

<p>1 Monday, 9 November 2015</p> <p>2 (10.30 am)</p> <p>3 Submissions by MR TROWER</p> <p>4 MR TROWER: My Lord, tranche C of Waterfall II is before</p> <p>5 your Lordship this morning. I appear together with</p> <p>6 Mr Bayfield and Mr Robins for the joint administrators.</p> <p>7 Your Lordship has Mr Dicker, Mr Fisher and Mr Phillips</p> <p>8 for the Senior Creditor Group. Wentworth are</p> <p>9 represented by Mr Zacaroli, Mr Allison and Mr Al-Attar,</p> <p>10 on my far left, and on my far right a new arrival at</p> <p>11 this great occasion, Mr Foxton and Mr Morrison.</p> <p>12 My Lord, what I was going to do was introduce</p> <p>13 your Lordship to the case and give, in particular,</p> <p>14 I hope, a helpful perspective from the administrators'</p> <p>15 point of view for a period of time this morning. The</p> <p>16 parties have then agreed -- mostly agreed, I think it is</p> <p>17 fair to say -- a timetable as to how matters should go</p> <p>18 hereafter, subject of course to your Lordship.</p> <p>19 There is a small debate about whether Mr Foxton or</p> <p>20 Mr Dicker should go first in their replies on the</p> <p>21 English law issues, but I think we can leave that for</p> <p>22 the moment. We can wait to see how that develops.</p> <p>23 There also is a question in relation to one of</p> <p>24 the experts of German law and their availability, where</p> <p>25 they are only available for 20 November. So if we run</p> <p>Page 1</p>	<p>1 because it was only amended after the PTR. But my Lord</p> <p>2 should have that there.</p> <p>3 The issues directed to be heard are: English law</p> <p>4 issues 10 to 16 and 18; New York law issue 19; and</p> <p>5 German law issues 20 and 21.</p> <p>6 There is also issue 27, which is actually agreed</p> <p>7 now. It crosses all other issues and relates to whether</p> <p>8 the answer to any of the other issues is different based</p> <p>9 on the identity of the relevant payee. It is the one</p> <p>10 whether it makes any difference as to the relevant payee</p> <p>11 is a financial institution or some other form of entity.</p> <p>12 But I don't think your Lordship will be troubled with</p> <p>13 that as a separate issue.</p> <p>14 Now, as my Lord knows, all these issues raise</p> <p>15 questions of construction of master agreements. We are</p> <p>16 dealing with the ISDA 1992 and 2002 master agreements</p> <p>17 for English law purposes, and that's issues 10 to 16</p> <p>18 and 18. We are dealing with the ISDA '92 and 2002</p> <p>19 master agreements under New York law for issue 19. Then</p> <p>20 there is the German master for financial derivatives</p> <p>21 transactions, which are issues 20 and 21.</p> <p>22 Now, these questions of construction, my Lord, arise</p> <p>23 in the context, of course, of rule 2.88 sub-rule 9 of</p> <p>24 the insolvency rules, which one has to keep in mind, in</p> <p>25 our submission, all the time. For my Lord's note, as</p> <p>Page 3</p>
<p>1 early, we may have to deal with that in some other way.</p> <p>2 But subject to that, I think everyone is content with</p> <p>3 the timetable. I hope my Lord has a draft of</p> <p>4 the timetable which came through a little while ago. If</p> <p>5 it is not there, we can easily hand your Lordship up</p> <p>6 a copy.</p> <p>7 MR JUSTICE HILDYARD: No, thank you very much. Yes, I did</p> <p>8 receive that, and I also received the indication via</p> <p>9 Mr Bayfield that there was a wrinkle that had developed</p> <p>10 as to the sequence of replies. But I am rather hoping</p> <p>11 that, bearing in mind that it is not going to help</p> <p>12 anyone -- I don't think I am going to be much influenced</p> <p>13 by whether something is said once or twice, to be</p> <p>14 honest. It would obviously be best if it were said</p> <p>15 once, but I don't think it should change simply out of</p> <p>16 fear of that.</p> <p>17 MR TROWER: Yes. My Lord, I quite understand that. I am</p> <p>18 sure it will be sorted, and if it is not, we can deal</p> <p>19 with it at the appropriate moment.</p> <p>20 My Lord, this, as your Lordship knows, is the third</p> <p>21 substantive hearing of the joint administrators'</p> <p>22 application for directions which was originally issued</p> <p>23 in June last year. Your Lordship has the re-amended</p> <p>24 application notice behind tab 1 of the core bundle.</p> <p>25 I think it is a fairly new insertion into the documents</p> <p>Page 2</p>	<p>1 I am sure you will find, the relevant version of it is</p> <p>2 behind tab 6 of the core bundle. It is one of those</p> <p>3 rules that's been amended from time to time since its</p> <p>4 original introduction; what we have behind tab 6 is the</p> <p>5 version that's relevant to LBIE's administration.</p> <p>6 The rule is part of the statutory scheme which the</p> <p>7 joint administrators are under a duty to administer, and</p> <p>8 the starting point is that all creditors have</p> <p>9 a statutory right to interest on their admitted claims</p> <p>10 payable out of any surplus. The rate at which they are</p> <p>11 entitled to interest depends on whether there is any</p> <p>12 rate applicable to their debt apart from the</p> <p>13 administration. If there is, they are entitled to that</p> <p>14 rate. If there is not, they are entitled to the</p> <p>15 Judgments Act rate. That is the broad thrust.</p> <p>16 Obviously, if the Judgments Act rate comes in at higher</p> <p>17 which the rate to which they are otherwise entitled,</p> <p>18 that's the one they will go for.</p> <p>19 So it follows that the joint administrators in</p> <p>20 administering the scheme must be satisfied that any</p> <p>21 creditor who claims more than 8 per cent is claiming</p> <p>22 a rate which is applicable to the debt apart from the</p> <p>23 administration.</p> <p>24 Now, in many instances, this is a mathematical</p> <p>25 exercise that is relatively straightforward. Subject to</p> <p>Page 4</p>

<p>1 issues such as compounding and contractual variations</p> <p>2 from time to time and issues arising from sources other</p> <p>3 than a contract, whether a rate is or is not greater</p> <p>4 than the Judgments Act rate simply requires a comparison</p> <p>5 between 8 per cent and whatever the contract governing</p> <p>6 the admitted debt provides for. But in the case of</p> <p>7 master agreements, as my Lord will have seen, the</p> <p>8 position is more complex, because the main applicable</p> <p>9 rate, which is the default rate, does not identify</p> <p>10 a rate by reference to a percentage, whether fixed or</p> <p>11 floating, but instead uses the concept of cost of</p> <p>12 funding, which is where we are all here.</p> <p>13 So it follow that if creditors are to assert</p> <p>14 entitlements to interest out of the surplus at rates</p> <p>15 gather than that 8 per cent, the joint administrators</p> <p>16 don't, as matters presently stand, have clear guidance</p> <p>17 that they really need to enable them to administer the</p> <p>18 surplus. That is why we are here.</p> <p>19 Now, can I move, then, on to just give your Lordship</p> <p>20 a flavour of the extent of the problem, although it is</p> <p>21 obvious that one can't be terribly accurate about the</p> <p>22 extent of the problem at this stage. But the extent of</p> <p>23 the problem can be found in three places: one is</p> <p>24 Mr Lomas's 12th witness statement; the second is his</p> <p>25 14th witness statement; and the third is the</p> <p style="text-align: center;">Page 5</p>	<p>1 Of the total admitted claims -- that's of the total</p> <p>2 2,838 figure -- 868, is the upstate figure, arise under</p> <p>3 ISDA master agreements, with a total value of</p> <p>4 4.521 billion. Those figures are in Mr Lomas's</p> <p>5 14th witness statement. Bundle 2, tab 9.</p> <p>6 Now, the vast majority arise under the 1992 master</p> <p>7 agreement, the majority of which -- but not the vast</p> <p>8 majority of which -- are governed by English law. The</p> <p>9 figures work out as follows. 98 per cent of the claims</p> <p>10 are under the 1992 master agreement, 98 per cent by</p> <p>11 value. Of those, 72 per cent are English law claims and</p> <p>12 26 per cent are New York law claims.</p> <p>13 The numbers are 543 English law, 310 New York law.</p> <p>14 Only 2 per cent of the claims arise under the 2002</p> <p>15 master agreement. They are all English law claims, and</p> <p>16 there are 15 of them.</p> <p>17 There are also a material number of claims under the</p> <p>18 German master agreements: 15, valued at approximately</p> <p>19 311 million. The figures in relation to the German</p> <p>20 master agreement claims are in Mr Lomas's 13th witness</p> <p>21 statement.</p> <p>22 So, returning to the English and New York law</p> <p>23 creditors under the ISDAs, there are a very significant</p> <p>24 number of creditors with very substantial claims who are</p> <p>25 entitled to certify cost of funding for the purposes of</p> <p style="text-align: center;">Page 7</p>
<p>1 14th progress report.</p> <p>2 The 12th witness statement is behind tab 5 of</p> <p>3 the core bundle. The 14th witness statement is in</p> <p>4 bundle 2, tab 9. The 14th progress report is in</p> <p>5 bundle 6, tab 13.</p> <p>6 I will dip into those documents from time to time,</p> <p>7 but I don't think we need to turn them up now and go</p> <p>8 through them. Just to give your Lordship the headline</p> <p>9 points --</p> <p>10 MR JUSTICE HILDYARD: Those are the ones that you indicated</p> <p>11 to me that I should read, I think?</p> <p>12 MR TROWER: Yes, your Lordship.</p> <p>13 MR JUSTICE HILDYARD: I don't mean that I have mastered</p> <p>14 them. I just have read them.</p> <p>15 MR TROWER: I'm grateful. Can I give your Lordship, then,</p> <p>16 the headline points. The surplus is now estimated to be</p> <p>17 between 6.17 billion and 7.72 billion sterling. So that</p> <p>18 is what we are talking about as the surplus out of which</p> <p>19 the interest entitlements can be paid.</p> <p>20 The total admitted claims are 2,838, with a value of</p> <p>21 12.27 billion, and your Lordship gets those details</p> <p>22 from -- the most up-to-date details -- the 14th progress</p> <p>23 report. There are 30 disputed claims which are still</p> <p>24 out there where the administrators' present estimate of</p> <p>25 the value of them is between 120 and 160 million.</p> <p style="text-align: center;">Page 6</p>	<p>1 the default rate definition. Whether they do so or not</p> <p>2 is likely to depend on whether they assert their cost of</p> <p>3 funding plus 1 per cent will exceed 8 per cent, because</p> <p>4 otherwise they just simply rely on the Judgments Act</p> <p>5 rate.</p> <p>6 In fact, not a large number of creditors have</p> <p>7 certified yet, and whether or not they do so and what</p> <p>8 they are entitled to take into account in so certifying</p> <p>9 will depend in large part on the outcome of this</p> <p>10 application, and so this application -- it is important</p> <p>11 from the administrators' point of view, but the</p> <p>12 conclusions which the court reaches will also, one</p> <p>13 hopes, affect the way in which the creditors certify.</p> <p>14 Now, it is not possible to give comprehensive</p> <p>15 evidence for that reason on how the answers to</p> <p>16 particular construction points will affect the way in</p> <p>17 which the surplus is distributed, but there are two bits</p> <p>18 of evidence that we put in that may or may not be</p> <p>19 helpful. The first is in Mr Lomas's 12th witness</p> <p>20 statement. If we can just briefly turn that up. It is</p> <p>21 in the core bundle, tab 5. It is paragraph 11. In that</p> <p>22 paragraph, what Mr Lomas does is describe the impact on</p> <p>23 some very simple hypotheses. If all ISDA claims were to</p> <p>24 have simple interest at 8 per cent, ie, the Judgments</p> <p>25 Act rate, the interest entitlement will be 1.7 billion.</p> <p style="text-align: center;">Page 8</p>

<p>1 If you take into account the ISDA compounding 2 entitlement, because you are entitled to compound 3 interest under the ISDA, and have a default rate 4 certified at either 8 per cent, 12 per cent or 5 18 per cent, the entitlements go up to 2.1 billion at 6 8 per cent; 3.7 billion at 12 per cent and 6.8 billion 7 at 18 per cent. So those are very, very approximate 8 hypotheticals. We will see straight away the difference 9 between the 1.7 billion, where there is an entitlement 10 to Judgments Act rate interest on a simple basis, as 11 1.7 billion, it goes up to 2.1 billion when you have the 12 8 per cent together with compounding under the ISDA 13 entitlements.</p> <p>14 MR JUSTICE HILDYARD: That includes the additional 15 1 per cent?</p> <p>16 MR TROWER: I think that -- yes, it does include it. 17 Because the default rate is the cost of funding plus 18 1 per cent. So when they are referring to default rate, 19 that's the cost of funding plus the 1. So that is the 20 first piece of evidence.</p> <p>21 The second piece of evidence is exhibited to this 22 witness statement, and, in a sense, all I just want to 23 do is draw my Lord's attention to it so my Lord can see 24 what's been done. But there is an annex, an appendix, 25 an annex to the witness statement which gives evidence</p> <p style="text-align: center;">Page 9</p>	<p>1 purposes, to spend very much time on this. It was an 2 attempt to see if it was possible to draw any 3 substantive or generalised conclusions in the absence of 4 much in the way of existing certification as to what the 5 impact of these questions would be on the actual 6 outcome, and it only goes so far, I think one has to 7 accept that.</p> <p>8 So, my Lord, that is all I was going to dip into by 9 way of the witness statement evidence for present 10 purposes. Can I just move on to what the role of 11 the joint administrators is and the role of the parties 12 is in the context of this application.</p> <p>13 So far as the joint administrators are concerned, 14 there are two aspects to their role. The first is, and 15 I have touched on this already, they do seek as much 16 guidance as the court can give so as to enable them to 17 administer the estate, and in particular the surplus, in 18 as efficient a manner as possible. To that end, they 19 have had in mind, when addressing the way this 20 application is to proceed, the practical consequences of 21 some of the arguments that have been made by the 22 parties, as my Lord would expect.</p> <p>23 They are conscious that they don't yet know exactly 24 what it is that the claimants will seek to have taken 25 into account as costs of funding, and so, to an extent,</p> <p style="text-align: center;">Page 11</p>
<p>1 of five example counterparties and how they might 2 approach a certification of cost of funding using six 3 different methods for quantifying borrowing costs. So 4 that is what this is doing, it is an annex that starts 5 at page 71, behind tab 5.</p> <p>6 What it demonstrates is the following rather general 7 points which may or may not be obvious in any event, and 8 there are three of them. The first is that there will 9 be substantial differences in borrowing costs between 10 different entities, and that's fairly obvious; the 11 second is substantial differences in borrowing costs for 12 the same entities in different scenarios where they are 13 borrowing on different bases, so that's the second 14 variable; the third point that comes out from it, and 15 you get this from a table which appears at page 90 as 16 a sort of summary, is that, where the cost of borrowing 17 is the certified cost of funding, 8 per cent is rarely 18 exceeded on these scenarios, although it can be, and it 19 appears on these hypothetical examples the category of 20 a smaller public international corporation seems to be 21 one where it might be.</p> <p>22 But, of course, this is dealing with borrowing 23 costs, and as my Lord knows, the issues which my Lord is 24 having to decide extend beyond pure borrowing costs.</p> <p>25 I don't think it is productive, for present</p> <p style="text-align: center;">Page 10</p>	<p>1 one is a little bit in the dark. But, to that end, we 2 have suggested -- and this may or may not ultimately be 3 helpful in all respects -- some questions which can be 4 asked when assessing particular claims by reference to 5 characteristics that may or may not require to be 6 satisfied before something is capable of being funding 7 and having a cost within the meaning of the definition.</p> <p>8 That is an area of our skeleton that I will come 9 back to in a little bit more detail in a moment. I'm 10 not going to address any substantive submissions to 11 my Lord on those, but I will just take you through what 12 we sought to do there in a moment, and why we sought to 13 do it.</p> <p>14 Now, the second aspect of the joint administrators' 15 role is that we have sought to identify submissions on 16 substance which we consider are arguable but which have 17 not been advanced by either party. Some of those 18 positions were mentioned in our position paper.</p> <p>19 Now, on the basis of the existing skeletons, there 20 seems to be very little which falls into that category 21 now, although we continue to keep a close eye on it. 22 That wasn't the case we considered at the time of 23 the position papers, but it appears to be the case now.</p> <p>24 This second role is important and one of some 25 sensitivity in this case because none of the respondents</p> <p style="text-align: center;">Page 12</p>

<p>1 act as representative parties in a formal way. Apart</p> <p>2 from anything else, the complexity of the way in which</p> <p>3 some of the issues interrelate and the different</p> <p>4 commercial interests which the parties have would have</p> <p>5 made any representation orders pretty difficult to make</p> <p>6 in a case like the present.</p> <p>7 Just so that my Lord can see how this works in the</p> <p>8 context of the issues that your Lordship has before you</p> <p>9 by reference to the position of the three respondents,</p> <p>10 the Senior Creditor Group has a broad interest, as</p> <p>11 my Lord knows, in maximising claims to interest. It</p> <p>12 has, according to Mr Lomas's evidence -- it is his 12th</p> <p>13 witness statement, again paragraph 8 -- claims under</p> <p>14 ISDAs of 1.1 billion. So that's its position. That's</p> <p>15 behind tab 5 of the core bundle, page 65, Lomas 12,</p> <p>16 paragraph 8.</p> <p>17 Wentworth also does have ISDA claims and they are</p> <p>18 quite substantial -- about 1.6 billion, according to</p> <p>19 Mr Lomas's 12th witness statement, paragraph 8 -- but</p> <p>20 critically it is also the holder of the subordinated</p> <p>21 debt, so, in that capacity, its interest is in</p> <p>22 minimising the claims to interest. That's why it argues</p> <p>23 from that position.</p> <p>24 GSI also has ISDA claims, and argues in the same</p> <p>25 interest as the SCG, but it does so from the perspective</p> <p style="text-align: center;">Page 13</p>	<p>1 to ensure that a proper balance is struck and that the</p> <p>2 application doesn't become a free for all. That has not</p> <p>3 happened in this case. But the obvious reasons are that</p> <p>4 your Lordship is not going to be assisted and it is</p> <p>5 going to increase costs, or likely to increase costs, if</p> <p>6 you have too many people come along, which is why the</p> <p>7 balance needs to be struck.</p> <p>8 All I just want to make clear at the outset --</p> <p>9 I quite understand that the respondents all appreciate</p> <p>10 this -- is that the joinder of GSI was accepted by the</p> <p>11 joint administrators as being appropriate at the time of</p> <p>12 the hearing in front of Mr Justice David Richards</p> <p>13 in June so long as there was no duplication and so long</p> <p>14 as the SCG continued to take the lead. That is clear</p> <p>15 from the transcript of the hearing, which I don't think</p> <p>16 we need to look up, but Mr Howard, who was then acting</p> <p>17 for GSI, then accepted this was an appropriate basis for</p> <p>18 joinder. That is what Mr Justice David Richards meant</p> <p>19 when he said there was no duplication in the order.</p> <p>20 My Lord, can I now move on to another subject, which</p> <p>21 is what one might describe as common ground as we</p> <p>22 understand it. What I am also going to do as part of</p> <p>23 this section of my submissions is just take my Lord to</p> <p>24 the interest provisions in the 1992 and 2002 ISDAs.</p> <p>25 I quite understand that the parties all have substantive</p> <p style="text-align: center;">Page 15</p>
<p>1 of a financial institution. So, in broad terms, one of</p> <p>2 the reasons why the joint administrators have been</p> <p>3 keeping a very careful eye on the arguments being</p> <p>4 advanced is that it isn't possible to say that</p> <p>5 particular respondents fall neatly into a particular</p> <p>6 box. Although I think it is also fair to say that some</p> <p>7 of the concerns that they did have at the time of</p> <p>8 the position papers have proved to be unfounded in the</p> <p>9 light of the way the skeletons have been adduced and the</p> <p>10 arguments that have been advanced.</p> <p>11 Can I just make one or two hopefully uncontentious</p> <p>12 observations about Goldman Sachs's presence here, just</p> <p>13 largely because they are rather late to the party. As</p> <p>14 my Lord knows, they joined in June 2015.</p> <p>15 We have always recognised, can I stress at the</p> <p>16 outset, that it may be appropriate for other creditors,</p> <p>17 apart from the principal respondents, to be heard of</p> <p>18 parts of the Waterfall application, and indeed</p> <p>19 information is regularly placed on the website to enable</p> <p>20 creditors to be fully informed as to what is going on so</p> <p>21 they can make their own decisions as to whether or not</p> <p>22 they want to attend. It is in everyone's interests of</p> <p>23 course that arguments that need to be ventilated are</p> <p>24 ventilated now.</p> <p>25 But, on the other side of the coin, we are concerned</p> <p style="text-align: center;">Page 14</p>	<p>1 submissions, but I thought it would be helpful if, in</p> <p>2 a hopefully reasonably dispassionate way, I simply point</p> <p>3 your Lordship to where it is that the relevant</p> <p>4 provisions work. I'm sure my Lord has picked up some if</p> <p>5 not all of them. And just show your Lordship the</p> <p>6 architecture of it insofar as it relates to the interest</p> <p>7 provisions, and I hope that will be helpful.</p> <p>8 MR JUSTICE HILDYARD: Just one thing. Given the</p> <p>9 sophistication of the parties, this may not really be</p> <p>10 a point at all, but you have explained that the various</p> <p>11 questions have been notified, as it were, on the</p> <p>12 internet. Have the creditors been given, as it were,</p> <p>13 a "now or forever hold your peace" suggestion or have</p> <p>14 they simply been alerted to the fact that there is this</p> <p>15 thing going on in which it is hoped that the various</p> <p>16 possibilities are canvassed and adjudicated?</p> <p>17 MR TROWER: I don't think it has explicitly been said "Now</p> <p>18 or forever hold your peace". I will corrected if I am</p> <p>19 wrong. This has been going on as a process for several</p> <p>20 years now, since this type of application was first</p> <p>21 initiated.</p> <p>22 What the administrators have done is, they have --</p> <p>23 when a stage has been reached in the course of</p> <p>24 the application, whether it is the filing of position</p> <p>25 papers or skeleton arguments, which are then placed on</p> <p style="text-align: center;">Page 16</p>

