

Anthony L. Paccione (AP-4986)
Bonnie Lynn Chmil (BC-1826)
KATTEN MUCHIN ROSENMAN LLP
575 Madison Avenue
New York, NY 10022-2585
(212) 940-8800 – Phone
(212) 940-8776 – Fax
Attorneys for Defendant

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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ELLINGTON OVERSEAS PARTNERS, LTD. and :
ELLINGTON LONG TERM FUND, LTD., :

Plaintiffs, :

- against - :

HSBC SECURITIES (USA) INC., :

Defendant. :

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06 Civ. 2353 (RMB)(FM)

Oral Argument Requested

**DEFENDANT HSBC SECURITIES (USA) INC.'S
REPLY MEMORANDUM OF LAW IN FURTHER SUPPORT
OF ITS MOTION FOR PARTIAL SUMMARY JUDGMENT OR IN THE
ALTERNATIVE MOTION IN LIMINE**

Defendant HSBC Securities (USA) Inc. (“HSBC”) submits this reply memorandum of law in further support of its motion for partial summary judgment pursuant to Fed. R. Civ. P. 56 by which HSBC seeks to establish the date upon which to measure damages (the “valuation date”) for the breach of contract claims asserted by Plaintiffs Ellington Overseas Partners, Ltd. and Ellington Long Term Fund, Ltd. (collectively “Ellington”), or, if construed as a *Motion In Limine*, by which HSBC seeks an Order excluding evidence at trial of a valuation date other than the subject settlement dates as described more fully below.

STATEMENT IN REPLY

In its opposition, Ellington has admitted the precise facts needed for this Court to award summary judgment determining that the value of the subject Warrants is to be measured on each of the subject Settlement Dates for damages purposes. Ellington concedes, as it must, that each of the trades had the Settlement Dates identified in HSBC’s moving papers¹ and that on those dates HSBC was “obligated” to, but failed, to deliver the Warrants. (See Ellington Rule 56.1 Stmt. ¶¶ 9-21.) Ellington’s concessions on this point include its Rule 56.1 statement, its allegations in the complaint and the testimony of its own witnesses, including its expert witness. (See HSBC Mem. 6-8.) Thus, there is no question that the breach arose on the Settlement Dates and, therefore, under settled law in this Circuit, Ellington’s damages are to be measured at that time.

¹ Unless otherwise stated, capitalized terms shall have the same meaning ascribed to them in HSBC’s moving papers. The terms of the subject transaction are reproduced below for the Court’s convenience.

Trade Date	Settlement Date	Bond Quantity	Warrants Attached
04/26/01	05/01/01	\$10.0 million	50,000
05/16/01	05/21/01	\$6.5 million	32,500
11/01/01	11/06/01	\$2.5 million	12,500
11/01/01	11/06/01	\$3.0 million	15,000

Ellington's attempt to sidestep this result rests on its strained and exhaustive efforts to suggest that even after HSBC failed to deliver the Warrants on the Settlement Dates it had some "continuing obligation" to make delivery and that this supposed continuing obligation somehow changes the way to measure breach of contract damages under the well-established law in this Circuit. Ellington has not – and indeed cannot – point to any case that demonstrates that in a breach of sale context (a) this novel species of "continuing obligation" contracts exists under the law; and (b) even if it exists, that the measure of damages would be any different.

Because Ellington has conceded that HSBC was "obligated" to deliver the Warrants on the Settlement Dates and that HSBC failed to honor that obligation, there is no ambiguity in the contracts at issue and therefore no reason the Court need consider this supposed market practice. (See Point I, *infra*). HSBC's breach accrued on – and thus damages are to be measured on – the Settlement Dates. This very point was made in a recent decision involving the failed delivery of the same series of Venezuelan Oil Obligations at issue here. See Seguros Caracas De Liberty Mutual, S.A. v. Goldman, Sachs & Co., No. CIV.A. 06-10035-WGY, 2007 WL 2241978 (D. Mass July 27, 2007) (discussed more fully at pp. 4-5, and copy attached as Exhibit A) (breach of contract to deliver securities occurs on settlement date unless otherwise extended by the parties).

As will be explained more fully below, Ellington also simply errs in pointing to the Part 5 Rules of Article 8 of the Uniform Commercial Code since those rules do not at all apply to this matter and, even if they did apply, they would not change the result. (See Point II, *infra*).

Finally, Ellington's efforts to sidestep the Oscar Gruss line of cases falls short and rests on a strained interpretation of those cases. (See Point III, *infra*). The law is clear that upon a breach for the failure to deliver a security, damages are measured at the time and place of the breach.

ARGUMENT

The bulk of Ellington's opposition relates to evidence concerning HSBC's supposed "continuing obligation" to deliver the Warrants to Ellington. Given Ellington's admission that HSBC was obligated to deliver the Warrants on the Settlement Dates, there is no need to burden the Court by refuting that proof here. Nevertheless, HSBC expressly states that by failing to confront Ellington's proof now, HSBC neither concedes its admissibility nor its probative value.²

POINT I ELLINGTON'S OWN OPPOSITION CONCEDES ALL FACTS NECESSARY FOR THE GRANTING OF SUMMARY JUDGMENT

Ellington specifically admits that: "Plaintiffs do not dispute that HSBC was obligated to deliver the Bonds and the Oil Obligations on each respective settlement date. . . ." (Ellington Rule 56.1 Stmt. ¶21) (emphasis added). Ellington also admits that it paid for the Warrants and that HSBC failed to deliver them on the Settlement Dates. (*Id.* ¶¶ 9-20.)

