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 POST-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)

TABLE OF CONTENTS

Page

ii

TABLE OF AUTHORITIES

Page

Cases

iii

Foreign Cases

Statutory Authorities

iv

I.   **PRELIMINARY STATEMENT**

The issue before this Court is whether Defendant AG Financial Products, Inc.'s ("AGFP") calculation of the 'Loss' on 28 Credit Default Swaps ("CDS") was ***objectively*** reasonable and made in good faith under the parties' ISDA Master Agreement as of the July 23, 2009 termination date. In denying AGFP's motion for summary judgment and setting this case for trial, Justice Friedman held that answering that question requires the Court to consider evidence of industry custom and practice: "Where, as here, evidence is submitted that there may be a uniform or highly consistent practice of calculating Loss in a particular manner under similar circumstances, and the Non-Defaulting Party [AGFP] deviates from that practice, that deviation raises a genuine issue of fact as to the Non-Defaulting Party's reasonableness or good faith in calculating Loss." Dkt. 156 ("SJ Decision") at 28. The First Department affirmed Justice Friedman's decision on the same basis. It expressly approved her consideration of market practice evidence and cited its own prior precedent holding that "[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered." Dkt. 354 (Order on Appeal) *available at* 168 A.D.3d 527, 528 (1st Dep't 2019) (citing *Hoag v. Chancellor, Inc.*, 246 AD2d 224, 231 (1st Dep't 1998)).

In five weeks of trial, AGFP never attempted to argue (let alone prove) that its Loss calculation was consistent with industry norms, either in the process that it applied or the results it reached. No witness testified to having ever seen any counterparty to an ISDA Master Agreement calculate Loss using a subjective insurance reserve model as AGFP did here. No witness testified that the results of that subjective process—which projected only minor losses on two of the trades at issue, and zero losses on the other 26—were consistent with the projections of any other objective independent observer at the time.

By contrast, Plaintiff Lehman Brothers International (Europe) (in administration) ("LBIE") established beyond doubt the existence of a uniform market practice of determining Loss under an

ISDA Master Agreement by reference to, or at the very least consistent with, prevailing market prices. Every witness with prior experience valuing derivatives under an ISDA Master Agreement acknowledged this practice, which was corroborated by the unrebutted fact evidence that AGFP was the only one of LBIE's 77 counterparties on the types of trades at issue that submitted a valuation deviating materially from the market price.

Trial has also established beyond question that even if AGFP had been entitled to calculate Loss in a manner totally inconsistent with market practice and market prices, and to instead project the future performance of the CDS at issue, it *still* breached the parties' contract. For 26 of the 28 trades, AGFP has not come forward with *any* evidence supporting its subjective and self-serving assumption that it would never have to pay a single penny to LBIE over their life—an assumption completely at odds with the state of the economy at the time. As Justice Friedman observed, "[i]t cannot be disputed that, at the time of the terminations at issue, the financial crisis had significantly increased the prospect of shortfalls" on the trades. SJ Decision at 38.

For the other two CDS, which reference the widely traded ABX sub-prime residential mortgage index, trial has established that AGFP's projections were based on assumptions about the US housing market that had no independent evidentiary support and that were completely at odds with the expectations of every independent third-party observer.

Trial in this case has therefore established that AGFP acted unreasonably in calculating Loss under the parties' ISDA Master Agreement, resulting in a breach of contract by AGFP that requires this Court to disregard AGFP's subjective, self-serving valuation of the CDS trades at issue (and to dismiss its Counterclaims) and to instead award LBIE damages based on an objectively reasonable valuation. The evidence supporting such a valuation is also clear and substantial. LBIE has presented evidence of the official market value of the ABX trades on the

2

valuation date, and it has presented expert testimony and analysis establishing the market value of

the other 26 trades based on available market data and standard valuation methods. This evidence

establishes an objective market value for all 28 trades of $498 million which, after applying Unpaid

Amounts, requires a damages award to LBIE of $485 million.

Alternatively, even if the Court were to rule (contrary to industry custom and prior case

law) that the ISDA Master Agreement permits a valuation based on loss projections rather than

market values, LBIE has presented evidence that an objectively reasonable valuation based on

independent projections—not AGFP's own subjective and self-serving assumptions—would result

in a damages award to LBIE of over $262 million for the ABX trades alone.

II.   FACTUAL BACKGROUND

A.   The Contractual Terms Governing This Dispute Date To When LBIE Executed An ISDA Master Agreement With ACE, A Multi-Line Reinsurer

The contract at issue was originally executed by LBIE and ACE Capital Re Overseas Ltd.

("ACE") in April 2000. JX-02 at 1; Tr. 77:6-25 (Rahl). LBIE was the London-based operating

arm of global investment bank Lehman Brothers, then one of the world's leading financial

companies. Tr. 1869:21-23 (Adamidou). ACE was a Bermuda-based multi-line insurance

company and reinsurer that also traded credit default swaps.[1] Tr. 2391:1-4 (Schozer); Tr. 1858:23-

25 (Adamidou). As detailed below, ACE later assigned its credit default swap portfolio and ISDA

to AGFP; AGFP did not sell *any* insurance—it *only* transacted in credit default swaps.

The parties' ISDA Master Agreement is not an insurance contract or a "monoline-specific"

contract, as AGFP has argued in an effort to avoid the consequences of the required market

---

[1] CDS are derivatives that reference a financial obligation, such as a bond, with one party (here, AGFP) selling protection against a shortfall of payments by the reference obligation, in exchange for fixed payments from the protection buyer (here, LBIE). Tr. 64:1-65:6 (Rahl).

3

valuation.[2] Rather, it is the standard-form agreement used throughout the swaps and derivatives industry. Published in 1992 by the International Swap Dealers Association (now known as the International Swaps and Derivatives Association, or "ISDA"), this same contract is used to document more than $600 trillion of bilateral derivative trades across the globe. Tr. 73:9-11 (Rahl).

The ISDA Master Agreement provides an industry-standard contractual framework that sets out overarching terms governing the parties' future derivative trades. *See generally* JX-01. Parties also execute a Schedule to the Master Agreement, also published by ISDA, in which they make certain elections, such as what law governs, what events will allow which party to terminate, and what obligations will result from an early termination. JX-01 at 19-24; *See* JX-02 at 3-14. While parties may agree to exchange collateral pursuant to a Credit Support Annex, ACE and LBIE, like other highly rated entities, chose to provide guarantees from their respective affiliates instead. JX-02 at 10-12, 15-16, 40-44. With a Master Agreement and Schedule in place, parties document the terms of subsequent trades through trade-specific Confirmations. *See e.g.*, JX-05 (May 27, 2008 Confirmation between LBIE and AGFP).

The termination provisions at issue in this case provide that the parties' ISDA Master Agreement may be terminated following an "Event of Default," including upon the bankruptcy filing of a party or its guarantor. JX-01 at 8 (§6(a)). Following an Event of Default, the Non-defaulting Party "may" terminate all outstanding transactions and calculate "Payments on Early Termination" pursuant to Section 6(e)(i) of the ISDA Master Agreement. JX-01 at 9.

Section 6(e)(i) then sets forth four standard options to measure Payments on Early Termination. *Id.* at 9-10. Many market participants, including most monoline insurance affiliates

---

[2] A "monoline" is an insurance carrier that writes financial guaranty insurance policies, also known as bond insurance.

4

like AGFP, mutually agreed with counterparties to not use any of these four standard options and instead amend the agreement to use a different valuation mechanism for termination payments.[3] AGFP itself replaced the standard termination provisions in agreements executed with other counterparties. Tr. 2401:25-2402:15 (Schozer).[4] And even LBIE and AGFP jointly amended the termination provisions governing nine trades that AGFP terminated in December 2008. Tr. 87:1-87:9 (Rahl); *see also* Dkt. 31 (Decision/Order) at 2, 7-8. Those trades contained "Additional Termination Events" that permitted AGFP to terminate if LBIE failed to deliver periodic reports, and to calculate the termination payment using a "walkaway clause," under which only amounts owed up to termination would have to be paid. Tr. 510:3-21, 647:2-9 (Viegas); AX90182 at 1-2.

For the 28 trades at issue, however, AGFP did ***not*** bargain for a walkaway and there is no dispute that the parties selected the ***standard unamended*** "Second Method and Market Quotation" calculation and payment provisions in their Schedule. JX-02 at 4, 17-21.[5] This was "by far, the most common" choice among derivatives counterparties and was the standard termination provision in the ISDA itself. Tr. 85:22-85:25 (Rahl); JX-01 at 9 (§6(e)). AGFP did not amend the contract's termination payment provisions when it took assignment from ACE or when it executed the 28 trades at issue. JX-02 at 17-21; JX-05 through JX-32 (confirmations).

The "Second Method and Market Quotation" payment provision requires a Non-defaulting Party, in the first instance, to attempt to value the terminated trades using the average of market

---

[3] Tr. 73:12-74:6, 86:11-25 (Rahl); Tr. 1828:1-25, 1853:19-1854:4, 1859:3-15, 1861:8-18 (Adamidou).

[4] For example, in 2008, AGFP modified the termination provisions contained in its ISDA Master Agreement with Deutsche Bank to ensure that AGFP would ***not*** owe an early termination as the Non-defaulting Party, and AGFP proposed similar terms to one of LBIE's U.S. affiliates. AGFP's competitors had made use of similar terms dating back to at least 2000. *See e,g,,* LX20 at 12 (Ambac-Lehman ISDA).

[5] Here, the parties only agreed to an immaterial revision to the companion definition of "Reference Market-makers." JX-02 at 13.

quotations from "Reference Market-makers," meaning "four leading dealers in the relevant market." JX-02 at 4, 13; JX-01 at 9-10, 16.

If these rigid requirements cannot be satisfied "or would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result," then "Second Method and Market Quotation" requires that the termination payment instead be calculated using the "Loss" method. "Loss" is the:

> amount [the Non-defaulting Party] ***reasonably determines in good faith*** to be its total losses and costs (or gain, in which case expressed as a negative number) 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).

JX-01 at 15 (emphasis added).

"Second Method" specifies that the amount due upon early termination can go in ***either direction*** depending on which party is "in the money" and therefore has incurred a "loss" as a result of the termination of the trades. JX-01 at 9-10, 15; Tr. 79:12-80:4 (Rahl); Tr. 505:25-506:11 (Viegas). In other words, it is a no-fault provision. Thus, AGFP (the Non-defaulting Party) would owe money to LBIE (the Defaulting Party) if AGFP was "out of the money" and gained by terminating the trades through the elimination of a liability. JX-01 at 15; *see also* Tr. 2728:2-8 (Cohn) (admitting that a Non-defaulting Party may be out of the money).

In sum, LBIE and AGFP adopted the market-standard termination provision requiring AGFP to first attempt the "Market Quotation" process. Then, if that process failed, the contract required AGFP to calculate "Loss" "reasonably" and "in good faith," with the party who was "out of the money" making a payment to the party that was "in the money" in accordance with the Second Method. Tr. 1859:3-15 (Adamidou); Tr. 2396:23-2397:7, 2405:18-2406:19 (Schozer); JX1 at 15-16. As the evidence at trial showed, fallback to "Loss" after a failed "Market Quotation"

6

process was the most common methodology used by LBIE's counterparties to calculate payments on early termination of their credit default swaps. Tr. 85:22-25 (Rahl); LX92.

B. LBIE Entered Into Credit Default Swaps With AGFP Under The Same ISDA Master Agreement

Within weeks of executing their Master Agreement, LBIE and ACE began to enter CDS transactions and thereafter executed CDS referencing a range of debt securities, including corporate bonds. JX-02 at 23. In December 2001, ACE assigned its interest in its ISDA Master Agreement and CDS trades with LBIE to AGFP, then known as AGR Financial Products Inc. JX-02 at 17-21. AGFP was not and is not a monoline insurance company. Tr. 1858:15-22 (Adamidou). Rather, AGFP is an entity created specifically to execute CDS trades that its affiliate company, the monoline insurer Assured Guaranty Corporation ("AGC"), is legally prohibited from trading. Tr. 2032:10-2033:20 (Schozer); Tr. 1820:21-1821:9 (Adamidou); LX169 at 9, 17.

LBIE and AGFP entered into the 28 trades at issue between August 2005 and May 2008. *See* JX-05 through JX-32 (confirmations); JX-34 at 8-12. Through each trade, LBIE purchased credit protection from AGFP on asset-backed securities issued by third parties. LBIE agreed to make recurring fixed payments to AGFP in exchange for AGFP's contingent obligation to cover any missed payments of principal or interest. *Id.* The 28 CDS trades at issue include:

- **Two ABX trades.** These trades reference residential mortgage-backed securities (RMBS)[6] comprising two series of the ABX index, a widely traded index created by market data vendor Markit Partners ("Markit") twice-yearly beginning in 2006. Each series—referred to by year and series suffix, for example "2006-2" or simply "06-2"—referenced a Markit-selected

---

[6] A "residential mortgage-backed security" ("RMBS") is a bond that makes payments generated by a pool of residential mortgages. As borrowers make principal and interest payments, those payments are distributed to RMBS investors according to the seniority of their investments. Tr. 819:11–822:10 (Bruce); LDX04-4.

7

group of RMBS that each had claims on payments generated by pools of subprime[7] loans. JX-34 at 8-12; Tr. 65:17-21 (Rahl). Each ABX series is further subdivided into ratings-based "tranches," with more higher-rated (senior) tranches typically offering smaller investment returns but promising earlier repayment and less risk, and more junior tranches typically offering higher returns but promising later repayment and involving more risk.[8] Tr. 1397:24-1398:16 (Niculescu); LDX06–11. In the two trades at issue here, LBIE bought CDS protection on the "last cash-flow"[9] AAA tranche (the riskiest AAA tranche) of the 06-2 and 07-1 series, which were backed by pools of US subprime loans originated in 2006. Tr. 825:18–826:15 (Bruce); LDX04–6. The ABX was actively traded in July 2009, and Markit published official prices for the ABX trades at the close of every trading day. LX114; LX133; Tr. 871:9-19, 891:12-15 (Bruce); LDX06-28.

- **14 CDS on UK RMBS ("UK RMBS") trades.** These trades reference nine securities backed by five pools of residential mortgages originated in the United Kingdom. Tr. 65:22-66:1 (Rahl); 831:12-832:12 (Bruce); 1485:3-18 (Niculescu). Markit regularly published prices for the mortgage-backed securities underlying these trades in 2009, including on July 23, 2009 specifically. Tr. 1491:15-1492:9 (Niculescu); LDX06-34; LX136 at 2.

---

[7] A "subprime" mortgage is one to riskier borrowers with low credit scores, less reliable income, and fewer assets than prime borrowers and often features low "teaser" interest rates that reset and fluctuate after two to three years. Tr. 1385:22-1387:12, 3815:7-3817:1 (Niculescu).

[8] Mortgage payments and losses are allocated to individual securities according to a waterfall structure governing priorities of claims on the mortgage pool. Junior tranches are the first to absorb losses. Meanwhile, senior tranches receive early payouts from well-performing mortgages. As losses increase and lower tranches absorb losses equal to their notional amount, incremental losses are incurred by more senior tranches. LDX06-11.

[9] The "last cash-flow" AAA tranche is the tranche that, among all AAA-rated tranches, is last in line to receive payments generated by the underlying mortgage pool and is the first to incur losses if the underlying pool does not repay in full. Tr. 820:12-21 (Bruce); LDX04-4.

8

- **11 CDS on CLO ("CLO") trades.** These trades reference "collateralized loan obligations" or CLOs, financial instruments backed by pools of high-yield[10] loans, such as business loans to small and medium-sized companies that put up trade assets, such as tractors or construction equipment, as collateral. Tr. 834:14-20 (Bruce); 1496:23-1498:14 (Niculescu).

- **One CDO trade.** One trade referencing a collateralized debt obligation or "CDO," the valuation of which is not in dispute. Tr. 282:9-24 (Rahl); 841:17-842:25 (Bruce).

On the Early Termination Date in July 2009, AGFP's maximum liability to LBIE on these 28 trades was nearly *$5.7 billion*. Tr. 1111:11-18 (Rosenblum). In contrast, the present value of all of the future fixed payments that LBIE would ever owe AGFP for protection was just $34 million. JX-34 at 4; Tr. 1525:24-1526:9 (Niculescu).

C. The Global Financial Crisis Greatly Increased The Likelihood That The Securities Underlying The LBIE-AGFP Trades Would Default

The parties agree that, when AGFP and LBIE entered into the 28 trades at issue, a default by any of the instruments referenced by the trades was considered unlikely. Tr. 1401:1-12 (Niculescu); LDX06-12. Accordingly, the ratings agencies rated all the instruments on which AGFP sold protection AAA upon issuance, and AGFP described its expectations regarding these CDS as "zero loss." Tr. 2488:9-2489:17 (Schozer); LDX06-12.

Time would reveal that, as AGC's former President admitted at trial, "zero loss" was just a "marketing term," not a realistic expectation that AGFP was "never ever going to experience a single loss." Tr. 2488:9-2489:17 (Schozer). As for the AAA ratings, it became well-recognized "that the credit rating agencies abysmally failed in their central mission to provide quality ratings on securities for the benefit of investors." AX50022 (Financial Crisis Inquiry Commission Report)

---

[10] High-yield (or "leveraged") loans are commercial loans to companies with elevated credit risk, as evidenced by higher interest rates and/or lower credit ratings.

at 241, 251. After LBIE and AGFP entered their CDS trades, the markets suffered from the greatest financial shock since the Great Depression. AX50022 at 418; Tr. 1175:14-21, 1276:9-12 (Rosenblum); Tr. 2272:19-2273:2 (Schozer). "Seventeen trillion dollars in household wealth evaporated within 21 months." AX50022 at 418.

By July 2009, "home prices had dropped nationally by about a third," and "[m]ost subprime borrowers were significantly under water,"[11] owing, "on average, 40 percent" more than the now-reduced values of their homes. Tr. 3811:25-3812:23 (Niculescu); LDX06-5; AX-50022 at 418. Following a months-long economic recession, there was a general expectation that home prices would keep falling as unemployment rose toward its highest level on record. Tr. 3811:5-3812:24 (Niculescu); LX119 at 6, 11; LX123 at 9-10; AX5022 at 419. "Without jobs, people could not afford their house payments." AX50022 at 418. The subprime loans underlying the ABX index had collapsed: most loans were delinquent[12] (44% had not been paid in more than three months), a record 20% or more per year were going past delinquency into default,[13] and the severity of such defaults had nearly doubled, from a 40% loss to a 75% loss.[14] LDX06-7, 8, 13. Although all 40 of the securities referenced by the two ABX indices at issue had originally been assigned AAA ratings, by July 2009, 34 of 40 were rated junk or worse.[15] LDX06-12. This meant that by 2009,

---

[11] A homeowner is "underwater" on a mortgage when the principal balance due on the mortgage is greater than the value of the mortgaged property. Tr. 3812:7-10 (Niculescu).

[12] A mortgage is "delinquent" when the borrower is at least thirty days past due on a mortgage payment. Tr. 1247:9-1248:1 (Rosenblum); Tr. 1392:5-21 (Niculescu).

[13] A mortgage is in "default" when it has been delinquent for an extended period of time and the lender ultimately declares a default. Tr. 1392:5-21 (Niculescu).

[14] "Severity" is the amount that the mortgage lender ultimately loses after foreclosing and selling the property, as a percent of the mortgage. Tr. 1394:8-1395:11 (Niculescu).

[15] Investment grade refers to debt obligations assigned a credit rating by one of the major credit ratings agencies of between AAA (the highest rating) and Baa3 (also referred to as BBB-). Junk bonds, also referred to as non-investment grade, high yield, or speculative grade, are debt obligations assigned a credit rating of between Ba1 (also referred to as BB+) and C. A bond that falls to C level or below is considered in default. LDX06-12.