<p>1 the website, or whether it is in the form of</p> <p>2 a particular issue no longer being argued, because there</p> <p>3 are some agreed issues, there has been a notification to</p> <p>4 that effect. So one can see a series of news items</p> <p>5 tracking through over many months the progress of</p> <p>6 the administration, and this application in particular.</p> <p>7 I don't think that it has actually been put in quite the</p> <p>8 terms in which my Lord has suggested, although we would</p> <p>9 suggest that it is probably not necessary for that to be</p> <p>10 done.</p> <p>11 These are, as my Lord knows, a very sophisticated</p> <p>12 group of creditors. Most of the debt is actually within</p> <p>13 a fairly small number of people now. They have been</p> <p>14 following it very closely for a very long time.</p> <p>15 So, my Lord, just turning to the common ground, if</p> <p>16 I can put it that way, what we did in our skeleton</p> <p>17 argument was we put at the back of it -- it is behind</p> <p>18 tab 1 of bundle 3, page 44 -- an appendix which sought</p> <p>19 to provide in one place what we perceived to be common</p> <p>20 ground and where we derived what we thought were</p> <p>21 a series of uncontroversial propositions but which would</p> <p>22 help my Lord in working his way through the various</p> <p>23 documents.</p> <p>24 That appendix has a number of parts to it. There is</p> <p>25 a bit on ISDA and the purpose of the ISDA master</p> <p style="text-align: center;">Page 17</p>	<p>1 next page, the penultimate definition on the next page,</p> <p>2 which is the arithmetic mean of the cost of funding of</p> <p>3 each party is certified by each party.</p> <p>4 I will explain how that fits in a moment when</p> <p>5 I explain briefly the circumstances in which the</p> <p>6 interest at the various rates is payable.</p> <p>7 The other thing for my Lord just to note, apart from</p> <p>8 the three substantive rates -- that's the default rate,</p> <p>9 the non-default rate and the termination rate -- there</p> <p>10 is a concept called the applicable rate which appears</p> <p>11 above the definition of default rate on page 160, but</p> <p>12 itself refers to one of the three substantive rates. So</p> <p>13 when you look at the definition of the applicable rate,</p> <p>14 you then get taken to one of the other three.</p> <p>15 What are the circumstances in which interest is</p> <p>16 payable under this agreement? The first circumstance is</p> <p>17 to be found in section 2(e), which is on page 149. This</p> <p>18 is dealing with a situation "prior to the occurrence or</p> <p>19 effective designation of an Early Termination Date", the</p> <p>20 opening line. The party in default pays interest at the</p> <p>21 default rate.</p> <p>22 So this is simply dealing with circumstances before</p> <p>23 closeout where there is non-payment of an amount owing;</p> <p>24 and non-payment of an amount owing, perhaps not</p> <p>25 surprisingly, the amount you pay is the default rate,</p> <p style="text-align: center;">Page 19</p>
<p>1 agreement; there is a bit on the architecture of</p> <p>2 the ISDA master agreement; and there is a bit starting</p> <p>3 at page 46 on structure and terms of the ISDA master</p> <p>4 agreement.</p> <p>5 The bits dealing with interest start at page 49.</p> <p>6 What I thought your Lordship may find helpful is if,</p> <p>7 having that on one side, my Lord would take up the two</p> <p>8 ISDA master agreements, which most conveniently can be</p> <p>9 found in the core bundle behind tabs 7 and 8, and I can</p> <p>10 just fairly shortly, I hope, take my Lord to the</p> <p>11 relevant provisions insofar as they deal with interest.</p> <p>12 If we deal first with the 1992 master agreement</p> <p>13 behind tab 7, can I start by doing it this way: there</p> <p>14 are three types of rate that are referred to in the '92</p> <p>15 ISDA master: there is a default rate; a non-default</p> <p>16 rate; and a termination rate. If one goes to the</p> <p>17 definitions provisions, the default rate, which is the</p> <p>18 one we are primarily concerned with for present</p> <p>19 purposes, starts at the bottom of page 160. It is those</p> <p>20 two lines there. Then the non-default rate my Lord</p> <p>21 finds on page 162, and that is the non-defaulting</p> <p>22 party's cost of funding certified by the non-defaulting</p> <p>23 party. So there is no reference there to the plus</p> <p>24 1 per cent.</p> <p>25 Then we have a termination rate, which is on the</p> <p style="text-align: center;">Page 18</p>	<p>1 you're in default. So we are talking about a</p> <p>2 pre-closeout situation here.</p> <p>3 The next substantive provision is to be found in</p> <p>4 section 6(d)(ii), which is amounts calculated as being</p> <p>5 due in respect of early termination date. That's</p> <p>6 page 155.</p> <p>7 If, before we look at that, I can just mention to</p> <p>8 my Lord when an early termination date occurs for the</p> <p>9 purposes of this definition. An early termination date</p> <p>10 occurs either under section 6(a), when there is an event</p> <p>11 of default designated as such by a non-defaulting party.</p> <p>12 So that's 6(a). So a non-defaulting party designates an</p> <p>13 event of default as giving rise to an early termination</p> <p>14 date under section 6(a). That's the first circumstance.</p> <p>15 The second circumstance is that it can occur</p> <p>16 automatically on the occurrence of certain events of</p> <p>17 default if automatic early termination is specified in</p> <p>18 the schedule. So you can have automatic occurrence of</p> <p>19 an early termination date in circumstances where certain</p> <p>20 events of default arise if the parties have so provided</p> <p>21 in the relevant schedule to the ISDA agreement.</p> <p>22 The third circumstance -- this is the explanation of</p> <p>23 termination rate -- where an early termination date</p> <p>24 arises is where there's been what's called a termination</p> <p>25 event under section 6(b)(iv) of the agreement, ie, at</p> <p style="text-align: center;">Page 20</p>

5 (Pages 17 to 20)

<p>1 the bottom of page 154.</p> <p>2 Those termination events are things like</p> <p>3 illegalities, tax events, tax events upon mergers,</p> <p>4 credit events upon mergers. The parties can specify</p> <p>5 additional termination events. But they are not events</p> <p>6 of default. But they can give rise to an early</p> <p>7 termination date occurring.</p> <p>8 So the consequences of an early termination date in</p> <p>9 those circumstances also have to be dealt with under the</p> <p>10 terms of the agreement.</p> <p>11 So, with that in mind, we go to section 6(d)(ii),</p> <p>12 which is the second of the substantive circumstances in</p> <p>13 which an entitlement to interest arises. So we are here</p> <p>14 dealing with a situation in which an early termination</p> <p>15 date has occurred, and the party who is obliged to pay</p> <p>16 the closeout amount, which could either be a defaulter</p> <p>17 or a non-defaulter, or indeed a party affected by</p> <p>18 a termination event, but for prevent purposes</p> <p>19 a defaulter or a non-defaulter, is required to pay</p> <p>20 interest from the early termination date to the payment</p> <p>21 at the applicable rate.</p> <p>22 So one can immediately see there that this is</p> <p>23 dealing with a circumstance in which somebody who is in</p> <p>24 default and somebody who is not in default who has to be</p> <p>25 dealt with as the possible paying party. The way it</p> <p style="text-align: center;">Page 21</p>	<p>1 Subsequent to the amount becoming payable, everybody</p> <p>2 pays at the default rate. So that's the distinction as</p> <p>3 a matter of architecture.</p> <p>4 Then the final point is that, where the early</p> <p>5 termination date occurs as a result of a termination</p> <p>6 event, which we are not directly concerned with here,</p> <p>7 but your Lordship just needs to know, interest is then</p> <p>8 payable at the termination rate.</p> <p>9 So those, my Lord, are the primary provisions.</p> <p>10 There is one other aspect of this that one needs to</p> <p>11 understand to see the architecture of it, which is</p> <p>12 a concept of unpaid amounts. Interest is dealt with</p> <p>13 separately in relation to the calculation of the actual</p> <p>14 closeout amount, itself, which is where we go on this.</p> <p>15 If my Lord would then turn to paragraph 6(e) on</p> <p>16 page 155, there are different methods for calculating</p> <p>17 closeout amounts on early termination under 6(e)(i),</p> <p>18 where there has been an event of default, and under</p> <p>19 6(e)(ii), where there has been a termination event.</p> <p>20 I think we can just look at where there's been an event</p> <p>21 of default.</p> <p>22 There's market quotation and there's loss and</p> <p>23 there's a first method and second method applicable to</p> <p>24 both. So far as market quotation is concerned, the</p> <p>25 obligation is to pay a settlement amount plus an unpaid</p> <p style="text-align: center;">Page 23</p>
<p>1 works is that you pay at the applicable rate, and then</p> <p>2 one goes to applicable rate, which is at page 160, and</p> <p>3 the applicable rate is either the default rate or the</p> <p>4 non-default rate or the termination rate, depending on</p> <p>5 the circumstances. Those are the circumstances that are</p> <p>6 described in subparagraphs (a) to (d) of the definition.</p> <p>7 Now, when my Lord is considering the applicable rate</p> <p>8 and the circumstances, insofar as one ever gets into it,</p> <p>9 the definitions and the architecture of the agreement</p> <p>10 contemplate two separate periods of time which the</p> <p>11 applicable rate is dealing with. There is a period of</p> <p>12 time between the moment of the early termination date</p> <p>13 and the moment in time at which the amount becomes</p> <p>14 payable under the agreement. Because the amount</p> <p>15 actually only becomes payable once the necessary</p> <p>16 calculation has been carried out.</p> <p>17 Then there is subsequent to the date on which the</p> <p>18 closeout amount the payable, so after the calculation</p> <p>19 has been notified, up until payment.</p> <p>20 So one has to bear in mind those two separate</p> <p>21 periods because during period A, ie, between the early</p> <p>22 termination date and the date the amount is payable,</p> <p>23 interest is at the default rate if the defaulting party</p> <p>24 is the paying party, but it is at the non-default rate</p> <p>25 if the non-defaulting party is the paying party.</p> <p style="text-align: center;">Page 22</p>	<p>1 amount. The settlement amount, broadly speaking, is the</p> <p>2 market quotation, that you go out into the market to get</p> <p>3 a quotation. The unpaid amount has to be added to the</p> <p>4 settlement amount when working out a closeout figure.</p> <p>5 The unpaid amount includes an element of interest.</p> <p>6 I will just show my Lord how that works.</p> <p>7 If we go to the definition of unpaid amounts, which</p> <p>8 appears at page 163, the unpaid amount is amounts that</p> <p>9 are payable on or prior to the early termination date</p> <p>10 and remaining unpaid at that date. Then if you go over</p> <p>11 the page, to the second line on page 164:</p> <p>12 "... in each case together with ... interest, in the</p> <p>13 currency of such amounts, from (and including) the date</p> <p>14 such amounts or obligations were or would have been</p> <p>15 required to have been paid or performed to ... such</p> <p>16 Early Termination Date, at the Applicable Rate."</p> <p>17 So the applicable rate is included within the</p> <p>18 concept of an unpaid amount when working out the</p> <p>19 closeout figure. So the consequence of that is that the</p> <p>20 closeout amount carries with it an interest entitlement</p> <p>21 at the applicable rate up to the early termination date.</p> <p>22 Thereafter, the interest entitlement is dealt with by</p> <p>23 6(d)(ii), the definition that I have already shown</p> <p>24 your Lordship.</p> <p>25 So that is how interest comes into the definition of</p> <p style="text-align: center;">Page 24</p>

6 (Pages 21 to 24)

<p>1 unpaid amounts, which is relevant by reference to the</p> <p>2 concept of market quotation.</p> <p>3 If the method specified isn't market quotation, but</p> <p>4 is loss, the entitlement to interest in respect of</p> <p>5 unpaid amounts for this period, for the period from the</p> <p>6 date payment fell due to the early termination date, is</p> <p>7 swept up in the definition of loss, which my Lord finds</p> <p>8 on page 161.</p> <p>9 Now, there isn't a specific reference to interest in</p> <p>10 the definition of loss, but the users' guide to this</p> <p>11 says that this includes all elements of unpaid amounts,</p> <p>12 ie, including interest. For my Lord's note, the users'</p> <p>13 guide reference is volume 5, tab 5, page 136.</p> <p>14 My Lord, that is the architecture of the interest</p> <p>15 entitlements under the 1992 ISDA.</p> <p>16 MR JUSTICE HILDYARD: The users' guide, does it have some</p> <p>17 status under the master agreements or is it merely</p> <p>18 illustrative of a possible answer or a possible</p> <p>19 conclusion?</p> <p>20 MR TROWER: I will give your Lordship the answer to that in</p> <p>21 a moment, because I can't tell you straight off the top</p> <p>22 of my head. We would say it is something the court</p> <p>23 would be bound to look at but I don't know whether it</p> <p>24 has formal status --</p> <p>25 MR JUSTICE HILDYARD: It would be part of the matrix, but is</p> <p style="text-align: center;">Page 25</p>	<p>1 at page 192, which is primarily dealing with termination</p> <p>2 events and varies according to the circumstances. It</p> <p>3 also refers, like the non-default rate, to rates offered</p> <p>4 by banks in the interbank market, although in (a) and</p> <p>5 (b) the wording is slightly different. Then in (c), it</p> <p>6 refers to an arithmetic mean between interbank rates and</p> <p>7 the relevant payee's cost of funding.</p> <p>8 So those are the rates, themselves. Then if my Lord</p> <p>9 then turns back to 9(h)(i) and (ii), one can see the</p> <p>10 structure against that background of the circumstances</p> <p>11 in which the various rates are payable, and one tends to</p> <p>12 find the reference to the relevant rate at the end of</p> <p>13 each of the subparagraphs, just for convenience, so we</p> <p>14 find the default rate and it appears at the end of</p> <p>15 (i)(1), which is where there is a defaults payment, so</p> <p>16 that's the broad equivalent of what used to be (2)(e).</p> <p>17 Then sub (3) is dealing with the -- as I explained</p> <p>18 to my Lord earlier on, everything under (i) is dealing</p> <p>19 with the position prior to early termination. Then</p> <p>20 sub (3) is the place where one finds most reference to</p> <p>21 the applicable deferral rate, and is dealing primarily</p> <p>22 with termination events. Then if you move on to (ii),</p> <p>23 over the page, you have the circumstances or the</p> <p>24 consequences of amounts arising on early termination so</p> <p>25 far as interest is concerned, and the way that works --</p> <p style="text-align: center;">Page 27</p>
<p>1 it something from which you can actually directly derive</p> <p>2 a meaning, if you like?</p> <p>3 MR TROWER: Yes, I understand the point. I don't know the</p> <p>4 answer to it in those terms, but I will let you know.</p> <p>5 Then, moving on to the 2002 agreement, in this</p> <p>6 agreement, all of the substantive interest provisions</p> <p>7 have been moved into one place. They have been moved</p> <p>8 into section 9(h). It is behind tab 8 at page 187.</p> <p>9 Subsection (h) is divided up into two substantive parts:</p> <p>10 (i) is prior to early termination date; (ii), which</p> <p>11 appears over the page, on page 188, is post.</p> <p>12 As to the rates, themselves, and the definition of</p> <p>13 them, the definitions of default rate and termination</p> <p>14 rate are unchanged. My Lord gets those at page 194 and</p> <p>15 page 197. Page 194, halfway down; 197, three-quarters</p> <p>16 of the way down.</p> <p>17 The definition of non-default rate is changed, if</p> <p>18 my Lord turns to page 195, to refer to rates offered to</p> <p>19 the non-defaulting party by a major bank in a relevant</p> <p>20 interbank market for overnight deposits. Because if one</p> <p>21 compares that with the non-default rate that's referred</p> <p>22 to in the '92 agreement on page 162, that was simply</p> <p>23 a cost of funding definition.</p> <p>24 The 2002 agreement then introduces a new rate,</p> <p>25 called the applicable deferral rate, which my Lord finds</p> <p style="text-align: center;">Page 26</p>	<p>1 we are here dealing with early termination, so we are</p> <p>2 dealing with closeout -- is that in all circumstances</p> <p>3 referred to here, the interest is payable at what is</p> <p>4 described as the applicable closeout rate. And to find</p> <p>5 what that is, you go to page 191.</p> <p>6 The applicable closeout rate takes you, at page 191,</p> <p>7 to the default rate, the non-default rate or the</p> <p>8 applicable deferral rate, depending on the</p> <p>9 circumstances.</p> <p>10 Although it is quite complex, we have actually</p> <p>11 included, at paragraph 27 of the annex at page 52 of our</p> <p>12 skeleton, a simplified description of the circumstances</p> <p>13 in which the various rates are payable. But I think for</p> <p>14 present purposes, for the purposes of this introduction,</p> <p>15 my Lord doesn't need to understand all the complexities</p> <p>16 built into this.</p> <p>17 The final aspect of the 2002 ISDA that I was going</p> <p>18 to show my Lord is just to concentrate for a moment on</p> <p>19 the unpaid amounts aspect of it. The 2002 ISDA</p> <p>20 simplifies the calculation of the actual closeout</p> <p>21 amount. It is to be found at 6(e)(i), 6(e), "Payments</p> <p>22 on Early Termination". But the first and second methods</p> <p>23 and loss and market quotation concepts have been</p> <p>24 abandoned -- we are on page 183.</p> <p>25 MR JUSTICE HILDYARD: I'm so sorry, Mr Trower. Yes.</p> <p style="text-align: center;">Page 28</p>

<p>1 MR TROWER: The concept as first and second method and</p> <p>2 market quotation and loss have been abandoned, and the</p> <p>3 principal concept is one of the closeout amount, as</p> <p>4 my Lord will see there, in 6(e)(i):</p> <p>5 "If the Early Termination Rate results from an Event</p> <p>6 of Default, the Early Termination Amount will be an</p> <p>7 amount equal to (1) the sum of (A) the Termination of</p> <p>8 Currency Equivalent of the Closeout Amount ... [and] The</p> <p>9 Termination Currency Equivalent of the Unpaid</p> <p>10 Amounts ..."</p> <p>11 So we have a closeout amount and unpaid amounts.</p> <p>12 Just so my Lord can see how this works on the</p> <p>13 definitions, page 192 gives the definition of closeout</p> <p>14 amount. It is quite a lengthy definition, but in</p> <p>15 essence it's losses or cost determined by, amongst other</p> <p>16 things, market quotations, if that is what is</p> <p>17 appropriate. So it is a broader concept.</p> <p>18 So you have got that definition at page 192,</p> <p>19 closeout amount, and going over the page, but to that</p> <p>20 you have to add the unpaid amounts, as we saw in</p> <p>21 6(e)(i). Unpaid amounts, again, is defined at page 197.</p> <p>22 It is, broadly speaking, very similar to the position</p> <p>23 under the 1992 ISDA. It includes, and one gets this</p> <p>24 from the last line on page 197 and over the page:</p> <p>25 "... any amount of interest accrued or other</p> <p style="text-align: center;">Page 29</p>	<p>1 commentary on the strict wording as it was being</p> <p>2 prepared. But I can easily, I'm sure, find out --</p> <p>3 MR JUSTICE HILDYARD: It may be an irrelevant question, but</p> <p>4 with some of these market documentations and with some</p> <p>5 of the provisions of codes, such as the uniform</p> <p>6 commercial code in the United States, the background</p> <p>7 workings are -- they are not sort of like Hansard</p> <p>8 because they are more available than that, but they are</p> <p>9 nevertheless available assistance to any drafting</p> <p>10 difficulties.</p> <p>11 MR TROWER: Yes. The best I can say do straight off the top</p> <p>12 of my head is, in the users' guide to the 2002 master,</p> <p>13 there is an introduction which explains the process</p> <p>14 going on with working groups. What I don't know is how</p> <p>15 much of these working groups' workings were conducted in</p> <p>16 public and were subject to toing and froing of debate</p> <p>17 between people. But one imagines that those interested</p> <p>18 in these things contributed through the working groups</p> <p>19 at least. But how much further than that one can go,</p> <p>20 I don't know.</p> <p>21 MR JUSTICE HILDYARD: With apologies for my French accent,</p> <p>22 the travaux préparatoires would, in some circumstances,</p> <p>23 actually be a very important guide. Are there</p> <p>24 equivalents? I suppose that is my question.</p> <p>25 MR TROWER: I understand the question. I don't think they</p> <p style="text-align: center;">Page 31</p>
<p>1 compensation in respect of that obligation ... as the</p> <p>2 case may be, pursuant to section 9(h)(ii)(1) or (2) as</p> <p>3 appropriate."</p> <p>4 So that then takes you back to interest at the</p> <p>5 applicable closeout rate.</p> <p>6 So far as the users' guide is concerned, my Lord, it</p> <p>7 is not represented to be formally part of the document,</p> <p>8 although it is -- it doesn't purport and shouldn't be</p> <p>9 considered to be a guide or explanation of all relevant</p> <p>10 issues. That is the first point. It is designed to</p> <p>11 explain the 1992 agreement. It is not intended to go</p> <p>12 further than that.</p> <p>13 MR JUSTICE HILDYARD: I'm sorry if you have answered this</p> <p>14 question in your skeleton, but in terms of the changes</p> <p>15 which are affected by sequential versions of the master</p> <p>16 agreement, in this case 1992 and onwards, are the</p> <p>17 changes the product of publicised workings? For</p> <p>18 example, by analogy -- take the example of the uniform</p> <p>19 commercial code, where the workings are both public and</p> <p>20 instructional.</p> <p>21 MR TROWER: So far as the changes between 1992 and 2002 are</p> <p>22 concerned, I can say this much, that there was an</p> <p>23 enormous amount of market debate that led to the changes</p> <p>24 in the agreement. What I don't know is how much drafts</p> <p>25 of the 2002 agreement went out into the market for</p> <p style="text-align: center;">Page 30</p>	<p>1 are formal travaux préparatoires as they would be in the</p> <p>2 form of UCC materials, but whether one can go any</p> <p>3 further than that's said on the face of the users'</p> <p>4 guide, I don't know at the moment. But I can see</p> <p>5 whether we can help a bit more on that.</p> <p>6 MR JUSTICE HILDYARD: The other thing, I was just looking at</p> <p>7 the various choices of jurisdiction and the denomination</p> <p>8 of the currencies, the primary currencies appear to be</p> <p>9 euro, if it is English law; dollars if it is New York</p> <p>10 law; but any currency and any law can be chosen under</p> <p>11 the schedule.</p> <p>12 MR TROWER: Yes, that's right.</p> <p>13 MR JUSTICE HILDYARD: That's right?</p> <p>14 MR TROWER: That is right, yes. Of course my Lord needs to</p> <p>15 bear that in mind when construing them, but as it</p> <p>16 happens in this case, we are only dealing with English</p> <p>17 law and New York law, and I think --</p> <p>18 MR JUSTICE HILDYARD: No, but I suppose it goes to technical</p> <p>19 meanings under one law might be difficult under another.</p> <p>20 MR TROWER: That's certainly the case. Although, of course,</p> <p>21 one has to bear in mind -- it goes both ways -- that the</p> <p>22 form of the schedule and the confirmation can make</p> <p>23 variations, and presumably one could make an appropriate</p> <p>24 variation if there was a particularly obscure law with</p> <p>25 some particularly obscure provision.</p> <p style="text-align: center;">Page 32</p>