Because Ellington concedes that HSBC was obligated to deliver the Warrants on the Settlement Dates, and does not dispute the Settlement Dates, there is no ambiguity in the contract terms and thus no need to look to extrinsic evidence to interpret the contract. See, e.g., Hunt v. Lifschultz Fast Freight, Inc., 889 F.2d 1274, 1277 (2d Cir. 1989) (and cases cited therein) (when contract terms are unambiguous, the obligations imposed are to be determined without reference to extrinsic evidence).³ Ellington admits, as it must, that HSBC was obligated to deliver the Warrants on the Settlement Dates and failed to do so. By definition, that is a breach of contract.

² For example, Ellington's cobbling of rules and regulations governing internal accounting procedures for failed trades has no bearing on this matter. Many of the rules cited apply to inter-broker transactions and are not even applicable to these transactions. Moreover, Ellington has not cited to any regulation that alters the contractual rights of parties to a trade.

³ Ellington seems to suggest that there is a market practice to waive breaches for failed trades *ad infinitum*. This novel theory is belied by the fact that no waiver claim has been asserted by Ellington, no proof of a market practice of waiver existing for over five years has been adduced, and there is no evidence that Ellington communicated any waiver to HSBC in the four year period between the 2001 trades and Ellington's contacts with HSBC in 2005.

See Black's Law Dictionary (8th ed. 2004) ("Breach of Contract" defined as "a violation of a contractual obligation by failing to perform one's own promise.") HSBC has cited ample authority demonstrating that in the case of the failure to deliver securities, the breach arises when delivery is due and does not occur. (See HSBC Mem. 12, citing Jeremias and Waxman.) Ellington does not distinguish these cases or submit authority suggesting otherwise.

Indeed, Judge William G. Young of the United States District Court of Massachusetts was confronted with the same issue when Goldman Sachs failed to deliver Venezuelan Oil Obligations to Liberty Mutual in 2001. Seguros, 2007 WL 2241978 at *1. In a decision on defendant's motion for judgment as a matter of law (curiously not mentioned by Ellington in its opposition to the present motion even though that decision was dated weeks before Ellington's filing date), Judge Young found that unless a settlement date is extended, the breach for failure to deliver securities occurs on the settlement date. Id. at *5. In Seguros, the purchaser, Liberty Mutual, who was aware that broker-dealers were having difficulty obtaining delivery of the securities, "made it a policy to obtain verbal assurances from broker-dealers that they would make delivery of the . . . VOOs." Id. at *2. The Court found that Liberty Mutual extended the settlement date when it "communicated clearly to Goldman that it would give Goldman more time to obtain the VOOs." Id. at *5. Goldman, in turn, "repeatedly assured Liberty Mutual that it would make good on delivery." Id. at *6. The Court determined that absent an extension of the performance date, breach occurs on the settlement date and damages are to be measured at that time. Id. at *5.

Here there is no evidence that the parties extended the Settlement Dates and, in fact, Ellington has admitted that the Settlement Dates were not changed. (See Paccione Aff. Ex. R, Collins Dep. 27-28.)⁴ Ellington disavows imposing any special condition on the delivery terms,

⁴ According to Ellington, it did not even communicate with HSBC at any point during the period between the dates of the breach of the trades in 2001 and in early 2005; thus there could have

and unlike the purchaser in Seguros, Ellington required no verbal assurance from HSBC at the time of the trade and had no special policy regarding delivery of the Warrants. Ellington understood that suing for damages arising from the failure to deliver on the Settlement Dates was an option it had. (See Ex. B, Franko Dep. 49-52, 117-18). Ellington's own complaint asserts claims for failure to deliver the Warrants on the Settlement Dates. Thus, as Ellington concedes, HSBC had an "obligation" to deliver the securities on the Settlement Dates and failed to do so.

In short, the record is clear that Ellington's claims arose in 2001 when the Oil Obligations were not delivered and Ellington's damages must be measured by the value of the Oil Obligations on the Settlement Dates in 2001 when the breaches occurred. Ellington cannot prove that the dates of the breaches are dates other than the Settlement Dates; therefore partial summary judgment as to the valuation dates is warranted.

POINT II
ELLINGTON WRONGLY RELIES UPON UCC § 8-501 ET SEQ.
WHICH DOES NOT EVEN APPLY TO THIS CASE

Ellington's initial legal argument wrongly relies upon Part 5 of Article 8 of the Uniform Commercial Code ("UCC"), N.Y. U.C.C. Law § 8-501, *et seq.* (McKinney 2007). (See Ellington Mem. 12-15.) In its brief, Ellington seeks comfort under the Part 5 Rules, suggesting that those rules somehow altered the contractual arrangement between HSBC and Ellington. (See *id.*) Its belated reliance on the Part 5 Rules (which are not even mentioned in Ellington's complaint or responses to contention interrogatories) is misplaced. Initially, Article 8 does not impact common law contractual remedies. "When there is a breach of contract for the sale of securities, the remedies available are those proscribed under non-Code law which continues under the Code because not displaced." 8 Lary Lawrence, Lawrence's Anderson on the Uniform Commercial

been no other waiver of the Settlement Dates. (See Paccione Aff. Ex. P, Penn Dep. 156; Ex. Q Sugrue Dep. 109.)

Code § 8-102:23 (3d ed. 2005) (hereinafter Lawrence’s Anderson). Thus, Article 8 does not alter the New York common law rules on damages discussed in Point III *infra*. In addition, as explained below, the Part 5 Rules do not apply to this case because HSBC cannot be deemed to be a “securities intermediary” within their meaning, and the remaining conditions necessary to give Ellington rights as an “entitlement holder” have not been met.