10

losses on the ABX indices were far more likely, and expected to be far larger, than when the trades were executed. Tr. 1397:24-1399:22 (Niculescu). This was reflected in the soaring cost of buying protection on the ABX index and other asset-backed securities and the plummeting value of those securities. LX114; LDX04-13.

Expectations of loss increased dramatically for UK RMBS and CLO trades as well. LDX06-33; LX135 at 38, LX136 at 4; Tr. 1413:5-25, 1485:19-1487:5 (Niculescu); Tr. 831:12-832:12 (Bruce). AGFP recognized this deterioration; by September 2008, it calculated that it was out of the money on *all* 28 trades facing LBIE, resulting in enormous liability. LX170. As once-remote risks became real and present dangers, the 28 trades at issue—by which AGFP was exposed to potential losses of $5.7 billion on securities at the epicenter of the financial crisis—became a major liability to AGFP. *Id*.

D. The Global Financial Crisis Forced LBIE Into Administration, And Most Of LBIE's Counterparties Terminated Their CDS Trades

As a result of the financial crisis, LBIE entered bankruptcy administration in the U.K. on September 15, 2008. LX33 at 62. The English courts appointed four administrators to act as public fiduciaries overseeing LBIE's administration and gave them a mandate to identify debtors, collect debts in an organized manner, and fairly distribute money to creditors. Tr. 383:12-383:22, 391:12-392:16 (Viegas); LX33 at 62. As Dr. Eduardo Viegas, then a PricewaterhouseCoopers employee leading the administration's valuation group, testified at trial, neither LBIE, nor its administrators, nor its employees or independent consultants, "had any economic stake in the outcome of LBIE's relationships with its creditors and its debtors." Tr. 392:17-393:3 (Viegas). Rather, "[t]he princip[le] most of all was treating everybody consistently." Tr. 392:7-8 (Viegas).

As a dealer, LBIE had bought and sold CDS protection in roughly equal amounts with thousands of counterparties, of which AGFP was only one. Tr. 390:19-391:3 (Viegas). LBIE's

11

entry into administration constituted an Event of Default under its ISDA Master Agreements with AGFP and all of its ISDA counterparties. JX-01 at 6; Tr. 85:1-5 (Rahl); Tr. 382:19-383:3, 386:24-387:3, 391:16-392:2 (Viegas). A large majority of LBIE's counterparties chose to terminate their derivative trades with LBIE as of September 15, 2008, or shortly thereafter. Tr. 503:7-13 (Viegas). As detailed below, these counterparties—acting as Non-defaulting Parties obliged to follow the *same* termination payment procedures as AGFP—*uniformly* agreed that trades in which LBIE had *sold* credit protection required a termination payment *from* LBIE, and trades in which LBIE had *bought* credit protection required a termination payment *to* LBIE. *See* LX92.

E. AGFP Chose Not To Terminate Its CDS Trades Upon LBIE's Entry Into Administration, Then Terminated Nine Trades In December 2008

Like LBIE's other CDS counterparties, AGFP had the right to terminate its CDS trades immediately upon LBIE's entry into administration, but it chose not to do so. Tr. 2173:22-2174:12 (Schozer). AGFP was deeply out-of-the-money on its trades, and any market-based valuation would have valued the trades in LBIE's favor. Tr. 4120:7-22, 4121:1-11 (Bruce). AGFP instead held the positions open, despite no longer receiving fixed payments from LBIE—a decision that AGFP's expert, Prof. Craig Pirrong, admitted was consistent with the approach an out-of-the-money counterparty would take if it wanted to wait before terminating its trades and see if prices would rebound in its favor. Tr. 3592:21-3593:2, 3594:13-21 (Pirrong).

On December 23, 2008, more than two months after LBIE's entry into administration, AGFP terminated nine CDS trades with LBIE referencing CLOs that are no longer at issue. AX-90182. AGFP could have terminated these trades (along with the 28 at-issue trades) under the "Market Quotation and Second Method" approach. But AGFP instead chose to invoke a provision specific to these nine trades that allowed it to "walk away" based on LBIE's failure to deliver periodic collateral reports. AX-90182; Tr. 2195:5-17 (Schozer). Under this provision, all future

12

gains or losses for either party were wiped out. Tr. 510:4-510:21 (Viegas). This is notable. If AGFP actually believed that all its trades with LBIE were assets under "Market Quotation and Second Method," as it claims in this litigation, then terminating on a "walk-away" basis was irrational—since, under AGFP's approach to "Market Quotation and Second Method," LBIE owes it money. *See* Tr. 2437:2-9 (Schozer). AGFP's choice thus demonstrates that it understood what every other market participant understood: sales of credit protection had become massive liabilities during the financial crisis, which required massive payments by protection sellers like AGFP.

F.   Despite AGFP's Conduct And Lack Of Participation, LBIE Generated Interest In Novating Its Trades With AGFP To A Third Party

Because AGFP did not immediately terminate its CDS trades with LBIE, the trades remained live. LBIE did not have the unilateral right to terminate the trades, and AGFP was unwilling to make any payment to LBIE for the trades despite their obvious market value. Tr. 506:12-18 (Viegas), LX221. Thus, the only possible alternative for LBIE to realize the value in the trades was to explore a novation, in which a third party would step into LBIE's shoes, taking over LBIE's "fixed payment" obligations and receiving any "floating payments" AGFP was required to make. Tr. 507:2-507:8, 533:19-534:1 (Viegas). And crucially, any novation would have *required* AGFP's consent. Tr. 507:9-11 (Viegas). It was undisputed at trial that AGFP ***never*** agreed to approve such a novation. Tr. 524:7-14, 544:14-18 (Viegas). Nor did AGFP provide any assistance evincing it might desire a novation; instead, it fell solely upon the LBIE administration to identify potential counterparties. Tr. 525:21-526:9, 529:13-530:20 (Viegas). Traders at Nomura were "very interested" in a novation, and agreed to enter into a non-disclosure agreement to pursue the opportunity. Trial Tr. 537:9-19 (Viegas) (testifying also that Nomura's "interest continue[d] after January 2009"); Tr. 558:25 (Viegas) ("My understanding is that Nomura was always interested."); *see also* LX74 (indicative quotes from Nomura); Trial Tr. 562:11-563:17

13

(Viegas) (testifying that the quotes reflected in LX74 indicated that "they were to be valuable trades").

As Dr. Viegas testified, however, LBIE's early belief that AGFP might be willing to keep the trades alive through a novation "certainly changed over time," especially after AGFP used LBIE's inadvertent failure to provide publicly-available reports as a basis to terminate the walk-away trades without ever asking LBIE for the reports. Tr. 509:13-510:24 (Viegas); Tr. 1344:4-13 (Rosenblum). This, combined with AGFP's failure to engage on a potential novation, put a halt to LBIE's negotiations with Nomura. Tr. 512:8-12, 537:20-538:3, 541:23-542:4 (Viegas).

Although LBIE did not know it at the time, trial revealed the true reason "AG stopped engaging" in novation efforts. Tr. 541:23-542:4 (Viegas). In fact, AGFP had decided late in 2008 to reduce its internal risk limits on CDS trades referencing ABX indices and UK RMBS, adopting a maximum target exposure *below* its existing exposure. In other words, AGFP not only internally prohibited new trades, but also decided to reduce existing exposure. LX226; Tr. 1066:10-1070:25 (Bruce); 2362:19-2366:7 (Schozer). These new risk limits explain AGFP's failure to engage in LBIE's efforts to novate: had Nomura agreed, the trades would have kept AGFP far above its newly adopted risk limits. Although a single AGFP witness implausibly claimed AGFP would have consented to a novation of the trades it did nothing to pursue, *see* Tr. 2184:25-2185:3 (Schozer), no AGFP witness ever explained why AGFP would agree to retain billions of dollars of risk that it could terminate when it had just forbidden new trades covering the exact same risks.

G. AGFP Terminated Its Remaining 28 Trades In July 2009, Then Purported To Value Them In October 2009

AGFP finally elected to terminate the remaining trades with LBIE in July 2009, and it designated July 23, 2009 as the Early Termination Date, the date as of which the trades had to be valued. JX-33 at 2; SJ Decision at 37. AGFP did not have experience valuing derivatives under

14

an ISDA Master Agreement, and to comply with the Market Quotation requirement it engaged a third party, Henderson Advisors, to perform an auction to solicit the quotations required. Tr. 2206:24-2208:8 (Schozer). The auction, like many other contractually-valid Market Quotation processes, was recognizable as a pricing exercise. Tr. 2801:19-2802:7, 2803:24-2804:5 (Cohn); 3618:2-3619:19 (Pirrong). In fact, one bank invited to the auction wrote that "[AGFP] might just be fulfilling their 'market quotation' obligations under their existing (terminated 23 July 09) LBIE ISDA," *i.e.*, that AGFP's auction was a pricing exercise and that, after doing all the work to value the trades, there would be no trade available to the bidder. LX411-001; 3644:21-3645:9 (Pirrong). With this expectation, the invited participants submitted no bids. Tr. 2210:5-7 (Schozer).

Because the Market Quotation auction process failed, as is common, the ISDA Master agreement required AGFP to fall back to the Loss methodology to value the trades. Although AGFP had no more experience with the Loss methodology than the Market Quotation methodology, it chose **not** to employ outside consultants to assist it. Tr. 1088:5-25, 1089:10-1091:25, 1092:1-21, 1154:19-24 (Rosenblum); 2504:10-17 (Schozer). Instead, to calculate Loss, AGFP subjectively projected the floating amounts it claimed it would have to pay to LBIE during the remaining life of the trades based on its monoline affiliate AGC's model for determining loss reserves for financial guaranty insurance. JX34 at 5. Where AGC decided to take a loss reserve, AGC's Reserve Committee, of which AGC's Chief Actuary Ben Rosenblum was a member, determined the amount of the reserves. Tr. 1237:8-1238:9 (Rosenblum).

But for 26 of the 28 trades—every single trade referencing CLOs and UK RMBS—AGC decided to take no reserve, and AGFP thus claimed to project that it would pay *nothing* to LBIE over the remaining life of the trades. JX-34; Tr. 1125:12-15 (Rosenblum). That was nothing more than an assumption, supported by no evidence at trial. The Reserve Committee did not perform

15

any calculations or even review these transactions, but instead relied entirely on the fact that AGC's Surveillance Group—a different division staffed by others employees, none of whom appeared at trial—had assigned an internal AAA rating to these securities. Tr. 1132:11-1133:19 (Rosenblum); Furnari Dep. Tr. 70:19-24 (the Surveillance Group did not update its ratings for each security on a regular basis). Mr. Rosenblum admitted that the "Reserve Committee did not go through those transactions in the third quarter of 2009" because they "deferred to the analysis that the Surveillance Department did in assigning the rating." Tr. 1132:3-25 (Rosenblum). None of AGFP's trial witnesses was a member of the Surveillance Group, and no one testified with personal knowledge about how AGFP calculated projected zero losses on the UK RMBS, CLO, or CDO trades. Tr. 1133:20-1134:10 (Rosenblum); Tr. 2250:21-23 (Schozer); Tr. 2907:23-25 (Bailenson).

For his part, Mr. Rosenblum did not know what analysis, if any, the Surveillance Group conducted to determine that every CLO and UK RMBS trade should be assigned a AAA rating. Tr. 1135:2-1136:13 (Rosenblum). He did not know what data, if any, the Surveillance Group considered when assigning those ratings. Tr. 1138:17-19 (Rosenblum). He did not know what scenarios, if any, the Surveillance Group considered. Tr. 1136:16-1137:24 (Rosenblum). There is no memo or written analysis of any kind that reflects calculations the Surveillance Group did on the CLOs and UK RMBS. Tr. 1138:2-15 (Rosenblum). Mr. Rosenblum admitted that he "can't point … to any piece of paper or memo or calculation showing the analysis, if any, done by the Surveillance Group." Tr. 1138:12-15 (Rosenblum). When the Court asked Mr. Rosenblum, "What about what they actually did? Do you know the answer?" he responded with a single word: "No." Tr. 1136:11-13 (Rosenblum).

For the two ABX trades, by contrast, Mr. Rosenblum did calculate expected losses "based

16

on a handful of assumptions": liquidation rates,[16] a default rate curve over time,[17] loss severity rates over time,[18] and prepayment rates over time.[19] Tr. 1154:1-13 (Rosenblum). These assumptions were not based on contemporaneous "third-party market data or benchmark" or on the assumptions used by any other market participants. Tr. 1154:25-1155:2, 1157:5-9 (Rosenblum). Nor were they chosen based on any governing "policy or procedure." Tr. 1155:7-10 (Rosenblum). AGFP used no "calculations [or] mathematical formula[e]" to derive its assumptions. Tr. 1155:7-10 (Rosenblum). Instead, AGFP simply chose its handful of assumptions through an off-the-record conversation among Reserve Committee members about their personal beliefs. Tr. 1155:11-23, 1157:10-14 (Rosenblum).

At trial, Mr. Rosenblum attempted to explain the general thinking behind each of AGFP's four key assumptions. With respect to the first assumption—liquidation rates for the mortgages underlying the ABX indices, Tr. 1168:13-23 (Rosenblum)—Mr. Rosenblum testified that he *believed* AGFP's assumptions were based on data he had never seen but that was ostensibly from "the last 6 months of 2008" and therefore, by Q3 2009, "nine months out of date." Tr. 1161:13-15, 1164:5-1165:6 (Rosenblum); JX-71 at 23.

---

[16] Liquidation Rates measure the probability that already-delinquent borrowers will ultimately default on their mortgages. Tr. 1159:10-23 (Rosenblum).

[17] Default Rates measure the overall percentage of mortgage loans that are liquidated per year. A Default Rate Curve, also referred to as a CDR curve, measures how Default Rates are projected to change over time. Tr. 1167:12-1168:6 (Rosenblum).

[18] Loss Severity Rates measure what amounts of outstanding loan balances are lost as a result of borrowers being in default. Tr. 1177:13-16 (Rosenblum). There are generally two types of Loss Severity Rates—the current or initial rates, which are known statistics that can be looked up in published reports, and Loss Severity Rates "over time," also referred to as terminal rates), that are projected (like a CDR curve). Tr. 1177:20-1178:10 (Rosenblum).

[19] Prepayment Rates refer to the portion of loans that are paid off by the borrowers ahead of maturity (for instance because a homeowner sells the home or refinances). Tr. 1185:3-1185:8 (Rosenblum).

17

AGFP's second assumption was that within three years, mortgage defaults would fall to "normalish" levels that were 75% to 90% *lower* than the levels AGFP observed in and projected for 2009. Tr. 1168:7-1169:14 (Rosenblum). This assumption of a return to "normalish" default levels within three years "wasn't based on any analysis that the committee reviewed," or *any* "specific market data that was published by any third-parties," and the Committee knew it differed from the expectations of "leading financial institutions." Tr. 1174:16-21, 1175:23-1176:1, 1176:3-17 (Rosenblum). Rather, AGFP's default curve assumption was "largely based" on the supposed recollections of other, unnamed employees regarding conditions in the housing market in 2001—nearly a decade before the financial crisis. Tr. 1174:22-25 (Rosenblum). As both AGFP and LBIE witnesses testified, and as discussed in Section V.B.2, conditions in the housing market in 2001 did not remotely resemble the far worse conditions associated with the 2008-2009 financial crisis. Tr. 1175:1-21 (Rosenblum); Tr. 1430:13-1431:4 (Niculescu).

Third, for the loans projected to default pursuant to the above default curves, AGFP applied a loss severity curve that measured how "the amount of the loan balance that is lost as a result of the borrower's default" would change over time. Tr. 1177:13-16 (Rosenblum). AGFP started its loss severity curve off at 70%, even though the most recent data showed that loss severities among affected mortgages was actually 74% and data reflecting any decline in this loss severity "didn't exist yet." Tr. 1178:12-25 (Rosenblum); LDX06-8. AGFP then took a guess as to what would happen in the future. The guess was not based on any research or analysis, even though AGFP had access to and could have considered such research. Tr. 1180:10-15, 1183:25-1185:1 (Rosenblum). Instead, it was apparently based on off-the-record conversations at a Reserve Committee meeting, Tr. 1179:4-6, 1183:19-23 (Rosenblum). Unsurprisingly, their guess self-servingly made an extremely rosy prediction about loss severities unsupported by any objective

18

evidence. AGFP decided to assume that, in about three years, loss severities would reach normal levels, similar to the levels other, unnamed employees supposedly recalled observing in 2001. Tr. 1179:8-22, 1180:25-1182:16 (Rosenblum). When asked if AGFP had reviewed any analysis done in or related to 2001 before adopting this assumption, Mr. Rosenblum testified, "Nope," and said he did not know of anyone with access to any such analysis. Tr. 1179:17-1180:9 (Rosenblum). And while Mr. Rosenblum agreed that, in order for loss severities to quickly fall to normal levels in three years, home prices would have to rise substantially, he also testified that AGFP considered no analysis of how much home prices would have to rise, how quickly, or whether any such home price projection was at all realistic. Tr. 1180:10-15, 1182:21-23, 1183:25-1185:1 (Rosenblum).

Fourth, for prepayment rates AGFP took the same approach. It assumed prepayment rates would rise from current levels (close to zero) to "normalized market prepayment rates" of 10-15% within a few years, again based on no research or analysis. Tr. 1186:13-1187:4 (Rosenblum).

Based on these subjective assumptions, entirely unsupported by independent data or analysis, AGFP projected that it would have to pay LBIE $23.4 million more over the life of the ABX trades than LBIE would have to pay in fixed payments. JX-34 at 8. When combined with the expected fixed amounts that AGFP calculated LBIE would be owe it on the CLO and UK RMBS trades, AGFP claimed a total Loss amount of $24.8 million in its own favor. *Id.* at 10. Almost a decade later, AGFP acknowledged an error in its calculations, and revised its claimed Loss amount to $20.6 million. JX-35 at 2.

AGFP had an obvious motivation to ignore market prices and depart from the standard valuation approach adopted by every other one of LBIE's counterparties with comparable trades. By July 2009, sales of CDS credit protection on assets that AGFP had wrongly assumed posed "zero risk" had become massive liabilities. In the words of AGFP's expert, "Armageddon had to

19

happen for the monolines to pay off what they insured. But Armageddon did happen. They had to pay off and they had far too little capital to deal with it." Tr. 3716:16-3718:18 (Pirrong). As the Court heard at trial, all of the major monoline insurance companies that competed with AGFP's monoline affiliate, AGC, were either forced into receivership or underwent a form of corporate reorganization that effectively drove them out of business. Tr. 3665:1-14, 3667:3-3668:16 (Pirrong). There can be no denying AGFP's overwhelming incentive to assume that things would get much better very quickly, especially since a different assumption—namely that things would continue to be bad for years to come, as everyone else assumed—would have required AGFP to pay hundreds of millions of dollars to LBIE. That inherent bias infected every part of AGFP's Loss calculation, highlighting the importance of the ISDA Master Agreement's requirement that the calculation of Loss be *objectively* reasonable. AGFP's undeniably subjective calculation, which was at odds with the calculations of all independent sources, was a clear breach of contract.

H.   Procedural History

As the only seller of protection on mortgage-backed CDS that claimed LBIE owed *it* money, AGFP was an extreme outlier among the counterparties that submitted claims to the LBIE administration. LX92; Tr. 483:13-24, 494:10-495:4, 565:17-566:6 (Viegas). AGFP's subjective and self-serving valuation deprived LBIE of hundreds of millions of dollars. Those funds properly belonged to LBIE's stakeholders, including other CDS counterparties who had bought protection from LBIE (sometimes on the exact same reference obligations at issue here) and to whom LBIE, as protection seller, recognized that it owed money. To recover the true value of the trades at issue, and to ensure that all CDS counterparties were treated equally, the LBIE administration sued AGFP for breach of contract in November 2011. Dkt. 1.

In March 2013, the Court granted AGFP's motion to dismiss LBIE's first cause of action regarding the nine trades that AGFP had terminated in December 2009 on a walk-away basis. Dkt.