<p>1 MR JUSTICE HILDYARD: This is too general a question, but 2 just so I can begin to find my feet, are you looking for 3 a meaning which is common to all the laws or do you 4 accept that party autonomy means that the same 5 expression may under one law have a different meaning 6 under another?</p> <p>7 MR TROWER: I think I have to -- for my part, I think it is 8 plainly capable of having a different meaning under 9 another law. That is one of the issues that is touched 10 on, actually, as between English and New York law in 11 this case.</p> <p>12 The parties' position is -- this is obviously not 13 surprising given the nature of the laws concerned -- 14 that there is no material distinction between English 15 and New York law for these purposes and that English and 16 New York law each reach the same result, although the 17 parties say they differ on what that result should be. 18 But nobody contends for a different result under 19 New York law from the result they contend for under 20 English law. But whether the same would be applicable 21 in relation to --</p> <p>22 MR JUSTICE HILDYARD: I suppose I'm thinking of a question 23 of outlook to interpretation. If you are looking for, 24 as it were, a meaning which, to the best of your 25 ability, you think will not be unsettled by any</p> <p style="text-align: center;">Page 33</p>	<p>1 semi public forum in which it was going on. But that 2 was the extent of the publicity.</p> <p>3 My Lord, what I was going to go on to next was just 4 to introduce the issues, and for most of them there is 5 really very little for me to say.</p> <p>6 Perhaps it would be helpful for my Lord just to have 7 the application notice to hand while we are doing this. 8 For the most part, as my Lord knows, we don't expect to 9 be making substantive submissions on any of the issues 10 because of the way the arguments have been addressed. 11 But we thought it would be helpful just briefly to 12 explain to my Lord the position that everyone adopts, 13 and there are a couple of points that I want to bring 14 out so far as the joint administrators' position is 15 concerned.</p> <p>16 The first issue is issue 10, dealing with transfers. 17 As my Lord knows, both of the agreements permit the 18 transfer of certain rights in certain circumstances, and 19 the parties will be looking at how those transfer 20 entitlements work in making their substantive 21 submissions.</p> <p>22 It essentially boils down to this: does the phrase 23 "relevant payee" in the definition of "default rate" 24 refer only to LBIE's contractual counterparty or to 25 a third part transferee? The Senior Creditor Group say</p> <p style="text-align: center;">Page 35</p>
<p>1 particular jurisdiction, so you adopt almost a common 2 language approach, that is one thing. Alternatively, if 3 you accept that a given phrase may have a different 4 meaning according to the system of law which is 5 applicable, you have to be less worried about that. You 6 just accept that parties appreciate that under their law 7 the master agreement could mean simple completely 8 different. I'm not saying it would because there is 9 probably more commonality than that.</p> <p>10 MR TROWER: I think it is fair to say, isn't it that, where 11 you are seeking to construe a master agreement which has 12 been designed to be useful in a wide range of different 13 circumstances, both so far as different types of 14 counterparty are concerned and different applicable laws 15 are concerned, that might point towards adopting an 16 approach to construction which is capable of working, so 17 the agreement is capable of working, under what one 18 might regard as being the most likely to be used 19 applicable laws. I think one can certainly go that far.</p> <p>20 My Lord, the answer I have had in relation to 21 your Lordship's question about the debate on changes to 22 the ISDA master agreements is that the debate was 23 apparently not public, but it was available to ISDA 24 members, and so the papers from the working groups were 25 available to ISDA members, and so there was a sort of</p> <p style="text-align: center;">Page 34</p>	<p>1 it relates to the person entitled to receive, so that's 2 the transferor pre-transfer and the transferee 3 post-transfer. Wentworth says it only refers to the 4 contractual counterparty and Mr Foxton's clients aren't 5 joined to argue this issue.</p> <p>6 We don't anticipate making any substantive points on 7 this because, looking at the skeletons, all the 8 arguments seem to have been ventilated.</p> <p>9 Issue 11, this is a crucial one insofar as the joint 10 administrators are concerned. It is phrased as 11 a question seeking guidance as to whether the cost of 12 funding wording is capable of including particular 13 categories of actual or asserted cost. Of those 14 categories of actual or asserted cost, there isn't any 15 dispute, as I understand it, in relation to 16 category 11(1), which is the cost of funding the 17 relevant amount by borrowing the relevant amount. The 18 remaining parts of issue 11 open up a range of arguments 19 between Wentworth on the one hand and the SCG and 20 Goldmans as to how far the concept of cost of funding 21 the relevant amount actually goes.</p> <p>22 Now, again, we don't anticipate that we are likely 23 to make any arguments of substance on this, given the 24 very comprehensive way in which the skeletons have 25 developed. But just to say this, that as my Lord will</p> <p style="text-align: center;">Page 36</p>

<p>1 have seen, much of the debate between the parties</p> <p>2 focuses on the distinction between funding by debt and</p> <p>3 funding by the issue of forms of equity. The joint</p> <p>4 administrators are a little concerned that there are</p> <p>5 dangers in using labels in this area without an</p> <p>6 appropriate concentration on the essential</p> <p>7 characteristics of the form of funding and the cost of</p> <p>8 that funding.</p> <p>9 So to that end, we have extracted from the parties'</p> <p>10 skeletons eight questions or characteristics which the</p> <p>11 court may find helpful, both in testing the submissions</p> <p>12 made by the parties and in describing the</p> <p>13 characteristics of what is and what is not capable of</p> <p>14 amounting to the cost to the relevant payee of funding</p> <p>15 if it were to fund or of funding the relevant amount.</p> <p>16 We deal with that in paragraphs 65 and following in our</p> <p>17 skeleton argument.</p> <p>18 If I can just show you those. I am not going to</p> <p>19 make submissions on what we saw there now because if any</p> <p>20 submissions have to be made, it is appropriate for me to</p> <p>21 make them after the parties have made their submissions.</p> <p>22 But just so my Lord can see where they are, they are</p> <p>23 listed out in paragraph 65 of the skeleton on page 19</p> <p>24 and then further developed.</p> <p>25 MR JUSTICE HILDYARD: Yes.</p> <p style="text-align: center;">Page 37</p>	<p>1 the Senior Creditor Group skeleton, I think it is</p> <p>2 suggested that they are not suggesting that. I imagine</p> <p>3 that Wentworth wouldn't and I haven't seen anything</p> <p>4 on --</p> <p>5 MR TROWER: Yes. The way we have summarised the position is</p> <p>6 in paragraph 55 of our skeleton. I think we certainly</p> <p>7 thought that was the case.</p> <p>8 MR JUSTICE HILDYARD: Yes, that's right. It seems to me to</p> <p>9 be right, anyway.</p> <p>10 MR TROWER: Yes. Nobody has said we have got that wrong.</p> <p>11 MR DICKER: Your Lordship is absolutely right.</p> <p>12 MR JUSTICE HILDYARD: Thank you.</p> <p>13 MR TROWER: Issue 12 then deals with questions which arise</p> <p>14 where the cost of funding is a cost of borrowing. So it</p> <p>15 is predicated on the basis that we are dealing with</p> <p>16 costs of borrowing.</p> <p>17 12(1) is agreed, as we understand it. The</p> <p>18 assumption has to be that the lender has recourse to the</p> <p>19 relevant payee's assets generally and not solely to the</p> <p>20 claim against LBIE. 12(2) is not agreed. This is</p> <p>21 concerned with the question of whether the cost includes</p> <p>22 the incremental cost to the relevant payee of incurring</p> <p>23 additional debt against its existing asset base or the</p> <p>24 weighted average costs on all borrowings. Now,</p> <p>25 initially the joint administrators had advanced some</p> <p style="text-align: center;">Page 39</p>
<p>1 MR TROWER: We do consider that answers to or at least</p> <p>2 a discussion of whether these characteristics have to be</p> <p>3 present or not for the relevant cost of funding to</p> <p>4 qualify will provide a helpful checklist for the</p> <p>5 administrators in dealing with certificates.</p> <p>6 When one considers the form of this application</p> <p>7 against the background of the administrators needing</p> <p>8 assistance to determine whether or not certificates do</p> <p>9 give rise to cost of funding entitlements which are</p> <p>10 greater than 8 per cent, as much as possible that can be</p> <p>11 done to assist in that what might be quite difficult</p> <p>12 process is, we would respectfully suggest, desirable.</p> <p>13 So, my Lord, as I say, there is a bit of development</p> <p>14 of that, but I am not going to develop that any further</p> <p>15 in my submissions at this stage because I think it more</p> <p>16 appropriate to see how it needs development in light of</p> <p>17 the parties' actual submissions. But we do suggest that</p> <p>18 those characteristics may be of real assistance.</p> <p>19 MR JUSTICE HILDYARD: Is there a dispute between the</p> <p>20 relevant parties as to subparagraph (4) of paragraph 11,</p> <p>21 which is the funding a claim? I wasn't sure when</p> <p>22 reading the skeleton arguments whether there was or</p> <p>23 wasn't. I rather thought maybe it wasn't.</p> <p>24 MR TROWER: I think your Lordship is right on that.</p> <p>25 MR JUSTICE HILDYARD: In subparagraph (3) of paragraph 68 of</p> <p style="text-align: center;">Page 38</p>	<p>1 position paper arguments on this point, but in the light</p> <p>2 of the arguments now made by Wentworth, they don't</p> <p>3 anticipate saying anything further on it because the</p> <p>4 arguments, such as they were, now we can see Wentworth's</p> <p>5 skeleton, seem to have been articulated.</p> <p>6 Issue 12(3), the same. There is a dispute. This is</p> <p>7 whether the cost of funding, where that funding is</p> <p>8 borrowing, can include any additional impact on the cost</p> <p>9 of other sources of funding. We haven't identified any</p> <p>10 further arguments that others aren't running on that.</p> <p>11 Issue 12(4) is largely agreed. It is concerned with</p> <p>12 any limitations on the nature of the funding, ie,</p> <p>13 overnight or term funding. Now, the only outstanding</p> <p>14 issue, as we understand it, is whether a certificate can</p> <p>15 certify based on the actual period for which funding can</p> <p>16 now be seen to have been required or whether it must be</p> <p>17 based on a good faith estimate of what the certifier</p> <p>18 would have done at the time. Now, it is not entirely</p> <p>19 clear to us, based on Goldman Sachs's supplemental</p> <p>20 skeleton, as to whether that is still an issue or not.</p> <p>21 It may not be an issue. But we will hear in due course.</p> <p>22 One of the reasons we say that is because of</p> <p>23 the parties' position on issue 13, which is concerned</p> <p>24 with how the calculation of cost of funding should take</p> <p>25 into account the circumstances pertaining at</p> <p style="text-align: center;">Page 40</p>

<p>1 a particular date and what that date should be, and we</p> <p>2 have summarised what we understand the position to be in</p> <p>3 paragraphs 128 and 129 of our skeleton. If my Lord</p> <p>4 would just read 127 and 128 and 129.</p> <p>5 My Lord, I was then just going to go on to the next</p> <p>6 series of issues quite quickly. It won't take me long</p> <p>7 to do the last few English law, and then I have one</p> <p>8 thing I need to explain to your Lordship about the</p> <p>9 German law issues and the interface with a point that</p> <p>10 arises out of Waterfall II tranche A. But I see the</p> <p>11 time is quarter to, and we do have shorthand writers.</p> <p>12 Would your Lordship consider this a convenient moment?</p> <p>13 MR JUSTICE HILDYARD: Yes. A generous five minutes.</p> <p>14 (11.46 am)</p> <p>15 (A short break)</p> <p>16 (11.51 am)</p> <p>17 MR TROWER: My Lord, just one point to pick up from this</p> <p>18 morning on governing law. The '92 and the 2002</p> <p>19 agreements didn't contemplate that any law other than</p> <p>20 English law or New York law would in fact be chosen.</p> <p>21 One can get that from the jurisdiction provision which</p> <p>22 actually only refers to English law and New York</p> <p>23 jurisdiction. It is always open to the parties to</p> <p>24 change it, but the draftsman did not contemplate that</p> <p>25 anyone would choose anything other than English law or</p> <p style="text-align: center;">Page 41</p>	<p>1 MR JUSTICE HILDYARD: So although they are entitled to</p> <p>2 nominate a different termination currency,</p> <p>3 theoretically, than euro or dollars, that does not</p> <p>4 connote that there be any other different system or</p> <p>5 jurisdiction?</p> <p>6 MR TROWER: I don't think one can go quite that far because</p> <p>7 it would always be open to parties to use another law</p> <p>8 simply by making provision for that --</p> <p>9 MR JUSTICE HILDYARD: Yes, but it is not --</p> <p>10 MR TROWER: But it is not contemplated that it will be.</p> <p>11 MR JUSTICE HILDYARD: Yes.</p> <p>12 MR TROWER: My Lord, can I move on then to issues 14, 15 and</p> <p>13 16, which are the certification issues. These questions</p> <p>14 relate to the true construction of words "as certified</p> <p>15 by it" in the definition of default rate.</p> <p>16 The parties are agreed that the certificate is</p> <p>17 conclusive subject to certain exceptions. It is agreed</p> <p>18 that the certificate is not conclusive if it is</p> <p>19 otherwise an in good faith or irrational. There are two</p> <p>20 issues, both of which may have gone. I'm afraid it is</p> <p>21 still slightly unclear to us as to whether or not these</p> <p>22 are live issues. The first is whether irrationality</p> <p>23 includes manifest error and, if so, what that means.</p> <p>24 The second is, is it sufficient for a certifier to</p> <p>25 rationally and honestly consider that its certificate</p> <p style="text-align: center;">Page 43</p>
<p>1 New York law under the ISDA.</p> <p>2 Actually, as it happens, I think LBIE has discovered</p> <p>3 one agreement which is governed by another law, and</p> <p>4 that's it. If you look at page 159, so far as the '92</p> <p>5 master agreement is concerned, the governing law is:</p> <p>6 "... governed by and construed in accordance with</p> <p>7 the law specified in the schedule."</p> <p>8 If you go on to the schedule -- page 169 is the</p> <p>9 relevant bit -- they only thought about English law or</p> <p>10 the laws of the state of New York. At the bottom of</p> <p>11 page 169, at (h).</p> <p>12 MR JUSTICE HILDYARD: Yes. In the 2002?</p> <p>13 MR TROWER: In the 2002 agreement, 13(a), page 190, and the</p> <p>14 governing law is on page 204, at the bottom of the page.</p> <p>15 So one has those two as being the identified laws.</p> <p>16 That is what everyone had approached it as being. It is</p> <p>17 given further fortification by the jurisdiction</p> <p>18 provisions at 13(b), so far as the 1992 is concerned --</p> <p>19 well, 13(b) for both of them, page 159 for 1992 and 190</p> <p>20 for 2002.</p> <p>21 As I say, the draftsman contemporaneously</p> <p>22 contemplated that people would simply be looking to</p> <p>23 New York law and English law. That is borne out by</p> <p>24 LBIE's experience. Although, as I say, there is one</p> <p>25 agreement that is apparently given by Italian law.</p> <p style="text-align: center;">Page 42</p>	<p>1 falls within the definition when it doesn't, as a matter</p> <p>2 of construction, fall within the words of the phrase?</p> <p>3 On the second point -- this is largely an issue</p> <p>4 where we are not entirely sure what the position is so</p> <p>5 far as Goldmans are concerned -- Goldmans seemed to be</p> <p>6 saying -- anyway, in paragraph 15 of their PTR</p> <p>7 skeleton -- that this was the case. But as far as we</p> <p>8 can tell, they don't now pursue that argument according</p> <p>9 to their supplemental skeleton in paragraph 30. But it</p> <p>10 is not entirely clear to us. So the parameters of</p> <p>11 exactly what is covered by the certification and the</p> <p>12 circumstances in which one can go behind it I don't</p> <p>13 think are formally agreed yet. Although it may be that</p> <p>14 the parties will come closer and closer together.</p> <p>15 MR FOXTON: My Lord, we don't pursue that argument.</p> <p>16 MR TROWER: I'm grateful.</p> <p>17 Issues 15 and 16 are agreed. They deal with the</p> <p>18 burden of proof and the authority to certify. The</p> <p>19 parties are agreed on that. We have explained the</p> <p>20 position in paragraphs 147 to 153 of our skeleton</p> <p>21 argument.</p> <p>22 Issue 18 deals with whether the transfer rights</p> <p>23 under section 7(b) extend to interest, and it is agreed</p> <p>24 by all parties that they do. We summarise the position</p> <p>25 in our skeleton at paragraphs 154 to 157.</p> <p style="text-align: center;">Page 44</p>

<p>1 Issue 19, are the answers to issues 10 to 18 2 different if the governing law is New York law? Now, as 3 I mentioned at the outset, it is agreed that the answers 4 are the same under English and New York law, but of 5 course those answers are said to be different. 6 Issue 27, which deals with the identity of 7 the counterparty, everyone agrees that the identity of 8 the counterparty doesn't affect any of the earlier 9 questions. 10 That then leaves me, my Lord -- this will just take 11 a moment or two -- to deal with one issue arising on the 12 German law issues. As my Lord knows, we haven't put in 13 any submissions on the German law issues, and we didn't 14 advance any position in the position papers. But there 15 is just one question that we need to address which has 16 been thrown into relief since the consequential hearing 17 in front of Mr Justice David Richards. 18 If my Lord turns up to issue 20, as it is now 19 formulated, it is concerned with the question of whether 20 a creditor would, following LBIE's administration, be 21 entitled to make a damages interest claim within the 22 meaning of section 288 of the German civil code on sums 23 that are payable under clauses 7 and 9 of the German 24 master agreement. That issue as formulated in that way, 25 under 20(1), is a German law issue.</p> <p style="text-align: center;">Page 45</p>	<p>1 pre-administration. So in a pre-administration judgment 2 case, it does extend to such a rate. 3 But he decided that it did not where the foreign 4 judgment was or could have been obtained 5 post administration. He deals with the argument on this 6 in paragraphs 171 to 183 of his judgment. Your Lordship 7 will find that in bundle 6 at tab 3. In bundle 6, 8 tab 3, this is the Waterfall II A judgment. 9 This bundle, my Lord -- I can't remember how much of 10 this your Lordship was asked to look at, but it has got 11 a miscellaneous collection of documents in it. It has 12 all the previous judgments by Mr Justice David Richards 13 and the Court of Appeal insofar as they bear on the 14 Waterfall applications generally. The one that is 15 probably most relevant for present purposes is the one 16 behind tab 3, because it is the II A judgment. On this 17 particular point, it is paragraphs 171 and following. 18 The conclusion -- I don't think we need to go 19 through it now, but 171 through to 183 -- 20 MR JUSTICE HILDYARD: It is 177, really, the paragraph. 21 MR TROWER: I'm so sorry, I must have misspoken. 22 MR JUSTICE HILDYARD: It may be the second sentence that is 23 particularly -- 24 MR TROWER: Yes, that's it. My Lord has the point. 25 No declarations have been made on this judgment yet,</p> <p style="text-align: center;">Page 47</p>
<p>1 If the answer to this question is yes, there is then 2 a further issue, under 20(2), as to whether such 3 a damages interest claim can constitute part of the rate 4 applicable to the debt apart from the administration for 5 the purposes of rule 2.88 sub-rule (9), which appears on 6 the face of it, to us, anyway, to be an English law 7 issue. 8 On this English law issue, one of the arguments made 9 by Wentworth is that it is not such a rate, because 10 a rate applicable to the debt apart from the 11 administration does not extend to a rate applicable to 12 a debt only if certain steps are taken after the 13 commencement of the administration. They deal with that 14 in paragraph 126 of their skeleton argument. 15 On this point, they rely on the reasoning of 16 Mr Justice David Richards when answering one of 17 the issues in Waterfall II A, which was issue 4. 18 Issue 4 was concerned with a slightly different 19 question, which was the circumstances in which rate 20 applicable to the debt apart from the administration 21 includes a foreign judgment rate, or other statutory 22 rate. 23 What Mr Justice David Richards accepted was -- well, 24 he did two things. First of all, he accepted the 25 parties' agreement that it did when judgment was entered</p> <p style="text-align: center;">Page 46</p>	<p>1 although the parties are quite close to agreeing the 2 declarations. 3 Just to your Lordship can see how far this has 4 developed, York, who were not a respondent appearing on 5 this application but were a respondent before 6 Mr Justice David Richards, said that the judge made 7 a wider declaration than the declaration relating to 8 foreign judgments only. 9 Just so my Lord can see that -- I think you ought 10 just to see it on this point -- in bundle 7A, if you 11 turn up tab 2, the declaration that we are talking about 12 which was in issue between the parties starts at the 13 bottom of page 9 and goes over to page 10, and it is 14 (x)(c) which is relevant, so volume 7A. 15 MR JUSTICE HILDYARD: 7A, tab 2? 16 MR TROWER: Tab 2, page 9, and going over to 10. 17 This was the form of declaration that relates to 18 this issue, and (c) was a form of declaration that York 19 wanted but the other parties said went too far because 20 the judgment decided the point. 21 MR JUSTICE HILDYARD: I'm being stupid. Where is that? 22 I have got it, yes. 23 MR TROWER: Over the page. There is (c) underlined. 24 MR JUSTICE HILDYARD: "Any other rate would only accrue". 25 I see. They might have been extrapolating from the fact</p> <p style="text-align: center;">Page 48</p>

<p>1 that they had to have a sort of claim fixed.</p> <p>2 MR TROWER: Yes. Expressed in those terms, it has quite</p> <p>3 wide ramifications, because it looks, on the face of it,</p> <p>4 as if it would mean that, in any case where a debt was</p> <p>5 contingent at the administration date, there was no</p> <p>6 entitlement to interest, apart from the administration.</p> <p>7 You couldn't use what your contractual rights were</p> <p>8 because the right had not yet accrued.</p> <p>9 There was a debate at the consequential hearing as</p> <p>10 to how the issue might be resolved. My Lord knows that</p> <p>11 the transcript of that hearing is in the bundle.</p> <p>12 What Mr Justice David Richards said was that he</p> <p>13 would decide this issue, given that it had been</p> <p>14 raised -- in other words, whether or not a broader</p> <p>15 declaration ought to be made -- if he was able to do so,</p> <p>16 but he wouldn't require the point to be decided before</p> <p>17 tranche C came on.</p> <p>18 Now, there has then been further correspondence, and</p> <p>19 on this particular issue, I think it is fair to say that</p> <p>20 it is York on one side of the argument and the SCG on</p> <p>21 the other side, who have been making the main running,</p> <p>22 because it doesn't affect York's position, but it does</p> <p>23 affect the SCG's position, and largely in respect --</p> <p>24 because of the number of ISDA agreements that they had.</p> <p>25 But it affects most of the parties before the court on</p> <p style="text-align: center;">Page 49</p>	<p>1 conclusion on other issues that might arise.</p> <p>2 You will doubtless wish to test the arguments on</p> <p>3 tranche C by reference to other example circumstances in</p> <p>4 which those arguments might have relevance or to which</p> <p>5 they might have relevance.</p> <p>6 MR JUSTICE HILDYARD: I'm sorry to interrupt you, did</p> <p>7 Mr Justice David Richards regard this point as, as it</p> <p>8 were, settled by reference to the judgment he gave for</p> <p>9 the reasons he would explain in a sub-judgment?</p> <p>10 MR TROWER: No, he didn't go that far. He recognised, given</p> <p>11 that it was raised, it needed to be thought about and</p> <p>12 that the parties should have the ability to put in --</p> <p>13 I think at that stage it was anticipated that we would</p> <p>14 all put in some written submissions --</p> <p>15 MR JUSTICE HILDYARD: Did he retain that matter?</p> <p>16 MR TROWER: No, he did not, specifically. What he indicated</p> <p>17 was that, if the parties were agreeable to it and it was</p> <p>18 possible, he would deal with anything that could be</p> <p>19 dealt with. It has obviously been on paper and would</p> <p>20 have a hearing if necessary.</p> <p>21 The problem with it is that it has become</p> <p>22 complicated by the fact that the parties were not in</p> <p>23 a position to have the matter determined before the</p> <p>24 tranche C hearing, largely for practical reasons and</p> <p>25 logistical reasons, and, as my Lord knows,</p> <p style="text-align: center;">Page 51</p>
<p>1 this hearing.</p> <p>2 But the debate has taken two forms, or there are two</p> <p>3 aspects to the debate. The first is, how actually the</p> <p>4 point should be resolved; and, secondly, who should</p> <p>5 actually resolve the point and when.</p> <p>6 There is some correspondence about this. The latest</p> <p>7 position is that everyone seems to agree that the issue</p> <p>8 needs to be determined now it's been raised. It needs</p> <p>9 determination. It can't be determined and doesn't need</p> <p>10 to be determined as part of the part C hearing. I think</p> <p>11 everyone has agreed that much.</p> <p>12 What I do need to show your Lordship, because we</p> <p>13 said we would show it to you, is what the latest</p> <p>14 position of York is in relation to how it should be</p> <p>15 decided, because we simply say in relation to it that</p> <p>16 my Lord has the decision of Mr Justice David Richards.</p> <p>17 If and insofar as it bears on any of the questions in</p> <p>18 relation to tranche C, my Lord has the decision and will</p> <p>19 take it into account in whatever way is appropriate, as</p> <p>20 previous authority, insofar as it bears on the point,</p> <p>21 and my Lord will have in mind that there is an argument</p> <p>22 which may be coming on which extends it in the way in</p> <p>23 which York wishes it to be extended, but you will have</p> <p>24 it in mind in exactly the same way as you always would</p> <p>25 have it in mind the consequences of a particular</p> <p style="text-align: center;">Page 50</p>	<p>1 Mr Justice David Richards is moving to higher places.</p> <p>2 MR JUSTICE HILDYARD: Yes.</p> <p>3 MR TROWER: Whether he will still be in a position to deal</p> <p>4 with it on paper, summoning the parties back to</p> <p>5 a further oral hearing should it be necessary, is not</p> <p>6 a question that we know the answer to yet, not least</p> <p>7 because at the time of the consequential hearings nobody</p> <p>8 even knew -- and I don't think he did -- exactly when it</p> <p>9 was he was going to be going to the Court of Appeal,</p> <p>10 although he knew it was sometime during November.</p> <p>11 MR JUSTICE HILDYARD: 16th.</p> <p>12 MR TROWER: Yes, so we understand now, but I don't think we</p> <p>13 knew that at the time.</p> <p>14 The indication from my left is that presumably, so</p> <p>15 long as it doesn't drag on for too long, he doesn't</p> <p>16 think there will be any difficulty in him being able to</p> <p>17 deal with anything that is consequential on tranche A --</p> <p>18 to tranche A, yes, from the Court of Appeal, so as to</p> <p>19 speak.</p> <p>20 I think our position is that, if this is going to</p> <p>21 drag on in any way, and your Lordship will have heard</p> <p>22 the arguments in relation to tranche C, it may be that</p> <p>23 your Lordship would wish to deal with the point or could</p> <p>24 more satisfactorily deal with the point. Whether "wish"</p> <p>25 is quite the right word, I don't know.</p> <p style="text-align: center;">Page 52</p>

