time. This goal is advanced by using objective market data that reflects interest from third-party buyers and sellers rather than one party's subjective view.

AGFP cannot identify any industry support for its approach to valuing derivatives, and the actual evidence and precedent firmly rejects its approach in favor of market values. As the Court ruled, the contract's requirement that Loss be calculated reasonably imposes "an objective standard of reasonableness," and "'[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered.'"[61] Those norms, like New York law, require a

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[59] The *Intel* decision dealt with a derivatives trade with no future payments owed and recognized that where the bargain is for a future series of payments, the two methodologies should reach the same valuation. AGFP's repeated invocation of *Intel*'s discussion of how to value a different species of derivative is belied by both the opinion itself and the fact that AGFP has strenuously resisted the prospect of trying this case before the Court that wrote it.

[60] Dkt. 156 (Summary Judgment Decision) at 30.

[61] Dkt. 156 (Summary Judgment Decision) at 21-22 (quoting *Hoag*, 246 A.D.2d at 231).

market-based valuation under which the CDS trades are worth half a billion dollars to LBIE. The Court should reject AGFP's diametrically opposed approach as objectively unreasonable.

III. NONE OF AGFP'S ARGUMENTS FOR IGNORING MARKET DATA DISPLACE NEW YORK LAW OR MARKET PRACTICE

AGFP and its experts have attempted to distinguish both New York law on contract damages and market practice in the CDS market by arguing that AGFP's actions conformed with regulations and market practice for an entirely different industry—financial guaranty insurance.[62] To advance this argument, AGFP and its experts attempt to conflate AGFP with its monoline parent company, AGC.[63] But AGFP is *not* a monoline insurance company, and it *never* provided financial guaranty insurance.[64] Instead, AGFP was established precisely to enter into derivative contracts that AGC could not. Like any other CDS market participant, AGFP took on the regulatory responsibilities and accounting obligations of an entity authorized to trade derivatives.[65] Its attempt to evade its legal and contractual responsibilities based on the arbitrary and subjective business practices of one of its affiliates contradicts and undermines the certainty and uniformity that New York law and the ISDA Master Agreement are meant to achieve.

LBIE's experts will testify that monoline insurers—including AGC—were aware that it was customary in the CDS industry to value terminated trades using a market-based valuation.[66] In fact, AGFP's parent company acknowledged in its 2008 Annual Report that "[i]f a credit

[62] JX-48 (Goldin & Prager Rpt.) ¶¶ 15-23, JX-47 (Cohn Rpt.) ¶¶ 46-50.

[63] *See, e.g.*, JX-48 (Goldin & Prager Rpt.) ¶¶ 22-23] ("CDS written by Assured and other monolines contained monoline-specific terms."); JX-47 (Cohn Rpt.) ¶¶ 46-48 (opining that "AG pursued an insurance business").

[64] *See, e.g.*, JX-47 (Cohn Rpt.) ¶ 46; *see also* N.Y. Ins. Law § 6901(j-1) ("'Credit default swap' . . . does not constitute an insurance contract and the making of such credit default swap does not constitute the doing of an insurance business.").

[65] *See, e.g.*, Dkt. 508 (FAS 133) ¶¶ 4, 281; LX-96 (Fin. Accounting Stds. Bd., *Statement of Financial Accounting Standards No. 157— Fair Value Measurements*, 2010 ("FAS 157")) at 4.

[66] JX-38 (Adamidou Rpt.) ¶ 34; JX-39 (Parker Rpt.) ¶ 22; JX-40 (Bruce Rpt.) ¶¶ 92-95.

derivative is terminated, the Company ***could be required to make a mark-to-market payment as determined under the ISDA***," and that ***"[t]he process for determining the amount of such payment … generally follows market practice for derivative contracts***."[67]

Monoline affiliates that wanted to avoid a market-based payment obligation could, and routinely did, negotiate to displace the normal valuation requirements of the ISDA Master Agreement.[68] For these trades, AGFP did not. Unlike AGFP contracts with other dealers,[69] LBIE contracts with other monoline affiliates,[70] and other Confirmations between AGFP and LBIE themselves,[71] the contracts governing the 28 trades at issue in this trial adopted the market-standard payment regime of Second Method, measured by Market Quotation. Under New York law, "if parties to a contract omit terms—particularly, terms that are readily found in other, similar contracts—the inescapable conclusion is that the parties intended the omission." *Quadrant Structured Prod. Co. v. Vertin*, 23 N.Y.3d 549, 560 (2014). By selecting Second Method, LBIE and AGFP agreed that an "early termination payment [would] be made to the in-the-money party regardless of whether that party is in default." *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31, 35 n.9 (Bankr. S.D.N.Y. 2011).