20

31. In July 2018, the Court granted summary judgment as to LBIE's causes of action regarding the failed Market Quotation auction, holding that LBIE failed "to raise a triable issue of fact as to AGFP's good faith in the design and execution of the Market Quotation auction." SJ Decision at 15. But the Court denied AGFP's summary judgment motion with respect to LBIE's claim that AGFP's calculation of Loss breached the parties' contract, setting that claim for trial.

The Court ruled that "an **objective standard of reasonableness** applies to a contractual provision requiring performance of an obligation in a reasonable manner." Id. at 22 (emphasis added) (citing cases); see also id. (quoting Hoag, 246 A.D.2d at 230-31 for the proposition that "[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered"). The Court went on to identify 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." SJ Decision at 29. Dismissing AGFP's argument that the failed Market Quotation auction justified its valuation, the Court critically 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." Id. at 30.

AGFP appealed but the First Department affirmed, holding that the Court had properly considered LBIE's evidence "that defendant's calculations were not reasonable under the circumstances." Dkt. 354 (Order on Appeal) available at 168 A.D.3d 527, 528 (1st Dep't 2019) (citing Hoag, 246 AD2d at 230-31). As a result, this case proceeded to trial on LBIE's claim that AGFP breached the contract by failing to act reasonably and in good faith in calculating Loss.

III.   LEGAL STANDARD

As Justice Friedman recognized, the ISDA Master Agreement at issue in this case "is probably the most important standard market agreement used in the financial world." SJ Decision at 21 n. 10 (quoting *Anthracite Rated Invs. (Jersey) Ltd. v. Lehman Bros. Finance S.A.*, [2011] EWHC 1822 (Ch) [114] (Eng.)).[20]   The ISDA Master Agreement "serves as the contractual foundation for more than 90% of derivatives transactions globally." *Id*. (quoting *Matter of Lehman Bros. Holdings Inc. v. Intel Corp.*, 2015 WL 7194609 at * 1, n 1 [Bankr. SDNY, Sept. 16, 2015]) ("Intel").[21]   In the past two decades, a "significant body of recent case law has developed in relation to the interpretation and application both of Loss and Market Quotation under the 1992 Master Agreement." *Anthracite*, [2011] EWHC 1822 (Ch) [116] (Eng.).   "[C]ourts in New York and England, the two forums most commonly called upon to interpret the Agreement, have held that the Agreement should be 'enforced so as to promote legal certainty and hence, market stability.'" SJ Decision at 21, n.10 (quoting *Intel* at *11).

A.   A Non-Defaulting Party Must Calculate Loss Using Objectively Reasonable Procedures That Generate A Commercially Reasonable Result

As detailed in Section II.A above, Loss is "an amount [AGFP] ***reasonably determines in good faith*** to be its total losses and costs . . . or gain" JX-01 at 15 (emphasis added).   Under New York law, "an objective standard of reasonableness applies to a contractual provision requiring performance of an obligation in a reasonable manner." SJ Decision at 22 (citing *MBIA Ins. Corp. v. Patriarch Partners VIII, LLC*, 842 F. Supp. 2d 682, 704 (S.D.N.Y. 2012) and *Christie's Inc. v. SWCA, Inc.*, 22 Misc. 3d 380, 383-384 (Sup. Ct. N.Y. Cty. Sept. 12, 2008)).

---

[20]   For the Court's convenience, the foreign law decisions cited in this brief have been filed concurrently in an appendix.

[21]   *See also* Tr. 73:9-11 (Rahl) (estimating that $600 trillion in global derivatives trades are governed by ISDA Master Agreements).

22

As the First Department has held, "[i]n determining whether conduct is objectively reasonable, industry norms may be appropriately considered." *Hoag v. Chancellor, Inc.*, 246 A.D.2d 224, 231 (1st Dep't 1998); *accord* Dkt. 354 (Order on Appeal affirming SJ Decision) *available at* 168 A.D.3d 527, 528 (1st Dep't 2019); *see also* SJ Decision at 22-23 ("It is a basic tenet, applied across a wide range of legal issues, that the question of what is reasonable may require consideration of the facts and surrounding circumstances in the case.") (citing cases).

Where evidence demonstrates that "there may be a uniform or highly consistent practice of calculating Loss in a particular manner under similar circumstances, and the Non-Defaulting Party deviates from that practice, that deviation raises a genuine question of fact as to the Non-Defaulting Party's reasonableness or good faith in calculating Loss." SJ Decision at 28; *see also id.* at 29 ("[E]vidence of departure by Assured, as the Non-Defaulting Party, from standard industry practice is a factor, among others, to be considered in assessing its reasonableness and good faith in calculating Loss.")

In addition, Courts interpreting the ISDA have consistently held that a Non-defaulting Party must reach a "commercially reasonable result" when calculating Loss. *Barclays Bank PLC v. Devonshire Trust*, [2013] ONCA 494 (Can Ont CA) ¶ 268; *Anthracite* at ¶ 115. In assessing whether a Loss calculation is commercially reasonable, courts apply the "cross-check principle," a doctrine first developed in English courts that has since "hardened into hornbook law" that "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." SJ Decision at 28-31 (citing cases). The cross-check principle arises from the text and structure of the ISDA Master Agreement itself:

> Given that [the Agreement] expressly contemplates that, if a Market Quotation cannot be determined or would not produce a commercially reasonable result, the

23

fallback position will be a calculation of Loss, it would be very odd if the two payment measures were not intended to achieve broadly the same result, in terms of the payments that have to be made either way . . . .

Brittania Bulk plc [in liquidation] v. Pioneer Nav. Ltd., [2011] EWHC 692 (Comm) [44]; *see also* JX-72 (1992 ISDA User's Guide) at 36 (explaining that when Unpaid Amounts are calculated separately—as AGFP did here—Market Quotation and Loss are both intended to reflect "the future value of the Terminated Transactions"). In this case, the Court held that "[c]onsideration of the cross-check principle in assessing whether [AGFP] reasonably determined its loss is appropriate here, as the parties agreed to use Loss solely as a fallback method in the event that the Market Quotation process failed to produce a Replacement Transaction." SJ Decision at 31.

B. Under New York Law, Damages For Breach of Contract Are Determined As Of The Date Of Breach Using Fair Market Value

In a highly analogous case involving the valuation of CDS, Justice Friedman held that "[i]t is well-settled 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.'" *UBS Securities LLC et al. v. Highland Capital Management, L.P. et al.*, No. 650097/2009, Nov. 14, 2009 (Decision and Order After Trial) (NYSCEF Doc. No. 641), at 20 (quoting *Sharma v. Skaarup Ship Mgmt. Corp.*, 916 F.2d 820, 825 (2d Cir. 1990)). This bedrock principle of contract damages has been affirmed repeatedly. *See, e.g.*, *White v. Farrell*, 20 N.Y.3d 487, 494 (2013) ("'[T]he generally accepted measure of damages [for loss of bargain] is the difference between the contract price and the fair market value of the property at the time of the breach.'") (quoting 25 Williston on Contracts § 66:80 (4th ed.)); *Sharma*, 916 F.2d at 826 ("Measuring contract damages by the value of the item at the time of the breach is eminently sensible and actually takes expected lost future profits into account.").

Courts applying New York law have specifically addressed the circumstance where "the

market value at the time of the breach" differs from a non-breaching party's own projections of lost profits, and has held that, as between the two, market value "is the measure of damages." *Sharma*, 916 F.2d at 825-26. That is because "[t]he value of assets for which there is a market" captures "the discounted value of the stream of future income that the assets are expected to produce." *Id.*; *accord Schonfeld v. Hilliard*, 218 F.3d 164, 178 (2d Cir. 2000) ("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.") (internal quotation marks omitted). Under these well-established principles of New York law, the value calculated for a party's loss of bargain upon trade termination should be consistent with objective market prices.

Consistent with the aforementioned legal principles, courts interpreting the ISDA have held that the market value of a derivative is the proper measure of Loss. Judge Shelley Chapman of the United States Bankruptcy Court for the Southern District of New York, who presided over the bankruptcy of LBIE's US-based affiliates and oversaw numerous ISDA disputes, described the Loss methodology as follows:

> [F]ollowing 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 a termination payment would be calculated based on the value of the Swap parties' positions at the time of the Early Termination Date. For instance, 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. A party whose Swap position has value at the time of a termination is considered "in-the-money."

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); *see also, e.g.*, *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31, 35 n.9

25

(Bankr. S.D.N.Y. 2011) (holding that selection of "Second Method" means the parties agree that an "early termination payment [would] be made to the in-the-money party regardless of whether that party is in default"); *The High Risk Opportunities Hub Fund Ltd. v. Lyonnais*, 2005 WL 6234513, at *8 (N.Y. Sup. Ct. July 06, 2005) (determining Loss using the parties' internal market-based value for the trades).[22] On this basis, New York courts have found that valuations of CDS that diverge from available market prices on the date of breach are unreasonable. *See, e.g., UBS, No. 650097/2009, Dkt. 641 at 29 (Friedman, J.)* (rejecting results of CDS auction 11 days after breach in favor of $470 million mark-to-market valuation as of the date of breach).

This substantial authority is not at odds with the final sentence of the Loss definition, which states that a Non-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." JX-01 at 15. As Justice Friedman has explained, that sentence "should be read as an acknowledgment that there may . . . be situations in which calculation of Loss using market prices may not be possible or would be unreasonable," but it "does not mean that the Non-Defaulting Party's choice to ignore market prices can never be unreasonable or taken in bad faith." SJ Decision at 26.[23]

C.   AGFP's Creditworthiness Is Irrelevant To Its Calculation of Loss

Decades of black letter law stands for the proposition that a party cannot escape its contractual liabilities by arguing that it is no longer able or willing to perform. *E.g., Stasyszyn v.*

---

[22]   English courts have similarly held that Loss "precisely reflects the principle . . . 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." *Anthracite*, at ¶ 117.

[23]   According to the 1992 ISDA User's Guide, this sentence was added to allow parties to use dealer quotations even if the quotes were "not necessarily in accordance with the technical requirements set forth in Market Quotation," discussed above in Section II.A. JX-72 at 34-35.

26

Sutton E. Assocs., 161 A.D.2d 269, 271 (1st Dep't. 1990) ("[T]he law is well-established that economic inability to perform contractual obligations, even to the extent of insolvency or bankruptcy, is simply not a valid basis for excusing compliance."). Instead, contract law assumes for the purpose of compensatory damages that both parties would have ***fully performed***. *See Adar Bays, LLC v. GeneSYS ID, Inc.*, 37 N.Y.3d 320, 340 n.8 (2021) ("[E]xpectancy damages … give force to the provisions of a contract by placing the aggrieved party in the same economic position it would have been in had both parties fully performed.") (internal quotation marks omitted); *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 the non-repudiating party will fail to perform in the future is irrelevant to the calculation of damages); *cf. In re Highland Superstores, Inc.*, 154 F.3d 573, 580 n. 9 (6th Cir. 1998) ("Under basic contract law, however, the ability of a breaching promisor to pay does not affect the promisee's award of damages. . . . In short, collectibility is simply not factored into the calculation of damages for breach of contract."); *Kucin v. Devan*, 251 B.R. 269, 273 (D. Md. 2000) ("[The bankrupt creditors'] claims for retirement benefits, discounted to present value, are a legal certainty and need not be further discounted for the risk of nonpayment [by the bankrupt party]. Otherwise, the risk of nonpayment would be accounted for twice since the [creditors] already stand to receive only a fraction of their claims.").

In accord with these principles, courts interpreting the 1992 ISDA Master Agreement have consistently held that the Non-defaulting Party's creditworthiness is irrelevant to a valuation on early termination. *See Peregrine Fixed Income Ltd. v. Robinson Dep't Store Public Co.* [2000] EWHC 99 (Comm) [30] (Eng.) ("When 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 and I can see nothing in the definition of Loss to suggest that a different approach is called for under this

27

Agreement.") (holding that Market Quotation results affected by Non-defaulting Party's lack of creditworthiness were unreasonable); *Anthracite*, at ¶ 116(2) ("[L]oss 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."). It would be contrary to law to discount the value of AGFP's trades with LBIE, or disregard available market pricing, based on AGFP's own alleged lack of creditworthiness as of the Early Termination Date.

D. The Question Before the Court Following Trial

The question before the Court following trial is whether AGFP breached the parties' Agreement by failing to calculate Loss reasonably and in good faith. As detailed below, trial has established that the answer is yes: AGFP breached the contract *both* by unreasonably calculating Loss without regard to available market prices and standard market practice (Section IV), *and* by calculating Loss on the basis of self-serving, subjective, and unsupported assumptions regarding projected future performance that were totally out of line with the projections of every other independent observer whose views have been put before the Court (Section V).

Either of these breaches is enough for this Court to discard AGFP's unreasonable Loss calculation, and instead award LBIE damages in the amount of a reasonable and objective Loss calculation that would return the parties to the positions they would have been in on July 23, 2009 had AGFP recognized the objective value of the trades upon its termination (Section VI).

IV. AGFP BREACHED THE PARTIES' CONTRACT BY IGNORING STANDARD MARKET PRACTICE TO REACH A RESULT INCONSISTENT WITH MARKET PRICES

After trial, it is undisputed that in calculating Loss, AGFP "didn't use market prices, didn't use market-observable data," did not even "*consider[]* using mid-market prices to calculate a mark" in its Loss calculation, and did not even attempt to understand or follow standard market practice.

28

Tr. 2524:14-16, 2215:21-2216:11 (Schozer) (emphasis added); Tr. 1088:4-1091:25, 1097:16-1098:21 (Rosenblum). In light of the overwhelming evidence of market practice presented at trial, AGFP's failure to calculate Loss by reference to available market prices was a breach of contract.

A. Uniform Practice In The Derivatives Market Is To Calculate The Value Of Terminated CDS Using Market Prices

It is the law of the case that "evidence of departure by [AGFP], as the Non-Defaulting Party, from standard industry practice is a factor . . . to be considered in assessing its reasonableness and good faith in calculating Loss." SJ Decision at 29. That is because, "[i]n determining whether conduct is objectively reasonable, industry norms may appropriately be considered." *Id.* at 23 (quoting *Hoag*, 246 A.D.2d at 231). Here, the evidence before the Court is overwhelming: there is a uniform market practice, reflected in witness testimony, industry statements, and the contemporaneous behavior of numerous other counterparties that Loss is determined by reference to available market prices. There is no evidence of any counterparty anywhere ignoring available prices—except for AGFP.

1.   After LBIE's Entry Into Administration, Thousands Of Other Terminated CDS On Asset-Backed Securities Were Valued Using Market Prices, And None Were Valued Using Loss Reserves

The evidence at trial was clear and consistent: The uniform practice in the derivatives market, both in the ordinary course and upon termination, was to value CDS trades using objective market prices. This was shown through fact witnesses on both sides, through experts on both sides, and perhaps most compelling through unrebutted evidence of hundreds of close outs on the exact same types of CDS under the same circumstances prompted by LBIE's entry into administration. The First Department's decision setting this case for trial specifically cited *Hoag*, the decision that holds that "industry norms may be appropriately considered" when determining whether a party's conduct is "objectively reasonable." 246 A.D.2d at 231. AGFP's conduct cannot be squared with

29

these industry norms, which instead require a market price-based calculation of Loss.

At trial, LBIE's Eduardo Viegas testified, at great length and with extensive detail, about the ways that AGFP was a clear outlier among all of LBIE's counterparties with comparable CDS positions. Tr. 443:14-20, 565:2-566:6 (Viegas). As Mr. Viegas explained, when LBIE entered administration, it faced 77 counterparties on a total of 643 CDS trades referencing asset-backed securities, like the trades at issue here. Tr. 410:2-410:6, 447:11-447:24 (Viegas) (noting 606 trades with 76 counterparties, excluding AGFP). In some of those trades, LBIE acted as purchaser, and in others it acted as seller. LX92; Tr. 472:21-474:4 (Viegas). AGFP was just one of those 77 counterparties, and its 37 trades (including those it terminated in December 2008) represented only a fraction of all the comparable trades that needed to be valued. *See* Tr. 410:2-6, 445:10-17, 447:11-24 (Viegas). Like AGFP, those 76 other counterparties were each the Non-Defaulting Party, which entitled them to terminate and calculate the Termination Payment for their 606 CDS trades. Tr. 503:7-504:16 (Viegas).

LBIE's counterparties consisted of a wide range of financial institutions and entities, including investment banks, pension funds, hedge funds, and commercial banks. Tr. 390:13-18 (Viegas). Regardless of the counterparties' business models, their subjective views about the future, and the details of their contracts with LBIE, the evidence was uniform: (i) when LBIE was the protection buyer, the counterparty recognized LBIE as being in the money and entitled to a payment; and (ii) when LBIE was the protection seller, the counterparty recognized LBIE as being out of the money and thus obligated to make a payment.[24] The uniformity of this exactly-on-point evidence of market practice speaks to just how far outside of market practice AGFP placed itself as a protection *seller* that nonetheless demanded a payment, particularly given that all other

---

[24] Tr. 457:6-458:21, 473:24-475:13, 481:3-495:4 (Viegas); LX92 (Tab "Ctpy Values").

30

protection sellers had incentives to take the same position as AGFP—yet did not.[25]

The details of the 606 other CDS trades further reinforces both the depth and the certainty of this market practice. For 604 out of 606 trades, LBIE and its counterparty agreed on the direction of payment, and the two exceptions (less than half of one percent of all trades) appear to consist of one typo and one *de minimis* $17,000 difference in valuation.[26] By contrast, LBIE and AGFP disagree on the direction of payment for 26 of the 28 trades at issue, and for the two ABX trades (the only trades for which AGFP agrees that the seller of protection owed the buyer of protection a payment), the parties nonetheless disagree on value by more than $300 million. *Compare* JX-34 (Statement of Calculations) at 8 (valuing ABX trades at $19.7 million to LBIE)*, with* LDX06-23 (valuing ABX trades at $329 million to LBIE). The sharp contrast between AGFP's intentional disregard of market pricing and the uniform practices of all of LBIE's other counterparties demonstrates that AGFP acted unreasonably in breach of its contractual obligations.

2.   Witnesses Called By Both Parties Agreed They Had Only Seen Loss
         Calculated On The Basis Of Appropriate Market Prices

In addition to Mr. Viegas, LBIE presented four expert witnesses with decades of collective experience in the derivatives industry, each of whom testified at trial that it was consistent market practice to value derivatives using market-based inputs. Meanwhile, not a single witness called

---

[25] AGFP's Loss calculation also contrasts with its process for determining mid-market marks for the trades at issue. From the third quarter of 2008 through June 30, 2009, AGFP valued *all* of the trades at issue in LBIE's favor. LX170 (Column "Mark Excluding AGC's CDS Spread" in tabs "Q3 2008", "Q4 2008", "Q1 2009", "Q2 2009").

[26] LX92 (Tab "Ctpy Values"). The apparent typo relates to one ABX trade to which LBIE and its counterparty assigned nearly identical absolute values, $225,240 versus $223,460, but disagreed about the direction of payment. This appears to be a typo, because for 65 other ABX trades with the same counterparty, both parties agreed that the protection seller owed a payment, suggesting the value for this trade was inverted. *See* LX92, Tab "Ctpy Values," filtered for Client Code "9754" and Trade Type "ABX." The *de minimis* difference is also obvious in the broader context of the hundreds of millions of dollars of value documented in LX92. *See id.* (Tab "Ctpy Values" filtered for Client Code "77700380").

31

by *either* side could identify a prior termination under an ISDA contract using a reserve-based valuation.[27] This consistent testimony further confirmed that AGFP discarded established industry practice in order to reach a self-serving result completely at odds with available market data.