<p>1 MR JUSTICE HILDYARD: It would be jolly tempting to see what</p> <p>2 many Mr Justice David Richards said, but I suppose</p> <p>3 technically it would be a decision between other</p> <p>4 parties.</p> <p>5 MR TROWER: Well, yes. Although, actually, we are all in</p> <p>6 the same application and people have been joined to the</p> <p>7 application to argue particular points. But, yes,</p> <p>8 I accept that. York is not here.</p> <p>9 I ought just to show you, because we need to just</p> <p>10 see it, the last letter from York, because they set out</p> <p>11 their position on it, which is in bundle 7A behind</p> <p>12 tab 2.</p> <p>13 MR JUSTICE HILDYARD: In 7A?</p> <p>14 MR TROWER: We said we would show it to your Lordship. It</p> <p>15 is tab 2, page 49, and Michelmores act for York.</p> <p>16 MR JUSTICE HILDYARD: I see. I'm not sure I have the full</p> <p>17 hang of it, really, but it seems, if it is being</p> <p>18 suggested that by extrapolation, even if not directly,</p> <p>19 there is something said or to be said by</p> <p>20 Mr Justice David Richards which might impact on</p> <p>21 arguments under issue 20 or otherwise, it would be</p> <p>22 a pity if there were inconsistency or any difference of</p> <p>23 view, and it would be a pity if either one, York or</p> <p>24 Wentworth, felt they hadn't had a proper crack at the</p> <p>25 whip at determining whichever may be the first decision.</p> <p style="text-align: center;">Page 53</p>	<p>1 Unless anyone has any objection, as a first step that</p> <p>2 seems to be the most logical course.</p> <p>3 MR TROWER: My Lord, with the greatest respect, we entirely</p> <p>4 agree with that. That seems a sensible way forward.</p> <p>5 MR JUSTICE HILDYARD: He may say, "Maybe I should simply</p> <p>6 hand it over to you", or, alternatively, "You should let</p> <p>7 me deal with it and await the result".</p> <p>8 MR TROWER: Yes. We certainly accept that this is not an</p> <p>9 issue which, as formulated by York, is going to be</p> <p>10 decided at tranche C, which is one of the concerns that</p> <p>11 they have, but the question is, how soon thereafter --</p> <p>12 MR JUSTICE HILDYARD: And is it a building brick or not?</p> <p>13 MR TROWER: Yes.</p> <p>14 MR JUSTICE HILDYARD: At the moment, it isn't clear that it</p> <p>15 has been decided. Hence the need for further</p> <p>16 submissions.</p> <p>17 MR TROWER: Yes. That's right. Would you just give me</p> <p>18 a moment?</p> <p>19 MR JUSTICE HILDYARD: Yes.</p> <p>20 MR TROWER: My Lord, I should make this point as well: there</p> <p>21 are three other consequential issues which</p> <p>22 Mr Justice David Richards has to deal with on paper in</p> <p>23 any event. This falls into a slightly different</p> <p>24 category because of the knock-on on tranche C. So he</p> <p>25 will, unfortunately, be troubled in any event and has</p> <p style="text-align: center;">Page 55</p>
<p>1 MR TROWER: I think that's right so far as it goes, my Lord.</p> <p>2 It is slightly complicated, of course, by the fact it</p> <p>3 doesn't look as if this issue -- what is described in</p> <p>4 Michelmores' letter as issue 1 -- is going to be capable</p> <p>5 of being argued before we finish the argument on</p> <p>6 tranche C. One possibility that had originally</p> <p>7 attracted us was that, my Lord, after hearing tranche C</p> <p>8 but before giving judgment might consider arguments on</p> <p>9 that issue in writing. That is one possibility.</p> <p>10 In a way, I would perhaps encourage your Lordship</p> <p>11 not to make a final decision over how to deal with this</p> <p>12 here and now, today, because it may well be that it is</p> <p>13 once you have heard the arguments on tranche C and the</p> <p>14 German law issue, issue 20, you can reach a rather</p> <p>15 clearer view as to which way to jump on this. But</p> <p>16 my Lord does need, we respectfully suggest, to have this</p> <p>17 in mind when deciding about the shape of the issues</p> <p>18 generally, as to how to deal with it.</p> <p>19 MR JUSTICE HILDYARD: What I have in mind also, unless</p> <p>20 anyone objects, is that I will discuss with</p> <p>21 Mr Justice David Richards whilst he is still among us in</p> <p>22 this division to see, you know, what his timing would be</p> <p>23 and what his further thoughts might be.</p> <p>24 MR TROWER: Yes.</p> <p>25 MR JUSTICE HILDYARD: Obviously, I would report back to you.</p> <p style="text-align: center;">Page 54</p>	<p>1 agreed to be troubled in any event.</p> <p>2 MR JUSTICE HILDYARD: Orally?</p> <p>3 MR TROWER: I'm not sure orally. The oral submissions on</p> <p>4 that will only take place if he requires them. I think</p> <p>5 the plan, at the moment, is it will be written</p> <p>6 submissions put in immediately after this.</p> <p>7 Although this particular issue, issue 1, I think has</p> <p>8 the potential for much more significant ramifications</p> <p>9 than the other three issues.</p> <p>10 MR JUSTICE HILDYARD: I think what I had best do is, as</p> <p>11 I say, unless anyone objects, talk, insofar as I can</p> <p>12 sensibly, to Mr Justice David Richards, but park this</p> <p>13 until I have a far better understanding of issue 20 and</p> <p>14 whether this, in my understanding, does or could affect</p> <p>15 that issue.</p> <p>16 MR TROWER: Yes. My Lord, I think that is very sensible.</p> <p>17 My Lord, that was all I was going to say by way of</p> <p>18 opening, unless there are any other issues which</p> <p>19 your Lordship would like me to address?</p> <p>20 MR JUSTICE HILDYARD: No, that is a very helpful opening</p> <p>21 Thank you, Mr Trower.</p> <p>22 Submissions by MR DICKER</p> <p>23 MR DICKER: My Lord, I was proposing to start with a few</p> <p>24 short introductory comments in relation to the</p> <p>25 ISDA master agreements and the present application</p> <p style="text-align: center;">Page 56</p>

<p>1 before turning to the detail of our submission.</p> <p>2 Your Lordship may have noted Mr Justice Briggs'</p> <p>3 comment that the ISDA master agreements are one of</p> <p>4 the most widely used standard form agreements in the</p> <p>5 world. Probably the most important of such agreements</p> <p>6 in the financial world.</p> <p>7 My Lord, the figures -- I don't know if</p> <p>8 your Lordship has ever seen them -- are striking. The</p> <p>9 Bank for International Settlements in 2014 estimated the</p> <p>10 total notional amount of over-the-counter derivatives</p> <p>11 outstanding were some 630 trillion US dollars, some</p> <p>12 eight times the world's then GDP. The overwhelming</p> <p>13 majority of those derivatives are understood to be</p> <p>14 governed by ISDA master agreements.</p> <p>15 My Lord, against that background, we emphasise three</p> <p>16 points. The first is that the agreements have been</p> <p>17 drafted with considerable skill and care by persons who</p> <p>18 are experts in the market. My Lord, in many cases,</p> <p>19 references to the skill and care of the draftsmen don't</p> <p>20 add much. They are almost ritual incantation. Another</p> <p>21 way of simply saying the court should assume the parties</p> <p>22 meant what they said, despite the fact the documentation</p> <p>23 may be drafted in quite difficult circumstances.</p> <p>24 My Lord, that we say is most certainly not the case</p> <p>25 here.</p> <p style="text-align: right;">Page 57</p>	<p>1 ISDA itself, they are just ordinary corporates.</p> <p>2 The parties to a master agreement can be almost any</p> <p>3 kind of entity. Obviously, banks, financial</p> <p>4 institutions, other corporates, but not limited to that;</p> <p>5 it extends to state enterprises, local authorities,</p> <p>6 governmental bodies, and a wide variety of entities in</p> <p>7 other jurisdictions, the form of which may not be</p> <p>8 familiar to English lawyers.</p> <p>9 We say your Lordship should proceed on the basis</p> <p>10 that the master agreements were intended to be capable</p> <p>11 of applying sensibly to all such entities, regardless of</p> <p>12 their type and regardless of the jurisdiction in which</p> <p>13 they are incorporated or located.</p> <p>14 My Lord, the third point is, the master agreements</p> <p>15 should not be construed by assuming they were intended</p> <p>16 to reflect, let alone replicate, particular aspects of</p> <p>17 English or New York law. They are commercial agreements</p> <p>18 intended to produce commercially sensible results. They</p> <p>19 may or may not reflect aspects of English or New York</p> <p>20 law.</p> <p>21 In our submission, the answer is to be obtained from</p> <p>22 the language of the agreements, not from any presumption</p> <p>23 or assumption that the draftsman started by having in</p> <p>24 mind the particular concept of English or New York law</p> <p>25 and was drafting by reference to that concept.</p> <p style="text-align: right;">Page 59</p>
<p>1 The 1992 master agreement, for example, has now been</p> <p>2 in use for more than 20 years; as your Lordship has</p> <p>3 seen, is still used. We say it is striking that it is</p> <p>4 in the same terms as it was when it was first issued,</p> <p>5 and it is also remarkable quite how few reported</p> <p>6 decisions there are in relation to it, at least prior to</p> <p>7 the onset of the recent financial crisis.</p> <p>8 Similar comments can be made about the 2002 master</p> <p>9 agreement, bearing in mind of course it is slightly more</p> <p>10 recent.</p> <p>11 My Lord, in our respectful submission, the drafting</p> <p>12 of those agreements appears in practice to have operated</p> <p>13 almost flawlessly. Your Lordship should proceed on the</p> <p>14 basis that if there is any situation in which the</p> <p>15 draftsman really meant what he said and said what he</p> <p>16 meant, this is it.</p> <p>17 My Lord, is second point is, as I think a comment of</p> <p>18 your Lordship indicated, the agreements are intended to</p> <p>19 apply in a wide variety of circumstances to a wide</p> <p>20 variety of parties. Again, it may be worth just</p> <p>21 emphasising quite what that means in the present case.</p> <p>22 According to a 2014 ISDA publication called "The</p> <p>23 Value of Derivatives", ISDA in 2014 had members in</p> <p>24 62 different jurisdictions. Obviously many</p> <p>25 counterparties to master agreements are not members of</p> <p style="text-align: right;">Page 58</p>	<p>1 There are some striking examples of that. The most</p> <p>2 striking is probably the existence of two-way payments,</p> <p>3 the second method under the '92 agreement and the</p> <p>4 closeout amount under the 2002 agreement. Obviously, as</p> <p>5 a matter of English law, a party in repudiatory breach</p> <p>6 is not entitled to payment. That is not the case under</p> <p>7 the second method and it is not the case under the 2002</p> <p>8 master agreement.</p> <p>9 Dealing with the point I think your Lordship raised</p> <p>10 with my learned friend Mr Trower, as I understand it,</p> <p>11 there are only two officially sanctioned versions of</p> <p>12 the ISDA master agreement. It is the English language</p> <p>13 version either governed by English law or governed by</p> <p>14 New York law. ISDA has from time to time considered</p> <p>15 whether or not to approve other versions, but has</p> <p>16 consistently refused to do so.</p> <p>17 My Lord, the reason given for that, I think in an</p> <p>18 article by Professor Golden, one of the authors of</p> <p>19 the ISDA master agreement, is essentially to achieve</p> <p>20 uniformity of result, avoid documentation of a basis</p> <p>21 risk, in other words different consequences depending on</p> <p>22 which document you happen to enter into, and to ensure,</p> <p>23 to the extent you can, market liquidity.</p> <p>24 It follows, therefore, that GMA, the German master</p> <p>25 agreement, for example, is not an officially sanctioned</p> <p style="text-align: right;">Page 60</p>

<p>1 version.</p> <p>2 MR JUSTICE HILDYARD: I'm not sure where that takes one,</p> <p>3 though. It could take one either way, couldn't it?</p> <p>4 Does it mean that, therefore, the German master</p> <p>5 agreement is not to be informed by the English/New York</p> <p>6 approach, on the grounds that it isn't an authorised</p> <p>7 version?</p> <p>8 MR DICKER: My Lord, I think what we would submit is</p> <p>9 twofold: one, so far as the English and New York</p> <p>10 versions are concerned, the draftsmen anticipated that</p> <p>11 they would produce the same result. Essentially, we say</p> <p>12 because English and New York courts construe contracts</p> <p>13 in accordance with the language and the process of</p> <p>14 construction is sufficiently similar they should achieve</p> <p>15 that result.</p> <p>16 So far as the GMA is concerned -- your Lordship will</p> <p>17 see material on this in due course -- although not an</p> <p>18 officially sanctioned version, we say it was intended to</p> <p>19 achieve essentially the same outcome as the master</p> <p>20 agreements so far as that was possible under German law.</p> <p>21 My Lord, the other introductory matter I just wanted</p> <p>22 to say a few words about was the present application.</p> <p>23 As your Lordship knows, the administrators have issued</p> <p>24 the application to obtain guidance from the court.</p> <p>25 Although the Senior Creditor Group has not been</p> <p style="text-align: center;">Page 61</p>	<p>1 My Lord, we do say, when seeking to decide the</p> <p>2 issues, it is vital that your Lordship bears in mind at</p> <p>3 all times your Lordship is concerned not merely with the</p> <p>4 parties before your Lordship or even all creditors of</p> <p>5 ISDA, but with all potential users of the ISDA master</p> <p>6 agreement and the circumstances that may arise.</p> <p>7 We say that is no doubt why the administrators have</p> <p>8 phrased, for example, question 11 as they have, in other</p> <p>9 words, asking whether something is capable of</p> <p>10 constituting a cost of funding for the purpose of</p> <p>11 the default rate. In other words, the issue for the</p> <p>12 court on this application is, essentially: can you be</p> <p>13 sure, regardless of the breadth of the parties and</p> <p>14 circumstances, that any particular approach to cost of</p> <p>15 funding is not capable of being a legitimate approach?</p> <p>16 If the answer to that is yes, the administrators have</p> <p>17 obtained guidance to that extent. If the answer is no,</p> <p>18 then inevitably, obviously the matter will have to be</p> <p>19 progressed in other ways. That is simply a limitation</p> <p>20 which we say is inherent in this process.</p> <p>21 My Lord, with those introductory remarks, I was</p> <p>22 proposing to start, subject to your Lordship, with</p> <p>23 question 11. It seemed to us appropriate to do so,</p> <p>24 given that it appears to be recognised as the most</p> <p>25 important question and certainly the only one on which</p> <p style="text-align: center;">Page 63</p>
<p>1 appointed a representative of different classes of</p> <p>2 creditors, it is advancing arguments, in effect, on</p> <p>3 behalf of unsecured creditors to assist the</p> <p>4 administrators to obtain such guidance. It is obviously</p> <p>5 keen to assist the administrators to obtain the guidance</p> <p>6 that they need, if only because, unless and until this</p> <p>7 process finishes, they won't receive any of the money to</p> <p>8 which they are entitled.</p> <p>9 But, my Lord, I think, as all the parties sensibly</p> <p>10 recognise, there are obvious limits to the guidance the</p> <p>11 court can provide on this application. The questions</p> <p>12 are all raised in general terms. You are not being</p> <p>13 asked to decide issues by reference to specific sets of</p> <p>14 facts. You haven't been given, as it were, a series of</p> <p>15 determinations, certifications, by parties and asked to</p> <p>16 rule on whether or not those constitute rational, good</p> <p>17 faith certifications.</p> <p>18 As your Lordship knows, that is not normally how</p> <p>19 a court would deal with such matters. Indeed,</p> <p>20 interestingly, it isn't even, I think, a course</p> <p>21 anticipated in the new financial list which means you</p> <p>22 would have agreed specific facts for any test case.</p> <p>23 This is plainly not a normal case and the application is</p> <p>24 obviously a sensible application for the administrators</p> <p>25 to have made.</p> <p style="text-align: center;">Page 62</p>	<p>1 all the parties here are intending to make submissions.</p> <p>2 MR JUSTICE HILDYARD: I suppose the questions do feed off</p> <p>3 each other. I notice you've done question 10 after 11</p> <p>4 and, I think, 12. But your broader universe introduces</p> <p>5 another question with respect to the very different</p> <p>6 circumstances which may affect an assignee.</p> <p>7 MR DICKER: Yes.</p> <p>8 MR JUSTICE HILDYARD: Therefore, there may be</p> <p>9 cross-fertilisation between the points.</p> <p>10 MR DICKER: Your Lordship is absolutely right. One could do</p> <p>11 it in either order. It seemed to us sensible to deal</p> <p>12 with what you may claim first before actually</p> <p>13 identifying who and in what circumstances is able to</p> <p>14 make that claim.</p> <p>15 As your Lordship knows, the Senior Creditor Group's</p> <p>16 case is straightforward: the definition should be given</p> <p>17 its broad and natural meaning.</p> <p>18 The relevant payee is required to determine the cost</p> <p>19 of funding or if it were to fund the relevant amount.</p> <p>20 In other words, what has it costed to fill the gap or</p> <p>21 what would it have costed to fill that gap.</p> <p>22 For these purposes, we say funding covers all</p> <p>23 sources of funding; depending on the circumstances, it</p> <p>24 is capable of including debt funding, equity funding or</p> <p>25 funding by any other means, hybrid instruments, repo</p> <p style="text-align: center;">Page 64</p>

<p>1 agreements, sale and leasebacks, whatever form of</p> <p>2 funding one may be able to identify.</p> <p>3 We also say costs of that funding include all costs</p> <p>4 borne or which would have been borne by the relevant</p> <p>5 payee as a consequence of funding the relevant amount.</p> <p>6 So, in short, the definition permits a wide range of</p> <p>7 possible answers subject only to the requirements of</p> <p>8 rationality and good faith.</p> <p>9 Picking up a comment of your Lordship earlier, we do</p> <p>10 say it is very important, when one construes cost of</p> <p>11 funding, to bear in mind the context within which that</p> <p>12 question requires to be answered, ie, as part of</p> <p>13 the certification process by the relevant party. We say</p> <p>14 that provides a clear, straightforward and workable</p> <p>15 regime, and in most cases will be an end of any</p> <p>16 discussion, exactly as the draftsman intended.</p> <p>17 My Lord, what I was proposing to do next is just</p> <p>18 remind your Lordship of certain points in relation to</p> <p>19 the 1992 and 2002 agreements. To some extent, that</p> <p>20 exercise has already been done by Mr Trower, and I will</p> <p>21 try to avoid duplicating points he made. But I want to</p> <p>22 do a couple of things. Essentially, one, put the</p> <p>23 relevant provisions in context, just to remind</p> <p>24 your Lordship of how they arise as a matter of process;</p> <p>25 and, secondly, to draw out some distinctions between the</p> <p style="text-align: center;">Page 65</p>	<p>1 Termination Date shall be determined pursuant to</p> <p>2 Section 6(e)."</p> <p>3 So we then go to section 6(e), and, as my learned</p> <p>4 friend indicated, it identifies two payment measures,</p> <p>5 referred to as market quotation or loss, and two payment</p> <p>6 methods, either the first method or the second method.</p> <p>7 My Lord, again, I am sure, as your Lordship knows,</p> <p>8 where the first method is selected, the early</p> <p>9 termination amount is only ever capable of being payable</p> <p>10 by the defaulting party. So that effectively reflects</p> <p>11 the common law position on termination for breach.</p> <p>12 Where the second method applies, it may be payable</p> <p>13 either by the defaulting party or by the non-defaulting</p> <p>14 party, so two-way payments.</p> <p>15 My Lord, just to pick up one point at this stage in</p> <p>16 relation to the definition of loss, if your Lordship</p> <p>17 goes on to page 161, halfway down:</p> <p>18 "'Loss' means, with respect to this Agreement or one</p> <p>19 or more Terminated Transactions, as the case may be, and</p> <p>20 a party, the Termination Currency Equivalent of an</p> <p>21 amount that party reasonably determines in good faith to</p> <p>22 be its total losses and costs (or gain, in which case</p> <p>23 expressed as a negative number) in connection with this</p> <p>24 agreement or that Terminated Transaction or group of</p> <p>25 Terminated Transactions, as the case may be, including</p> <p style="text-align: center;">Page 67</p>
<p>1 1992 and the 2002 agreements.</p> <p>2 My Lord, the starting point is, as my learned friend</p> <p>3 indicated, the definition of default rate is identical</p> <p>4 in the 1992 and the 2002 agreements. So we have the</p> <p>5 same definition of default rate in the two agreements,</p> <p>6 but the context between the two differs slightly.</p> <p>7 Can I ask your Lordship to take up the</p> <p>8 1992 agreement and, using the same version as my learned</p> <p>9 friend was using in the core bundle at tab 7, turn to</p> <p>10 section 6 at page 154. I will deal with this fairly</p> <p>11 quickly, as I am sure your Lordship is reasonably</p> <p>12 familiar with this, but 6(a) permits a party, if at any</p> <p>13 time there is an event of default which has occurred and</p> <p>14 is then continuing, to send a notice specifying the</p> <p>15 relevant event of default and thereby designate a day</p> <p>16 not earlier than the day such notice is effective as an</p> <p>17 early termination date.</p> <p>18 The next sentence indicates that if they chose an</p> <p>19 automatic early termination, then the agreement will</p> <p>20 terminate, there will be an early termination date</p> <p>21 immediately upon the occurrence of an event of default,</p> <p>22 without regard to notice.</p> <p>23 My Lord, then section 6(c), "Effect of designation".</p> <p>24 The last sentence of 6(c)(ii):</p> <p>25 "The amount, if any, payable in respect of an Early</p> <p style="text-align: center;">Page 66</p>	<p>1 any loss of bargain, cost of funding or ..."</p> <p>2 Et cetera.</p> <p>3 Firstly, there is also a discretion to the</p> <p>4 certifying party, in this case expressly said to be</p> <p>5 subject to the discretion being done reasonably and in</p> <p>6 good faith, and, secondly, loss includes total losses of</p> <p>7 costs, including any loss of bargain, and then the</p> <p>8 phrase "cost of funding".</p> <p>9 So, as my learned friend indicated, the cost of</p> <p>10 funding also comes in to the question of loss as part of</p> <p>11 one of the methods.</p> <p>12 My Lord, there is consideration of correct approach</p> <p>13 to loss in a very helpful judgment of Judge Chapman,</p> <p>14 sitting in the US Bankruptcy Court in the Southern</p> <p>15 District of New York in a case called Lehman Brothers</p> <p>16 Holdings v Intel Corporation.</p> <p>17 My Lord, it is in the authorities, just to give</p> <p>18 your Lordship the reference, bundle 4, tab 128.</p> <p>19 It was decided on 16 September 2015.</p> <p>20 MR JUSTICE HILDYARD: Could you give me, bundle 4 --</p> <p>21 MR DICKER: 4/tab 128. It was decided as recently as</p> <p>22 16 September of this year, so it is right hot off the</p> <p>23 press. It is also interesting because, in that case, as</p> <p>24 I understand it, ISDA submitted an amicus brief. I am</p> <p>25 not going to take your Lordship to that. I think it is</p> <p style="text-align: center;">Page 68</p>