Regulatory and accounting evidence further demonstrates the fundamental differences between subjectively reserving against insurance loss and objectively valuing CDS. An insurance company may use its "own assumptions" when modeling "expected net cash outflows"

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[67] LX-115 (Assured Guaranty Ltd., Form 10-K (2008)) at 58 (emphasis added).

[68] JX-38 (Adamidou Rpt.) ¶¶ 20-30; JX-39 (Parker Rpt.) ¶¶ 24-35.

[69] *See, e.g.*, LX-28 (Schedule to the Master Agreement between AGFP, Assured Guaranty Corp., and Deutsche Bank AG) at 68, Part1(f)(ii)(B).

[70] *See, e.g.*, LX-20 (ISDA Master Agreement between LBIE and Ambac Credit Products, LLC) at 12, Part 5(j) of Schedule.

[71] Dkt. 31 at 8 ("As the December 2008 terminations were based on an 'Additional Termination Event,' the Confirmations require LBIE to pay an Accrued Fixed Payment Amount.").

for financial guaranty insurance contracts which are "not adjusted for market participant assumptions that might be different.[72] CDS, in contrast, are valued at their "fair value," which "should be determined based on the assumptions that *market participants* would use in pricing the asset or liability … includ[ing] assumptions about risk,"[73] where possible "us[ing] prices and other relevant information generated by market transactions."[74] The model that AGFP employed here was built to reserve against financial guaranty insurance contracts, not to value derivatives,[75] and its use to calculate a termination value for CDS was unreasonable.

LBIE's expert CDS trader Graham Bruce will testify that it was standard industry practice to value CDS using market prices, with model-based estimates used only where market prices were unavailable.[76] New York law, CDS accounting standards, and derivatives industry practice all require the use of market data, not a party's subjective beliefs, to value CDS trades.[77]

AGFP cannot justify ignoring market data by noting that it failed to obtain the quotations necessary to perform a Market Quotation valuation. As LBIE's experts will testify, the Market Quotation process often fails for reasons that have nothing to do with market value, including the fact that it is often viewed as an empty pricing exercise with little upside for the bidder.[78] LBIE's experience bears this out: Of its 470 ABX trades governed by Market Quotation, 443

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[72] LX-171 (Fin. Accounting Stds. Bd., *Statement of Financial Accounting Standards No. 163—Accounting for Financial Insurance Contracts*, 2008 ("FAS 163")), at ¶¶ 25, B38.

[73] LX-96 (FAS 157) at ¶¶ 11, 21 (emphasis added). This is true even if a discounted cash-flow approach is used to determine fair value. *See id.* ¶ 18b ("The measurement is based on the value indicated by current market expectations about those future amounts.").

[74] *Id.* ¶ 18a.

[75] *See* JX-048 (Goldin & Prager Rpt.) ¶ 58; Schozer Tr. 289:8-17; Rosenblum Supp. Tr. 22:21-23 ("Q. FAS 163 did not apply to CDS; is that right? A. Yes, that is correct."); JX-34.

[76] JX-40 (Bruce Rpt.) ¶ 39.

[77] *See* Dkt 511 (*Fin. Accounting Stds. Bd., Statement of Financial Accounting Concepts No. 7—Using Cash Flow Information and Present Value in Accounting Measurements, Feb.* 2000) at 4-5 ("While the expectations of an entity's management are often useful and informative, the marketplace is the final arbiter of asset and liability values."); *see also* Dkt. 156 at 21 (ruling that "an objective standard of reasonableness," not subjective views, controls here).

[78] JX-40 (Bruce Rpt.) ¶¶ 96-103; JX-37 (Rahl Reb.) ¶¶ 79-83.

failed to obtain the necessary bids.[79] Other than AGFP, *all* counterparties to those trades still closed them out at market prices, and none argued that an absence of bids was proof of a lack of value—an absurd position indistinguishable from arguing that a house that attracts no binding offers during its first three days on the market is properly valued at zero.