Leslie Rahl, the CEO of Capital Market Risk Advisors and a former member of ISDA's board, testified about her vast expertise in the derivatives market. Tr. 56:17-20, 59:15-62:16 (Rahl). Since 1983, Ms. Rahl has been involved with approximately "a hundred separate terminations" of ISDA Master Agreements, involving "the termination of tens of thousands of transactions." Tr. 129:19-130:5 (Rahl). Across all of this experience, her testimony was clear: until this case, she had never "been involved in a matter where a party disputed whether loss, when calculated as a fallback from a failed market quotation, should reach a market-based result." Tr. 98:2-98:7 (Rahl). This was true for trades where neither party posted collateral, true for trades "documented under pay-as-you-go forms," and true no matter "which types of companies entered into a particular derivative transaction"—even specifically "where a counterparty is an affiliate to an insurance company." Tr. 98:8-99:18 (Rahl). In all her experience, Ms. Rahl ***never*** saw a counterparty use a subjective loss reserve methodology without considering any market data, an approach she called "totally outside the practice that I've observed." Tr. 122:2-123:1 (Rahl).

Graham Bruce, who served as the former Global Head of Structured Credit Trading at Commerzbank and was the only witness at trial to have traded CDS in 2009, including each of the types of trades at issue, confirmed the importance of market-based valuations and terminations.[28] His career included a "very large number" of early terminations of CDS, and he testified about the

---

[27] *See, e.g.*, Tr. 1088:17-21, 1090:5-1090:13 (Rosenblum), Tr. 2276:12-2276:17, 2277:24-2278:11 (Schozer) Tr. 2597:10-2600:22 (Cohn); Tr. 3180:10-3180:19 (Prager), Tr. 3587:3-3587:12 (Pirrong).

[28] Tr. 810:13-813:18, 827:5-9, 833:13-835:2, 922:13-922:22 (Bruce); LDX04 at 2.

standard market practice of valuing derivatives using the best-available market data. Tr. 866:3-9, 921:4-922:12 (Bruce). As he explained, he had *never* "come across a dispute, before today, where the parties did not agree the starting point was mid-market fair value," calculated by reference to trades on identical instruments (Level 1), trades on similar instruments (Level 2), or, in the absence of those, model-based prices using market-based inputs or market standard assumptions (Level 3).[29] Mr. Bruce testified that AGFP used this same "hierarchy of inputs" in its public disclosures,[30] and demonstrated that Level 1 and Level 2 inputs were available to AGFP for the ABX, UK RMBS, and CLO trades at issue.[31] Moreover, Mr. Bruce confirmed that he had not only never seen a termination methodology like the one AGFP employed, he had "never seen an insurance regulatory reserve approach used for valuing a derivative for any purposes whatsoever." Tr. 971:15-971:17 (Bruce).

Evy Adamidou, who started working with credit derivatives in 1990 and started working at monoline insurers in 2000, testified consistently with Ms. Rahl and Mr. Bruce. Tr. 1806:18-1808:19 (Adamidou). She explained that she had personally been involved in voluntary terminations of CDS trades with counterparties to monolines at market prices, and that the monoline industry expended great resources in negotiating their ISDA contracts to ensure that they would not have to terminate on the basis of Loss because they "understood very well that the standard provision of the ISDA Master Agreement would lead to a Mark-To-Market termination of the credit default swaps." Tr. 1812:18-24, 1829:4-1829:6, 1832:16-1833:6 (Adamidou). Documentary evidence supported her unimpeached testimony on this topic, including other monoline affiliate ISDA Master Agreements that featured "heavily customized Loss definition[s],"

---

[29] Tr. 867:6-869:10, 925:24-926:8 (Bruce); LDX04 at 7.
[30] Tr. 867:6-867:21, 1058:10-1059:6 (Bruce); JX-57 at 100.
[31] Tr. 899:12-18, 906:21-907:4, 910:1-912:10, 1058:10-1059:6 (Bruce) LDX04 at 8, 9.

one of which was executed by Michael Schozer himself, as part of his insistence on "eliminat[ing] all provisions from the standard ISDA agreement that could potentially generate mark-to-market exposures." Tr. 1864:5-1865:10 (Adamidou); *See e.g.* LX20 at 12, 14 (LBIE-AMBAC ISDA); LX28 at 68 (AGFP-Deutsche Bank ISDA); LX40 at 22 (LBIE-FSA ISDA).

In contrast, AGFP "did not make similar modifications" in its ISDA Master Agreement with LBIE, leaving the standard Market Quotation/Loss and Second Method payment terms in place, and thus leaving both parties exposed to a market valuation at termination. Tr. 1878:19-1879:1 (Adamidou). Under New York law, the fact that AGFP and LBIE did *not* add a monoline-specific termination provision to their contract is crucial to interpreting the contract: "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).

Dr. Peter Niculescu, who has worked in the financial industry since 1985 with leading roles at Goldman Sachs, Fannie Mae, and CMRA, provided the same insight from his personal involvement with over 20 closeouts involving the valuation of approximately 50,000 terminated derivatives trades. Tr. 1384:7-1385:7, 1529:18-1530:1, 1530:20-1531:8 (Niculescu); LDX06-02. Dr. Niculescu testified that it was "uniform consensus market practice" that Loss and Market Quotation are intended to arrive at broadly the same result: the market price of the transaction. Tr. 1533:13-1534:2 (Niculescu). He confirmed that the Market Quotation process frequently failed, and that when it did it was uniform practice to use the "hierarchy of inputs" described by Mr. Bruce to generate a market price for Loss. Tr. 1531:25-1534:9, 1582:21-1582:25 (Niculescu) ("When you have a market price you use the market price."). In his words, "there's been a universal understanding and universal application that when a market price is available, even if Market

34

Quotation fails, that the fallback to Loss needs to be based on that market price." Tr. 1443:14-1443:17 (Niculescu). As he explained, using projections instead of available market data was "unprecedented," and would not be consistent with market practice even if AGFP "had used its model but substituted in assumptions of others." Tr. 1443:1-1443:22 (Niculescu). That is because "[m]arket prices are an amalgam of all current market information and all views, and they're created by willing buyers and sellers, in general, who are informed, professional and who are prepared to risk capital . . . . [The market price] is impartial, third party, and fully informed." Tr. 1534:10-1536:12 (Niculescu). This is consistent with the law of this case that the valuation at issue here must be objectively reasonable. *See* SJ Decision at 22. Like other witnesses, Dr. Niculescu could not recall any other instances of a party ignoring market pricing when valuing a terminated trade. *See* Tr. 1534:3-9 (Niculescu).

No AGFP witness testified to the contrary with anything other than conclusory denials. Not a single AGFP witness had *ever* traded CDS, and other than AGFP's termination of the trades with LBIE, none of them had *any* experience valuing CDS trades upon termination.[32] AGFP's sole market practice expert, Joshua Cohn, testified that it was "common" practice for Lehman's counterparties to terminate and value derivatives trades with reference to market prices, Tr. 2750:5-22 (Cohn), and that he would advise clients terminating CDS trades "to look at the market price." Tr. 2790:20-24 (Cohn). Neither he nor any other AGFP witness during the entirety of the five-week trial identified a ***single*** instance in which a derivatives counterparty calculated Loss using an insurance loss reserve model, as AGFP did here.

---

[32]   *See, e.g.,* Tr. 1088:5-1088:21, 1090:5-1090:13 (Rosenblum); Tr. 2062:24-2063:3, 2194:21-2195:1, 2276:12-2278:11 (Schozer); Tr. 2597:10-2600:22 (Cohn); Tr. 3180:10-3181:4 (Prager); Tr. 3586:15-3587:12, 3654:21-3655:15 (Pirrong).

3. <u>Documentary Evidence Reinforced The Necessity And Uniformity Of Market-Based CDS Valuations</u>

Contemporaneous documentary evidence at trial further demonstrated that a wide range of market participants—including AGFP—understood that following an Event of Default under an ISDA Master Agreement, market pricing should be used to value terminated trades. Just one month before Lehman's bankruptcy, a diverse group of derivatives industry leaders (including banks, hedge funds, ISDA, and major law firms) put together a report published by the Counterparty Risk Management Policy Group ("CRMPG"). *See generally* JX-64. The CRMPG III Report "considered in detail the challenges of closing out a major market participant and reache[d] the following conclusions: . . . ***There is general agreement that in determining close-out amounts market inputs should be used unless doing so would produce a commercially unreasonable result.***" *Id.* at 137 (emphasis added). As discussed below, there was no evidence at trial showing that using market prices—as dozens of other counterparties did, and as every industry participant expected—would produce a commercially unreasonable result in this case. The "general agreement" in favor of objective "market inputs" is consistent with the expert opinions of LBIE's witnesses, Tr. 359:3-360:19 (Rahl), and consistent with commercial reality and expectations—but inconsistent with the unreasonable approach taken by AGFP.

Following Lehman Brothers' bankruptcy, this market consensus was put into practice by LBIE's American affiliates. In a derivatives claim framework, those affiliates and their largest bank counterparties agreed to value their derivatives trades (including the types of CDS at issue here) as of September 2008 using either (i) mid-market pricing with a bid-offer adjustment, or (ii) actual replacement trades executed on the relevant early termination date. LX35 at 11-12, 42; Tr. 946:7-947:16 (Bruce); Tr. 1463:18-1464:19 (Niculescu). This agreed approach between the Lehman affiliates and their largest counterparties provides further evidence that there was a

36

consistent market practice to value terminated CDS trades using market pricing.

LBIE presented documentary evidence that even monoline insurance entities recognized that it was standard practice to value terminated derivatives on a mark-to-market basis. When monoline insurer Ambac Assurance Corporation ("Ambac") entered into a plan of rehabilitation in 2009 to avoid bankruptcy, it sought to reach agreement with its bank counterparties on a portfolio of distressed CDS on CDO positions. AX50039 at 31-34; *See* Tr. 924:13-925:24 (Bruce). At the time, neither CDS on CDO trades nor the underlying CDOs were actively trading, so market prices were unavailable. Tr. 935:10-935:16 (Bruce). Ambac never took the position that the trades should therefore be valued using a statutory loss reserve model, nor did Ambac assert that the trades were worthless because no one would write new trades facing them.[33] Instead, the parties acknowledged that the mark-to-market value of the trades "was ***indicative of the market-value based termination payment*** which could have arisen if certain conditions occurred and the Bank Group members successfully exercised their ***termination rights***." AX50039 at 33 (emphasis added); Tr. 1052:2-1053:16 (Bruce). There was no dispute that an early termination payment under an ISDA contract would be based on a market valuation.

LBIE presented additional evidence that even where derivatives markets are not functioning—unlike the situation here—it was nonetheless industry practice to determine the market price as of the date of termination. In the *Devonshire* case, there was a "a ***seventeen-month*** standstill in the market," which meant that no single day's market price accurately reflected the parties' bargain. Tr. 100:19-101:5, 105:1-14, 341:8-20 (Rahl). As Ms. Rahl explained, one solution to this unique circumstance was to approximate projected losses, and then "add[] in market risk premium, which is what you have to do to get a market price." Tr. 105:1-14 (Rahl);

---

[33] Tr. 1050:22-1051:23, 1054:4-1055:2, 1055:24-1056:14 (Bruce).

see also Tr. 108:8-15 (Rahl) (explaining that all market prices are composed of projected gains/losses plus risk premium); *see also* [Barclays Bank PLC v. Devonshire Trust, 2013 ONCA 494 (Can Ont CA)](#) ("*Barclays*") at ¶¶ 282-289. In the *Devonshire* case, Ms. Rahl calculated the projected losses as a mere $12,000, but then added in ***$264 million*** in risk premiums to approximate the market price. *[Barclays](#)*, at ¶¶ 282-286. This commitment to reflecting a market price was to her client's detriment—it increased her client's liability by $264 million—but it was necessary to achieve a valuation consistent with the well-established industry practice that requires valuing Loss by reference to market prices even when no single price for the terminated trade can be observed. The circumstances in this case contrast sharply with the unusual situation in *Devonshire*—here, there was no standstill, and the markets for the CDS at issue were active and liquid. *See* Tr. 105:1-14; 248:10-18 (Rahl); Tr. 826:18-826:22, 833:13-833:-835:2, 4139:2-13 (Bruce); Tr. 1451:3-5, 3811:5-3812:24 (Niculescu). Far from supporting AGFP's position, the *Devonshire* case establishes that AGFP's methodology was contrary to accepted market practice.

Finally, the trial record is replete with examples of AGFP's parent company acknowledging market practice for valuing CDS trades upon termination. In its 2008 10-k filing with the United States Securities and Exchange Commission ("SEC"), AGC wrote that "[i]f a credit derivative is terminated, the Company could be required to make ***a mark-to-market payment*** as determined under the ISDA documentation. . . . The process for determining the amount of such payment is set forth in the credit derivative documentation and ***generally follows market practice for derivative contracts***." JX-57 at 58. In a presentation to the SEC in September 2010, AGC again acknowledged that with CDS trades, unlike financial guaranty insurance policies, a "[r]isk of ***mark-to-market termination payments*** exists." LX169 at 6-7. While AGFP suggested at trial that it didn't mean what it said in these filings and agency presentations, and that mark-to-

market payments would only arise if AGFP itself was the defaulting party, that distinction does not appear in the documents themselves, and it is refuted by other materials, including a May 2008 presentation to the Board of Directors of AGC, which acknowledged that "if **the counterparty** defaults . . . mark-to-market may apply." LX159 at 3 (emphasis added). AGFP cannot credibly deny the existence of a uniform market practice when it recognized this market practice repeatedly at and around the time of termination here.

B.   AGFP Has No Basis To Discard The Requirements Of New York Law Or Industry Consensus

In addition to establishing that the derivatives industry uniformly agrees that Loss under an ISDA Master Agreement must be calculated by reference to market prices, the evidence at trial showed that AGFP lacked any "legitimate reasons" to depart from that settled expectation. SJ Decision at 28-29. The Court should not even *consider* whether there could be circumstances that might excuse AGFP's failure to use market prices, because AGFP does not claim that there was *any* circumstance in which it would have used market prices or followed market practice. *See, e.g.*, Tr. 2215:21-2216:11, 2492:4-13 (Schozer) (admitting did AGFP never "considered using mid-market prices to calculate a mark" in its Loss calculation); Tr. 1088:4-1091:25, 1097:16-1098:21 (Rosenblum) (admitting he did not consider market practice or market pricing to value the LBIE trades). But even if such an argument is considered, the evidence at trial provides no basis to ignore market practice in this case.

There is no evidence, for example, that the markets for CDS were "disrupted" such that it was impossible to determine a market price. Tr. 1451:3-5, 3811:5-3812:24 (Niculescu). It is undisputed that Markit published official daily prices for the ABX indices on July 23, 2009, based on submissions from five different derivatives dealers. LX114; Tr. 3304:9-20 (Prager). In addition, at least seven dealers were actively quoting prices to both buy and sell the ABX indices at issue

39

throughout the day on July 23, 2009, reflecting an active marketplace in which trades were occurring. LX133; Tr. 1458:22-1461:5 (Niculescu); LDX06-28. Based on this wealth of evidence of available market pricing for the ABX trades, Dr. Niculescu found that pricing those two trades was "very straightforward." Tr. 1446:13-24 (Niculescu). LBIE also established that market pricing information was readily available for the UK RMBS and CLO trades at issue.[34]

Trial also showed that AGFP itself acknowledged the continued functioning of the CDS markets,[35] and that AGFP relied on the very data cited by LBIE's experts in order to mark its derivatives to market for accounting purposes.[36] An AGFP document entitled "Lehman Info by Quarter without CDS" reflects AGFP's *own* market-based valuation of each of its CDS trades with Lehman, including a market value (excluding adjustment for AGFP's own supposed credit risk) of ***$438 million in LBIE's favor*** as of June 30, 2009. LX170 (Tab "Q2 2009"); Tr. 1352:20-1354:3 (Rosenblum); Tr. 2477:15-2478:5 (Schozer). In short, AGFP had no problem obtaining objective third-party information regarding market pricing of derivatives positions for its own internal purposes, and had determined that it was massively out-of-the-money facing LBIE. There is no reason it could or should not have used the same information to calculate Loss.

AGFP's refusal to consent to a novation does not show that derivatives markets were not

---

[34] *See* LX135, LX136; Tr. 1444:9-21 (Niculescu) (stating that the UK RMBS trades were "actively quoted by Markit"; and for the CLOs there was "an available price for the cash securities from which we can derive the derivative prices"). These objective inputs are more than sufficient to enable the determination of a market price, and AGFP presented no evidence at trial rebutting LBIE's evidence that the markets for CDS referencing UK RMBS and CLOs were functioning on the Early Termination Date.

[35] LX352 at 18-19 (acknowledging an active market for AGFP's CDS positions); LX355 at 21-23 (same).

[36] Repetto Dep. Tr. 80:11-23 (acknowledging use of Markit); LX355 at 6 (referencing JPMorgan benchmark for CDOs/CLOs); Tr. 896:17-896:22, 906:21-907:4, 910:24-912:2 (Bruce) (AGFP had access to market pricing for trades at issue).

40

functioning or that replacement trades were unavailable.[37] AGFP ultimately cloaked its reasons for failing to agree under privilege, depriving the Court of an explanation of why novation did not succeed. *See* Tr. 2452:19-2463:9. But the evidence that *was* allowed at trial shows that LBIE identified an interested novation counterparty in Nomura, [38] and that AGFP—a necessary participant in any novation—was uncooperative and never consented to a Nomura trade.[39]

AGFP's inability to obtain bids for replacement trades in its Market Quotation auction on September 16, 2009 is irrelevant to the value of the trades on July 23, 2009, which is undisputedly the relevant valuation date. JX-01 at 15 ("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.") In another highly analogous CDS valuation case, Justice Friedman held that the results of an auction a mere ***eleven days*** after the valuation date "did not provide a reliable basis for determining … losses at, or even, shortly after, the breach, due to the exceptional circumstances presented by the financial crisis." *UBS,* No. 650097/2009, Dkt. 641 at 18-20 ("UBS's delay of approximately 11 days in conducting the auction, while seemingly *de minimis*, in fact had momentous financial consequences, given the delay occurred in the wake of the September 15, 2008 Lehman bankruptcy filing and at the height of the financial crisis.") Here, AGFP conducted its auction two *months* after the Early Termination Date.

Moreover, there is overwhelming evidence that efforts to perform Market Quotation valuations fail far more often than they succeed. For example, LBIE presented evidence that its other CDS counterparties tried to perform a Market Quotation process for 470 other trades, but

---

[37] In addition to refusing a novation, AGFP did not even attempt numerous other reasonable approaches to replace the trades. Tr. 4192:13-22, 4194:1-4197:2 (Bruce).

[38] Tr. 509:13-510:2, 542:5-542:18, 659:17-660:9, 761:24-766:6 (Viegas); JX-62, JX-63.

[39] Tr. 524:7-524:18, 537:9-538:3, 541:23-542:4, 544:14-544:18, 558:16-559:8 (Viegas).

41

were successful in determining a Market Quotation for only 27 of those trades. Tr. 478:5-478:15 (Viegas); LX092. That empirical evidence is consistent with the testimony of both parties' experts that Market Quotation processes routinely fail because they are often viewed as a "pricing exercise" rather than a real opportunity to trade. *See* Tr. 4213:2-14 (Bruce); Tr. 90:8-92:19 (Rahl); Tr. 1772:21-1773:8 (Niculescu); Tr. 2801:14-2802:6 (Cohn).

Any suggestion that the failure of a Market Quotation process necessarily disproves the availability or applicability of market pricing information is also inconsistent with the text of the ISDA Master Agreement, which makes Loss the default fallback methodology if Market Quotation cannot be determined, and which expressly permits a party calculating Loss to consider "quotations of relevant rates or prices from one or more leading dealers in the relevant markets." JX-01 at 15. As Justice Friedman recognized in her summary judgment opinion, "[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." SJ Decision at 31.

C. The Market Value Of The 28 Trades Was $498 Million In LBIE's Favor As Of The Early Termination Date

LBIE presented evidence at trial that there was ample market pricing information available to AGFP as of the Early Termination Date which AGFP could have and should have used to calculate Loss.[40] Dr. Niculescu explained in detail how he used that available information to determine an objectively reasonable market value for each of the trades at issue.