<p>1 a point Mr Foxton is going to develop. Just to</p> <p>2 your Lordship knows at this stage, questions which arise</p> <p>3 in relation to the meaning of cost of -- of funding in</p> <p>4 the context of default rate are also potentially</p> <p>5 relevant in the context of the definition of loss, on</p> <p>6 which there is recent US authority.</p> <p>7 Going back, if I may, to section 6 in the '92</p> <p>8 agreement, I have referred to 6(a), 6(c) and 6(e). If</p> <p>9 one goes back, on page 155, to section 6(d), (i):</p> <p>10 "On or as soon as reasonably practicable following</p> <p>11 the occurrence of an Early Termination Date, each party</p> <p>12 will make the calculations on its part, if any,</p> <p>13 contemplated by Section 6(e) and will provide to the</p> <p>14 other party a statement (1) showing, in reasonable</p> <p>15 detail, such calculations ... and (2) giving details of</p> <p>16 the relevant account to which any amount payable to it</p> <p>17 is to be paid..."</p> <p>18 There is no reference there, as your Lordship will</p> <p>19 note, to the statement having to be done rationally or</p> <p>20 in good faith, but, as your Lordship knows, it is common</p> <p>21 ground it is required.</p> <p>22 Then, under 6(d)(ii), "Payment date":</p> <p>23 "An amount calculated as being due in respect of any</p> <p>24 Early Termination Date under 6(e) will be payable on the</p> <p>25 day that notice of the amount payable is effective..."</p> <p style="text-align: center;">Page 69</p>	<p>1 and (d) in particular. So far as (a) is concerned, if</p> <p>2 otherwise you are a defaulting party, you pay a default</p> <p>3 rate; and in (c), if you are the non-defaulting party,</p> <p>4 you pay at the non-default rate.</p> <p>5 My Lord, again, at this stage the definitions of</p> <p>6 default rate and non-default rate are identical save in</p> <p>7 one respect. If your Lordship goes to non-default rate</p> <p>8 at page 162:</p> <p>9 "A rate per annum equal to the cost (without proof</p> <p>10 or evidence of any actual cost) to the Non-defaulting</p> <p>11 Party (as certified by it) if it were to fund the</p> <p>12 relevant amount."</p> <p>13 There is no reference there to the additional</p> <p>14 1 per cent. I say they are identical. That is not</p> <p>15 straightly right, of course, because the non-default</p> <p>16 rate is payable by the non-defaulting party otherwise.</p> <p>17 The logic, we say, where the default rate applies is</p> <p>18 that the non-defaulting party has suffered a loss. It</p> <p>19 should have been paid a sum which it has not received.</p> <p>20 The premise of the draftsman is that it goes out and it</p> <p>21 fills that hole and it is entitled to the cost of</p> <p>22 filling that hole, we say.</p> <p>23 So far as the non-default rate is concerned, the</p> <p>24 logic is slightly different, in our submission. What is</p> <p>25 happening here, we say, is that, where the non-default</p> <p style="text-align: center;">Page 71</p>
<p>1 Dropping five lines:</p> <p>2 "Such amount will be paid together with (to the</p> <p>3 extent permitted under applicable law) interest thereon</p> <p>4 (before as well as after judgment) in the Termination</p> <p>5 Currency, from (and including) the relevant Early</p> <p>6 Termination Date to ... the date such amount is paid, at</p> <p>7 the Applicable Rate."</p> <p>8 As my learned friend indicated, calculated on the</p> <p>9 basis of daily compounding the actual number of days</p> <p>10 elapsed.</p> <p>11 My Lord, my learned friend showed you the definition</p> <p>12 of applicable rate, which is at page 160. The most</p> <p>13 important subparagraph in this case is likely to be (b):</p> <p>14 "Applicable rate means ... in respect of an</p> <p>15 obligation to pay an amount under Section 6(e) ..."</p> <p>16 In other words, a termination amount:</p> <p>17 "... of either party from and after the date ... on</p> <p>18 which that amount is payable..."</p> <p>19 That is a default rate. So at this stage, under the</p> <p>20 1992 agreement, if you owed a termination amount and</p> <p>21 failed to pay it, you paid at the default rate whether</p> <p>22 you were otherwise the defaulting party or the</p> <p>23 non-defaulting party.</p> <p>24 Again, as my learned friend indicated, in other</p> <p>25 circumstances the relevant rate is governed by (a), (b)</p> <p style="text-align: center;">Page 70</p>	<p>1 rate applies, the non-defaulting party is treated as</p> <p>2 having received a benefit for which it may be obliged to</p> <p>3 account to the other party, depending on the payment</p> <p>4 method which has been chosen.</p> <p>5 Obviously if the first method is chosen, the</p> <p>6 non-defaulting party can never be liable to make</p> <p>7 a payment to the defaulting party. So there is no</p> <p>8 question of any interest running on that sum because no</p> <p>9 sum is payable. But if, however, the second method is</p> <p>10 chosen, the position is different. If the derivative is</p> <p>11 out of the money, the non-defaulting party is required</p> <p>12 to pay the defaulting party the amount that it has</p> <p>13 gained, and the logic of the approach underlying the</p> <p>14 non-default rate under the 1992 agreement is that, if</p> <p>15 the non-defaulting party doesn't make that payment, it</p> <p>16 receives, essentially, a benefit, which is, it hasn't</p> <p>17 had to incur the cost of funding which it otherwise</p> <p>18 would have had to incur in getting that sum, and that's</p> <p>19 essentially a benefit for which it must, consistent with</p> <p>20 the second method, account to the defaulting party for.</p> <p>21 That is the 1992 agreement. The 2002 agreement, as</p> <p>22 my learned friend indicates, takes a slightly different</p> <p>23 approach in some respects. So, going on to tab 8 and</p> <p>24 the 2002 agreement, and just identifying the relevant</p> <p>25 provisions and the differences, if one starts with 6(a)</p> <p style="text-align: center;">Page 72</p>

<p>1 on page 181, that's essentially the same, for present 2 purposes, as in the 1992 agreement: if there is an event 3 of default, you can serve a notice specifying the 4 relevant event of default and designating an early 5 termination date.</p> <p>6 Section 6(c) is slightly different, in that the last 7 sentence of 6(c)(ii) now says:</p> <p>8 "The amount, if any, payable in respect of an Early 9 Termination Date will be determined pursuant to Sections 10 6(e) and 9(h)(ii)."</p> <p>11 As my learned friend indicated, interest is now 12 dealt with under a separate section.</p> <p>13 In section 6(e), there are a number of changes, the 14 most significant of which -- again, I am sure 15 your Lordship knows the first and second method have 16 been abolished. The only option is two-way payments.</p> <p>17 There is also, as a result, a new definition of 18 closeout amount which also refers to cost of funding.</p> <p>19 If your Lordship just goes to page 193, just above 20 the second hole punch, there is a paragraph beginning, 21 "The Determining Party will consider, taking into 22 account", and then (i) and (ii), and then it says: 23 "When considering information described in 24 clauses (i), (ii) or (iii) above, the Determining Party 25 may include costs of funding to the extent costs of</p> <p style="text-align: center;">Page 73</p>	<p>1 relevant early termination date to the date on which 2 that amount is payable, and the rate then depends, for 3 that period, on whether you are the defaulting party, in 4 which case you pay the default rate, or the 5 non-defaulting party, in which case you pay the 6 non-default rate. Otherwise, in any other case, the 7 applicable deferral rate.</p> <p>8 "Non-default rate", if your Lordship goes on to 9 that, non-default rate differs from the definition of 10 non-default rate in the 1992 agreement. In the 11 2002 agreement, it means:</p> <p>12 "... the rate certified by the non-defaulting party 13 to be a rate offered to the non-defaulting party by 14 a major bank in a relevant interbank market for 15 overnight deposits in the applicable currency, such bank 16 to be selected in good faith by the non-defaulting party 17 for the purposes of obtaining a representative rate that 18 will reasonably reflect conditions prevailing at the 19 time in that relevant market."</p> <p>20 Now, your Lordship will see that, whereas in the 21 1992 agreement non-default rate was also defined by 22 reference to cost of funding, cost of funding for the 23 non-defaulting party, that's changed here. What 24 essentially the non-defaulting party has to pay is the 25 sum that he would have received from a bank if he had</p> <p style="text-align: center;">Page 75</p>
<p>1 funding are not and would not be a component of 2 the other information being utilised."</p> <p>3 So a similar reference to cost of funding, in this 4 case not, obviously, as part of definition of loss, but 5 as part of the definition of closeout amount.</p> <p>6 Again, as my learned friend indicated, interest is 7 now separately dealt with under section 9, and, for 8 present purposes, your Lordship is primarily concerned 9 with 9(ii)(2), "Interest on early termination amounts": 10 "If an early termination amount is due in respect of 11 such early termination date, that amount will, to the 12 extent permitted by applicable law, be paid together 13 with interest (before as well as after judgment) on that 14 amount in the termination currency, for the period from 15 (and including) such early termination date to (but 16 excluding) the date the amount is paid, at the 17 applicable closeout rate."</p> <p>18 My Lord, there are some differences, and I wanted to 19 identify a couple, in relation to the approach to 20 interest.</p> <p>21 If your Lordship goes on to the definition of 22 applicable closeout rate at page 191, subparagraph (b) 23 deals with its meaning in respect of an early 24 termination amount, and the definition divides the 25 period into two. First of all, the period from the</p> <p style="text-align: center;">Page 74</p>	<p>1 placed the money on an overnight deposit.</p> <p>2 One can put it this way: it is effectively a minimum 3 gain that he is treated as having received. He is 4 treated as having received the sum that he would have 5 received if he'd placed the money on an overnight 6 deposit with a bank, and that's the sum essentially 7 which defines the rate which he is liable to pay if the 8 non-default rate applies.</p> <p>9 So cost of funding is no longer relevant to the 10 non-default rate. It was relevant in the 1992 11 agreement. Essentially, the non-defaulting party had to 12 pay the entirety of his gain. Now, the draftsman simply 13 requires him to pay what he would have received if he'd 14 placed the money on deposit.</p> <p>15 Just going back to the definition of applicable 16 closeout rate, I dealt with the first period in 17 subparagraph (b)(i). There is also (b)(ii), which is 18 the period from and including the date determined in 19 accordance with section 6(d)(ii) on which the amount is 20 payable but excluding the date of actual payment. So 21 this is the next period from the date that the 22 certification effectively is effective, the amount is 23 payable, up to the date of actual payment.</p> <p>24 At (ii), if the early termination amount is payable 25 by a defaulting party, he pays at the default rate, but</p> <p style="text-align: center;">Page 76</p>

<p>1 if the early termination amount is payable by a non-</p> <p>2 defaulting party, he pays at the non-default rate.</p> <p>3 That, again, is a change from the 1992 agreement.</p> <p>4 The 1992 agreement operated on the basis that, if you</p> <p>5 are liable to pay a termination sum from the date of</p> <p>6 payment, you should pay the default rate whether you</p> <p>7 were otherwise the defaulting or the non-defaulting</p> <p>8 party. Under the 2002 agreement, if you are the</p> <p>9 non-defaulting party you pay at the non-default rate.</p> <p>10 My Lord, having identified the relevant provisions,</p> <p>11 the process and the differences between the 1992 and</p> <p>12 2002 agreement, I now wanted to turn to our submissions</p> <p>13 as to how the definition should be construed, and to</p> <p>14 start with a few general comments.</p> <p>15 MR JUSTICE HILDYARD: When you are in the course of that,</p> <p>16 explain to me, if it is relevant, the reasoning for the</p> <p>17 change from the 1992 position, which, as I understand</p> <p>18 it, was a measure of the receipt of benefit, to</p> <p>19 the 2002, which was a more settled sum by reference to</p> <p>20 an appropriate bank's overnight rate.</p> <p>21 MR DICKER: The obvious effect is likely to be in most cases</p> <p>22 to reduce the amount which the non-defaulting party --</p> <p>23 MR JUSTICE HILDYARD: Yes, unless the entity is less</p> <p>24 efficient than the rate, yes.</p> <p>25 MR DICKER: So, to that extent, it is reducing the amount of</p> <p style="text-align: center;">Page 77</p>	<p>1 relevant amount. As your Lordship knows, we say that</p> <p>2 has a very simple meaning: you need to fill a hole.</p> <p>3 That's the relevant amount. What you are entitled to is</p> <p>4 the cost of doing that plus, in relation to default</p> <p>5 rate, 1 per cent.</p> <p>6 We also say the draftsman had three important</p> <p>7 objectives when he structured the provision. First, and</p> <p>8 following on from the submission I just made, he wanted</p> <p>9 to ensure the non-defaulting party was fully compensated</p> <p>10 for the cost of plugging the gap.</p> <p>11 Secondly, he wanted to ensure the provision was as</p> <p>12 flexible as possible so it could deal with a multitude</p> <p>13 of different parties and circumstances to which it might</p> <p>14 need to be applied. We say he did that by using very</p> <p>15 broad terms, like "funding" and like "cost".</p> <p>16 So the second element, flexibility.</p> <p>17 The third objective: he also, in our submission,</p> <p>18 wanted to achieve certainty and finality, avoid disputes</p> <p>19 and litigation. He did that by giving the relevant</p> <p>20 payee a wide discretion, limited only by concepts of</p> <p>21 rationality and good faith, and by expressly stating no</p> <p>22 proof or evidence of any actual cost was required.</p> <p>23 My Lord, one other point, just to emphasise at this</p> <p>24 stage: the definition refers to the cost if it were to</p> <p>25 fund or of funding. In other words, it envisages two</p> <p style="text-align: center;">Page 79</p>
<p>1 the gain which the non-defaulting party might otherwise</p> <p>2 have to pay. It might also be said to be simplifying</p> <p>3 the process which it might otherwise have to carry out</p> <p>4 in determining what its cost of funding is. There may</p> <p>5 be other reasons. Those are the two that --</p> <p>6 MR JUSTICE HILDYARD: Was it to sort of squeeze out</p> <p>7 a subjective assessment, or was it for some other</p> <p>8 reason?</p> <p>9 MR DICKER: My Lord, our submission would be, it is simply</p> <p>10 to reduce the amount which the otherwise non-defaulting</p> <p>11 party is required to pay in the event of termination and</p> <p>12 to draw a slightly clearer distinction between the</p> <p>13 position of the defaulting and the non-defaulting party.</p> <p>14 My Lord, one starts, we say, with the fact the basic</p> <p>15 function and purpose of the default rate provision is to</p> <p>16 compensate the relevant payee for its lost time value of</p> <p>17 money, as we have said, by awarding it the cost that it</p> <p>18 has or would have incurred by funding a sum equal to the</p> <p>19 amount owed.</p> <p>20 My Lord, there is a temptation to focus on the word</p> <p>21 "cost" and the word "funding" and to spend time</p> <p>22 construing each essentially in isolation from the other.</p> <p>23 My Lord, we say that that obviously has a role to play,</p> <p>24 but one should not lose sight of the concept as a whole.</p> <p>25 The concept as a whole is the cost of funding the</p> <p style="text-align: center;">Page 78</p>	<p>1 possible scenarios.</p> <p>2 My Lord, we do say, when one considers what the</p> <p>3 phrase means and what its constituent parts mean, it is</p> <p>4 useful to test any suggested constructions by reference</p> <p>5 to both possibilities. Firstly, where the relevant</p> <p>6 payee actually went out and obtained funding, and is</p> <p>7 required to certify on a good faith and rational basis</p> <p>8 the cost of the funding which it in fact obtained. And,</p> <p>9 secondly, where it didn't do so, where it has to work</p> <p>10 out what it would have done, work out what that funding</p> <p>11 would have cost, again on a good faith and rational</p> <p>12 basis.</p> <p>13 My Lord, I notice the time. I wonder whether that</p> <p>14 might be a convenient moment?</p> <p>15 MR JUSTICE HILDYARD: If convenient for you, Mr Dicker, yes</p> <p>16 2 o'clock, then.</p> <p>17 (1.00 pm)</p> <p>18 (The short adjournment)</p> <p>19 (2.01 pm)</p> <p>20 MR DICKER: My Lord, I showed your Lordship the relevant</p> <p>21 provisions in the 1992 and 2002 master agreement.</p> <p>22 No-one, as your Lordship knows, is contending that the</p> <p>23 differences I pointed out to your Lordship affect the</p> <p>24 issues of construction which your Lordship has been</p> <p>25 asked to decide. All parties are proceeding on the</p> <p style="text-align: center;">Page 80</p>

<p>1 basis that the answer is the same whether one is talking</p> <p>2 about the 1992 or the 2002 agreement, although obviously</p> <p>3 the answers each gives differ in certain respects.</p> <p>4 My Lord, I was going to turn now and deal next with</p> <p>5 the concept of funding. There are obviously a number of</p> <p>6 ways in which commercial entities, if one has regard at</p> <p>7 this stage solely to them, seek to fund themselves, in</p> <p>8 other words, get in money which they need to conduct</p> <p>9 their business. I have already identified a few of</p> <p>10 those.</p> <p>11 We say the concept is no more than that. It is</p> <p>12 a way of obtaining money which the company needs to</p> <p>13 conduct its business. It may be by way of equity</p> <p>14 funding, debt funding, hybrid instruments, or any other</p> <p>15 instruments. Some may be familiar to English lawyers,</p> <p>16 some -- I'm thinking, in particular, for example, of</p> <p>17 Islamic financing techniques -- may be rather less</p> <p>18 familiar.</p> <p>19 The concept, we say, is capable of embracing all</p> <p>20 means of funding.</p> <p>21 My Lord, we say that is supported by two particular</p> <p>22 points about the language of the definition, both of</p> <p>23 which, in our submission, are obvious and clear. The</p> <p>24 first point is that the draftsman literally used the</p> <p>25 word "funding", not the word "borrowing". We say there</p> <p style="text-align: center;">Page 81</p>	<p>1 have done and with the costs which have been or which</p> <p>2 would have been incurred by that particular person as</p> <p>3 a result.</p> <p>4 So if the relevant payee did in fact fund the</p> <p>5 relevant amount by means of equity funding, then that is</p> <p>6 the relevant source of funding for the purposes of this</p> <p>7 definition. That is how it, the relevant payee, funded</p> <p>8 the relevant amount, and the costs then are the costs of</p> <p>9 that funding.</p> <p>10 The same, we say, is equally the case if the</p> <p>11 relevant payee determines rationally and in good faith</p> <p>12 that it would have funded the relevant amount through</p> <p>13 equity funding. In short, the provision requires the</p> <p>14 relevant payee to certify the cost of funding by</p> <p>15 reference to what it did or would have done, not by</p> <p>16 reference to something different. It is back to the</p> <p>17 very basic structure of the agreement, we say, which is:</p> <p>18 termination event occurs, the relevant payee has to</p> <p>19 certify its cost of funding. That is a very broad</p> <p>20 phrase. Provided it does so rationally, in good faith,</p> <p>21 that is an end of it.</p> <p>22 MR JUSTICE HILDYARD: Does it mean -- I'm puzzled by how</p> <p>23 then -- do you say it controls our funding as well?</p> <p>24 Does it say, if it were to fund -- does it mean, rather,</p> <p>25 if it funded or were to fund, or is the "of funding"</p> <p style="text-align: center;">Page 83</p>
<p>1 is no justification for ignoring the word he did use and</p> <p>2 treating him as having used a word which he didn't. It</p> <p>3 is not as if he could have been unaware of</p> <p>4 the difference between the two words.</p> <p>5 As I think Goldman Sachs point out in their skeleton</p> <p>6 argument, the word "borrowing" is used elsewhere in the</p> <p>7 master agreement. One example I think they give is in</p> <p>8 the definition of "specified indebtedness", which refers</p> <p>9 to any obligation in respect of borrowed money. That is</p> <p>10 in both the 1992 and the 2002 agreements.</p> <p>11 At no stage, as we understand it, does Wentworth</p> <p>12 explain why the draftsman used the word "funding" rather</p> <p>13 than the word "borrowing".</p> <p>14 The second point is this: if your Lordship takes up</p> <p>15 the 1992 agreement, which is core bundle tab 7, this</p> <p>16 goes back to the definition of default rate. I just</p> <p>17 want to focus on one small word in that definition:</p> <p>18 "Default rate means a rate per annum equal to the</p> <p>19 cost (without proof of evidence of any actual cost) to</p> <p>20 the relevant payee (as certified by it) if it were to</p> <p>21 fund or of funding the relevant amount plus 1 per cent</p> <p>22 per annum."</p> <p>23 My Lord, we say this emphasises a point I made</p> <p>24 before the short adjournment: the draftsman's starting</p> <p>25 point is what the relevant payee actually did or would</p> <p style="text-align: center;">Page 82</p>	<p>1 a more realised concept, or what?</p> <p>2 MR DICKER: We say it is the former. There are two concepts</p> <p>3 here and two possibilities. The first is that the</p> <p>4 relevant payee actually went out and obtained funding.</p> <p>5 MR JUSTICE HILDYARD: That's one, yes. That is not the "if</p> <p>6 it were to fund".</p> <p>7 MR DICKER: No. That is, if the relevant payee, for</p> <p>8 whatever reason, decided not, in fact, to obtain</p> <p>9 funding. What it is required to do is to work out the</p> <p>10 cost of funding if it had obtained funding. And we say,</p> <p>11 within the structure of the agreement, what it has to do</p> <p>12 is make an assessment, good faith and rationally, of how</p> <p>13 it would have funded the relevant amount, and then it</p> <p>14 has to work out, again, rationally and in good faith,</p> <p>15 what the cost of that funding would have been.</p> <p>16 MR JUSTICE HILDYARD: I understand the counterpoint, which</p> <p>17 I think Wentworth described as the counterfactual</p> <p>18 between actual and hypothetical funding, but what I am</p> <p>19 just trying to get fixed in my mind is what you say is</p> <p>20 the importance of the word "it", because "it" is only</p> <p>21 used on the hypothetical. "Funding" appears to look to</p> <p>22 something which is not necessarily tied to "it", but the</p> <p>23 cost of funding.</p> <p>24 MR DICKER: But the cost of funding is --</p> <p>25 MR JUSTICE HILDYARD: That's the actual, is it?</p> <p style="text-align: center;">Page 84</p>