A. The Part 5 Rules Do Not Apply Because HSBC Was Acting as Principal in the Subject Trades and Did Not Maintain an Account for Ellington That Was To Hold These Securities

The Part 5 Rules of Article 8 simply do not apply to this case. The statutory framework makes clear that Part 5 only applies to a “securities intermediary” “maintaining” a securities account on behalf of its customers. See N.Y. U.C.C. Law §§ 8-501(a), 8-102(a)(14)(ii). The Part 5 Rules apply to custodial accounts, *i.e.*, accounts holding securities and maintained by broker dealers. HSBC, however, maintained no such account for Ellington and was only acting as principal to effectuate a trade in the Bonds and Warrants. There is no evidence that Ellington had a brokerage account with HSBC where the Warrants were to be maintained. To the contrary, there is no dispute that the Warrants were to be delivered to an account maintained by Ellington at its prime broker, Credit Suisse. (See Ellington Rule 56.1 Stmt. ¶ 22.)

The Official Comment to § 8-102 makes clear the distinction between a broker who is simply effectuating a trade and a broker who maintains securities accounts for others. The former, like HSBC here, is not a securities intermediary while the latter falls within that definition. See N.Y. U.C.C. Law § 8-102, Official Comment 14 (“Broker means a person engaged in the business of buying and selling securities as agent for others or as principal. Securities intermediary means a person maintaining securities accounts for others.”) Other Official Comments demonstrate this same point. See N.Y. U.C.C. Law § 8-501, Official Comment 1 (stating that “broker and customers who *leave securities with the broker*” are covered

by the Part 5 rules); see also R. Hales UCC Article 8: Will The Indirect Holding of Securities Survive The Light of Day?, 35 Loy. L.A. L. Rev. 661, 682-83 (2002) (footnotes omitted) (“Securities intermediaries also include brokers . . . maintaining securities accounts for others in the course of their business. The securities intermediary designation is limited to their custodial role in holding securities. Brokers effecting trades are agents for their customers or principals, not securities intermediaries.”)

As stated in a leading UCC treatise, “[w]hether the relationship between a broker and its customer is governed by the Article 8 Part 5 rules depends on the nature of the services that the broker performs for the customer.” Anderson, Lawrence’s Anderson, *supra*, at § 8-101:1 [Rev] (C)(3) (copy annexed as Ex. C). There Professor Lawrence describes customers, like Ellington, who use brokers to purchase and sell securities and take those securities in their own names and hold them for their own use. “The Article 8 Part 5 rules would not affect such customers, because the Part 5 rules deal with arrangements in which investors hold securities through securities intermediaries.” Id. Thus, the Article 8 Part 5 rules apply where investors use brokers not only to purchase and sell securities, but also [to act] as the custodians through whom they hold their securities.” Id. The “indirect holding system of part 5 applies to the custodial aspect of their relationship.” Id.

Ellington’s flawed reliance on the Part 5 Rules is made more evident by very casual reference to the definition of “account holder” and its proof on that point. Ellington proffers no account agreement and does not contend (because it cannot) that HSBC held a custodial account for Ellington to hold the Warrants. Ellington simply points to “account statements” issued by HSBC referencing the transactions in the Bonds. (See Ellington Mem. 13, n.7.) The Warrants that were to accompany those Bonds, however, were to be delivered to Ellington’s Prime Broker, Credit Suisse. (Ellington Rule 56.1 Stmt. ¶ 22.) Thus, the Court should reject Ellington’s

arguments based upon the Article 8 Part 5 Rules because those rules do not apply to HSBC who was not maintaining an account for Ellington to hold the Warrants.

B. Ellington Also Has Not Established the Applicability of U.C.C. § 8-501

Even if the Court were to find that HSBC was a “securities intermediary,” Ellington’s reliance on the Part 5 Rules still fails. Ellington claims it became an “entitlement holder” pursuant to either U.C.C. § 8-501(b)(1) or U.C.C. § 8-501(b)(3). (Ellington Mem. 13.) A person may acquire a security entitlement by virtue of having a financial asset credited to its securities account by the securities intermediary pursuant to UCC § 8-501(b)(1), or if the securities intermediary becomes obligated under other law, regulation or rule to credit a financial asset to the persons account pursuant to § 8-501(b)(3). See U.C.C. §§ 8-501(b)(1), 8-501(b)(3) (2007).

Accordingly, to obtain a security entitlement under either subsection 8-501(b)(1) or (b)(3), it must be shown either that the financial asset was credited to the securities account or an obligation to credit the account existed. Ellington has not demonstrated that HSBC “credited” the warrants to Ellington’s account and in fact has not established any such account. In fact, Ellington acknowledges that “HSBC did not book the Warrant components of the trades separately from the Bonds.” (Ellington Mem. 5). Moreover, contrary to Ellington’s claim, the NYSE form (Slarskey Aff. Ex. O), which it relies on as proof that the Warrants were credited to its account, does not show that HSBC “credited” Ellington’s account. Rather, the NYSE form merely reflects that HSBC failed to deliver the Warrants. Other than the irrelevant NYSE form and self serving conclusory allegations, Ellington has submitted no evidence showing the Warrants were “credited to its account” within the meaning of UCC § 8-501(b)(1).

Nor did Ellington obtain a security entitlement arising from HSBC’s obligation under any “other law, regulation or rule” to credit the Warrants to Ellington’s account pursuant to UCC 8-501(b)(3). In support of its UCC 8-501(b)(3) entitlement claim, Ellington cites In re Adler,

Coleman Clearing Corp., No. 95-08203 (JLG), 1998 WL 551972 (Bankr. S.D.N.Y. Aug. 24, 1998) and In re Daiwa Securities America, Inc., NYSE Hearing Bd. Decision, No. 06-137, July 10, 2006. (Ellington Mem. 13-14.) The In re Adler case concerned securities transactions that settled through the Continuous Net Settlement System (“CNSS”). The case did not reference UCC Article 8 at all and concerned a system of guaranteed and global settlements through the NSCC that are inapplicable here.⁵ Thus, In re Adler is inapposite.