Moreover, a potential contributing factor to the lack of bids—indeed, one that AGFP has touted—was concern that AGFP might not be able to make floating payments that came due. However, cases applying ISDA Master Agreements reject attempts by parties to profit from their own lack of creditworthiness, and instead recognize that "[w]hen assessing damages for the loss of a bargain one does not normally discount its nominal value for the chance that the obligor will fail to perform." *Peregrine Fixed Income Ltd. v. Robinson Dep't Store Public Co.* [2000] EWHC 99 (Comm) [30] (Eng.).[80] AGFP has no right to discount its liabilities on the theory that it might fail to pay them when due, setting up an absurd situation in which, as AGFP's liabilities mount and move it closer to collapse, those exact same liabilities are *for that same reason* discounted into nullities. Unsurprisingly, ISDA and New York precedent rejects this, and instead hold "the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion, and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world." *Lehman Bros. Fin. AG v. Klaus Tschira Stiftung Gmbh*, [2019] EWHC 379 (Ch) [235] (Eng.) (quoting *Anthracite*, [2011] EWHC 1822 (Ch) [116(2)]);[81] *see also, e.g.*, *Bogdan and Faist P.C. v. CAI Wireless Sys. Inc.*, 295 A.D.2d 849, 853-54 (2002) ("[T]he injured party should not recover more from the breach than it would have gained had the contract been fully

[79] LX-92.
[80] Dkt. 515.
[81] Dkt. 516.

performed."); *Am. List Corp. v. U.S. News & World Report, Inc.*, 75 N.Y.2d 38, 44-45 (1989) (holding that in the case of anticipatory breach, the risk that a non-repudiating party will fail to perform in the future is irrelevant to the calculation of damages).[82]

IV. EVEN IF AGFP'S SUBJECTIVE METHODOLOGY WERE ACCEPTED, ITS PARTICULAR OFF-MARKET ASSUMPTIONS WERE UNREASONABLE, AND USING APPROPRIATE INPUTS CONFIRMS THE TRADES' VALUE TO LBIE

Finally, the evidence at trial will also establish that even if using an insurance policy reserve process to value CDS trades could be appropriate in some contexts—and the contract, the precedent, and industry practice all confirm that it cannot—AGFP's specific Loss calculation in this case still breached its contractual obligations to LBIE. AGFP's valuation process was unreasonable even on its own terms and a reasonable application of its own cash flow models results in a value payable to LBIE of hundreds of millions of dollars.

As noted above, AGFP ran no model at all for 26 of the 28 CDS trades at issue. Instead, AGFP's parent corporation made a blanket and subjective assessment that the trades referencing UK RMBS, CLOs, or a CDO would not require a regulatory reserve, and on that basis AGFP entered a $0 value for its expected payouts over the life of all these trades.[83] AGFP thus treats these trades as sources of pure profit, financial instruments that would generate years of "fixed" payments from LBIE without any risk of ever paying out a single "floating" dollar of credit protection against risky residential mortgages and corporate loans. Neither the ISDA Master Agreement nor New York law supports such a one-sided view of value.

Trial will further establish that in the only two instances in which AGFP and its parent

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[82] If any creditworthiness adjustment were applied, notwithstanding this precedent and the fact that AGFP's own valuation methodology does not apply one, the sole credible calculation of such an adjustment shows that the trades would *still* properly be valued at $248.9 million in LBIE's favor. JX-44 (Niculescu Supp.) ¶ 52, Ex. 7.

[83] Rosenblum Supp. Tr. at 21:24-22:20.

ran a cash-flow model—the ABX trades—it did so unreasonably. Nearly half of the subprime mortgage loans underlying these indices were already more than 60 days delinquent, in bankruptcy, in foreclosure, or owned by a lender after a failed foreclosure auction.[84] Trial will establish that the assumptions AGFP used were unrealistically optimistic, such as its assumption that 15% of the loans already in foreclosure and 30% of the loans already in bankruptcy would never default.[85] Among other blatant flaws, AGFP's assumptions were based on outdated data, such as loan default rates from a report a year prior to its valuation exercise, when market conditions were significantly different.[86]

That AGFP's assumptions were unreasonable is further demonstrated by third-party projections published in the market. For example, with respect to the mortgages underlying the ABX, Bank of America projected more defaults, with less recovery, from a pool with fewer prepaid loans.[87] JP Morgan and Barclays projected far worse performance for the subprime residential mortgage loans underlying the indices.[88] As LBIE's experts will explain at trial, when the ***same Intex model*** that AGFP relies on to value the ABX trades is run with assumptions that match contemporaneous third-party published projections, AGFP's expected "floating" payments skyrocket, and ***these two trades alone*** are valued at $269.5 million (using JP Morgan's August 2009 report), or $287.7 million (using Bank of America's projections), or $339.2 million (using JP Morgan's July 2009 report) in LBIE's favor; in fact, Barclays actually performed and published the full Intex calculation results at the time, and achieved a value of

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[84] JX-44 (Niculescu Supp.) at ¶¶ 66-67 & Exh. 14; LX-178 (Third Quarter Loss Projections presentation) at 23.