<p>1 MR DICKER: The cost of funding is the actual. We are</p> <p>2 necessarily talking about the cost of funding to the</p> <p>3 relevant payee.</p> <p>4 MR JUSTICE HILDYARD: I've got you.</p> <p>5 MR DICKER: It is a short point. We say what the draftsman</p> <p>6 was doing was asking the relevant payee, "How have you</p> <p>7 funded that and what has it cost you?", or, "How would</p> <p>8 you have funded it and what would it have cost you?"</p> <p>9 Those two simple alternatives, we say, are what the</p> <p>10 default rate is about, and the process the draftsman had</p> <p>11 in mind.</p> <p>12 So that is our submission so far as those points on</p> <p>13 the language are concerned. We also say the concept of</p> <p>14 funding needs to be construed broadly. It needs to be</p> <p>15 construed broadly for the obvious reason that this is</p> <p>16 the only way one can be sure that it will be capable of</p> <p>17 covering the wide range of parties and circumstances in</p> <p>18 which it needs to be applied, and it needs to be</p> <p>19 construed broadly because it needs to cover the various</p> <p>20 possible ways in which the relevant payee either did or</p> <p>21 would have chosen to fund itself.</p> <p>22 This isn't trying to impose some straitjacket on</p> <p>23 a relevant payee. It is essentially leaving it to the</p> <p>24 relevant payee: what did you do; what would you have</p> <p>25 done; and what was the cost of each of those?</p> <p style="text-align: center;">Page 85</p>	<p>1 substantially increasing its leverage.</p> <p>2 The appropriate, rational, good faith response in</p> <p>3 those circumstances might very well be, "I need to raise</p> <p>4 equity", or at least, "I need to raise a mixture of</p> <p>5 borrowing and equity to get my leverage back to the</p> <p>6 position it was beforehand".</p> <p>7 The third situation: if one takes this particular</p> <p>8 situation, when LBIE went into administration, as the</p> <p>9 administrators have stressed from time to time, it</p> <p>10 appeared unlikely at that stage that LBIE would ever be</p> <p>11 capable of repaying its debts in full. Now, again, at</p> <p>12 that stage we say perfectly rational and good faith for</p> <p>13 a party to have thought to himself, essentially, "I now</p> <p>14 have a capital-shaped hole", if I can use that phrase.</p> <p>15 "I have a sum, and I have got no expectation, and</p> <p>16 certainly no date by which LBIE will repay that sum,</p> <p>17 certainly in whole". One rational, good faith response</p> <p>18 to that is to say, "I need to raise equity. That's the</p> <p>19 best way of filling the particular hole that I have been</p> <p>20 confronted with".</p> <p>21 MR JUSTICE HILDYARD: This is rather an unformed thought</p> <p>22 but you can address it in due course, or now if you feel</p> <p>23 like it, borrowing and interest go together like a horse</p> <p>24 and carriage, but it must be rare that equity funding is</p> <p>25 transaction-specific. It may be because there may be</p> <p style="text-align: center;">Page 87</p>
<p>1 So the premise, we say, is you start with the</p> <p>2 actions of the relevant payee, either actual or</p> <p>3 hypothetical, and work out the cost of them. You don't</p> <p>4 start with some premise, some narrower stipulation as to</p> <p>5 what is permitted and what isn't, and then try to drive</p> <p>6 everything else from that. That is not how the</p> <p>7 mechanism is structured, we say.</p> <p>8 We say, on that basis, funding obviously is capable</p> <p>9 of including equity funding as well as the various other</p> <p>10 forms of funding I mentioned. Again, there are a number</p> <p>11 of obvious reasons why a party might rationally and in</p> <p>12 good faith have funded the relevant amount by equity</p> <p>13 funding. The first is because, as a matter of law or</p> <p>14 regulation, it wasn't actually entitled to borrow any</p> <p>15 further sum. The only way it could raise finance was</p> <p>16 through equity finance. So if it couldn't do that,</p> <p>17 essentially, it couldn't fund itself.</p> <p>18 Secondly, even if not required by law or regulation,</p> <p>19 there may be circumstances in which it was rational and</p> <p>20 good faith for a relevant payee to fund itself by using</p> <p>21 equity funding. One only has to imagine some of</p> <p>22 the potential consequences of LBIE's administration.</p> <p>23 Substantial sums were capable of being owed to</p> <p>24 a non-defaulting party which may have dramatically</p> <p>25 impacted on the counterparty's balance sheet,</p> <p style="text-align: center;">Page 86</p>	<p>1 a takeover or some specific and very large transaction</p> <p>2 to fund. But the notion of there being a direct linkage</p> <p>3 or sufficient linkage between equity funding and</p> <p>4 a specific transactional failure is less easy to sort of</p> <p>5 feel is normal.</p> <p>6 MR DICKER: Your Lordship may or may not be right on the</p> <p>7 facts. That is essentially a question of fact. But</p> <p>8 assuming for present purposes, which seems reasonable</p> <p>9 your Lordship is, firstly, there may be a transaction.</p> <p>10 Goldmans have given some examples, they say, of equity</p> <p>11 funding which were raised after the collapse of</p> <p>12 the Lehman group in direct response to that collapse,</p> <p>13 not perhaps necessarily in relation to the particular</p> <p>14 amount on its own, but at least in relation to the</p> <p>15 consequences of the collapse. So one question for</p> <p>16 your Lordship, we say, is: in that situation, is the</p> <p>17 concept of funding capable of including equity funding?</p> <p>18 In other words, where there is a transaction, it's</p> <p>19 perfectly possible there might have been, and one needs</p> <p>20 to answer that question before then moving on and</p> <p>21 dealing with other possible scenarios.</p> <p>22 Now, if the answer to that question is, yes, funding</p> <p>23 can include equity funding, is there any distinction</p> <p>24 between that situation and other situations of equity</p> <p>25 funding which mean that the first is fine but the second</p> <p style="text-align: center;">Page 88</p>

22 (Pages 85 to 88)

<p>1 isn't?</p> <p>2 So far as that is concerned, what we say is,</p> <p>3 plainly, there are measurement issues in relation to at</p> <p>4 least some equity funding that may be less</p> <p>5 straightforward than simple loan plus an interest rate.</p> <p>6 But those issues are not insurmountable. I will come to</p> <p>7 this in due course. There are well-established means of</p> <p>8 working out what one's costs of equity is.</p> <p>9 One then may have a question of whether or not --</p> <p>10 MR JUSTICE HILDYARD: There are, are there? I can</p> <p>11 understand there being a cost of equity in that you have</p> <p>12 to keep your shareholders content. We are still</p> <p>13 dealing, notwithstanding the breadth of the meaning you</p> <p>14 seek to ascribe -- I don't mean that rudely, I just mean</p> <p>15 you have a fairly expansive -- you invest it with quite</p> <p>16 an expansive and flexible meaning. I am just wondering</p> <p>17 whether the reasonable contemplation test is still</p> <p>18 there, in the sense of, is that likely to be the</p> <p>19 intention of the draftsman, and I am just wondering also</p> <p>20 whether the draftsman would have thought of the scenario</p> <p>21 you envisage, which is effectively failure on a single</p> <p>22 transaction, albeit possibly a large one, and going to</p> <p>23 shareholders and saying, "Something went wrong in this</p> <p>24 transaction. We have got to raise equity monies".</p> <p>25 MR DICKER: My Lord, in answer to that, we say it wouldn't</p> <p style="text-align: center;">Page 89</p>	<p>1 the sort of commercial parties who have influence on the</p> <p>2 drafting of these agreements.</p> <p>3 MR JUSTICE HILDYARD: I can quite see that, and I think the</p> <p>4 warning is well made, but it is far easier to grasp when</p> <p>5 you are thinking in terms of the funding of a business</p> <p>6 and its general means than in terms of</p> <p>7 a transaction-specific requirement which you need the</p> <p>8 money for or you are trying to replace the opportunity</p> <p>9 cost, if you like.</p> <p>10 It is much easier to understand it when you are</p> <p>11 looking at the needs of a business, where you can take</p> <p>12 well-known assessments of how much overall your cost of</p> <p>13 capital is than when you are looking at a specific</p> <p>14 transaction where you just have an instinctive surprise</p> <p>15 that funding by way of an equity raising would ever have</p> <p>16 been contemplated.</p> <p>17 MR DICKER: I understand that. We say that is no doubt one</p> <p>18 of the -- it may well have been, in our submission, one</p> <p>19 of the reasons why the draftsman had the words not</p> <p>20 merely "the cost of funding" but also "if it were to</p> <p>21 fund". In other words, the draftsman can't have</p> <p>22 intended that you would only recover cost of funding if</p> <p>23 you entered into a matching transaction. That is simply</p> <p>24 not how businesses fund themselves and it wouldn't be</p> <p>25 sensible for them to try to do so.</p> <p style="text-align: center;">Page 91</p>
<p>1 be right to assume that the draftsman, when drafting the</p> <p>2 master agreement, necessarily had a very long list of</p> <p>3 every possible situation which might constitute funding.</p> <p>4 What we say is, he plainly appreciated that there</p> <p>5 may be a very wide variety of ways in which a business</p> <p>6 may fund itself, and without necessarily trying to</p> <p>7 identify each and every one of those ways, he sought to</p> <p>8 cover that concept through the use of the word</p> <p>9 "funding".</p> <p>10 The second is this, and I will come on to this in</p> <p>11 due course: there is a danger -- I say this simply</p> <p>12 because I am conscious I have been tempted to fall into</p> <p>13 it from time to time -- of reading this through the</p> <p>14 perspective of a company lawyer familiar with corporate</p> <p>15 structure under English law and the differences between</p> <p>16 debt and equity, but in our submission, from the</p> <p>17 perspective of a commercial party, cost of equity is</p> <p>18 a very familiar metric. It is used in business for</p> <p>19 a whole range of reasons. It is regarded as part of</p> <p>20 your overall cost of funding; your overall cost of</p> <p>21 funding, again, very familiar acronym, WACC, weighted</p> <p>22 average cost of capital.</p> <p>23 All of these concepts, whilst they may not be as</p> <p>24 familiar to lawyers, are day-to-day stuff for the sort</p> <p>25 of commercial parties involved in master agreements and</p> <p style="text-align: center;">Page 90</p>	<p>1 MR JUSTICE HILDYARD: I understand that. What the draftsman</p> <p>2 is saying, "I know you didn't, but I am putting you on</p> <p>3 your honour as to what you would have done, and you have</p> <p>4 to certify at the end of the day, and your certificate,</p> <p>5 on any view, has to be in good faith and not pie in the</p> <p>6 sky". The sort of untutored observer, like myself,</p> <p>7 says, "Right. Well, if I am looking at the 'what would</p> <p>8 you have done' question, was it within the contemplation</p> <p>9 of the parties that they would say, 'I would have gone</p> <p>10 out with the prospectus, or whatever it was, with</p> <p>11 a rights issue, or whatever it was, to raise the funding</p> <p>12 for this specific transactional default?'" I need to get</p> <p>13 over my instinctive anxiety.</p> <p>14 MR DICKER: We say that is covered by the phrase "if it were</p> <p>15 to fund". We say, from the perspective of the parties</p> <p>16 to a master agreement, whether one is talking about</p> <p>17 banks, financial institutions or other corporate, fully</p> <p>18 familiar with the cost of capital, fully familiar with</p> <p>19 the distinction within that concept of cost of equity on</p> <p>20 the one hand, of cost of borrowing on the other hand,</p> <p>21 fully familiar with the idea that there are desirable</p> <p>22 capital ratios which each company will seek to maintain.</p> <p>23 In my submission, it is not from that perspective in any</p> <p>24 way a stretch of imagination to think a company involved</p> <p>25 in a transaction suffered a large loss. It is not in</p> <p style="text-align: center;">Page 92</p>

<p>1 any way unrealistic to think that a party might</p> <p>2 rationally and in good faith say the appropriate way of</p> <p>3 responding to that, because it is sufficiently large, is</p> <p>4 to deal with it by raising either just capital or</p> <p>5 a mixture of capital and debt.</p> <p>6 I think your Lordship is raising, if I may</p> <p>7 respectfully say, a slightly different point, which is,</p> <p>8 I'm not submitting that in every case a party would</p> <p>9 properly be entitled to certify that. It depends</p> <p>10 entirely on whether or not in doing so it was acting</p> <p>11 rationally and --</p> <p>12 MR JUSTICE HILDYARD: I know you say that the control</p> <p>13 mechanisms are good faith and rationality, or at least</p> <p>14 absence of irrationality.</p> <p>15 MR DICKER: That, we say, is an absolutely fundamental</p> <p>16 aspect of --</p> <p>17 MR JUSTICE HILDYARD: Well, the certificate for you is right</p> <p>18 at the centre of things, isn't it? It is not at the</p> <p>19 end. It is the control mechanism.</p> <p>20 MR DICKER: Yes. We say it is the control mechanism just as</p> <p>21 it is in relation to calculation of loss or calculation</p> <p>22 of the closeout amount. A critical aspect of</p> <p>23 the architecture of this documentation is the desire to</p> <p>24 achieve certainty and finality.</p> <p>25 My Lord, again, you will see that in due course</p> <p style="text-align: center;">Page 93</p>	<p>1 be certified is a cost of borrowing. There may or may</p> <p>2 not be other circumstances. What we say is, the</p> <p>3 structure is vital here, and the structure is:</p> <p>4 certification, provided it is good faith and rational,</p> <p>5 it is conclusive, and if you want to make a challenge,</p> <p>6 essentially it has to be on the basis it is either</p> <p>7 irrational or in bad faith.</p> <p>8 That line of reasoning is a line of reasoning one</p> <p>9 finds in the authorities both under English law and</p> <p>10 New York law in relation to the calculation of</p> <p>11 the closeout amount, and absolutely central to the</p> <p>12 operation of those provisions that they are conclusive</p> <p>13 save for whether irrational or in bad faith.</p> <p>14 We say the process is exactly the same here. It is</p> <p>15 almost the larger and the smaller. If the draftsman was</p> <p>16 prepared to permit a non-defaulting party to certify its</p> <p>17 own losses and to make that conclusive subject only to</p> <p>18 questions of rationality and in good faith, why on earth</p> <p>19 would he have wanted to change course when it came to</p> <p>20 the question of default interest on that calculated sum</p> <p>21 and say, "Actually, rationality and good faith is not</p> <p>22 enough here. There are going to be some limits on the</p> <p>23 sort of funding you can use or the sort of costs that</p> <p>24 you can take into account"? Why wouldn't he have just</p> <p>25 said, just as in relation to loss --</p> <p style="text-align: center;">Page 95</p>
<p>1 when --</p> <p>2 MR JUSTICE HILDYARD: Judge Chapman says it is not</p> <p>3 necessarily the right answer, but it is the honest</p> <p>4 answer.</p> <p>5 MR DICKER: Yes.</p> <p>6 MR JUSTICE HILDYARD: It is an honest answer within a very</p> <p>7 broad number of available honest answers.</p> <p>8 MR DICKER: That is the control mechanism, because that is,</p> <p>9 we say, if one wants to look at it this way, the price</p> <p>10 of certainty and finality which, above all else, the</p> <p>11 draftsman of this agreement wanted to achieve. I think</p> <p>12 Professor Golden at one point in one of his articles</p> <p>13 says it is an obvious point, but if the market knows</p> <p>14 where it is, it can at least transact around it. If it</p> <p>15 doesn't like -- the worst thing for the market is not</p> <p>16 knowing where you are. The certainty, we say, is given</p> <p>17 by the rationality and good faith test.</p> <p>18 Just to take your Lordship's case, a party who --</p> <p>19 assume Wentworth is right. Assuming on one of its</p> <p>20 submissions Wentworth was able to establish that it</p> <p>21 would be irrational, objectively, for a party to raise</p> <p>22 equity in any circumstance other than a circumstance in</p> <p>23 which it simply couldn't borrow at all, well, if it can</p> <p>24 establish that, then the certification requirements are</p> <p>25 not met and the relevant cost of funding that needs to</p> <p style="text-align: center;">Page 94</p>	<p>1 MR JUSTICE HILDYARD: It may be I am wrong about this but</p> <p>2 doesn't loss carry within it its own objective standard</p> <p>3 that it has actually been incurred or not?</p> <p>4 MR DICKER: You have to be able to identify a loss, yes.</p> <p>5 MR JUSTICE HILDYARD: I think the point -- I'm sorry to take</p> <p>6 you out of turn, but I think both the administrators,</p> <p>7 perhaps, and Wentworth say you must have a sort of basic</p> <p>8 objective minimum, for example in the context of</p> <p>9 Socimer, or anything like that, in order to not to have</p> <p>10 devolved entirely to this standard of good faith and</p> <p>11 lack of irrationality, the entire answer then binding on</p> <p>12 both.</p> <p>13 MR DICKER: I'm not suggesting that either in the context of</p> <p>14 loss or the context of default rate. In the context of</p> <p>15 loss, for example, you are required to certify your</p> <p>16 loss.</p> <p>17 MR JUSTICE HILDYARD: Yes.</p> <p>18 MR DICKER: That is a concept -- one might think a fairly</p> <p>19 broad concept -- but that is the constraining concept</p> <p>20 within which any determination needs to be rational and</p> <p>21 good faith. We say there is a similar, broad</p> <p>22 constraining context in relation to the default rate,</p> <p>23 which is the phrase "cost of funding the relevant</p> <p>24 amount".</p> <p>25 All that phrase means, we say, is the cost to the</p> <p style="text-align: center;">Page 96</p>

<p>1 relevant payee either of getting in the money it needs</p> <p>2 or the cost to the relevant payee that it would have</p> <p>3 incurred if it had got in the money, however it would</p> <p>4 have done so.</p> <p>5 With respect to your Lordship, I don't think the</p> <p>6 difference is between one side advocating a constraint</p> <p>7 and the other side, this side, advocating for completely</p> <p>8 untrammelled rationality and good faith without any</p> <p>9 context at all. The difference between us is simply how</p> <p>10 constraining the constraint is. We say it is broader</p> <p>11 than Wentworth. You still have to be within it, but it</p> <p>12 has to be broad enough to cover the wide range of</p> <p>13 parties and circumstances that the agreement was meant</p> <p>14 to apply to.</p> <p>15 My Lord, one footnote point in relation to this, at</p> <p>16 this stage. Wentworth has raised the point about the</p> <p>17 scope of the factual matrix, and it is an issue that</p> <p>18 also arises in relation to New York law, which we will</p> <p>19 come to in due course, because of its different approach</p> <p>20 to admissibility of the factual matrix.</p> <p>21 Wentworth says it would be wrong to interpret the</p> <p>22 master agreements in the light of the regulatory</p> <p>23 requirements applicable to a particular class of</p> <p>24 counterparty. Now, it is important your Lordship</p> <p>25 understands we do not say that the detail of any</p> <p style="text-align: center;">Page 97</p>	<p>1 course.</p> <p>2 So we say the word "funding" needs to be construed</p> <p>3 broadly, given the range of parties that may be</p> <p>4 involved. We also submit it should be construed broadly</p> <p>5 to ensure that the provision fulfils its commercial</p> <p>6 purpose. If its purpose is compensation, then what it</p> <p>7 ought to permit a party to recover is the cost of</p> <p>8 the funding it actually incurred, provided it did so</p> <p>9 rationally and in good faith, or the funding it would</p> <p>10 have incurred, again, rationally and in good faith, not</p> <p>11 some other form of funding which it didn't incur and</p> <p>12 which it wouldn't have incurred.</p> <p>13 The first, we say, ensures you properly compensate</p> <p>14 the relevant payee; the second risks not doing so. We</p> <p>15 say this is particularly in the case in the context of</p> <p>16 the default rate.</p> <p>17 One does, in our submission, have to ask: why would</p> <p>18 the draftsman have been concerned to protect the</p> <p>19 defaulting party from having to meet the cost incurred</p> <p>20 by a relevant payee, either that it actually incurred or</p> <p>21 would have incurred? If the relevant payee said, "This</p> <p>22 is rationally and in good faith what I did or would have</p> <p>23 done", why would the draftsman want to protect the</p> <p>24 defaulting party from paying compensation on that basis</p> <p>25 and entitle it to pay some lesser sum? We say no</p> <p style="text-align: center;">Page 99</p>
<p>1 regulatory requirements form part of the factual matrix.</p> <p>2 It doesn't seem reasonable to assume that any party to</p> <p>3 the amendment will either know of them or should</p> <p>4 reasonably have been expected to have been aware of</p> <p>5 them.</p> <p>6 What we do say is that what matters is corporate</p> <p>7 entities fund themselves in a variety of ways which are</p> <p>8 not limited solely to borrowing, and do so rationally in</p> <p>9 good faith, and that's not something that's applicable</p> <p>10 to any specific counterparty, and doesn't require any</p> <p>11 further facts, other than the ones I have mentioned.</p> <p>12 In any event, the fact that certain parties may be</p> <p>13 subject to regulatory capital requirements, in the</p> <p>14 sense, without going into the detail, there may be</p> <p>15 regulations governing the amount of capital they have,</p> <p>16 we say is something which one could expect</p> <p>17 counterparties either to know or reasonably to have been</p> <p>18 capable of being aware of.</p> <p>19 So, again, we say, so far as justification of equity</p> <p>20 funding is concerned, to the extent one relies on the</p> <p>21 example of an entity which can't fund itself by further</p> <p>22 borrowing because of regulatory requirements, we say</p> <p>23 that possibility is something which would fall within</p> <p>24 the factual matrix, certainly so far as English law is</p> <p>25 concerned. As I said, I will come on to US law in due</p> <p style="text-align: center;">Page 98</p>	<p>1 justification, certainly no apparent justification, from</p> <p>2 any of the other provisions in the agreement.</p> <p>3 MR JUSTICE HILDYARD: Time and again in litigation, in fact</p> <p>4 every day of the week, people are not actually</p> <p>5 compensated for not having their money, but there is</p> <p>6 a general rule that interest at a given rate over base</p> <p>7 rate is their lot.</p> <p>8 You say that that general rule, it is accepted day</p> <p>9 in day out, as I say, not to be an accurate measurement</p> <p>10 of loss, but is the deemed measurement of loss, mustn't</p> <p>11 affect my view of this commercial arrangement and also</p> <p>12 might suggest I'm using English spectacles?</p> <p>13 MR DICKER: My Lord, the answer, in our submission, is yes,</p> <p>14 to both of those.</p> <p>15 My Lord, the next point is, construing funding so as</p> <p>16 to limit it solely to borrowing, in my submission would</p> <p>17 raise difficulties and cut across the draftsman's</p> <p>18 objectives, particularly his objectives of certainty,</p> <p>19 finality, avoiding litigation, et cetera.</p> <p>20 The first thing you would need to do is to decide</p> <p>21 what "borrowing" means. In that respect, you obviously</p> <p>22 don't get any help from the master agreements. The</p> <p>23 definition of default rate does not define borrowing.</p> <p>24 It doesn't even use that word.</p> <p>25 Does the test depend, for example, on legal form or</p> <p style="text-align: center;">Page 100</p>