Likewise, In Re Daiwa is irrelevant and of little precedential value. There the NYSE found securities violations had occurred as a result of Daiwa’s inability to document outstanding balances of certain Value Recovery Rights or identify the correct counter-party to those trades. (See Decision annexed to Slarsky Affidavit, Ex. W ¶ 12). This decision does not demonstrate that HSBC had an “obligation to credit an account.”

Because Ellington is not an entitlement holder as defined by U.C.C. § 8-102(a)(7), and because Ellington has not established that UCC § 501(b)(1) or (b)(3) were satisfied, the Part 5 rules do not apply.

**POINT III
DAMAGES FOR BREACH OF CONTRACT ARE
INDEED MEASURED AT THE TIME OF THE BREACH**

Ellington insists that the Oscar Gruss measure of damages is inapplicable, yet Ellington fails to point to a single New York case that holds that damages in a breach of contract action are measured at any time other than the time of the breach. Oscar Gruss plainly states, *without qualification*, that “breach of contract damages are measured from the date of the breach,” and are determined by the loss sustained or the gain prevented at the time and place of breach. Oscar

⁵ Unlike the Euroclear rules here, the NSCC guarantees its members transactions and assumes obligations of its buying members to deliver to its selling members and its selling members to deliver to its buying members. Thus, the failure of either buyer or seller to the NSCC creates additional and very different obligations than those involved here.

Gruss & Son, Inc. v. Hollander, 337 F.3d 186, 196-97 (2d Cir. 2003) That holding reinforces the holdings of Lucente v. Int’l Bus. Machs. Corp., 310 F.3d 243 (2d Cir. 2002), Sharma v. Skaarup Ship Mgmt. Corp., 916 F.2d 820 (2d Cir. 1990), and Hermanowski v. Acton Corp., 729 F.2d 921 (2d Cir. 1984) and remains binding law in this Circuit. Ellington attempts to distinguish this decisive precedent by misconstruing certain dicta and offering no other support to the contrary. The points of distinction that Ellington incorrectly asserts, discussed in turn below, fall into two categories: (a) a requirement that Ellington had the ability to cover the failed Warrants; and (b) Ellington’s knowledge of the breach. (Ellington Mem. 19-20.)

A. Cover is Not a Requirement of the Date-of-Breach Damages Rule

Ellington propounds that the date-of-breach measure of damages only applies where “a plaintiff has the ability to ‘cover.’” (Ellington Mem. 19.) The leading and most recent Second Circuit decision, Oscar Gruss, however, makes no mention of, and imposes no requirement that a party be able to cover on the date of the breach. Oscar Gruss flatly rejects the use of the conversion measure of damages which takes into account the cover requirement to which Ellington refers. 337 F.3d at 197.

Ellington points to a quote from Scully v. US Wats, Inc., 238 F.3d 497, 510 (3d Cir. 2001), a case focused on determining whether to use the intrinsic or actual value of a stock option as the proper measure of damages. (Ellington Mem. 19.) The Scully court stated that “[b]oth the conversion and contract theories presume that a plaintiff has the ability to ‘cover,’ in other words, mitigate damages by protecting prospective profit, by entering the market to purchase the lost shares.” Scully, 238 F.3d at 510. Ellington does not mention that Scully immediately goes on to state that the contract theory “puts the onus on a plaintiff to cover immediately upon the breach because damages are fixed as of the breach date.” Id. The Scully court did not condition its holding that breach of contract damages are to be measured at the time and place of the breach on

the plaintiff's ability to cover. Id. In fact, it held that the date-of-breach "rule is precisely the same when the breach of contract is nondelivery of shares of stock." Id. (citations omitted). Scully also recognized the advantage of this rule since it would lead to a "more scrupulous damage calculation because it avoids any uncertainty concerning the amount of future profit or future loss."⁶ Id. at 510-11. The Court upheld the District Court's decision to award damages as of the date of the breach and its finding that "a failure to deliver securities or stock options, pursuant to a legally binding agreement, constitutes a breach of contract." Id. at 512 (citations omitted).

Ellington's reliance on Commonwealth Assocs. v. Palomar Med. Techs., Inc., 982 F. Supp. 205 (S.D.N.Y. 1997) (hereinafter "Commonwealth")⁷ is similarly misplaced, because the court simply measured damages from the date of the breach. The difference in that case is that the breach was found to be occasioned by the failure to register the subject warrants and not the delivery of same. Id. at 211. In Commonwealth, the contract in question contemplated certain steps required to be taken in order to provide plaintiff the benefit of the bargain with respect to the warrants: defendant's issuance of warrants to plaintiff and plaintiff's option, at a time of its

⁶ It should be noted that Ellington's "continuing obligation" theory would create an unworkable measure of damages which would have disastrous consequences for future cases by wreaking havoc on contract law and securities transactions. For example, if this continuing obligation contract were found to exist, the statute of limitations for breach of securities sales contracts would be extended indefinitely, instilling an overwhelming uncertainty into such contracts. If the date-of-breach law were rewritten, as Ellington suggests, damages would be measured whenever the failed-to party determines a breach has occurred. The failed-to party would have the power to ride the seas of the securities market and determine a breach when its return is at its highest crest. If Ellington suggests that the breach should be measured at the time when the failing party makes it clear that it is not going to honor this failed trade, an unscrupulous broker could ride the market wave and declare a breach (repudiate a contract) at the lowest point in the market. Any such rule would create such uncertainty as to be unworkable.