Dr. Niculescu calculated Loss on the two ABX trades using Markit's end-of-day pricing,

---

[40] *See, e.g.*, Tr. 873:21-874:6, 895:22-896:22, 906:21-908:8, 911:23-912:10 (Bruce); Tr. 1446:13-24, 1448:10-19, 1502:5-1503:6 (Niculescu); *see also, e.g.*, Tr. 444:5-12, 562:2-563:20 (Viegas) (indicative quotations were also available).

42

the same data-set that AGFP used to value the same trades in the ordinary course of its business. LX114; Repetto Dep. Tr. 80:11-23. As he explained, "[t]his was very straightforward. Markit simply publishes the prices. … So we just looked it up." Tr. 1446:13-24 (Niculescu). This was a simple calculation both because the widely-traded index provides a reliable data source for market prices and because the two ABX trades in this case involve completely market-standard payment, settlement, and termination terms. Tr. 1494:9-21 (Niculescu) ("the ABX trades were standard contract trades"); Tr. 4117:4-4118:23 (Bruce) ("they were entirely market standard terms"). Calculating a mid-market price for these trades requires nothing more than reference to Markit's published prices, which establish that they were worth $329 million to LBIE, the protection buyer, as of the Early Termination Date, as shown below. LDX06-26 to 27; LDX04-11 to 13.
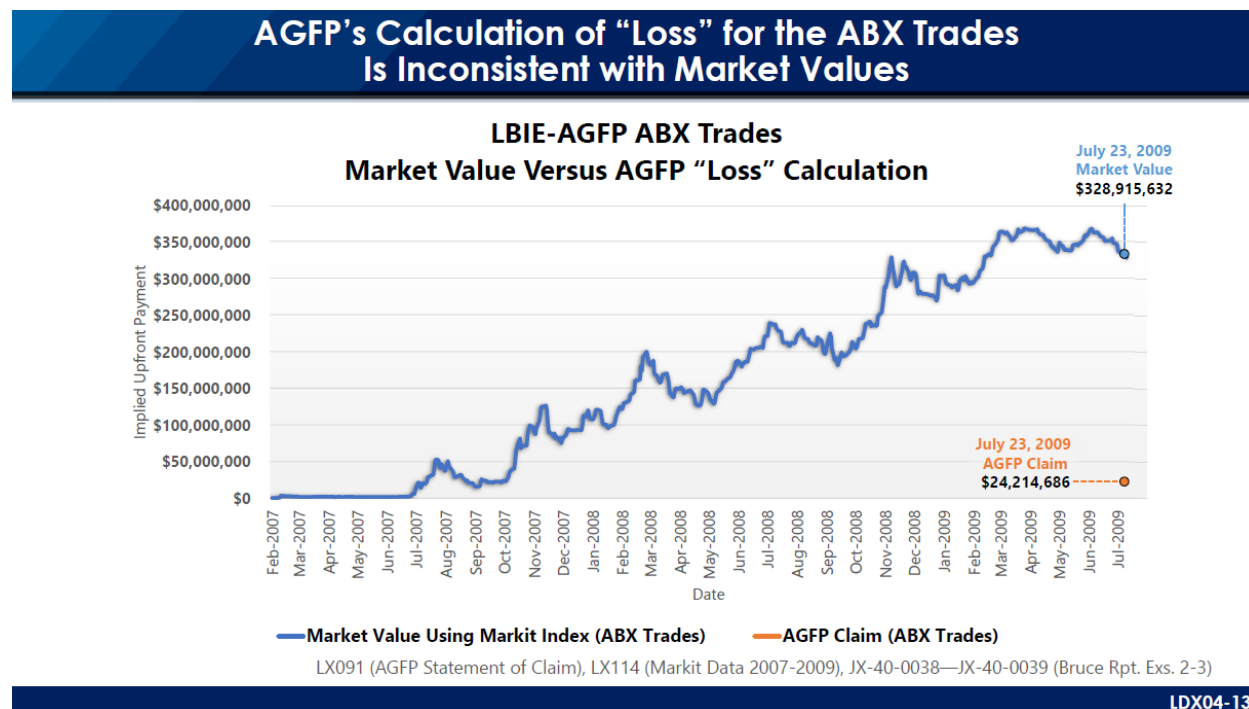
Notably, this value was *less* than the $352.5 million that AGFP recognized as the mid-market price for the same trades on June 30, 2009. LX170 (Tab "Q2 2009"). This evidence demonstrates the lack of any "legitimate explanations for Assured's calculation of a termination

43

payment to itself," and fully supports Justice Friedman's common-sense conclusion, at summary judgment that "[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." SJ Decision at 38-39.

The financial crisis, a worldwide phenomenon, also increased the likelihood of default by homebuyers in the United Kingdom, and thus the market price of CDS referencing UK RMBS. As Dr. Niculescu testified, the market price for these trades, which referenced more than $4 billion of securities, was also reliably calculated from third-party data provided by Markit. Tr. 1487:6-1488:18 (Niculescu); LX136. Dr. Niculescu adjusted Markit's market-price quotations on the same instruments underlying the trades here "to take into account [the] documentation difference" in the timing of the payments, which his analysis showed "was worth about 20 percent of the valuation of the trade"—an adjustment in AGFP's favor. Tr. 1492:10-1493:18 (Niculescu). Even after this conservative adjustment, the mid-market value of this protection on $4 billion of mortgage-backed securities was $137 million in LBIE's favor as of July 2009. LDX06-23.

Finally, the CLO trades, referencing "loans made to small and mid-sized businesses across the country, typically not investment-grade businesses," were similarly amenable to a market-standard market-price valuation. Tr. 1497:7-20, 1502:5-1503:6 (Niculescu). While Markit and other sources did not publish prices for CDS on CLOs, prices on indices reflecting "the [underlying] CLO securities themselves" were available. Tr. 1502:19-1503:6 (Niculescu); LX135 at 38. Dr. Niculescu then used "a completely market-standard process" to determine a market price for CDS referencing these CLOs, resulting in a $112 million mid-market price, again in LBIE's favor. Tr. 1505:2-1507:8 (Niculescu); LDX06-23.

Consistent with market practice, Dr. Niculescu applied a "bid-offer adjustment" to the mid-

44

market price, which estimates the price at which a replacement transaction could be executed. *See* Tr. 927:4-11 (Bruce); Tr. 1444:24-1445:3 (Niculescu); LDX06-23. Using a conservative estimate of such adjustments, Dr. Niculescu calculated such an adjustment for the 28 trades, which reduced their collective mid-market price of $578 million in LBIE's favor to a bid-adjusted market-price of $498 million in LBIE's favor. LDX06-23; Tr. 1444:6-23 (Niculescu). This value was effectively uncontested at trial; even AGFP's witness Mr. Prager accepted Dr. Niculescu's mid-market and bid-side valuations when calculating his own alternative values, which differed only through his application of a supposed "credit valuation adjustment" or "CVA." *See* ADX03-19.

A CVA, an accounting adjustment that discounts the expected value of a debtor's liabilities to account for the possibility that the debtor will be unable to pay them, is legally irrelevant to the determination of Loss under an ISDA Master Agreement. *See supra* Section III.C. Consistent with those precedents, no witness at trial reported ever seeing a Loss calculation incorporate a CVA. Tr. 326:9-326:21 (Rahl), 500:16-500:21 (Viegas), 931:1-931:17, 941:8-943:20 (Bruce); 1512:18-1513:3 (Niculescu). Any assertion by AGFP that it can discount its liabilities through a CVA would not be reconcilable with the simple fact that AGFP's own Loss calculation includes no CVA. Tr. 324:12-324:16 (Rahl), 933:11-933:13 (Bruce).

Even if a CVA were appropriate—which it is not as a matter of law—Dr. Niculescu presented detailed testimony and analysis demonstrating that any CVA adjustment could only reduce AGFP's payment obligation to LBIE, but could never eliminate it entirely. As he explained, a CVA is designed to estimate the likelihood that the protection seller (here, AGFP) is unable to make a future floating payment in the event the security underlying the CDS has defaulted. Tr. 1517:7-1518:14 (Niculescu). Using conservative assumptions regarding the relationship between a failure of the referenced securities and a failure of AGFP itself, Dr. Niculescu determined that

45

the resulting CVA would have only reduced the value of the trades to $249 million in LBIE's favor. LDX06-23. In fact, even if one were to assume a 100% correlation between the failure of the referenced securities and AGFP's own failure, that would still only reduce the value of the trades to $227 million in LBIE's favor. Tr. 1520:16-1521:18 (Niculescu). The supposed risk of AGFP's own failure in 2009 cannot explain AGFP's determination that the trades were worth $24 million *in its own favor*. That conclusion is fundamentally unreasonable and a breach of contract.

V. AGFP BREACHED THE PARTIES' CONTRACT BY CALCULATING A TERMINATION PAYMENT USING SUBJECTIVE, UNSUPPORTED, AND CONSENSUS-DEFYING ASSUMPTIONS ABOUT THE FUTURE

Part IV showed that there is no evidence that any other market participant has ever used or even discussed using a subjective insurance loss reserve methodology to calculate Loss under an ISDA Master Agreement. But even if AGFP was entitled to use a loss projection methodology to calculate Loss, it is law of the case, as discussed above in Section III.A, that AGFP was still required to measure Loss in a manner that was objectively reasonable and "in good faith." JX-01 at 15. This Part V details that, setting aside AGFP's insupportable choice of methodology, the specific projections, assumptions, and approaches AGFP used to project losses and value its CDS trades with LBIE were individually and collectively unreasonable and breached the parties' contract. Specifically, as detailed in Section V.A., at trial, AGFP failed to advance *any* evidence that could explain its projection of zero life-time losses for 26 of the 28 trades. As detailed in Sections V.B, C, and D, the evidence AGFP did provide regarding its projections for the remaining two ABX trades revealed that its projections were unsound, unsupported, directly at odds with contemporaneous projections from neutral third parties, and fundamentally biased by AGFP's one-sided position as a party on the hook if markets continued to suffer. AGFP's self-serving belief that zeros were appropriate for 26 trades and that subjective projections based on no contemporaneous analysis were appropriate for the remaining two is insufficient as a matter of law.

46

A.   **AGFP Produced No Competent Evidence At Trial Explaining Its Valuation For 26 Trades On UK RMBS Or CLO/CDO Reference Obligations**

In its Loss calculation, AGFP assumed that it would never have to pay out a single dollar of losses on any of the 26 CDS trades in which it sold LBIE credit protection on UK RMBS, CLO, or CDO instruments. *See* JX-34 at 8-10. The complete absence of any explanation for this assumption renders AGFP's valuation of these 26 trades legally deficient. *See, e.g.*, *Nick's Garage, Inc. v. Progressive Cas. Ins. Co.*, 875 F.3d 107, 120-21 (2d Cir. 2017) (applying New York law and holding that party with contractual obligation to "reasonably determine[]" rates could not do so simply by providing evidence of the rates determined without further explanation); *Metro Funding Corp. v. WestLB AG*, 2010 WL 1050315, *15 (S.D.N.Y. Mar. 19, 2010) (finding breach of contractual provision requiring party to "reasonably determine[]" whether loans remain collectible, where that party "offers no evidence" to support its determinations).

As described above, *see supra* Section II.G, none of AGFP's witnesses at trial testified with personal knowledge about how AGFP calculated projected losses on the UK RMBS, CLO, or CDO trades at issue. Nor did documentary evidence address the deficiency at the heart of AGFP's case. When AGFP's counsel sought to question Mr. Rosenblum about two spreadsheets purportedly created by the Surveillance Department, he admitted he did not know if he had so much as *seen* them at the time, Tr. 1306:5-9 (Rosenblum), and could not provide any definitive testimony about their provenance or creation, largely limiting himself only to describing what they "would have showed" and by whom it "would have been … generated." Tr. 1297:24-1299:15 (Rosenblum). There was no testimony or evidence about who *actually* created the documents, what the basis for any analysis *actually* was, or where any supporting data *actually* came from or was preserved. After trial, the failure of evidence remains unexplained, and is incompatible with a contractual obligation to calculate Loss reasonably.

47

Moreover, AGFP solicited Mr. Rosenblum's cursory and inadequate testimony with regard to only two such spreadsheets: AX20020, which purports to contain Surveillance Group analysis for a reference obligation underlying one of the twelve CLO trades, and AX20038A, which purports to contain the same type of analysis for one of the fourteen UK RMBS trades. *See* Tr. 1295:11-1310:25 (Rosenblum). Those documents, which contain no explanation regarding the assumptions and methodologies used by those who prepared them, provide no support for AGFP's conclusion that it would never have to make a payment on those two specific trades; by definition they provide no support for AGFP's identical conclusion with respect to the twenty-four *other* CLO, CDO, and UK RMBS trades. Recognizing this fatal deficiency of proof, AGFP sought to introduce more unexplained spreadsheets after trial, without ever placing them in front a witness—a tactic the Court rejected, ruling that if AGFP "wanted to use them, [it] should have laid a foundation at trial. They were not discussed at trial, they are out." Feb. 28, 2022 Hrg. Tr. 23:6-8. AGFP's inability, after more than a decade of litigation, to provide even the barest support for its projections that it would make no payments to LBIE on the UK RMBS and CLO trades cannot be squared with AGFP's contractual obligation to determine Loss "reasonably." JX-01 at 15.

B.   **Trial Established That AGFP's Analysis For The 2 ABX Trades Was Subjective, Unexplainable, And Impossible To Square With Objective Facts**

1.   Dire Contemporaneous Performance Data Indicated The Worst Subprime Market Ever Experienced

Where AGFP *did* present evidence of its Loss calculation in connection with the two ABX trades, it fared no better. The unreasonableness of AGFP's assumptions about the future performance of the ABX indices is glaring when placed within the economic context in which AGFP made these assumptions and when they are compared against performance data available in July 2009 regarding the dire situation in the U.S. subprime mortgage sector.

48

The rise of subprime. As trial established, beginning in the early 2000s, financial innovation created a boom in so-called "subprime" mortgages: home loans to borrowers with low credit scores, who put 10-20% down, had little savings, and typically received low "teaser" interest rates that reset to higher rates after about three years. Tr. 859:22-861:1 (Bruce); Tr. 1385:22-1387:8, 1390:1-8 (Niculescu). Because home prices were rising so rapidly, more than doubling in value from 2000 to 2006, as shown below, even diligent issuers only undertook to confirm that subprime borrowers could make mortgage payments during the first few years of low teaser mortgage rates, ignoring whether they would be able to pay higher rates in later years. Tr. 1387:2-8 (Niculescu); LDX06-5. Due to the increasing values of homes, the issuers figured that "once [borrowers] passed the first teaser rate they could refinance and get another mortgage if necessary." Tr. 1387:2-8 (Niculescu); *see also* Tr. 857:23-858:8 (Bruce).

Home Prices Had Fallen 33% Since Spring 2006 Peak
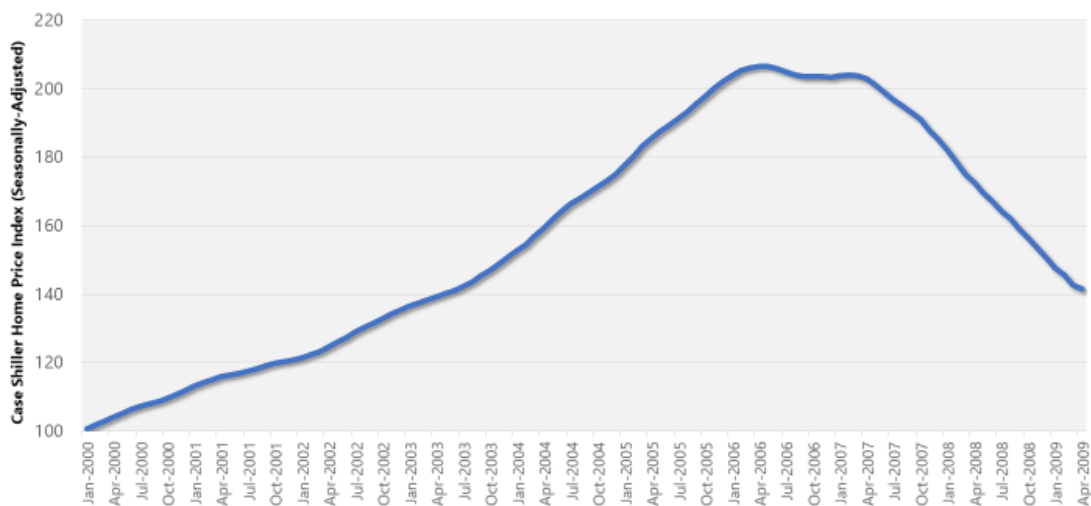
Rebuttal (JX43.90)

LDX06-5

And not all issuers were diligent enough to confirm borrowers' ability to make mortgage payments even in the short term. Many issued mortgages without verifying self-stated borrower income. Tr.

49

856:23-857:22 (Bruce). Borrowers regularly "misstated their income, or, frankly simply lied about it." Tr. 858:9-16 (Bruce). Nonetheless, this system worked so long as home prices kept rising.

The housing collapse. Home prices did not keep rising. In 2006, the same year the mortgages underlying the ABX trades were issued, home prices peaked and began to fall. In an "unprecedented" collapse, home prices lost 33% of their value by mid-2009. Tr. 1401:11-12 (Niculescu); Tr. 1201:7-23 (Rosenblum); LDX06-5 (above). When 2006-vintage mortgage loans were originally packaged up and sold into the securities behind the ABX, "nobody anticipated the depth and gravity of the – of the crisis and the decline in home prices." Tr. 1401:4-12 (Niculescu). This shocking collapse created the largest financial crisis since the Great Depression, driving up unemployment and generating "an economic crisis, not just in the United States but around the world." Tr. 863:20-864:9 (Bruce).

Immense pressures to default. The unprecedented 33% home price decline had "[a] very major impact" on the mortgages behind the ABX. Tr. 1389:23-25 (Niculescu). It wiped out borrowers' home equity, leaving them deeply "underwater." Tr. 1390:3-8 (Niculescu). As of 2009, home prices would have needed to rise 40% just to bring the value of these borrowers' homes in line with their existing mortgage balances. Tr. 3812:7-10 (Niculescu). And refinancing became impossible for most borrowers, just as teaser rates were replaced with much higher interest rates. Tr. 1390:9-18 (Niculescu).

The resultant pressure on underwater borrowers to default was significant. Tr. 3814:1-3819:20 (Niculescu). By mid-2009, default rates had risen dramatically to over 20% per year. LDX06-7. And for borrowers who had not yet defaulted, half were seriously delinquent or had entered foreclosure. Tr. 3814:14-21 (Niculescu); LDX06-13. Nearly all of those mortgages could

50

be expected to default, leading to foreclosure sales that would return only pennies on the dollar to

mortgage holders. Tr. 3814:19-21 (Niculescu); LDX06-8.
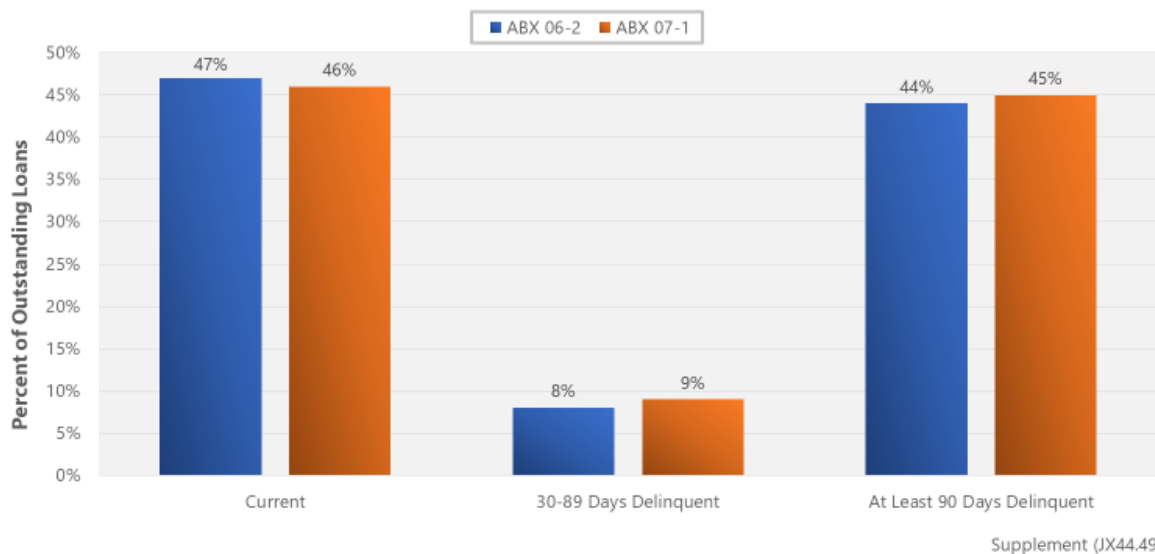
At trial, the Court asked whether "a fair percentage of the subprime borrowers" might elect

to "keep paying" in order to live in a home despite "ow[ing] more on the house than it's worth.