<p>1 economic substance? That is one issue that would need</p> <p>2 to be resolved.</p> <p>3 Descending to the specific, is a repo transaction</p> <p>4 a sale and leaseback borrowing or not? What about</p> <p>5 entities that may not fund themselves solely by</p> <p>6 borrowing or equity? Whether -- a local authority in</p> <p>7 England is an example or an Islamic-funded entity in</p> <p>8 other jurisdictions is another.</p> <p>9 MR JUSTICE HILDYARD: I can see that, in general, but it's</p> <p>10 the measurement of cost which is more difficult to the</p> <p>11 uninitiated when you are dealing with equity funding.</p> <p>12 I know that there are models, but is there</p> <p>13 measurement?</p> <p>14 MR DICKER: Yes.</p> <p>15 MR JUSTICE HILDYARD: That is going to be, I would imagine,</p> <p>16 quite an important point for me to understand.</p> <p>17 MR DICKER: I understand that. I was going to come to that.</p> <p>18 You need to know what "borrowing" means. You also</p> <p>19 need to work out what the dividing line between</p> <p>20 borrowing and equity or non-borrowing was.</p> <p>21 My Lord, as your Lordship knows, there isn't</p> <p>22 a strict bright line division between the two. Parties</p> <p>23 often issue hybrid instruments which contain</p> <p>24 characteristics of both debt and equity funding, and</p> <p>25 there are a number of different types of instruments</p> <p style="text-align: center;">Page 101</p>	<p>1 party B"? We say those sort of distinctions cannot be</p> <p>2 ones which the draftsman intended the definition of</p> <p>3 default rate would draw.</p> <p>4 My Lord, the next point is, such consequences we say</p> <p>5 are not merely arbitrary, but, in certain circumstances,</p> <p>6 capable of having absurd consequences.</p> <p>7 Assume a relevant payee did what your Lordship</p> <p>8 described as -- perhaps not very likely, it did actually</p> <p>9 go out and raise equity following Lehman's collapse, and</p> <p>10 it only had one outstanding derivative, and the amount</p> <p>11 of the equity reflected the amount of the unpaid amount,</p> <p>12 and assume also it did so rationally and in good faith.</p> <p>13 Now, assume it did so because regulatory requirements</p> <p>14 were such it wasn't allowed to raise borrowing. As we</p> <p>15 understand it on Wentworth's construction, in that</p> <p>16 situation the party would not be able to recover any</p> <p>17 cost of funding at all. It wouldn't be entitled to</p> <p>18 recover any cost of funding for the simple reason that</p> <p>19 what it did wasn't, on its definition, funding because</p> <p>20 funding means borrowing.</p> <p>21 That leads to this: you imagine -- take the example</p> <p>22 of LBIE, it goes into administration. If you are owed</p> <p>23 a modest amount by LBIE, you may choose to and be able</p> <p>24 to fund it through borrowing. As the amount gets larger</p> <p>25 compared to your own balance sheet, all other things</p> <p style="text-align: center;">Page 103</p>
<p>1 deliberately structured to exist on the boundaries</p> <p>2 between debt and equity.</p> <p>3 My Lord, I won't say much about this at this stage.</p> <p>4 I think Mr Foxton is going to deal with it in more</p> <p>5 detail.</p> <p>6 If one just takes, for example, on the one hand,</p> <p>7 preference shares carrying a fixed dividend and, on the</p> <p>8 other hand, contingent convertible capital, they may</p> <p>9 have identical economic effects in every situation. If</p> <p>10 you do say that borrowing is funding, non-borrowing is</p> <p>11 not, you necessarily accept that you have to be able to</p> <p>12 draw the line between the two. We say, at lowest, that</p> <p>13 is not an easy task to do.</p> <p>14 The next point follows from my last. Even assuming</p> <p>15 you embark on the path of defining borrowing and are</p> <p>16 able to draw a dividing line between that and other</p> <p>17 forms of funding, you will inevitably end up with</p> <p>18 consequences which we say are wholly arbitrary for the</p> <p>19 purposes of this agreement.</p> <p>20 What possible reason could there have been for the</p> <p>21 draftsman to say, "I know you bona fide and rationally</p> <p>22 entered into transaction A and someone else entered into</p> <p>23 transaction B, I know that they have identical</p> <p>24 commercial consequences, but I am prepared to allow</p> <p>25 party A to recover the cost of his instrument but not</p> <p style="text-align: center;">Page 102</p>	<p>1 being equal, the cost of borrowing is likely to go up.</p> <p>2 Fine. You can recover the additional cost of borrowing</p> <p>3 because it is still a cost of borrowing. You get to</p> <p>4 a particular stage when no-one is prepared to lend to</p> <p>5 you or lend to you on any sort of sensible basis, and</p> <p>6 the only basis on which you can raise funding is by</p> <p>7 means of equity. More expensive than borrowing, but the</p> <p>8 only option open to you. At that stage, up until then,</p> <p>9 the amount you have been able to recover has gone up,</p> <p>10 but you reach this precipice point, on Wentworth's</p> <p>11 argument, beyond which you then are entitled to recover</p> <p>12 nothing.</p> <p>13 The only thing that has changed is essentially the</p> <p>14 size of the sum that you are owed and its impact on your</p> <p>15 own balance sheet, and on any objective basis the cost</p> <p>16 to you of filling that particular gap. My Lord, again,</p> <p>17 we say those sort of precipice-like consequences would</p> <p>18 be absurd and cannot conceivably have been intended by</p> <p>19 the draftsman.</p> <p>20 That possibility has been raised with Wentworth. It</p> <p>21 was addressed at one stage in correspondence. I think</p> <p>22 it's briefly addressed in its reply skeleton argument.</p> <p>23 In correspondence, the suggestion appeared to be: well,</p> <p>24 in extreme circumstances, if you can't raise money by</p> <p>25 borrowing, maybe the solution is that you can have the</p> <p style="text-align: center;">Page 104</p>

<p>1 cost of equity in that situation.</p> <p>2 Now, my Lord, that is, if I may say, one way of</p> <p>3 solving the problem, but in our submission it causes</p> <p>4 Wentworth real difficulties with its argument, because</p> <p>5 that can only be a possible option if the word "funding"</p> <p>6 is actually broad enough to cover cost of equity.</p> <p>7 What its argument really amounts to, if that's where</p> <p>8 we get to, is actually an argument about what is</p> <p>9 rational and good faith. What it is essentially saying</p> <p>10 is, it would never be rational or it would never be in</p> <p>11 good faith to raise equity if you can borrow the money.</p> <p>12 My Lord, we say that is equally open to objection.</p> <p>13 The suggestion that whenever a party can borrow money it</p> <p>14 would be irrational or bad faith for it to raise equity</p> <p>15 only has to be stated to be seen to be, again, we say,</p> <p>16 absurd.</p> <p>17 My Lord, so those submissions by reference to what</p> <p>18 may be called commercial purpose or commercial</p> <p>19 commonsense.</p> <p>20 Can I turn now to deal with a separate point; it is</p> <p>21 an argument raised by Wentworth. Wentworth says funding</p> <p>22 must be limited to borrowing, cannot include equity</p> <p>23 funding because the definition of default rate implies</p> <p>24 that the amount to be funded is required to be repaid at</p> <p>25 the end of the period, which is an essential feature of</p> <p style="text-align: center;">Page 105</p>	<p>1 difficulty. The basic cost is then simply three years</p> <p>2 worth of interest rather than the five years. So that</p> <p>3 is the first point.</p> <p>4 The second point is, Wentworth says the requirement</p> <p>5 to repay at the end of the period is an essential</p> <p>6 feature of borrowing, not equity. We also say that is</p> <p>7 wrong. It is not true that borrowing can only be raised</p> <p>8 for a limited period. Borrowing can be raised on</p> <p>9 various bases, some of which may be essentially</p> <p>10 open-ended so far as repayment is concerned. One has</p> <p>11 the example of bonds with no maturity date, for example.</p> <p>12 And equity funding equally could be raised for a limited</p> <p>13 period. Preference shares which require to be redeemed</p> <p>14 on a certain date. Even if they don't, it is always</p> <p>15 open to a company -- it may be open to a company to go</p> <p>16 out and repurchase its shares and cancel them. So if</p> <p>17 there was a requirement that whatever source of funding</p> <p>18 was used had to come to an end at the end of</p> <p>19 the relevant period, that wouldn't necessarily rule out</p> <p>20 equity, in any event.</p> <p>21 My Lord, in short, so far as funding is concerned,</p> <p>22 we say one starts with how the relevant payee funded or</p> <p>23 would have paid the relevant amount. The only</p> <p>24 limitation is, it must have been acting rationally and</p> <p>25 in good faith, and funding as a concept is and needs to</p> <p style="text-align: center;">Page 107</p>
<p>1 borrowing, not equity.</p> <p>2 So they say if you look at the definition of default</p> <p>3 rate, it implies that the amount to be funded is</p> <p>4 required to be repaid at the end of the period. They</p> <p>5 say, well, that's an essential feature of borrowing and</p> <p>6 not equity.</p> <p>7 We say two parts to the argument, both of which are</p> <p>8 wrong. The first point, they say the definition</p> <p>9 impliedly requires that funding that is obtained is to</p> <p>10 be repaid at the end of the period. We say there is</p> <p>11 nothing in the definition that requires that. It</p> <p>12 doesn't say it and there is no proper basis on which it</p> <p>13 can be implied. All the definition requires is that the</p> <p>14 relevant payee certifies its cost of funding for the</p> <p>15 relevant period. It doesn't require the funding itself</p> <p>16 to be repaid at the end of that period.</p> <p>17 One can see why. Imagine a situation in which it is</p> <p>18 likely to be some years before the defaulting party pays</p> <p>19 the relevant amount. As a result, the relevant payee</p> <p>20 thinks to himself, "I will borrow. I will borrow for</p> <p>21 five years. That's my best guesstimate of how long it</p> <p>22 will take. That's the rational and good faith</p> <p>23 approach", and assuming the borrowing is, say, at</p> <p>24 8 per cent per annum. Now, as it turns out, the money</p> <p>25 is in fact paid within three years. There is no</p> <p style="text-align: center;">Page 106</p>	<p>1 be broad enough to cover all means by which companies</p> <p>2 may fund themselves.</p> <p>3 My Lord, that is all I was proposing to say in</p> <p>4 relation to funding. I was now going to turn to the</p> <p>5 word "cost" and the concept of cost of funding and make</p> <p>6 my submissions in relation to that.</p> <p>7 My Lord, again, the Senior Creditor Group's position</p> <p>8 is straightforward. The concept of cost in funding is</p> <p>9 also a broad one. It is capable of including all costs,</p> <p>10 including all sums paid, benefits provided, financial</p> <p>11 detriment incurred -- essentially, trying to pick up</p> <p>12 concepts of consideration, nothing else -- by the</p> <p>13 relevant payee in maintaining, raising or servicing the</p> <p>14 relevant type of funding. So it has an ongoing</p> <p>15 dimension as well. We say that is amply broad enough to</p> <p>16 cover the cost of equity.</p> <p>17 One preliminary point before, again, turning to the</p> <p>18 detail --</p> <p>19 MR JUSTICE HILDYARD: You draw the line at costs which</p> <p>20 aren't incidental to the borrowing or to the funding?</p> <p>21 Supposing you had an equity funding and you had to pay</p> <p>22 placing agents or a bank, you would be able to include</p> <p>23 that, would you?</p> <p>24 MR DICKER: There's a separate issue in relation to</p> <p>25 professional fees charged by third parties, et cetera.</p> <p style="text-align: center;">Page 108</p>

<p>1 I will deal with that. The short answer is, yes.</p> <p>2 MR JUSTICE HILDYARD: You do cap those?</p> <p>3 MR DICKER: Yes. It is a cost, and if it is a cost which</p> <p>4 you incur in funding the relevant amount, then you are</p> <p>5 entitled to recover it.</p> <p>6 MR JUSTICE HILDYARD: Anyway, you will come to that</p> <p>7 MR DICKER: I will.</p> <p>8 My Lord, I made a submission earlier that there is</p> <p>9 a temptation to treat concepts of funding and costs</p> <p>10 separately. One has to bear in mind they are also part</p> <p>11 of a single concept. That leads to this submission: if</p> <p>12 funding does include equity funding, then we say it</p> <p>13 necessarily follows that the cost of funding must</p> <p>14 include the cost of equity funding and the concept of</p> <p>15 cost must be construed accordingly.</p> <p>16 In other words, it doesn't make sense to say funding</p> <p>17 can include equity funding, but then, when you construe</p> <p>18 the word "cost", to construe it in such a way that there</p> <p>19 can't be a cost of equity funding for the purposes of</p> <p>20 the definition. The two halves obviously need to be</p> <p>21 capable of forming a coherent whole. So we say, if</p> <p>22 one's answer to the first question is, funding can</p> <p>23 include equity funding, then that informs the answer to</p> <p>24 what cost means, it must necessarily be capable of</p> <p>25 covering whatever the costs of equity funding are.</p> <p style="text-align: center;">Page 109</p>	<p>1 to deal with another argument of Wentworth's, which</p> <p>2 applies to all forms of funding, whether borrowing or</p> <p>3 equity, and that is its lowest cost argument.</p> <p>4 The argument obviously has particular implications</p> <p>5 on Wentworth's case for equity funding, given that</p> <p>6 equity funding tends to be more expensive, which is no</p> <p>7 doubt why it is advanced, but the logic of the argument</p> <p>8 is it applies to all forms of funds, whether borrowing,</p> <p>9 equity or any other.</p> <p>10 I again start just by ensuring that the Senior</p> <p>11 Creditor Group's position is clear, and I'm at risk now</p> <p>12 perhaps of repeating myself, but the agreement requires</p> <p>13 the relevant payee to identify the funding it actually</p> <p>14 obtained or would have obtained to determine such cost</p> <p>15 of funding rationally and in good faith.</p> <p>16 We accept, if there are two forms of funding and,</p> <p>17 all other things being equal, one is cheaper than the</p> <p>18 other, then that may provide scope for challenge. The</p> <p>19 basis for challenge would have to be that the relevant</p> <p>20 payee had not certified its cost of funding rationally</p> <p>21 and in good faith. That is the control mechanism. It</p> <p>22 would not be because part of the sums are not a cost but</p> <p>23 something different, namely, to be treated as</p> <p>24 a voluntary payment, or because the relevant payee</p> <p>25 certified something other than its cost of funding</p> <p style="text-align: center;">Page 111</p>
<p>1 MR JUSTICE HILDYARD: Don't they say it must be something</p> <p>2 which is measurable in cost terms, and maybe equity</p> <p>3 funding is, maybe it isn't, and that's what you are</p> <p>4 going to explain to me?</p> <p>5 MR DICKER: Yes, and that is one of the arguments, and it</p> <p>6 arises for different reasons. One of the reasons given</p> <p>7 is because, at least as a matter of English law, to some</p> <p>8 extent at least, although the extent can vary, payments</p> <p>9 made are made essentially as a matter of discretion.</p> <p>10 Not invariably, but if one just thinks in terms of</p> <p>11 ordinary shares, dividends are at the discretion of</p> <p>12 the directors. So that is one element.</p> <p>13 The other element is that payments are not</p> <p>14 necessarily as regular as a normal interest rate on</p> <p>15 a normal loan would be. So if one has as one's sort of</p> <p>16 paradigm interest accruing monthly at X per cent,</p> <p>17 payment of dividends again looks slightly different. But</p> <p>18 in our respectful submission, one is not trying to find</p> <p>19 something which is structurally the same as borrowing.</p> <p>20 The question is a different one, which is simply: this</p> <p>21 method of funding, assuming one has determined it comes</p> <p>22 within the phrase "funding", does it have a cost, is it</p> <p>23 capable of being measured, and, if so, how?</p> <p>24 My Lord, before dealing with that point, which</p> <p>25 obviously relates specifically to equity funding, I want</p> <p style="text-align: center;">Page 110</p>	<p>1 properly construed.</p> <p>2 We do say the court ought to be very wary, indeed,</p> <p>3 of accepting any challenge to the certification process</p> <p>4 dressed up as an argument of construction as to the</p> <p>5 meaning of the word "cost". We say cost is a broad</p> <p>6 concept. The only control mechanism is rationality and</p> <p>7 good faith. It is not reading down what is meant by</p> <p>8 cost.</p> <p>9 MR JUSTICE HILDYARD: It is not really a breach of good</p> <p>10 faith or rationality, is it, to want to recover from</p> <p>11 someone under a peculiar contractual arrangement whereby</p> <p>12 you can recover it and allocate the less-expensive cost</p> <p>13 to someone against whom you can't recover? Is that</p> <p>14 irrational? It seems quite rational. The question is</p> <p>15 whether it is permissible.</p> <p>16 MR DICKER: We say, if there are two forms of funding, all</p> <p>17 other things being equal, and one is cheaper than the</p> <p>18 other, then the way I described it was, there may be</p> <p>19 scope for challenge on the basis that it wouldn't be</p> <p>20 rational and good faith.</p> <p>21 I hesitate, as with all of these questions, to try</p> <p>22 to provide a definitive --</p> <p>23 MR JUSTICE HILDYARD: I'm sorry, I'm sort of talking out of</p> <p>24 turn in a way, but just so I share with you my</p> <p>25 confusions so you have a chance to address them.</p> <p style="text-align: center;">Page 112</p>

<p>1 Good faith and rationality are quite difficult to</p> <p>2 police sometimes, aren't they, because commercial</p> <p>3 behaviour may be quite brutal, but it is not irrational.</p> <p>4 MR DICKER: If it is not irrational, then it doesn't fall</p> <p>5 foul of the standard. It may still be contrary to good</p> <p>6 faith. That depends on where the court draws the line</p> <p>7 between good faith and bad faith so far as commercial</p> <p>8 counterparties are concerned.</p> <p>9 That may not be always an easy line to draw. It may</p> <p>10 not necessarily be drawn in the same place by the same</p> <p>11 court or at different times.</p> <p>12 MR JUSTICE HILDYARD: Would that worry the draftsman, that</p> <p>13 any certificate which was significantly in excess of</p> <p>14 the borrowing costs might trigger a dispute as to</p> <p>15 whether that particular certificate was in good faith?</p> <p>16 MR DICKER: In our respectful submission, what would have</p> <p>17 worried him a lot more was the possibility that the</p> <p>18 parties may have to litigate about the precise</p> <p>19 construction of the word "cost" and what was or wasn't</p> <p>20 included.</p> <p>21 MR JUSTICE HILDYARD: Why would they be more worried about</p> <p>22 that than a dispute about good faith?</p> <p>23 MR DICKER: Because there is considerably more scope for</p> <p>24 litigation if that is the route one goes down.</p> <p>25 MR JUSTICE HILDYARD: It all depends what you invest good</p> <p style="text-align: center;">Page 113</p>	<p>1 You are saying that's not right and you must look</p> <p>2 into the individual circumstances. You emphasised the</p> <p>3 word "it", you emphasised that the draftsman has</p> <p>4 expressly catered for the actual and the hypothetical,</p> <p>5 and you must simply see what it is which in good faith</p> <p>6 that person says would have been the mechanic for</p> <p>7 plugging the gap.</p> <p>8 MR DICKER: My Lord, yes. We say the draftsman hasn't</p> <p>9 ensured certainty by picking a specific metric, at least</p> <p>10 in this context. He hasn't said it's the interest rate</p> <p>11 you've received from a foreign bank, or anything of that</p> <p>12 sort. He hasn't said it is LIBOR or Euribor or anything</p> <p>13 of that sort. That is because, going back to the</p> <p>14 objectives I identified at the start, he wants to ensure</p> <p>15 full compensation, we say, and you wouldn't achieve it</p> <p>16 by the sort of blunt approach that that would involve.</p> <p>17 He wants to achieve certainty and finality, which he</p> <p>18 achieves through the certification process, not -- he</p> <p>19 has this situation where he wants full compensation. He</p> <p>20 wants, we say, to use concepts capable of applying to</p> <p>21 the multitude of parties who may be subject to this</p> <p>22 agreement. But he does want to achieve, one might say,</p> <p>23 a similar sort of certainty to that which would be</p> <p>24 achieved by saying everyone just has 8 per cent. In</p> <p>25 other words, something that isn't sensibly, in most</p> <p style="text-align: center;">Page 115</p>
<p>1 faith with. Anyway, yes.</p> <p>2 MR DICKER: My Lord, there is useful comparison, we say,</p> <p>3 with the approach taken in relation to loss. In</p> <p>4 a sense, the same issue arises writ large. Writ large</p> <p>5 in the sense it is a more fundamental provision, one may</p> <p>6 say, of the master agreement. It is the calculation of</p> <p>7 the termination amount itself. It is more fundamental</p> <p>8 because in most cases it is likely to be rather greater</p> <p>9 in amount than simply the interest accruing on it.</p> <p>10 My Lord, when this issue has been considered by the</p> <p>11 courts, here and in New York, they have unanimously</p> <p>12 produced the same answer: the draftsman intended it to</p> <p>13 be conclusive subject only to questions of rationality</p> <p>14 and in good faith.</p> <p>15 Such concerns as your Lordship has, which with the</p> <p>16 greatest respect I'm not seeking to minimise, weren't</p> <p>17 sufficient in those cases to lead to a different result,</p> <p>18 and we say shouldn't -- couldn't, in our submission,</p> <p>19 sensibly lead to a different result in this case.</p> <p>20 MR JUSTICE HILDYARD: I suppose courts are always quite</p> <p>21 reluctant to depart from the generic and get into the</p> <p>22 personal loss of every individual step, if you see what</p> <p>23 I mean. That is why we have a rule about interest. It</p> <p>24 is a generic response. It is a blunt instrument, but it</p> <p>25 is generic.</p> <p style="text-align: center;">Page 114</p>	<p>1 cases, open to challenge. And he does that through the</p> <p>2 certification process, just as he does, to repeat</p> <p>3 myself, in the context of loss and the closeout amount.</p> <p>4 MR JUSTICE HILDYARD: Anyway, I took you out of sequence to</p> <p>5 measurement -- well, what cost means.</p> <p>6 MR DICKER: My Lord, just dealing with --</p> <p>7 MR JUSTICE HILDYARD: The lowest cost is what you are</p> <p>8 really --</p> <p>9 MR DICKER: Yes.</p> <p>10 MR JUSTICE HILDYARD: Is there some implied commitment you</p> <p>11 will go for -- you will only put in your certificate or</p> <p>12 be permitted to do so, the lower cost, if there are two</p> <p>13 funding mechanisms available?</p> <p>14 MR DICKER: We say, all other things being equal, if one</p> <p>15 just looks at headline interest rate, one is higher than</p> <p>16 the other, and there may be grounds for challenge, we</p> <p>17 accept, but the grounds for challenge are, in that</p> <p>18 situation, the grounds of rationality and good faith,</p> <p>19 not some linguistic challenge.</p> <p>20 As we understand Wentworth's case, certainly in its</p> <p>21 position paper, and in its opening skeleton argument,</p> <p>22 the lowest cost argument appears to be presented as</p> <p>23 a linguistic point. It is a question of construction.</p> <p>24 It is for the court to determine. Its submission is</p> <p>25 that when you see the word "cost" what you should in</p> <p style="text-align: center;">Page 116</p>