⁷ To the extent Commonwealth relies on Schultz v. CFTC, 716 F.2d 136 (2d Cir 1983), Schultz applied the conversion measure of damages which this Circuit later rejected in Oscar Gruss, Lucente, Sharma and Hermanowski for breach of contract cases.

choosing within five years, to require defendant to register the warrants and issue the shares in exchange for the share price. Id. at 210. The Court determined that the issuance of the warrants, which would convey no title, was a mere technicality. Id. at 210-11. Rather, the key event for purposes of ensuring plaintiff the benefit of its bargain was the subsequent registration of the warrants, which would permit the issuance of shares and their sale to plaintiff for resale. Id. at 211. Thus, as the Court specifically noted, “unlike the cases involving a purchase of stock,” the relevant breach occurred when defendant failed to honor plaintiff’s request for registration of the warrants and issuance of the shares, not upon the initial failure to issue the warrants. Id. (emphasis added).

Here, the contracts between Ellington and HSBC, like virtually every ordinary contract for the purchase or sale of securities, definitively called for delivery of securities versus payment on the Settlement Dates. (See Paccione Aff. Ex. G, HSBC trade confirms.) Delivery of the securities on the Settlement Dates was the legal obligation HSBC assumed in the transactions. Distinguished from the registration obligation in Commonwealth, HSBC’s delivery of the Oil Obligations, along with the Bonds, was the benefit to Ellington’s bargain. Ellington attempts to blur the contractual obligations of the parties with its “market practice” theory – but that theory does not change or alter the obligations of parties to securities transactions to exchange securities for payment on settlement date. Even if, as Ellington contends, HSBC were obligated by financial industry custom to attempt to make good on the failed trades, the breach of HSBC’s contractual obligations on the Settlement Dates under New York contract law is no less complete.

B. Ellington’s Feigned Lack of Knowledge of the Fails Does Not Change the Result

Ellington contends that the date-of-breach measure of damages established in Oscar Gruss and the host of other cases previously cited should be re-written to require damages to be measured only after the plaintiff learns of the breach. This argument is fundamentally flawed.

First, Ellington's claim that it did not have knowledge of the breach is immaterial, as knowledge is not required. T & N PLC v. Fred S. James & Co. of New York, Inc., 29 F.3d 57, 58-60 (2d Cir. 1994) ("In New York it is well established that claims accrue upon breach, not when an alleged breach is discovered.") Second, the issue of a plaintiff's notice was discussed in the cases only because there were issues of whether a party had repudiated the contract thereby fixing the date of the breach. In Commonwealth, the issue of notice of the breach was discussed only because the defendant argued for an earlier breach date claiming that the contract had been repudiated (a "dead letter"). 982 F.Supp. at 211. The Court rejected this repudiation claim by citing to evidence that the parties continued to honor obligations under a consulting agreement and, therefore, had no reason to know that the contractual performance (registration of the warrants) would not be honored. Id. In other words, the Court had determined that under the terms of the parties' contract and the mutual views of the parties, no meaningful performance was due until plaintiff requested it. A substantive breach could not have occurred until plaintiff requested performance. Here, there is no claim of repudiation or anticipatory breach – thus plaintiffs' knowledge of whether a future contractual promise would be performed is irrelevant.

Ellington seizes on the fact that Oscar Gruss briefly distinguished the point made in Commonwealth about the notice of the repudiation. Oscar Gruss, fairly read, simply goes on to distinguish Commonwealth on grounds that the breach arose "when the defendant failed to honor the plaintiff's request for registration and issuance of the shares. The plaintiff did not learn of the defendant's **repudiation** until that time." Oscar Gruss, 337 F.3d at 197 (emphasis added). Thus, Oscar Gruss found Commonwealth to be "distinguishable" and "simply inapposite." Id. at 198. Insofar as it concerns notice of repudiation, the same result is warranted here.

Neither Oscar Gruss nor Commonwealth teach, as Ellington claims, that "where a party is 'justified in assuming that the [counterparty] would honor its obligations,' damages will not be

assessed until such time as that assumption is no longer reasonable.” (Ellington Mem. at 23.) Oscar Gruss merely references Commonwealth’s rejection of defendant’s argument that it had repudiated the contract. The contract at issue in Commonwealth was a financial advisory services contract in which plaintiff pledged to provide its services to defendant for a nine-month period in connection with anticipated merger or acquisition transactions. 982 F.Supp. at 206. The contract provided for certain monthly payments as well as the issuance of the warrants, and the subsequent registration of warrants and issuance of shares on demand, in exchange for the advisory services. Id. Because plaintiff had provided the promised advisory services and defendant had paid bills submitted by plaintiff for expenses incurred in carrying out such services, the Court simply noted that plaintiff was justified in assuming that defendant had not repudiated the contract. Id.

Even if Oscar Gruss required knowledge of the breach, which it and New York contract law do not, the record reflects that Credit Suisse, who as Ellington’s prime broker assumed responsibility for settling these transactions, knew that the Oil Obligations were not delivered. (See HSBC Mem. 13.)⁸ Ellington’s analysis of the fiduciary relationship issues addressed in Flickinger v. Harold C. Brown & Co., Inc., No. 89-CV-1218S, 1992 WL 373642 (W.D.N.Y. Nov. 11, 1992), *denying reconsideration of* 789 F.Supp. 616 (W.D.N.Y. 1992), simply has no bearing on Credit Suisse’s contractual agency relationship with Ellington and the fundamental principles of agency law that govern it. Ellington fails to refute the well-settled agency law principle that knowledge Credit Suisse acquired within the scope of its duty in settling transactions on behalf of Ellington – including the knowledge that the Oil Obligations were not delivered – is imputed to Ellington, regardless of whether Credit Suisse communicated the information to Ellington. N.Y. Mar. & Gen. Ins. Co. v. Tradeline L.L.C., 266 F.3d 112, 122 (2d Cir. 2001) (“Under New York

⁸ Ellington has not refuted the evidence that Credit Suisse had knowledge of the fails (See HSBC Mem. 13).

law, knowledge acquired by an agent acting within the scope of its agency is imputed to the principal, even if the information was never actually communicated.” (citing Christopher S. v. Douglaston Club, 275 A.D.2d 768, 769, 713 N.Y.S.2d 542, 543 (2d Dep’t 2000)); see also Center v. Hampton Affiliates, Inc., 66 N.Y.2d 782, 784, 497 N.Y.S.2d 898 (N.Y. 1985) (“The general rule is that knowledge acquired by an agent acting within the scope of his agency is imputed to his principal and the latter is bound by such knowledge although the information is never actually communicated to it.”).