Tr. 3813:19-3814:7. As Dr. Niculescu testified, economic pressure meant that there was little

chance that borrowers who remained "currently current," or not yet delinquent, on their mortgage

payments would continue to avoid default throughout the crisis. Tr. 3816:13-16 (Niculescu). The

fact that these borrowers took out subprime loans in the first place reflected that only "some of

them had jobs," that they "had FICO scores typically lower than 620," that they had little savings,

and that they "had demonstrated they had a tough time managing money," for instance by

previously declaring bankruptcy. Tr. 1366:8-15 (Rosenblum); Tr. 3815:25-3816:18 (Niculescu).

Many had exaggerated or misstated their income when they got their loans in 2006, and their

incomes had fallen as unemployment rates nearly doubled, with enormous consequences for

borrowers' ability to pay their mortgages. LX123 at 9; Tr. 3814:25-3815:6 (Niculescu). The challenges borrowers faced by falling income were compounded by simultaneously rising mortgage payments. Tr. 3815:7-24 (Niculescu). Thus, regardless of buyers' potential desire to keep paying for their "underwater" homes, a basic lack of funds made it impossible for many to make mortgage payments, forcing them to relocate to lower cost options. Tr. 3814:25-3815:6 (Niculescu). The most recent historical data indicated that *at least 70% of "currently current" borrowers were likely to default* before their loans matured. Tr. 1400:14-22 (Niculescu). Combining this liquidation data with the delinquency data indicated that, of the borrowers left, less than 15% were expected to repay. LX119 at 10; LDX06-13.

Dr. Niculescu was not alone in his assessment. AGFP's witness Mr. Rosenblum also agreed that "these are low-credit-score borrowers . . . [who] could get a mortgage for ten percent down or, sometimes, no money down . . . [for whom] there's no equity in [their] house . . . [a]nd if the borrower doesn't have a job, can't make the mortgage payments, then the borrower has no incentive to continue to pay and is better off just turning the keys over to the bank[.]" Tr. 1366:8-1367:16 (Rosenblum). In other words, even AGFP's own witnesses agreed that economic pressures resulted in an extremely high likelihood that subprime borrowers would default on their mortgages no matter how much they might have wished to stay in their homes.

Rise in losses upon default. The same collapse in property values that led to more defaults also meant that lenders lost far more money when defaults occurred—resulting in far more losses to the ABX indices. In boom times, if a borrower defaulted, the lender might foreclose and sell the property for nearly as much as the borrower owed. In 2009, foreclosure sales returned far less—the "severity" of the loss from default was far higher. On loans that defaulted, severities had risen "tremendously" to never-seen levels of 74%. LDX06-8; Tr. 1393:12-1394:5 (Niculescu).

52

Losses on Defaulted ABX Loans Had Nearly Doubled
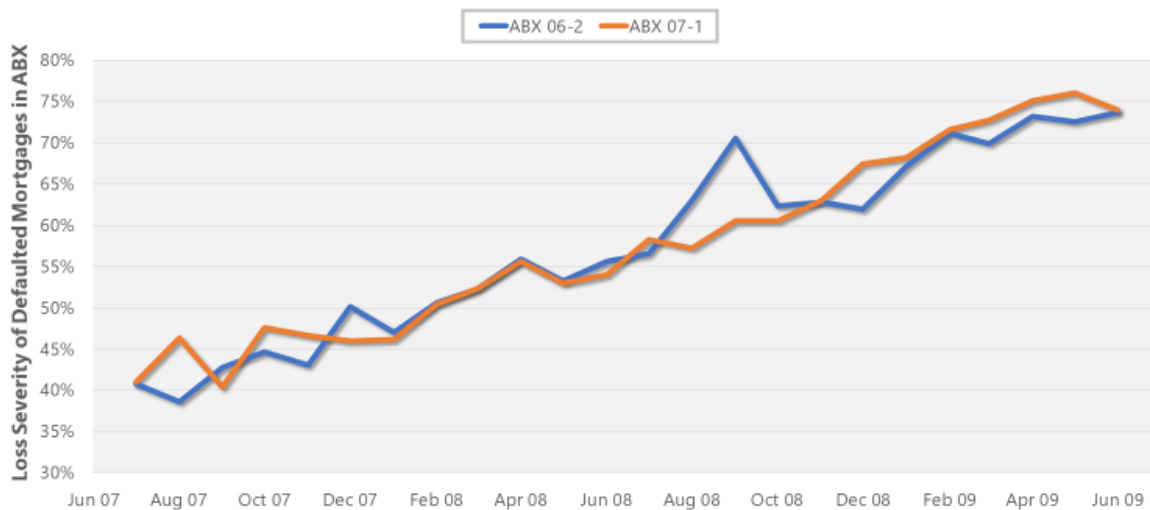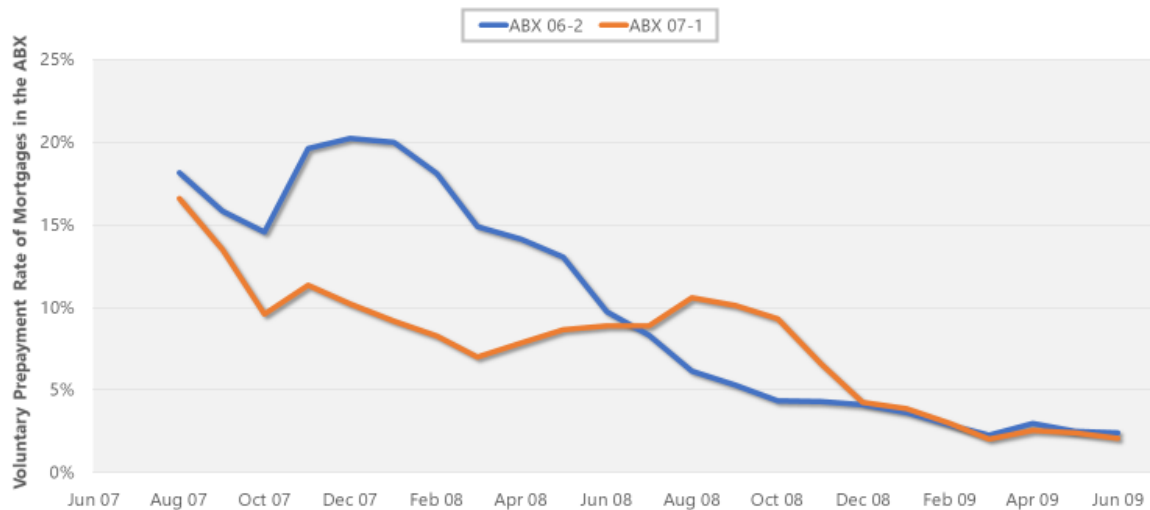
Rebuttal (JX43.16); LX263

LDX06-8

Collapse in prepayments. This lethal combination of declining borrower income, declining property value, and increasing interest rates also hit more mortgages than market participants had expected, because increasingly fewer loans were "prepaying," as shown below.

**ABX Prepayments Had Effectively Stopped**

Rebuttal (JX43.18); LX263

LDX06-6

In the housing boom times, around one-quarter of borrowers either refinanced or moved each year and repaid their existing mortgages. Tr. 1390:24-1391:14, 1398:17-22, 1427:17-19 (Niculescu). But by mid-2009, these prepayments fell "dramatically," to almost zero. LDX06-6; Tr. 1390:9-1391:14 (Niculescu).

Impact on the Last Cash Flow AAA ABX Tranche. Increasing default rates, increasing severities when loans *did* default, and decreasing prepayments squeezed the ABX tranche on which AGFP had sold protection from the top and the bottom. Tr. 1397:12-17, 1398:17-22 (Niculescu). Defaulted loans on which little was recovered caused losses that, by mid-2009, had eaten through more than half of the securities below AGFP's position. LDX06-11 (*see* light orange "Losses"). Simultaneously, while early prepayments had made more senior tranches whole, there were minimal prospects of further prepayments repaying the security AGFP backed. *Id.* (*see* light blue "Paid out"). This meant that, once losses hit the AAA level, more would be borne by AGFP.
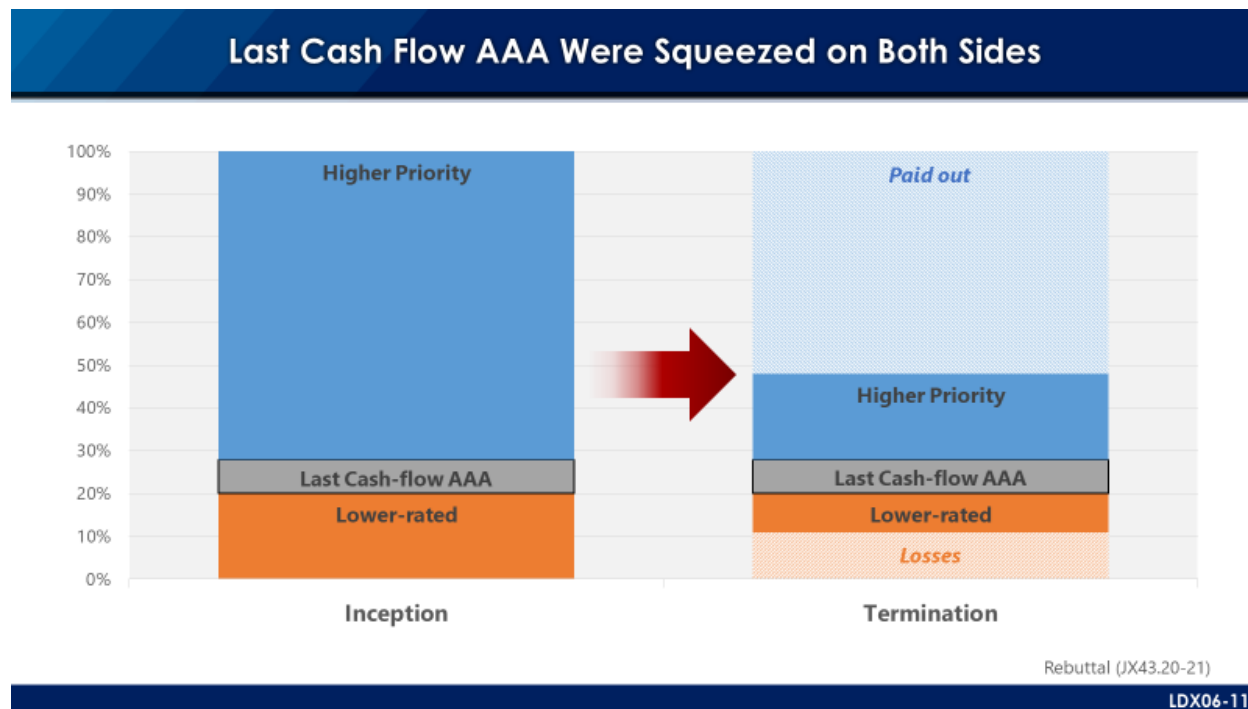
Another reflection of the dismal state of the loans behind the ABX indices as of mid-2009

54

was the change in ratings for the underlying securities. As shown below, these were initially all "AAA." By mid-2009, however, they had suffered unprecedented downgrades. LDX06-12. Some were already in default and almost all others were rated as junk bonds. Tr. 1143:11-18 (Rosenblum). In other words, even the ratings agencies agreed that defaults would soon hit securities that they had previously deemed perfect credits. Tr. 1399:7-22 (Niculescu).
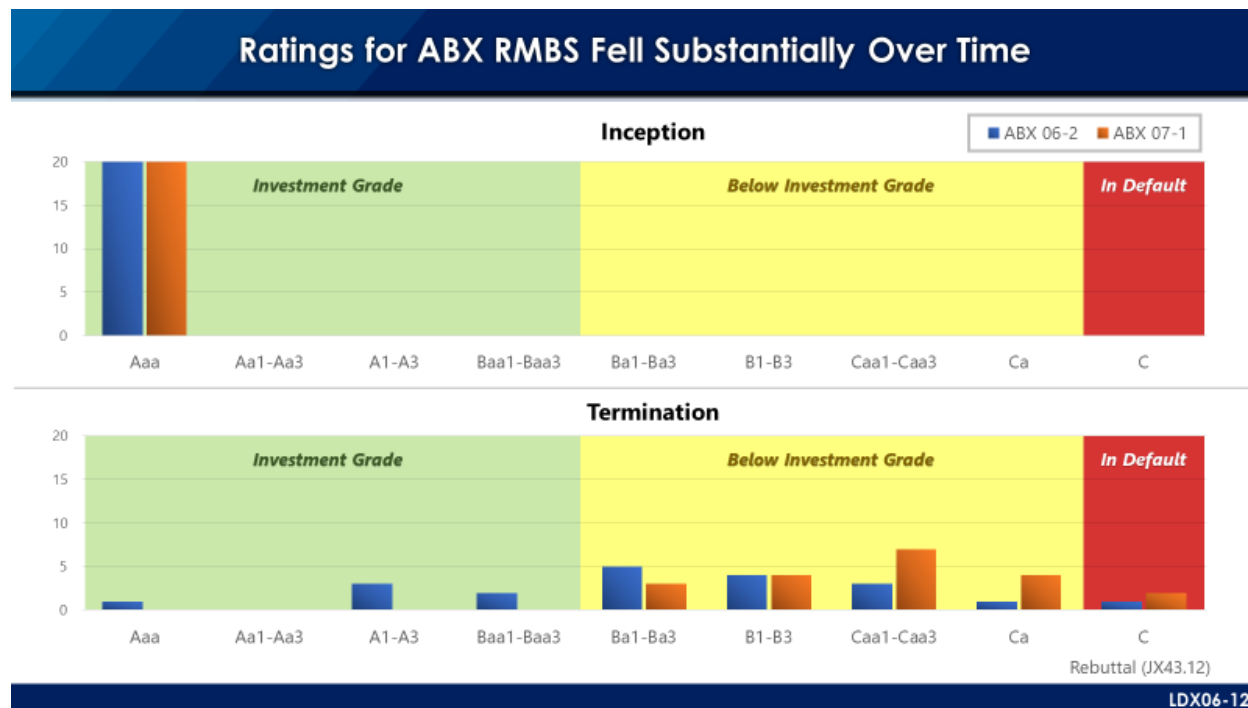
In sum, the contemporaneous market conditions and data reflecting those conditions was clear to all market watchers as of July 2009: the situation for borrowers remaining in the ABX mortgage pools was dire, home prices had collapsed, defaults and loss severities had risen to record highs, half of remaining loans were seriously delinquent, prepayments had ended, and the ABX bonds tied to these mortgages were junk-rated and facing imminent losses. LDX06-12.

> 2. AGFP's Rosy Assumptions Were Not Backed By Any Contemporaneous Data And Were Irrational And Inconsistent On Their Face

Against this backdrop, Chief Actuary Ben Rosenblum came to trial to try to explain the assumptions AGFP used to project the future performance of ABX mortgage loans and, ultimately,

55

the CDS contracts that reflected ABX performance. Tr. 1083:3-6, 1086:12-22 (Rosenblum). As described above, *see supra* Section II.G, Mr. Rosenblum's testimony revealed that AGFP's assumptions were subjective, based on no contemporaneous data, and out of step with all of the available objective information reflecting the economic present and projections of the future. Nor was AGFP's expert Mr. Prager able to offer the Court any justifications to fill these gaps.

At the outset, Mr. Rosenblum testified that although AGFP had previously relied on independent third-parties such as Blackrock to value derivatives trades for accounting purposes, it chose not to employ outside consultants to help it calculate expected losses on the ABX trades it terminated against LBIE. Tr. 1092:1-21, 1154:19-24 (Rosenblum). Instead, as discussed, AGFP simply chose its handful of assumptions through an off-the-record conversation among Reserve Committee members about their personal beliefs. Tr. 1155:11-23, 1157:10-14 (Rosenblum). AGFP knew, in doing so, that it was making assumptions that were more optimistic than "market consensus for these assumptions." Tr. 1158:2-9 (Rosenblum). Under the governing accounting standards, AGC was allowed to rely on its own subjective assumptions when determining loss reserves on Financial Guaranty Insurance policies. *See* JX-51 at 57 (FASB 163). But AGFP could not do so when calculating Loss amounts for CDS under the ISDA Master Agreement. As Justice Friedman explained, the ISDA requires Loss to be "commercially reasonable," a determination based on an "objective standard" of reasonableness. SJ Decision at 22. By determining Loss for the ABX trades according to its own subjective assumptions, rather than the objective market consensus, AGFP breached its obligation to calculate commercially reasonable Loss amounts.

As Dr. Niculescu explained at trial, AGFP's "assumptions all work in tandem . . . and the effect is cumulative." Tr. 1431:23-24 (Niculescu). AGFP started from an outdated and too-low initial rate of default, projected that this default rate would fall far faster than the evidence

56

supported, and then assumed that the artificially low number of projected defaults that resulted would each be less severe than available evidence already showed was the case—all while assuming that somehow many subprime borrowers would shortly begin not just paying the mortgages on homes that had lost 33% of their value but *prepaying* those loans in their entirety. At every turn these rosy assumptions benefited AGFP. Tr. 1431:7-1435:7; 1558:2-8 (Niculescu).

Mr. Rosenblum could not point to any analysis AGFP undertook to understand the impact of its optimistic assumptions on the ultimate dollar losses AGFP projected. But Dr. Niculescu undertook that analysis. He found that "what Assured's assumptions do is they project . . . a scenario where all that happens is the lower-rated tranches get eaten away . . . but only a tiny amount of [the tranches referenced in these ABX trades] gets eaten away." Tr. 1432:19-1433:6 (Niculescu). Specifically, AGFP's assumptions projected that 28% of the original mortgage pool would be lost, which translated into only $24 million of "Loss" at the tranche level. LDX10-6. But, "if [AGFP] had been just a little bit more pessimistic, or, perhaps, a little bit more realistic, you would have seen . . . significant losses" to the tranches on which AGFP owed LBIE protection. Tr. 1750:17-20 (Niculescu). S&P, for instance, projected that only 4% more of the original mortgage pool would be lost than AGFP , but this translated into *$83 million* of additional tranche-level losses. LDX10-6. Barclays projected 15% more of the original mortgage pool would be lost, and this translated into *$300 million* of additional tranche-level losses. *Id.* Effectively, AGFP predicted losses that would just barely touch their tranche, but once the tranche was breached even seemingly modest additional losses in the overall pool would cause heavy losses for AGFP.

Moreover, when it came to each of AGFP's individual assumptions, the evidence at trial established that AGFP's assumptions were not only subjective, unduly optimistic, and analysis-free, but also irrational and contradicted by the data and expectations available at the time.

57

Liquidation Rates Over Time. In defense of AGFP's use of liquidation rates based on nine-month-old data, *supra* Section I.G., Mr. Rosenblum contended that "liquidation rates don't change very much" and "the worst part, the hardest part for the housing market, was really through a lot of 2008. By 2009, the government was already beginning to try to – try to ameliorate the crisis" and thus "using the data from the last six months of 2008 . . . was . . . conservative." Tr. 1257:11-1258:2, 1258:19-1260:3 (Rosenblum). Neither Mr. Rosenblum, Mr. Prager, nor any other witness offered any analysis to show these contentions to be true. The data shows they were wrong.