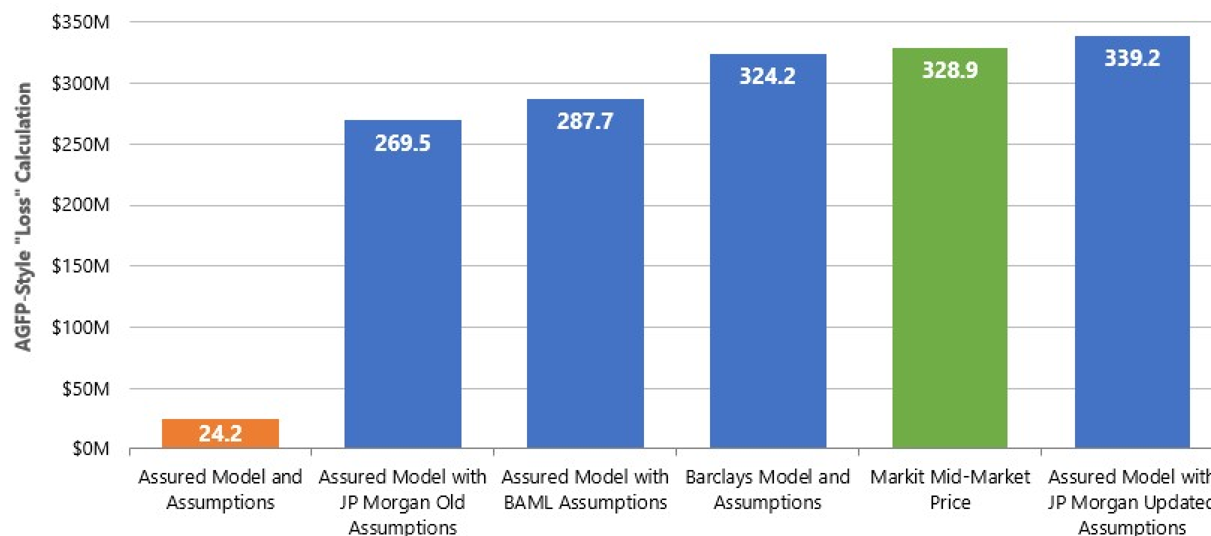
[85] JX-44 (Niculescu Supp.) at Ex. 14; LX-178 at 23.

[86] LX-178 at 23; JX-44 (Niculescu Supp.) at ¶ 66 & n.122.

[87] JX-44 (Niculescu Supp.) Ex. 16; LX-123 (BAML July 2009 Report) at 23.

[88] *See* LX-135 (JPMorgan July 2009 Report); LX-137 (Barclays July 2009 Report); LX-139 (Barclays Sept. 2009 Report).

$324.2 million in LBIE's favor.[89]



Like the prevailing mid-market prices ($328.9 million for the two ABX trades, $577.9 million for all 28 CDS trades together), discounted cash-flow projections that incorporate independent third-party consensus rather than AGFP's self-serving views produce the inescapable conclusion that these financial instruments were massive assets to LBIE and massive liabilities to AGFP.

It was only by *both* employing an improper cash-flow methodology *and* running it with off-market and unsupportable assumptions that AGFP was able to transmute a massive payable to LBIE into a purported receivable. Trial will establish that AGFP's choices were unreasonable in both theory and application and that any reasonable party following industry practice to use market prices, or at least market data, would have valued the CDS trades at hundreds of millions of dollars in LBIE's favor. AGFP's refusal to do either violated New York law, contradicted well-established market practice, and breached its contract with LBIE.

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[89] JX-44 (Niculescu Supp.) at Exs. 3-6.

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Respectfully submitted,

By: *\/s/ Andrew J. Rossman*

Andrew J. Rossman
David S. Mader
Lindsay M. Weber
Sage R. Vanden Heuvel (*pro hac vice*)
Owen F. Roberts
QUINN EMANUEL URQUHART
& SULLIVAN LLP
51 Madison Avenue, 22nd Floor
New York, New York 10010
Tel.: (212) 849-8700
Fax: (212) 849-7100
andrewrossman@quinnemanuel.com
davidmader@quinnemanuel.com
lindsayweber@quinnemanuel.com
sagevandenheuvel@quinnemanuel.com
owenroberts@quinnemanuel.com

Attorneys for Plaintiff Lehman Brothers International (Europe) (in administration)