Here, HSBC has not repudiated its contracts with Ellington. It simply breached them by failing to deliver the Oil Obligations on the respective settlement dates in 2001. Absent repudiation, Ellington’s purported assumption that HSBC would someday deliver the Oil Obligations is irrelevant.

CONCLUSION

By virtue of the foregoing, HSBC respectfully requests that the Court enter an Order finding that Ellington’s damages should be measured as of each respective Settlement Date, or alternatively, excluding evidence at trial of a valuation date other than the subject settlement dates, and for such other and further relief as the Court may deem just and proper.

Dated: New York, New York
August 31, 2007

KATTEN MUCHIN ROSENMAN LLP

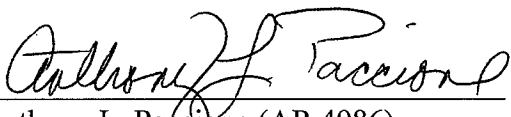

By: 
Anthony L. Paccione (AP-4986) 
Bonnie Lynn Chmil (BC-1826)
Attorneys for Defendant
575 Madison Avenue
New York, New York 10022
(212) 940-8800

EXHIBIT B

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

-----X
ELLINGTON OVERSEAS PARTNERS, LTD. And
ELLINGTON LONG TERM FUND, LTD.,

PLAINTIFFS,

-against-

HSBC SECURITIES (USA),

DEFENDANT.
-----X

DATE: July 13, 2007

TIME: 11:11 a.m.

EXPERT TESTIMONY by THOMAS FRANKO,
taken by the Defendant, pursuant to an
Agreement, held at the offices of KATTEN,
MUCHIN, ROSENMAN, LLP, 575 Madison Avenue,
New York, New York 10022, before a Registered
Professional Reporter and Notary Public of
the State of New York.

JOB NO. 12860



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1 **FRANKO**

2 Q. It is an important rule, right?

3 A. **Absolutely.**

4 Q. How did it add certainty to

5 the --

6 A. **By reducing the settlement**

7 **period, you had less time at which you were**

8 **at the risk of a failure by a contra-party,**

9 **less time when there would be money**

10 **outstanding, and, remember, the rule applied**

11 **to both broker and the customer side as**

12 **well.**

13 **So encouraged customers to pay**

14 **for their trades on a more timely basis was**

15 **an important component; at least as far as**

16 **we were concerned at Pershing.**

17 Q. Before I asked you to identify

18 the terms of the -- one of the contracts at

19 issue in this case. We talked about the

20 trade date, the settlement date, the

21 quantity of the securities and the type of

22 securities, right?

23 A. **Correct.**

24 Q. That are the terms of the

25 contract?

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2 copy of a page from the CCH Securities

3 Compliance library rules of the New York

4 Stock Exchange, and you will see at the

5 bottom of that page, Rule 142.

6 Do you see that?

7 A. **I do.**

8 Q. Do you recognize that as Rule

9 142 of the New York Stock Exchange?

10 A. **I do.**

11 Q. If you look at that rule at

12 the -- take your time to read it if you

13 would like.

14 The question I will ask you is,

15 what does liability mean at the end of that

16 Rule?

17 A. **Well, in the context here, it is**

18 **basically their obligation to perform the**

19 **contract according to its original terms.**

20 **In other words, the purchaser**

21 **has to pay for the trade and the seller has**

22 **to deliver the security.**

23 Q. And a Notice of Failure to

24 deliver or a failure to compare won't change

25 the terms of the contract.

1 **FRANKO**

2 A. **Everything that appears on the**

3 **trade confirm is.**

4 Q. Have you seen the trade confirms

5 in this case?

6 A. **I have not.**

7 Q. Do you know if the issuance of a

8 Notice of Failure to deliver changes the

9 terms of any of those contracts?

10 A. **No.**

11 Q. Does a Notice of Fail release a

12 party from liability for breaching the terms

13 of those contracts?

14 A. **No.**

15 Q. In fact, Rule 142 which you cite

16 in the report establishes this, right?

17 A. **That is correct.**

18 Q. I will hand you a copy of Rule

19 142. We will mark it as Franko Exhibit 3.

20 (Whereupon, the aforementioned

21 copy of Rule 142 was marked as

22 Defendant's Exhibit Franko-3 for

23 identification as of this date by the

24 Reporter.)

25 Q. Mr. Franko, I have handed you a

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2 Do you see that?

3 A. **That's correct.**

4 Q. It won't cancel the contract?

5 A. **That's correct.**

6 Q. And it doesn't release the

7 original parties from liability, right?

8 A. **Right.**

9 Q. And your liability would also

10 include liability for failing to perform?

11 A. **I believe -- not sure what you**

12 **mean in that context.**

13 Q. If, for example, someone fails

14 to deliver securities, they could be liable

15 to the other party for damages. Right?

16 MR. LANDRIGAN: Objection.

17 Beyond the scope.

18 A. **Well, either paid money damages**

19 **or performed the contract. I think the**

20 **context here is saying you have to**

21 **eventually perform on the contract.**

22 Q. But liability, as you use it,

23 can mean both things, either money damages

24 or performing the contract?