Liquidation rates changed significantly as the crisis proceeded: whereas currently current ABX borrowers were (according to AGFP) defaulting at only a 26% rate in late 2008, by mid-2009 the recent data showed them defaulting at a 79% rate. ADX03-12; LX119-0010. No evidence supports the supposition that government efforts "to try to ameliorate" these numbers would so thoroughly reverse the trend that it would make sense to use a rate only one-third of the observed rate. As Dr. Niculescu testified, "The data had come in already. Those modifications programs for subprime really began in November of 2008. So we already had a number of months of data there." Tr. 3825:15-3826:15 (Niculescu). The data showed that already-significant government efforts were failing and, as a result, defaults were mounting. *Id.*; LX119-0010.

The "2001 Subprime Crisis." The evidence at trial showed that AGFP's assumptions regarding the default rate, loss severities, and prepayments—each of which Mr. Rosenblum testified was based on some employees' recollections of a subprime crisis in 2001, *see supra* Section I.G—were truly based on nothing. Remarkably, even Mr. Rosenblum himself agreed that the so-called 2001 crisis "wasn't as bad" and in fact did not "resemble[]" the 2009 crisis that was "certainly, at least in my lifetime, the worst financial crisis." Tr. 1175:1-21, 1276:9-12 (Rosenblum). In 2001, Dr. Niculescu was at Fannie Mae, managing investments for one of the

58

largest participants in the mortgage market. Tr. 1430:18-20 (Niculescu); LDX06-2. When asked to describe the 2001 subprime crisis that Mr. Rosenblum referenced, Dr. Niculescu testified that he had no idea what Mr. Rosenblum was talking about. Tr. 1430:13-1431:4 (Niculescu). To the contrary, "during those years, 2000/2001, home prices nationally grew quite substantially. There was no home price decline nationally. They went up." Tr. 1430:25-1431:2 (Niculescu); *see also* LDX06-5 (reflected that the Case Shiller Index did not reflect even a blip in 2001). Moreover, 2001 was "before the subprime sector was really invented . . . low FICOs really weren't a significant feature at the time, so we had no possibility of observing losses on that class of mortgages." Tr. 1430:21-24 (Niculescu). The data and testimony thus show that AGFP's reliance on memories of 2001 was misplaced and irrational. Notably, AGFP's counsel did not ask Mr. Prager a single question about whether AGFP's reliance on 2001 to choose its default rate, loss severity, and prepayments curves was at all reasonable. *See generally* Tr. 2990:1-3412:25 (Prager).

The Impact of Home Prices. Witnesses from both sides agreed that home price expectations have a fundamental effect on the key assumptions used to forecast ABX losses. Tr. 1182:17-1183:2, 1275:6-13, 1370:15-24 (Rosenblum); Tr. 1437:9-13 (Niculescu). Yet AGFP offered no evidence at trial of any expectations for changes in home prices from any third party that were consistent with its assumptions. For those assumptions to work, home prices would have been required to immediately rocket back up to their bubble highs of mid-2006 and beyond—Mr. Rosenblum conceded, and Dr. Niculescu agreed, that loss severities would not fall to 40% as AGFP predicted until home prices *exceeded* 2006 levels. Tr. 1370:7-24 (Rosenblum); Tr. 1395:18-1396:-9 (Niculescu). AGFP produced no evidence that it genuinely believed this unrealistic view (which, as discussed in the next section, market participants dismissed), and in testimony Mr. Rosenblum accompanied his concession with an assertion that reaching home prices in excess of 2006 levels

59

within three years, as AGFP's model assumed, simply required home prices "improv[ing], you know, depending on the scenario, a couple points—you know – four or five points every year." Tr. 1371:2-4 (Rosenblum). It takes only middle school math to disprove this assertion: since home prices had fallen 33% from their 2006 levels, it would take 20 years of 2% annual home appreciation ("a couple points"), or 8 years of 5% appreciation, to reach those 2006 levels again.[41] Contrary to Mr. Rosenblum's assertion, to reach 2006 levels within only three years, home prices would have to rise at over *a 14% annual rate*, triple the rate Mr. Rosenblum thought possible.[42]

Using more sophisticated analysis based on a Citigroup study, Dr. Niculescu showed that even a 20% increase in home prices was only expected to drop loss severities for defaulted loans from 74% to 66%. LDX06-9; Tr. 1394:7-1395:11 (Niculescu). In order to drive severities down to 40%, Dr. Niculescu estimated home prices would have to rise roughly 80%, "well past their earlier [2006] peak." Tr. 1395:18-1396:9, 1422:4-19 (Niculescu). Nobody thought this was possible. "There was a consensus that home prices would, most likely, continue to decline. . . . [Forecasts] ranged from down five percent to down 20 percent, with possible outliers in either direction; but I'm not aware of anybody – any reputable researcher – suggesting that they would start rising substantially and dramatically, no." Tr. 1422:23-1423:4 (Niculescu). *See also* Tr. 856:15-20 (Bruce); AX50089; AX50031 at 6; AX50044 at 1; LX137 at 3; LX123 at 10.

The range of home price forecasts also indicated a strong likelihood that most borrowers behind the ABX who were current would ultimately default. As Dr. Niculescu explained, even under an optimistic home price forecast similar to projections by Moody's and S&P:

---

[41] Homes in mid-2009 were worth 67% of their value in 2006. If those homes rose in value by 2% each year for 20 years they would reach 100% of their 2006 values. $67\% * (1 + 2\%)^{20} = 100\%$. If those homes rose in value by 5% each year for eight years they would reach 99% of their 2006 values. $67\% * (1 + 5\%)^{8} = 99\%$.

[42] $67\% * (1 + 14\%)^{3} = 99\%$.

60

"if [a borrower is] 40 percent under water, which they were on average in this group in July of [200]9, then they're going to be more under water within a year and they're going to stay the same degree for four or five years. And even after that it's going to take decades to get back. . . . [T]hey're going to be under water on their mortgages for a very, very long time. So whatever pressures they feel about having a very large amount of debt to pay off relative to the value of their house, that pressure is going to stay in place."

Tr. 3820:7-3822:25 (Niculescu) (referencing AX50089 at 10 and Tr. 3375:4-23 (Prager)). No witness offered any rational explanation as to how 74% of still-current borrowers would manage to continue to make payments for decades, notwithstanding immense pressures to default and given these borrowers' credit histories. ADX03-12

C. Other Market Participants, Including Banks And Ratings Agencies, All Projected Far More ABX Losses Than Did AGFP

While AGFP's approach to selecting assumptions for ABX loss projections was to have an internal off-the-record chat, without conducting detailed analysis or referring to others' contemporary analysis, other market participants exposed to subprime risk were far more rigorous and, based on their rigorous analysis, projected far more losses. As Mr. Bruce testified, his "responsibility at Commerzbank was to try to ensure that the forecasts we were making were as accurate as I could achieve, and to do that, I wanted to get as much input as – from others as possible to make sure I wasn't making a mistake." Tr. 862:1-12 (Bruce). To that end, Mr. Bruce and his team "sat with the research teams of some of the large investment banks, people like JPMorgan, Morgan Stanley, Merrill Lynch, who published research on the housing markets and the crisis and what was happening, and we sought their views and we gave them our views. There was an interchange of information[.]" *Id.*

At trial, Dr. Niculescu presented detailed evidence of what AGFP would have found had it, like Commerzbank, studied contemporaneous housing market research from reputable, qualified, and well-resourced research teams. AGFP would have seen that its assumptions were

61

far more optimistic than those used by others. Mr. Rosenblum conceded that, while AGFP looked at no research, it was aware this was true, and Mr. Prager did not contest the point except with respect to the narrow issue of initial loss severities. Tr. 1158:2-9 (Rosenblum); ADX03-11-13.

As Dr. Niculescu testified, "there were three or four large firms that had really invested in doing good quality mortgage credit research; they put the resources in it; they had the people with the expertise; they were gathering the data; [and] they were doing the analysis and the quantitative work[.]" Tr. 1413:7-15 (Niculescu). In particular, Dr. Niculescu consulted and relied on mortgage research from July 2009 published by research divisions of Barclays, Bank of America Merrill Lynch, and JPMorgan Chase, which were all "premier research groups," "top-flight, kind of the gold standard." Tr. 1413:11-24 (Niculescu).

Barclays was "[a]t the time in question, 2009, the first-placed fixed income research team" according to Institutional Investor Magazine's poll of market-wide users of research. Tr. 3864:10-21 (Niculescu). However, "Barclays had a sophisticated model, which was proprietary," and did not share specific assumptions that could be compared to those that AGFP used. Tr. 1439:23-25, LX137 at 2-3. Thus, the best available comparators to AGFP's assumptions come from JP Morgan, "second place" in Institutional Investor's poll, and Bank of America, "third place." Tr. 3864:18-19 (Niculescu). Each entity published assumptions they used in late July 2009 that can be compared apples-to-apples with AGFP assumptions about liquidation rates, default rates, loss severities, prepayments, and home prices. LDX06-15; LDX06-16; LDX10-5.

Liquidation Rates. With respect to liquidation rate assumptions, AGFP projected, based on stale data from the last six months of 2008, that many but not all mortgages that were already delinquent (slightly more than half of those left) would default and be liquidated. ADX03-12. For

62

mortgages that were not yet delinquent, AGFP projected that only 26% would default. *Id.*[43] As

shown below, Dr. Niculescu compared these assumptions to JP Morgan's. JP Morgan conducted

its analysis based on the last "6 months' historical experience" as of "July 10, 2009." LX119 at

10; Tr. 1164:5-1165:6 (Rosenblum); JX-71 at 23. Based on this updated data, JP Morgan offered

significantly more pessimistic assumptions, namely that almost every already-delinquent loan

would default, and that nearly 80% of loans that were not yet delinquent would also default over

time. LX119 at 10.

Lifetime Liquidation Rates Across Models

Delinquency Bucket	Assured	Fitch	JP Morgan
Current	26%	67%	79%
30+	45%	72%	84%
60+	65%	90%	87%
90+	70%	93%	89%
FC	85%	100%	93%
REO	100%	100%	100%

JX71-23, ADX03-12, LX367, LX119-10

LDX10-5

The ratings agency Fitch also provided liquidation rate projections comparable to AGFP's.

Like JP Morgan, Fitch offered far more pessimistic assumptions than AGFP across the board,

---

[43] As Mr. Prager detailed in ADX03-12, Assured assumed that defaults of already-delinquent loans would occur within the next two years ("borrowers who are late on payments in 2009 projected to default by 2011") and assumed any defaults of currently current loans would occur only after two years ("borrowers who are current on payments projected to default after 2011"). ADX03-12. Nevertheless, the rates shown on Mr. Prager's slide are *lifetime* default rates, that can be compared apples-to-apples with lifetime default rates published by others. *Id.*; Tr. 3891:12-22 (Niculescu).

including projecting that about two-thirds of currently current borrowers would default, rather than AGFP's one-quarter. LDX10-5[44]; LX367. And while Dr. Niculescu testified that in 2009 ratings agencies' projections were widely seen as "optimistic" and "not accurate" due to their "universally known" "conflict of interest," of the three ratings agencies, "Fitch was the one making the most serious efforts to put in place real modeling, real statistical modeling." Tr. 3841:2-3842:1, 3847:10-12 (Niculescu). That said, Dr. Niculescu looked broadly and was also able to locate partial liquidation rate information from Moody's and MBIA, another monoline. Tr. 1403:17-1404:9 (Niculescu). These data too showed assumptions more pessimistic than AGFP's. *Id.*

Default Rates. With respect to default rates, AGFP's assumptions were "dramatically different from market expectations." Tr. 1430:1-4 (Niculescu).
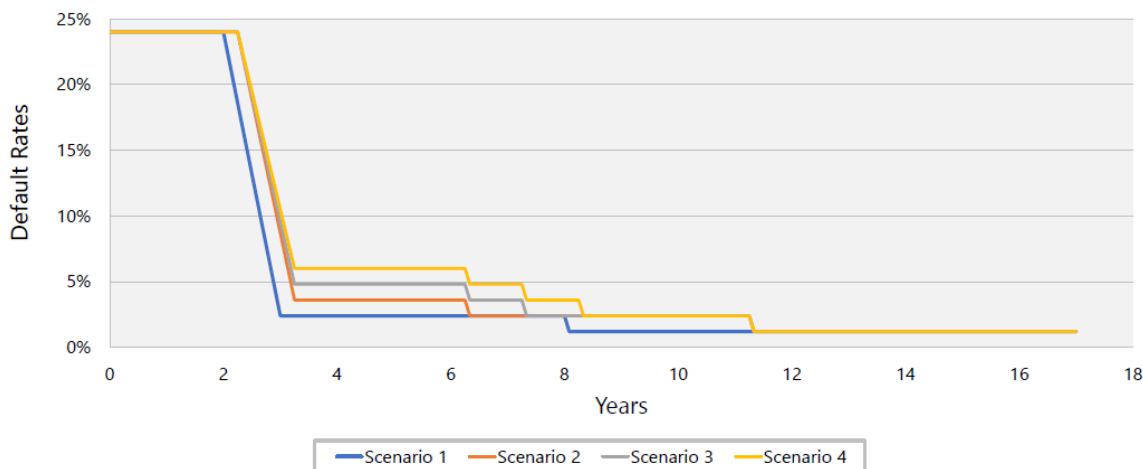

As shown above, AGFP assumed an initial default rate of 24% and then assumed that rate

---

44 In the demonstrative, "FC" stands for "in foreclosure," and "REO" stands for "real estate owned," meaning the property has been foreclosed and is awaiting auction.

64

would come "down very rapidly to between one-tenth and one-quarter of the starting level." Tr. 1745:3-12 (Niculescu). In contrast, Bank of America's initial default rate was almost 40% higher, at 33%. LDX06-16; LX123 at 23. Overall, as Dr. Niculescu summarized, "Bank of America['s default curve] started higher and remained higher over at least the next several years – AG started lower and then dramatically reduced their projected defaults." Tr. 1754:13-16 (Niculescu). Dr. Niculescu's analysis of the JP Morgan and Barclays models likewise indicated that overall "[t]he banks were projecting dramatically higher defaults than AG." Tr. 1754:17-21 (Niculescu).

Loss Severities. With respect to loss severities, the story was the same. JP Morgan, whose assumptions were similar to "most other forecasters," provided a loss severity curve projection that was easily comparable to AGFP's. Tr. 1755:8-15 (Niculescu); LDX06-15; LX129 at 16. As shown below, it was far higher throughout the coming decade.
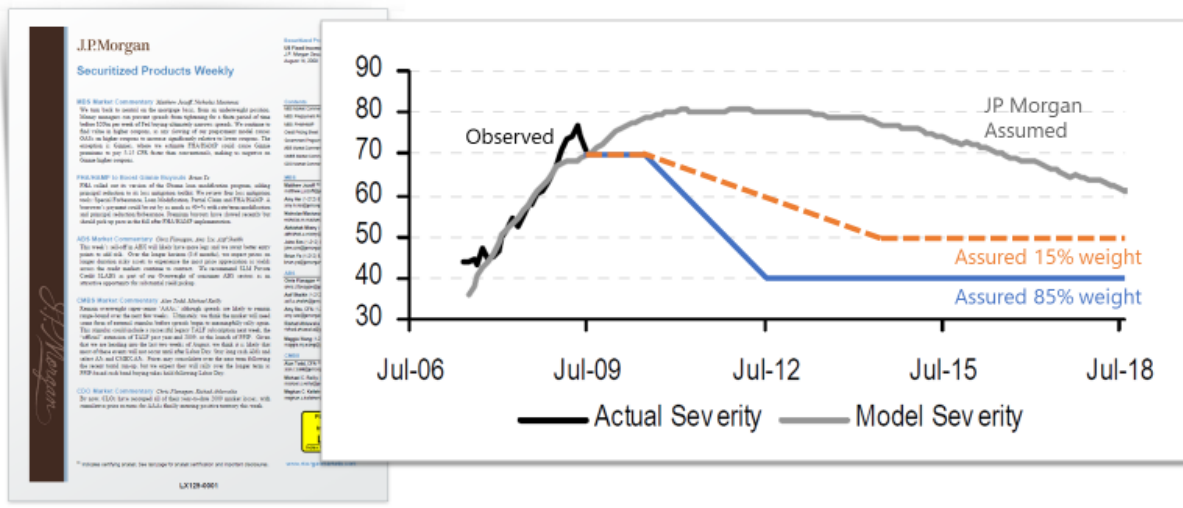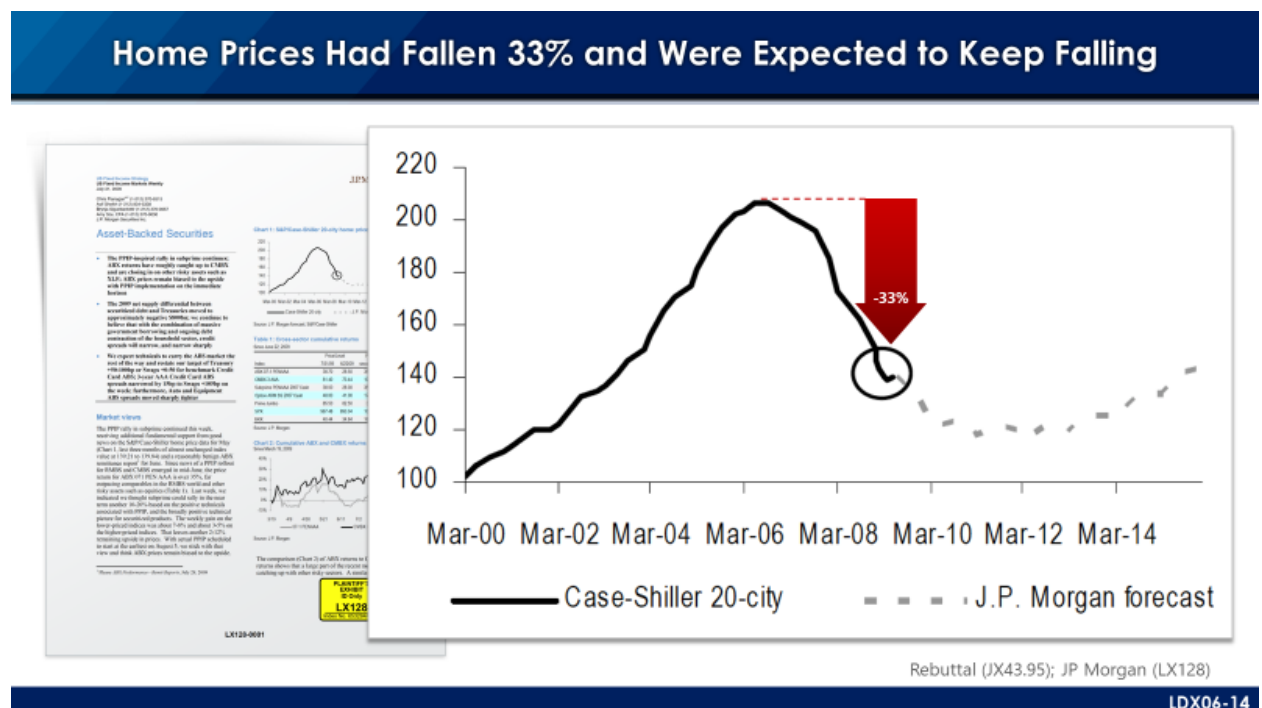

Other than *initial* loss severity, Mr. Prager did not contest that AGFP was below the very bottom of the distribution of market assumptions. ADX03-11. For this one assumption, Mr.