25 A. **Yes. Money damages would be a**

1 **FRANKO**
 2 **resolution as between the parties as apart**
 3 **from the clearing process.**
 4 Q. So liability as the word is
 5 being used here can mean either performing
 6 the contract or being liable for the
 7 damages?
 8 MR. LANDRIGAN: Objection.
 9 A. **I would that in the sense it is**
 10 **being stated here, it is not encouraging the**
 11 **parties to go to litigation or arbitration.**
 12 **Rather, it is saying that we**
 13 **expect the parties will eventually perform**
 14 **by delivering the money or delivering the**
 15 **securities; as to the case maybe.**
 16 Q. Are you aware of any
 17 interpretations of Rule 142?
 18 A. **I am not.**
 19 Q. Are you aware of any case law
 20 involving Rule 142?
 21 A. **I am not.**
 22 Q. Have you ever dealt with Rule
 23 142 in the course of your work as general
 24 counsel for securities?
 25 A. **Not directly. Most of the --**

1 **FRANKO**
 2 **any disputes that would arise today on the**
 3 **New York Stock Exchange for a failure, which**
 4 **would be pretty rare in itself, anything not**
 5 **involved in the QT process, would be**
 6 **resolved through DTC in the continuous**
 7 **settlement process.**
 8 Q. Who does Rule 142 apply to; does
 9 it apply to all broker-dealers?
 10 A. **Applies to New York Stock**
 11 **Exchange member firms.**
 12 Q. Does it apply to any particular
 13 type of securities or all securities?
 14 A. **Well, in effect, this is a rule**
 15 **is that is a rule that is part of the New**
 16 **York Stock -- it applies to New York Stock**
 17 **Exchange trades.**
 18 **You will notice the language**
 19 **about being submitted to the Exchange or a**
 20 **qualified clearing agency to which they**
 21 **mean, certainly in '93, they meant DTCC.**
 22 Q. A party that fails to deliver,
 23 how are they -- can they be held liable for
 24 money damages?
 25 MR. LANDRIGAN: Objection.

1 **FRANKO**
 2 **Beyond the scope. You can answer, if**
 3 **you know.**
 4 A. **There was a number of remedies**
 5 **available to which the party that is being**
 6 **failed. Forbear. Issue of notice of Buy-in**
 7 **or seek legal damages, sure.**
 8 Q. That would be the liability, the
 9 exposure that the failing settler would
 10 have, right, the exposure to the Buy-in?
 11 MR. LANDRIGAN: Objection.
 12 Q. The exposure to damages, right?
 13 MR. LANDRIGAN: Objection.
 14 Q. That would be the liability?
 15 MR. LANDRIGAN: Objection.
 16 **Beyond the scope. You can answer.**
 17 Q. You can answer.
 18 A. **Yes.**
 19 Q. Now, are you reading the words
 20 liability here in Rule 142 to mean only
 21 releasing the original parties from
 22 performing their obligations under the
 23 contract?
 24 A. **I think, as I say, my sense is**
 25 **that that would be the -- and this is just**

1 **FRANKO**
 2 **merely my sense of how it would operate,**
 3 **that normally as between brokers, you would**
 4 **expect the -- either eventually they will**
 5 **deliver the securities or the monies as the**
 6 **case maybe or that a Buy-in procedure will**
 7 **occur. As opposed to -- it would be very**
 8 **unusual for two brokers to bring an**
 9 **arbitration or litigation against each other**
 10 **on a fail.**
 11 Q. What is the purpose of this Rule
 12 142, if you know?
 13 A. **Well, I think it is to ensure**
 14 **the parties that the fail is -- there is a**
 15 **continuing obligation to cleanup a fail and**
 16 **that the parties understand that they need**
 17 **to work towards that resolution.**
 18 **Obviously, because it is capital**
 19 **implications and operational implications to**
 20 **having those fails.**
 21 Q. It is also to protect the
 22 counterparty who is being failed to, to make
 23 sure that they are not releasing or that the
 24 issuance of a Fail Notice by itself is not
 25 releasing the failing party from any claim?

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 2 customer, that I am walking -- that it is
 3 walking away from its obligations. It is
 4 unheard of.
 5 Q. So it is your position that --
 6 is it your position that there is no breach
 7 until HSBC tells Ellington that they are not
 8 going to perform?
 9 A. They have an ongoing obligation
 10 to perform. That obligation doesn't --
 11 unless the parties reach another agreement,
 12 HSBC has a continuing obligation to perform
 13 and as I said, I think if HSBC's operations
 14 department got delivery of the securities
 15 tomorrow, they -- well, they won't deliver
 16 it tomorrow, but on Monday, they deliver
 17 them to Ellington's custodian, including all
 18 the pieces and this would be done.
 19 Q. So there is a --
 20 A. A continuing obligation.
 21 Q. I wish it were that easy.
 22 A. I am just saying that's the way
 23 I would expect the industry to work.
 24 Q. The way the industry work and
 25 you don't have a breach of contract. That's

1 FRANKO
 2 which in effect is the same thing.
 3 But there is no reason for
 4 Ellington to sit back and, you know, --
 5 there is no obligation on Ellington's part
 6 to take those actions.
 7 Q. Okay. I want to go back to the
 8 -- when is the continuing obligation
 9 breached?
 10 A. I think it doesn't get --
 11 MR. LANDRIGAN: I will object.
 12 A. Again, from the way that the
 13 industry operates, it is not breached until
 14 HSBC says we are simply not going to
 15 perform.
 16 THE COURT REPORTER: Off the
 17 record.
 18 (Whereupon, an off-the-record
 19 discussion was held.)
 20 BY MR. PACCIONE:
 21 Q. Can you turn to paragraph 32.
 22 A. Um-hum.
 23 Q. In paragraph 32 in the second
 24 sentence you write "Because the seller's
 25 obligation in connection with the failed

1 FRANKO
 2 the way you expect the industry to work in
 3 the context of a non-breach of agreement?
 4 A. That's correct.
 5 Q. We are in a case where there is
 6 an alleged breach of contract, okay. When
 7 -- I will go back to, when you talk about
 8 continuing obligations, when is that
 9 continuing obligation breached?
 10 A. I think the only time it is
 11 breached is when the, in this case, HSBC,
 12 says -- I will not perform. I am just
 13 simply not going to deliver, go away, don't
 14 bother me.
 15 Q. It is at that point for the
 16 first time that somebody can then bring a
 17 lawsuit?
 18 A. I think the right to bring the
 19 lawsuit arises whenever the party wants to
 20 because it knows that it is out there. But
 21 it is always an option. It is an option to
 22 Ellington to say enough is enough, do
 23 something, fix this for me. But Ellington
 24 could wait. Ellington could order its
 25 custodian to, you know, demand a Buy-in

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 2 trade continue to exist for as long as the
 3 trade remains unsettled, my opinion is that
 4 the buyer would be entitled to recover in a
 5 lawsuit the same economic value that such a
 6 buyer would have received if the seller had
 7 honored its continuing obligations to
 8 deliver the securities and all payments made
 9 thereon after the trade date."
 10 Do you see that?
 11 A. Yes.
 12 Q. What do you mean by economic
 13 value?
 14 A. By that I mean they are entitled
 15 to the principal, the Warrants themselves,
 16 all of the -- all of the royalty payments
 17 that were -- that have been made up until
 18 that date. And interest on the royalty
 19 payments at some rate of interest.
 20 Q. Okay. Now, when you say the
 21 warrant, they are entitled to the Warrants
 22 themselves, this is a case for money
 23 damages, okay. So they are not asking us
 24 for the Warrants.
 25 So what is the equivalent of the

1 FRANKO
 2 Warrants themselves that they are entitled?
 3 MR. LANDRIGAN: Objection. Goes
 4 beyond the scope. Characterizes --
 5 mischaracterizes the events in the
 6 claim but I will not instruct him.
 7 Objection.
 8 A. **At least we are talking about**
 9 **the money value, what it would cost to buy**
 10 **the Warrants in an open market from a ready,**
 11 **able seller.**
 12 Q. As of what date?
 13 A. **I don't know the date. It is**
 14 **the date that this is brought to a**
 15 **conclusion. This is an ongoing obligation**
 16 **of HSBC to deliver. As far as when it gets**
 17 **cut off as a legal proposition, these are**
 18 **the judgment or whatever, not my job here.**
 19 **Not what I am doing.**
 20 **All I know is from the point of**
 21 **view of the industry, it is the obligation**
 22 **of HSBC to deliver and until it gets, either**
 23 **they get delivered or there is a new**
 24 **agreement to cut off that obligation of some**
 25 **date certain, then that obligation and**

1 FRANKO
 2 **everything along with it keeps on rolling.**
 3 Q. You did provide an opinion that
 4 the buyer is entitled to recover in a
 5 lawsuit, an economic value?
 6 A. **Right.**
 7 Q. As part of that economic value
 8 you said it was Warrants themselves?
 9 A. **Right.**
 10 Q. I asked you, if the Warrants are
 11 not available, if it is money damages, how
 12 do you measure the value of the Warrants
 13 themselves and you told me market value?
 14 A. **Um-hum.**
 15 Q. Then I asked you when do you
 16 measure the market value, on what date and
 17 are you telling me you don't have an opinion
 18 as to that issue?
 19 A. **As I said, I haven't thought**
 20 **about the relationship between a judgment**
 21 **and that obligation.**
 22 Q. That would be a legal question,
 23 wouldn't it?
 24 A. **That would be the legal side.**
 25 Q. And, in fact, when you measured

1 FRANKO
 2 the value of the damages for the failure to
 3 deliver the Warrants, that should be covered
 4 by case law?
 5 MR. LANDRIGAN: Objection.
 6 Q. There is no New York Stock
 7 Exchange Rule that governs the question of
 8 how you measure money damages?
 9 A. **No, the Stock Exchange would not**
 10 **get involved in that.**
 11 Q. NASD will?
 12 A. **No.**
 13 Q. Euroclear?
 14 A. **No.**
 15 Q. ISMA Rule?
 16 A. **No. Because all of them accept**
 17 **the idea that there is a continuing**
 18 **obligation to deliver.**
 19 Q. And none of those rules used the
 20 phrase continuing obligation?
 21 A. **That's my term, yes.**
 22 Q. And your understanding of the
 23 practices in the industry, you can't give me
 24 a date certain as to when one would measure
 25 the value of the Warrants and context of the

1 FRANKO
 2 damages?
 3 MR. LANDRIGAN: Objection.
 4 Mischaracterizes the testimony.
 5 Q. You don't know how that works?
 6 A. **The only way it would work is**
 7 **the way that ISMA suggests which is the**
 8 **parties agree to a number and, in effect,**
 9 **cancel that continuing obligation by that**
 10 **number.**
 11 **How they reach that number, how**
 12 **they measure that number, is something for**
 13 **the trade people to figure out. It is not**
 14 **something that I figured out. It is nothing**
 15 **I was asked to think about, and it is**
 16 **certainly nothing I would have the**
 17 **presumption to say I understand, you know,**
 18 **the, how -- I am not a trader. It is a**
 19 **trading decision, as far as I am concerned.**
 20 Q. You are opining what the buyer
 21 would be entitled to recover in the lawsuit,
 22 aren't you?
 23 A. **Yes, entitled to the value.**
 24 Q. But you can't tell me when that
 25 value should be measured with respect to the