65

Prager attempted to show that AGFP was "right in the middle of the pack," but his comparisons are inapt and misleading. ADX03-11; Tr. 3065:11-15.[45] Putting aside whether the figures in ADX03-11 are apples-to-apples and contemporaneous (a contention Mr. Prager never offered, *see* Tr. 3065:1-20 (Prager)), the fundamental problem with AGFP's loss severity assumptions is not the starting level but instead the levels AGFP assumed ***over time***. As Mr. Prager states in large bold letters on his slide, he considered only "Initial" levels, where AGFP had little ability to impose an optimistic view without contradicting undeniable, observable reality. Mr. Prager did not and could not deny that in its projections about the future, a far more fertile ground for optimistic shading, AGFP projected far different loss severity assumptions from others. For instance, S&P, a generally optimistic source, assumed that loss severities would remain at 70% indefinitely. AX50031 at 3. S&P's support for its projection of elevated loss severities was similar to JP Morgan's: "to reflect additional market value declines and the increasing inventory of real-estate owned properties." *Id.* So while S&P and AGFP started their projections with roughly the same levels of initial loss severities close to what the market was observing at that moment, AGFP's assumption that this initial, observed 70% loss severity would quickly fall to 40% in the near future bore no resemblance to S&P's overall loss severity projections. LDX06-15; JX-71 at 28.

Prepayments. With respect to future prepayments, again the data showed AGFP being far more optimistic than others. While AGFP assumed prepayments would rise to 13% within a few years, Bank of America assumed they would remain around 2% indefinitely. LDX06-16. Bank of America's view was consistent with market views generally. Tr. 1427:22-23 (Niculescu).

---

[45] Contrary to Mr. Prager's depiction in ADX03-11, Dr. Niculescu never offered his own loss severity assumption; rather Dr. Niculescu observed, and Mr. Prager did not contest, that the most recent available data as of July 23, 2009 showed ABX severities at 74%. LDX06-8; LX263. Even Assured's own data reflected the same. JX-71 at 12, 27.

66

Housing Prices. There was also substantial evidence at trial as to various market participants' expectations for home prices on or around July 23, 2009. The Court repeatedly saw a home price projection curve from JP Morgan, below, that continued to decline for years after mid-2009 and then slowly rise over time, only recovering to 2009 levels around 2015, and not reaching 2006 levels for many more years. *See also, e.g.,* AX50089 (showing a wide range of JP Morgan home price assumptions as of February 2009, all assuming more than a decade to return to 2006 levels).

Home Prices Had Fallen 33% and Were Expected to Keep Falling

Rebuttal (JX43.95); JP Morgan (LX128)

LDX06-14

Barclays considered a range of predictions, all of which projected home prices to continue to fall between 20% and 0%. LX137 at 3. Bank of America projected "further correction of around 10-15% (Q2 2009-Q4 2010)." LX123 at 10. Mr. Bruce testified that at Commerzbank "our expectations, [based on] a lot of market data, was that we didn't expect to see the bottom of the crisis when house prices stopped declining until probably around the middle of 2012, although . . . we felt there was a risk it might actually be longer than that." Tr. 856:15-20 (Bruce). Likewise,

67

S&P projected "an additional 5%-7%" decline before "prices start to stabilize in the first half of 2010, marking an overall decline of approximately 37% from the July 2006 peak." AX50031 at 6. Moody's projected home prices would "continue to fall until the middle of next year because of the large overhang in foreclosures and the slow start of [government modification efforts]." AX50044 at 1. That is, even Moody's and S&P expected home prices to, at the least, continue to be low for some time, and then only slowly recover. AX50031 at 6; AX50044 at 15. While views regarding future home prices differed to a degree, absolutely no one expected house prices to immediately reverse course and spike upwards, as required to generate AGFP's loss reserves and ultimately its Loss calculation.

In sum, with respect to each of the individual key assumptions that went into AGFP's projection of losses for the ABX trades—liquidation rates, default rates, loss severities, prepayments, and home prices—the evidence at trial showed that AGFP chose assumptions at every turn that generated lower losses than what others in the market were projecting. Put together, AGFP's assumptions built on one another and generated far lower projected losses to the pool of mortgages underlying the ABX. LDX10-4.

As shown below, while AGFP's assumptions projected that about one third of the remaining mortgage pool (the "current balance") would be lost, Barclays, Bank of America, and JP Morgan all projected that about two thirds would be lost, Fitch projected 60% losses, and even S&P projected 44% losses. *Id.* While AGFP's projection was more consistent with Goldman's from June 2008 and S&P's from February 2009, this underscores how important it was to use updated data for projections, and the impact of AGFP's reliance on liquidation data "nine months out of date" and other assumptions tied to vague recollections of 2001 that were blatantly inapt by mid-2009. *Supra* Section V.B.2.

68

Projected ABX-related Collateral Losses From Available Reports

PROJECTED LOSS SHOWN AS A PERCENT OF **CURRENT** BALANCE

Entity	As of Date	Projection	ABX-Specific?	Source
Barclays	July 24, 2009	67%	X	LX137-3, LX263
Assured	July 23, 2009	36%	X	JX43-135
BofA	July 23, 2009	67%	X	LX123-23
JP Morgan	July 9, 2009	65% / 74%	--	LX119-11, LX263
S&P	July 6, 2009	44%	--	AX50031-4, LX263
Fitch	June 12, 2009	60%	--	LX367
Moody's	March 5, 2009	41%	--	AX50083-1, LX263
JP Morgan	February 25, 2009	41% / 49%	X	AX50089-1 to 2, LX263
S&P	February 6, 2009	32%	--	AX-50090-2, LX263
Goldman	June 6, 2008	30%	X	AX50084-24, LX263

LDX10-4

D. Replacing AGFP's Subjective, Unexplainable, And Outdated ABX Assumptions With Projections From Third Parties Results In A Loss Payment Of, On Average, $305 Million In LBIE's Favor

Unsurprisingly, using AGFP's subjective and unduly optimistic projections resulted in a far smaller estimated Loss for the ABX trades than would have been generated by using loss projections from other market participants. Evidence at trial confirmed that AGFP's self-interested projections were more optimistic than any other contemporary projections, and that the better resourced and trusted the projecting party, the more extreme the difference.

Both bank research desks and rating agencies produced projections like the ones AGFP prepared internally, but their quality and reliability varied. Research departments at major banks are not staffed by traders or others with an interest in the level of losses projected, but instead by "professional research people, many of whom would have Ph.D.s or masters degrees relevant to the area." Tr. 1382:6-22 (Niculescu). Unlike trading positions, which "come and go frequently," the loss projection models at banks are "put in place and run and rerun over many months." Tr. 3864:22-3866:1 (Niculescu). It was uncontested at trial that such researchers' "first incentive"

69

was not to apply a positive or negative spin, but instead "to make sure that your clients trust you, and your credibility," a system that was reinforced by public awards for the teams "most helpful" to *users* of the research who had positions going both ways in the marketplace. Tr. 3864:13-3864:21 (Niculescu). As such, "[t]here is really no conceivable way that that process is going to be corrupted and/or tainted." Tr. 3865:14-15 (Niculescu).

In contrast, ratings agencies were, in the words of AGFP's own expert, "always the last to know. All too often they serve the same function as the Crime Scene Unit guy who draws the chalk line around the corpse on the sidewalk. Or, to put it differently, they're coroners rather than diagnostic physicians." Tr. 3674:23-3675:20 (Pirrong). "[T]he ratings agencies are for-profit entities who made money by selling ratings. And that created a well understood, well recognized conflict of interest at the time." Tr. 3841:16-19 (Niculescu). These agencies had strong incentives to project low losses that justified higher credit ratings, because too much pessimism would drive issuers to take their business to a competitor agency willing to shade its projections. Tr. 3841:2-5, 3846:19-3845:17 (Niculescu). The result was, in the words of AGC itself, that "the agencies clearly underestimated, by large margins, the potential severity . . . in their rating processes." LX266 at 7; *see also* LX438 at 41 (Congressional Oversight Panel Jan. 2009 report recognizing that "the credit rating system is ineffective and plagued with conflicts of interest"); AX50022 (Financial Crisis Inquiry Commission Report) at 241, 251 (similar). While Fitch had earned a reputation for more reliable projections than Moody's and S&P, which "had achieved a certain notoriety," Tr. 1738:22-1739:2 (Niculescu), the witnesses with market experience at the time relied on bank projections, not rating agencies. Tr. 3896:17-25 (Niculescu); 4148:13-4149:10 (Bruce).

Dr. Niculescu testified at trial about his analysis of ABX loss projections that the "premier research groups" at JP Morgan, Bank of America, and Barclays produced at the time. Tr. 1413:5-

70

25 (Niculescu). Reports by these research groups included both observed data and detailed projections about how the data would change in the future. *See* LX119 (JP Morgan), LX129 (JP Morgan); LX123 (Bank of America); LX137 (Barclays). Barclays' overall loss projection was the simplest to compare to AGFP's ABX Loss calculation as Barclays projected the same loss metric. Tr. 1436:19-1437:4 (Niculescu). Dr. Niculescu undertook additional calculations that used the figures available from JP Morgan and Bank of America in a manner that was apples-to-apples comparable to AGFP's projected losses, and ultimately generated figures for each of the three research groups, including two different JP Morgan models, that can be compared directly to AGFP's. Tr. 1435:10-1436:18 (Niculescu); LDX06-18. LDX06-21 below shows his findings.

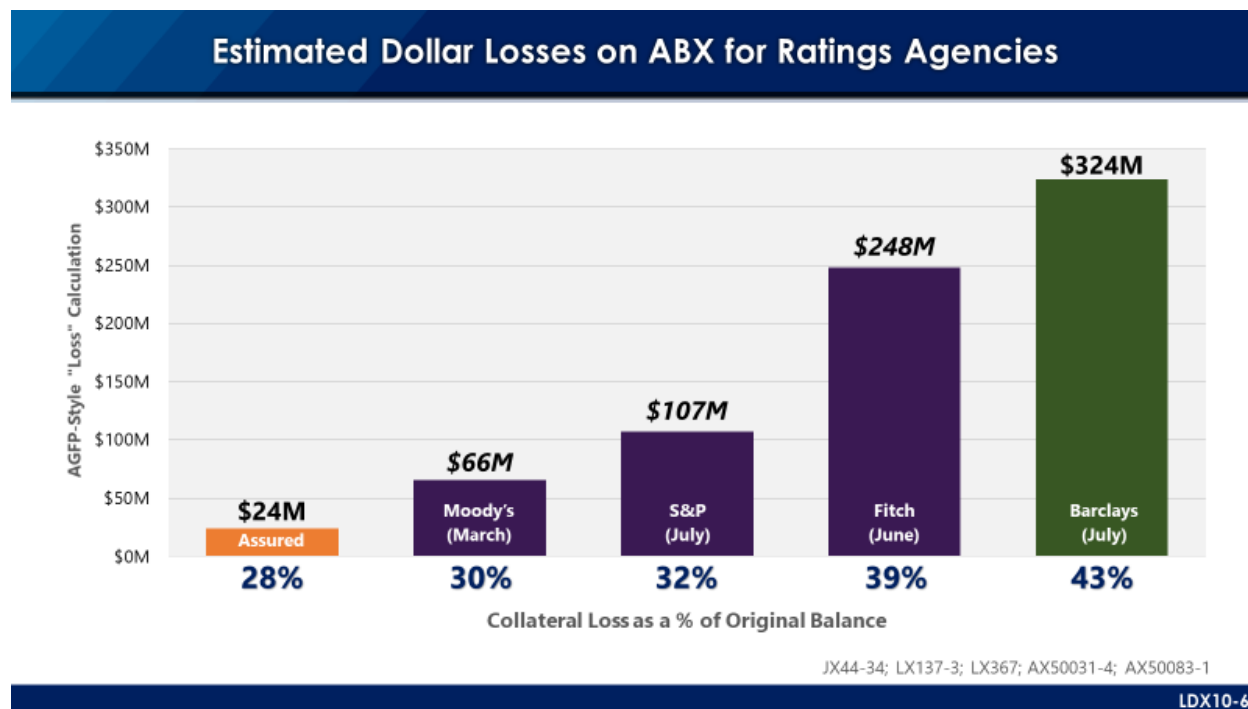

Market Research Expected Losses Close to the Price
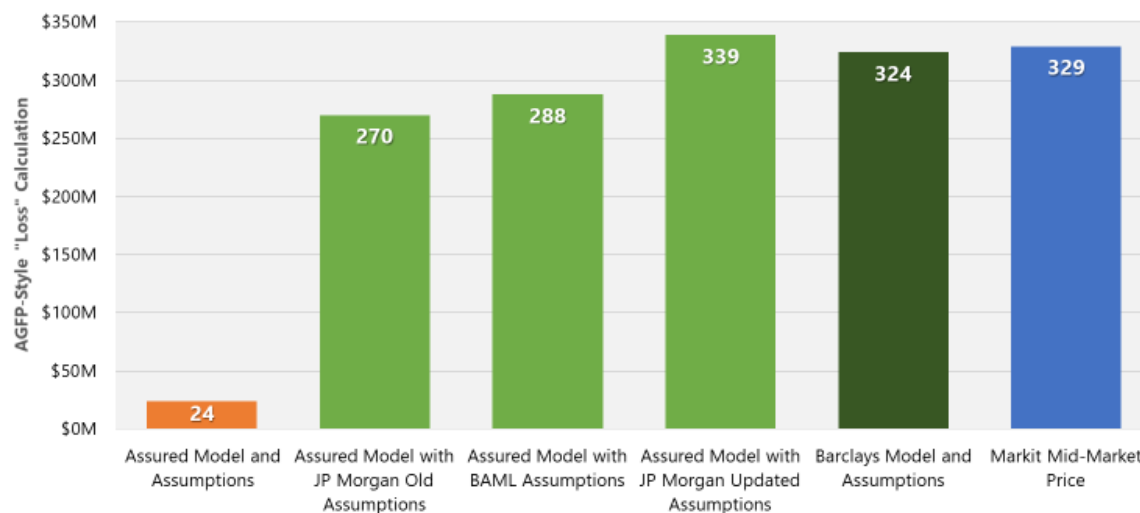
Supplement (JX44.6); LX114, LX119.10-11, LX123.23, LX129.16, LX137.3

LDX06-21

The research from these banks' research divisions, the gold standard for market projections in 2009, indicated an average of $305 million in net projected losses on the tranches of the ABX trades against which AGFP had sold protection. *Id.* The proximity between these objective sources and the observed mid-market price, and the gulf between all of these sources and AGFP's

projections, underscores the necessity of objective data rather than internal assumptions and demonstrates the unreasonableness of AGFP's Loss calculation and the extent of its breach.

Contemporaneous published projections from the ratings agencies were of a piece, as shown below. As Dr. Niculescu testified in his rebuttal testimony, Fitch's analysis, the most reliable of these sources, indicated about $248 million in ABX losses in June 2009; and the only other contemporaneous ratings agency analysis, from S&P in July 2009, indicated about $107 million in losses. LDX10-6; Tr. 3894:15-3896:16 (Niculescu). Indeed, even Moody's loss analyses from March 2009, which were far out of date by the time AGFP terminated its trades and by definition could not reflect the subsequent months of further declining data, indicated losses nearly three times larger than AGFP's projection. *Id.*

Estimated Dollar Losses on ABX for Ratings Agencies

	Assured	Moody's (March)	S&P (July)	Fitch (June)	Barclays (July)
Loss	$24M	$66M	$107M	$248M	$324M
Collateral Loss as a % of Original Balance	28%	30%	32%	39%	43%

JX44-34; LX137-3; LX367; AX50031-4; AX50083-1

LDX10-6

Overall, even putting aside the subjective loss reserve projection methodology AGFP chose, the record evidence shows that the level of AGFP's projected losses, which underlie a request for millions of dollars from LBIE, is also insupportable. At every turn, AGFP chose assumptions that:

72

diverged from existing market data (Section V.B.1); that were based on either no reasoning, stale numbers, or illogical theories (Section V.B.2); and that stood out from any fair comparison against contemporary projections in the market, whether such comparisons are drawn against individual assumptions and mortgage-level losses (Section V.C), or against ultimate ABX tranche-level losses (Section V.D). In all these respects AGFP was systematically unreasonable: it was alone on an island apart from any independent objective view among market participants.

VI. AGFP OWES LBIE DAMAGES OF $485 MILLION

AGFP breached the parties' contract, *both* by unreasonably calculating Loss without regard to available market prices, *and* by calculating Loss on the basis of self-serving, subjective, and unsupported assumptions. Either is a sufficient, compelling basis for this Court to discard AGFP's unreasonable Loss calculation, and to instead award LBIE damages in the amount of a reasonable and objective Loss calculation sufficient to put LBIE "in the same economic position [it] would have been in had [AGFP] fulfilled the contract." *Lucente v. Int'l Bus. Machines Corp.*, 310 F.3d 243, 262 (2d Cir. 2002). As detailed above in Section III.B., it is well-settled in New York 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.'" *UBS*, No. 650097/2009, Nov. 14, 2009 (Decision and Order After Trial) (Friedman, J.), at 20 (quoting *Sharma*, 916 F.2d at 825).

Had AGFP fulfilled its contractual obligation to act reasonably and in good faith, it would have calculated Loss in accordance with the governing legal standards that require Loss to be calculated consistent with market practice and market values. As explained above in Section IV.C, Dr. Niculescu has calculated that a party in AGFP's position that undertook a reasonable, market-standard approach, would have concluded that, as of July 23, 2009, each of the trades had a determinable bid-side market value: the ABX trades were worth $325 million to LBIE, the UK RMBS trades were worth $76 million to LBIE, and the CLO trades were worth $96 million to

73

LBIE, for a total of $498 million. LDX06-23. This valuation is consistent with New York law for the calculation of loss of bargain damages and with market practice for the calculation of Loss. After adding Unpaid Amounts, this approach yields a Termination Amount of **$485 million due to LBIE**. LDX06-49; Tr. 1537:12-22 (Niculescu).

Should this Court conclude that AGFP was not obliged to follow market practice or to reach a result consistent with market values, and was instead entitled to value the trades based on expected net losses as of July 23, 2009, it is the law of the case that "an ***objective standard of reasonableness*** applies" to the estimation of those expected net losses. SJ Decision at 22 (emphasis added). Consequently, to calculate damages that would place LBIE in the position it would have been in had AGFP undertaken such objective calculations, the Court should look to assumptions contemporaneously available as of July 23, 2009 from disinterested third-party sources. Dr. Niculescu has calculated the expected net loss that AGFP would have calculated for the ABX trades had it relied on contemporaneous projections made by Barclays ($324 million), Bank of America ($288 million), either of two models available from JP Morgan ($270 million or $339 million), Fitch ($248 million), or S&P ($107 million). LDX06-21; LDX10-6. Taking the average of these disinterested third-party estimates (and adding Unpaid Amounts) provides a damages figure of **$262 million due to LBIE** on the ABX trades alone. JX-34 at 8.[46]

---

[46] As discussed in Section V.A., AGFP has not presented ***any*** evidence supporting its Loss calculation for the UK RMBS and CLO trades, and has therefore failed to meet its burden of proof on its counterclaims for those trades. The Court should deny AGFP's claims for those trades, reject AGFP's demand for payment from LBIE on those trades, and instead award LBIE the fair market value of those trades as calculated by Dr. Niculescu to compensate for this breach. *See* Section IV.C.

74

VII. CONCLUSION

For the foregoing reasons, Plaintiff Lehman Brothers International (Europe) (in administration) respectfully requests that the Court enter judgment in its favor in the amount of $485 million, with an award of pre-judgment interest pursuant to CPLR § 5001.

Dated: April 22, 2022

Respectfully submitted,

By: /s/ Andrew J. Rossman
Andrew J. Rossman
David S. Mader
Ben Odell (*pro hac vice*)
Sage R. Vanden Heuvel (*pro hac vice*)
Owen F. Roberts
Emily Kapur (*pro hac vice*)
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
benodell@quinnemanuel.com
sagevandenheuvel@quinnemanuel.com
owenroberts@quinnemanuel.com
emilykapur@quinnemanuel.com

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

75