<p>1 fact read is "lowest cost".</p> <p>2 Therefore, the relevant payee has to make a good</p> <p>3 faith and rational determination of what this lowest</p> <p>4 cost would be. If it does something different, then its</p> <p>5 determination is not binding.</p> <p>6 The first point is, the agreement doesn't actually</p> <p>7 say what Wentworth would like it to say. It uses the</p> <p>8 word "cost". It doesn't use the word "lowest cost".</p> <p>9 The distinction is potentially important. As a matter</p> <p>10 of ordinary language, cost doesn't necessarily mean the</p> <p>11 lowest amount the relevant payee could or would have</p> <p>12 been required to pay over the relevant period.</p> <p>13 Take, for example, a party who actually funded the</p> <p>14 relevant amount by going out and borrowing money at</p> <p>15 a particular interest rate. There is nothing remotely</p> <p>16 unusual in saying that the cost of the funding to that</p> <p>17 party is the interest rate which he in fact incurred on</p> <p>18 the borrowing which he actually obtained.</p> <p>19 Another example, just to illustrate the point we say</p> <p>20 Wentworth's argument is wrong. Imagine a situation in</p> <p>21 which someone goes out and buys a jacket for GBP100.</p> <p>22 Perfectly natural, we say, the jacket cost him GBP100.</p> <p>23 It doesn't matter he might have obtained it more cheaply</p> <p>24 elsewhere. One can assume he might have bought it from</p> <p>25 another shop for GBP90. It wouldn't make sense in that</p> <p style="text-align: center;">Page 117</p>	<p>1 have in mind. You have a relevant payee. He is</p> <p>2 required to identify the funding he actually obtained or</p> <p>3 would have obtained and make a rational and good-faith</p> <p>4 determination of the cost.</p> <p>5 There may be very many factors which someone</p> <p>6 rationally and in good faith takes into account in</p> <p>7 deciding how it is going to fund the relevant amount,</p> <p>8 and the headline interest rate is undoubtedly one, but</p> <p>9 only one, of such factors.</p> <p>10 Now, on Wentworth's approach, the exercise that the</p> <p>11 relevant payee is required to perform changes. We say</p> <p>12 he has to certify the cost either of the funding he</p> <p>13 obtained or the funding he would have obtained</p> <p>14 rationally and in good faith. Wentworth says, no, what</p> <p>15 he needs to be doing is identifying the lowest cost, and</p> <p>16 if he does something else, he is simply not doing the</p> <p>17 exercise required by the contract and his certification</p> <p>18 is therefore either irrational or not in good faith.</p> <p>19 So, instead of having a basket of factors which the</p> <p>20 relevant payee may take into account, Wentworth</p> <p>21 essentially says: that's not the right approach, forget</p> <p>22 about the basket of factors, what he really has to be</p> <p>23 focusing on, and focusing only on, is the lowest cost.</p> <p>24 My Lord, I notice the time. I am conscious of</p> <p>25 the shorthand writers.</p> <p style="text-align: center;">Page 119</p>
<p>1 situation to say the cost of the jacket to him was GBP90</p> <p>2 and he also made a voluntary payment of an additional</p> <p>3 GBP10 on top.</p> <p>4 We say the position is exactly the same where the</p> <p>5 relevant payee did not in fact obtain funding. In that</p> <p>6 situation, he is required to identify how he would have</p> <p>7 funded it and then work out the cost to him if he had</p> <p>8 funded it in that way.</p> <p>9 The second linguistic point is this: I made the</p> <p>10 submission that the definition uses the word "cost", not</p> <p>11 "lowest cost". The other phrase which Wentworth uses is</p> <p>12 "required to pay", "the lowest cost you would have been</p> <p>13 required to pay". It is a small point, but it is</p> <p>14 interesting to note this phrase is used elsewhere in the</p> <p>15 master agreement. Section 2(d)(ii)(1). If</p> <p>16 your Lordship just goes perhaps to core bundle tab 7 --</p> <p>17 MR JUSTICE HILDYARD: 149.</p> <p>18 MR DICKER: 149. It is (d)(ii)(1), line 3. The phrase</p> <p>19 "would not be required to pay". So you do see the word</p> <p>20 "required to pay". It is not a phrase, however, you see</p> <p>21 in the definition of default rate.</p> <p>22 We say that makes sense because Wentworth's</p> <p>23 construction approach doesn't reflect the exercise that</p> <p>24 the master agreements require to be performed.</p> <p>25 Again, it is a very simple process the draftsmen</p> <p style="text-align: center;">Page 118</p>	<p>1 MR JUSTICE HILDYARD: We will break for five minutes.</p> <p>2 (3.10 pm)</p> <p>3 (A short break)</p> <p>4 (3.16 pm)</p> <p>5 MR DICKER: My Lord, dealing with the lowest cost, I made</p> <p>6 the point that in our submission it changes the nature</p> <p>7 of the exercise required of the relevant payee, to work</p> <p>8 out what the cost is; instead, he has to work out what</p> <p>9 the lowest cost is.</p> <p>10 It would also, in our submission, give rise to</p> <p>11 considerable, obvious uncertainty. In this respect, we</p> <p>12 say Wentworth is, again, between the proverbial rock and</p> <p>13 hard place.</p> <p>14 There are two possibilities as to what lowest cost</p> <p>15 means, and neither of them, in our submission, help</p> <p>16 Wentworth.</p> <p>17 The first possibility is the only thing that</p> <p>18 matters, and the only thing you can take into account is</p> <p>19 the headline interest rate. If that is what lowest cost</p> <p>20 means for the purposes of cost, then, in most cases, it</p> <p>21 will be possible to compare two different borrowing</p> <p>22 transactions. It is not necessarily easy. There may be</p> <p>23 some mathematics involved and there may be some</p> <p>24 uncertainty which also needs to be taken into account.</p> <p>25 But at least one is comparing, if I may say, sort of</p> <p style="text-align: center;">Page 120</p>

<p>1 apples with at least another type of apple rather than</p> <p>2 a different fruit entirely.</p> <p>3 But we say that can't possibly be what the draftsman</p> <p>4 intended. It leads to absurd consequences.</p> <p>5 If all that matters is the lowest cost by reference</p> <p>6 to the headline interest rate and everything else is</p> <p>7 left out of account, then the logic must be that the</p> <p>8 relevant payee can only recover the cost, one might have</p> <p>9 thought, of secured lending, because secured lending is</p> <p>10 cheaper than unsecured lending.</p> <p>11 It doesn't stop there, because secured lending with</p> <p>12 the benefit of fixed security is better security than</p> <p>13 merely floating security, so that too should result, all</p> <p>14 other things being equal, or if you ignore everything</p> <p>15 else, in a lower interest rate.</p> <p>16 We say that obviously isn't what the draftsman</p> <p>17 required, and Wentworth's problem is essentially reading</p> <p>18 "cost", first of all, as "lowest cost". If it is going</p> <p>19 to avoid that sort of problem, it needs to go further</p> <p>20 and say: well, it is not merely reading "cost" as</p> <p>21 "lowest cost", actually it is meaning "lowest unsecured</p> <p>22 cost". A process by which an increasing amount of</p> <p>23 violence is being done to the very simple broad term</p> <p>24 which the draftsman did include.</p> <p>25 Now, if this approach was correct and the only thing</p> <p style="text-align: center;">Page 121</p>	<p>1 So far as third party fees are concerned, Wentworth</p> <p>2 say those aren't properly part of cost of funding, so</p> <p>3 you can't take them into account, you have to exclude</p> <p>4 them. Again, that has consequences for the nature of</p> <p>5 the agreement by which you measure lowest cost of</p> <p>6 funding.</p> <p>7 All of this, in our submission, illustrates a very</p> <p>8 simple point: it simply doesn't make sense to talk about</p> <p>9 a particular type of funding having the lowest cost</p> <p>10 simply because it has a lower headline interest rate.</p> <p>11 True cost of a product depends on an assessment of its</p> <p>12 terms taken as a whole.</p> <p>13 So we say the agreement can't possibly mean lowest</p> <p>14 cost by reference solely to the headline interest rate.</p> <p>15 The only other alternative is that you have to</p> <p>16 assess lowest cost by reference to all of the terms of</p> <p>17 the transaction. In our submission, that raises equally</p> <p>18 fundamental objections. The various provisions that</p> <p>19 I have just been mentioning are often incommensurable.</p> <p>20 There is no easy way of translating them into a monetary</p> <p>21 value to be able to work out which is lower and which is</p> <p>22 higher. How do you assess, for example, the cost of two</p> <p>23 different financial covenants?</p> <p>24 So we say that is another objection to lowest cost.</p> <p>25 It can't sensibly be by reference to the headline</p> <p style="text-align: center;">Page 123</p>
<p>1 that mattered in assessing lowest cost is the headline</p> <p>2 interest rate, again the consequences could be dramatic.</p> <p>3 A party can only recover the cost incurred in the</p> <p>4 borrowing transaction with the lowest headline cost,</p> <p>5 regardless of whatever other terms there may be in</p> <p>6 agreement. So if, for example, he could get a slightly</p> <p>7 lower interest rate by including increasingly onerous</p> <p>8 financial covenants, it would seem he has to be judged</p> <p>9 by reference to a borrowing transaction with the most</p> <p>10 onerous financial covenants that anyone is capable of</p> <p>11 envisaging.</p> <p>12 Nor does it necessarily stop there if, again,</p> <p>13 headline interest rate is all that matters. It may be</p> <p>14 possible to lower the headline interest rate not merely</p> <p>15 by offering onerous financial covenants but by including</p> <p>16 other provisions, for example, an option to the lender</p> <p>17 to convert his lending into equity in circumstances</p> <p>18 where the lender might wish to do so. Such options are</p> <p>19 commonly sold for value and, again, you have to judge it</p> <p>20 by reference to a transaction that gives the lender an</p> <p>21 option to convert into capital.</p> <p>22 You may also be able to lower the interest rate by</p> <p>23 agreeing, for example, to pay a higher facility fee --</p> <p>24 pay the bank's legal costs, for example, rather than</p> <p>25 have those wrapped up in a headline interest rate.</p> <p style="text-align: center;">Page 122</p>	<p>1 interest rate and it can't sensibly be by reference to</p> <p>2 all the terms of the transaction either, because in the</p> <p>3 latter case lowest cost cannot simply mean a monetarily</p> <p>4 measurable figure.</p> <p>5 Again, just going back to the mechanics of</p> <p>6 the certification process, assume one decides what</p> <p>7 lowest cost means, what the relevant payee has to do is</p> <p>8 essentially to work out what that cost is. So imagine</p> <p>9 he went out and he borrowed a sum of money, he asked for</p> <p>10 a location from a couple of banks he usually banks with,</p> <p>11 and they provided it to him and he borrowed the money.</p> <p>12 On Wentworth's case, the relevant payee can no</p> <p>13 longer certify that sum. It has to, instead, engage in</p> <p>14 an exercise, one of the two types I mentioned, not</p> <p>15 necessarily, one assumes, by reference simply to those</p> <p>16 banks, but conceivably by reference to any other banks</p> <p>17 in the market.</p> <p>18 So how far is the relevant payee meant to go in</p> <p>19 working out what the lowest cost is?</p> <p>20 The premise of this argument, we say, is also</p> <p>21 flawed. It assumes that what the draftsman was</p> <p>22 intending to achieve was that the relevant payee can</p> <p>23 only recover the lowest cost that it could have</p> <p>24 obtained, and for reasons I have explained, we say that</p> <p>25 is not consistent with the general certification</p> <p style="text-align: center;">Page 124</p>

<p>1 process, actually funded or how you would have funded</p> <p>2 it. But there are two other indications in the master</p> <p>3 agreement that the draftsman wasn't necessarily</p> <p>4 concerned simply with maybe the lowest cost.</p> <p>5 The first, and it is an obvious example, is where</p> <p>6 the parties specify market quotation for the purposes of</p> <p>7 section 6(e). If your Lordship just talks the 1992</p> <p>8 agreement again at core bundle tab 7, there is a lengthy</p> <p>9 provision about market quotations, but the sentence that</p> <p>10 I want to show your Lordship is over the page, page 162.</p> <p>11 It is seven lines from the end of the definition, and it</p> <p>12 is a sentence beginning in the middle of the page, "If</p> <p>13 more than three quotations are provided":</p> <p>14 "If more than three quotations are provided, the</p> <p>15 market quotation will be the arithmetic mean of</p> <p>16 the quotations, without regard to the quotations having</p> <p>17 the highest and lowest values."</p> <p>18 So, in other words, what you can charge or have to</p> <p>19 pay isn't the lowest or -- what Professor Golden I think</p> <p>20 referred to in his evidence in the Lehman v Intel case,</p> <p>21 the best price. The draftsman has just said, well, it's</p> <p>22 the arithmetic mean, ignoring the highest and the</p> <p>23 lowest.</p> <p>24 In contrast, where the master agreements do impose</p> <p>25 an obligation on a party to use the lowest cost of</p> <p style="text-align: center;">Page 125</p>	<p>1 the relevant sentence at the moment, you are required to</p> <p>2 use the lowest quotation received as the buy-in price.</p> <p>3 Rather than spend time, if your Lordship would forgive</p> <p>4 me, I will come back to that.</p> <p>5 My Lord, that's the lowest cost argument, as we</p> <p>6 understood it, from Wentworth's position paper and</p> <p>7 skeleton. It appears that they may be taking a slightly</p> <p>8 different approach in their reply, the approach being</p> <p>9 that, as we understand it, all they are saying is that</p> <p>10 a rational party seeks to minimise the amount it has to</p> <p>11 pay. My Lord, that is obviously a shift in the</p> <p>12 argument, certainly as we understood it.</p> <p>13 They also accept, however, in that context, that the</p> <p>14 relevant payee is also entitled to consider other</p> <p>15 factors. We say, for reasons I have already submitted,</p> <p>16 there may be a myriad of reasons why, in any particular</p> <p>17 case, a party does not minimise the amount it has to</p> <p>18 pay, despite acting rationally, in good faith, at least</p> <p>19 in the sense of picking the lowest conceivable headline</p> <p>20 interest rate.</p> <p>21 But if you permit a party to take account of</p> <p>22 the factors, we say essentially the argument is simply</p> <p>23 about rationality and good faith. It collapses into</p> <p>24 that exercise. There ceases to be a separate definition</p> <p>25 argument involved here.</p> <p style="text-align: center;">Page 127</p>
<p>1 obtaining something, when making a calculation, they do</p> <p>2 so in clear terms. Now, I am not sure whether this has</p> <p>3 yet got into the bundles, but can I give your Lordship</p> <p>4 the reference and explain the point. It is section 9.9</p> <p>5 of the ISDA 2003 credit derivatives definitions. I am</p> <p>6 told it is in the bundles at bundle 5, tab 9. It is</p> <p>7 section 9.9, which I am told is on page 377 of</p> <p>8 the bundle.</p> <p>9 The effect of this --</p> <p>10 MR JUSTICE HILDYARD: Is this the indicative quotation,</p> <p>11 or -- what are you looking at?</p> <p>12 MR DICKER: It is where a derivative provides for physical</p> <p>13 settlement and the party due to deliver bonds by way of</p> <p>14 physical settlement has not done so.</p> <p>15 What happens is, the receiving party --</p> <p>16 MR JUSTICE HILDYARD: I think I haven't caught up with you</p> <p>17 yet. Where is it?</p> <p>18 MR DICKER: It is a requirement -- I'm sorry, my copy here</p> <p>19 isn't marked up. My Lord, can I come back? That is</p> <p>20 probably the easiest thing.</p> <p>21 The short point, just so your Lordship knows it --</p> <p>22 I will come back to this -- my Lord, the way it works</p> <p>23 is -- again, it is a quotation example. You were</p> <p>24 required to obtain five or more quotations for the sale</p> <p>25 of the bonds, and in this case, although I can't find</p> <p style="text-align: center;">Page 126</p>	<p>1 So if that is where Wentworth have ended up, then,</p> <p>2 in our submission, we are not talking about a special</p> <p>3 meaning of lowest cost, we are not talking about an</p> <p>4 additional ground of challenge, we are simply talking</p> <p>5 about whether the party acted rationally and in good</p> <p>6 faith. If that is not what they are saying, then,</p> <p>7 again, we come back to the rock and the hard place: are</p> <p>8 they talking about judging it simply by reference to the</p> <p>9 headline interest rate, which can't be right, or are</p> <p>10 they talking about working out what the lowest cost is</p> <p>11 in some mathematical sense, having regard to all the</p> <p>12 factors? Which equally, we say, doesn't work either.</p> <p>13 My Lord, what I was proposing to do next is turn and</p> <p>14 make some specific submissions in relation to equity</p> <p>15 funding. My Lord, it is true that most of the debate</p> <p>16 between these parties is between borrowing, on the one</p> <p>17 hand, and equity funding, on the other. My Lord, again,</p> <p>18 I would stress that is not necessarily the only two</p> <p>19 forms of funding available and the clause has to work</p> <p>20 for all of them.</p> <p>21 But so far as equity funding is concerned, Senior</p> <p>22 Creditor Group is, again, we say, straightforward.</p> <p>23 Equity funding has a cost. The relevant payee who</p> <p>24 funded the amount rationally and in good faith through</p> <p>25 equity funding is entitled to recover such costs as part</p> <p style="text-align: center;">Page 128</p>

<p>1 of its cost of funding.</p> <p>2 We are not entirely clear whether Wentworth is</p> <p>3 saying equity funding simply has no cost at all or that</p> <p>4 it does have a cost but it is not a relevant cost.</p> <p>5 Dealing with both of those, we say it would be absurd to</p> <p>6 suggest equity funding has no cost. As Goldman Sachs</p> <p>7 I think say in their skeleton argument, such</p> <p>8 a suggestion would surprise any institution which ever</p> <p>9 had to raise equity funding or assess possible</p> <p>10 investments or transactions by reference to the cost of</p> <p>11 capital involved.</p> <p>12 And, as your Lordship knows, cost of capital</p> <p>13 includes as a component, cost of equity. The concept is</p> <p>14 an important business and financial tool. It is used</p> <p>15 to, amongst other things, help determine corporation</p> <p>16 valuations and corporate strategy. It is treated as</p> <p>17 economically relevant by banks and other commercial</p> <p>18 entities when assessing their funding costs. Banks, for</p> <p>19 example -- I think Mr Foxton may be intending to deal</p> <p>20 with this -- use it to work out their pricing for</p> <p>21 trades. It is a concept regularly referred to in</p> <p>22 textbooks on corporate finance, and the concept is also</p> <p>23 found in the authorities, as your Lordship will see.</p> <p>24 We say, in short, it would be absurd if the</p> <p>25 submission was that equity has no cost.</p> <p style="text-align: center;">Page 129</p>	<p>1 the relevant period, and I will make some submissions on</p> <p>2 that in a moment, but there are also ways of measuring</p> <p>3 it prospectively, and, again, I was proposing to say</p> <p>4 something about that.</p> <p>5 My Lord, before I do so, it is probably appropriate</p> <p>6 to say this: the Senior Creditor Group at an earlier CMC</p> <p>7 in front of Mr Justice David Richards applied for</p> <p>8 permission to adduce expert evidence on cost of funding,</p> <p>9 but he held expert evidence was not required.</p> <p>10 Your Lordship then inevitably doesn't have the</p> <p>11 assistance of expert evidence. One may say it is not</p> <p>12 necessary. To the extent there is any challenge on</p> <p>13 whether or not a particular approach was permissible or</p> <p>14 not, that is all part of the certification process.</p> <p>15 Your Lordship is only concerned with the scope of</p> <p>16 the concepts.</p> <p>17 My Lord, I mentioned a moment ago textbooks which do</p> <p>18 refer to and explain the concept of cost of equity.</p> <p>19 My Lord, what I wonder might be sensible is, I have some</p> <p>20 submissions to make to your Lordship. If, having heard</p> <p>21 them, your Lordship thinks that some additional</p> <p>22 confirmation or further materials by way of textbook</p> <p>23 extracts are required, we can certainly provide those.</p> <p>24 I think I may have one here, but obviously it would be</p> <p>25 appropriate to give notice to the other side and deal</p> <p style="text-align: center;">Page 131</p>
<p>1 I have already briefly made a submission on the</p> <p>2 alternative possibility, that equity funding does have</p> <p>3 a cost but it is not a relevant cost, and the submission</p> <p>4 I made, just to remind your Lordship, was that if one</p> <p>5 accepts part of the first stage, that funding includes</p> <p>6 equity, then at the second stage of working out what</p> <p>7 a cost is, one needs to construe "cost" in a way that</p> <p>8 covers cost of equity.</p> <p>9 But to add a few more submissions, we say the</p> <p>10 starting point is that the concept of cost of funding</p> <p>11 includes sums paid, benefits provided or financial</p> <p>12 detriment incurred -- what I described together as</p> <p>13 essentially consideration, in the common law -- sense,</p> <p>14 in maintaining, raising or servicing the relevant type</p> <p>15 of funding -- that's the ongoing part of it.</p> <p>16 Now, any person who provides funding to a company</p> <p>17 demands a particular level of return depending on the</p> <p>18 riskiness of the company's business and the nature of</p> <p>19 the funding provided. There is nothing controversial</p> <p>20 there. The cost of equity funding is simply the return</p> <p>21 provided or to be provided to the company's shareholders</p> <p>22 and their equity investments. It essentially represents</p> <p>23 the consideration that the market demands in exchange</p> <p>24 for providing equity funding.</p> <p>25 Now, it is easy to identify that cost at the end of</p> <p style="text-align: center;">Page 130</p>	<p>1 with it tomorrow.</p> <p>2 But, my Lord, can we see, if this is convenient to</p> <p>3 your Lordship, how we get on?</p> <p>4 My Lord, can I start with what's been referred to as</p> <p>5 hybrid instruments? Again, I think Mr Foxton is going</p> <p>6 to say a little bit more about the detail of this</p> <p>7 certainly in relation to Goldman Sachs, but just in</p> <p>8 general terms, my Lord, in many cases, measuring the</p> <p>9 cost of equity in relation to such instruments should be</p> <p>10 no more difficult than it would be measuring the cost of</p> <p>11 borrowing. Take, for example, the case of preference</p> <p>12 shares carrying a right to a fixed dividend, provided</p> <p>13 there are sufficient distributable reserves and there is</p> <p>14 no issue about whether or not such reserves will be</p> <p>15 available.</p> <p>16 The cost of funding in that case simply includes the</p> <p>17 cost of the fixed dividend payments. I made the point</p> <p>18 that the distinction between debt and equity instruments</p> <p>19 on this border may be vanishingly small, and,</p> <p>20 commercially speaking, minute.</p> <p>21 Wentworth's response appears to be that, when you</p> <p>22 are dealing with hybrid instruments, in working out the</p> <p>23 cost of funding, what you have to do somehow is strip</p> <p>24 out the debt elements and the equity elements, and to</p> <p>25 the extent the debt element has a cost, you can charge</p> <p style="text-align: center;">Page 132</p>

<p>1 that; to the extent the equity element doesn't, you 2 can't. Again, we say in the context of a simple 3 provision like this, it can't be what the draftsman 4 intended, but I will leave any further responses on that 5 to reply.</p> <p>6 So hybrid instruments of that sort really raise no 7 additional issues, we say. We also submit the position 8 isn't materially more complicated when you are dealing 9 with ordinary shares which have actually been issued. 10 So test this with a hypothetical case where a relevant 11 payee funded the amount by actually issuing shares 12 shortly after LBIE went into administration, assume for 13 an amount equal to the relevant amount, and now needs to 14 certify its cost of funding.</p> <p>15 So what is the cost which it has incurred in respect 16 of that equity funding which it has obtained, sitting 17 here now? The answer, we say, is it includes the 18 dividends which it has paid in respect of the shares. 19 Cost includes cost of servicing the particular form of 20 funding and the cost of servicing the funding in this 21 case is, we say -- or includes the dividends which have 22 been paid.</p> <p>23 Now, on what basis can one say that does not 24 constitute a cost? Wentworth's response, as we 25 understand it, is, well, it didn't constitute a response</p> <p style="text-align: center;">Page 133</p>	<p>1 A number of well-established methods exist for 2 measuring such costs, used by companies, accountants, 3 other commercial parties and referred to in authorities. 4 My Lord, one model, which seems to be the most commonly 5 referred to model, is capital asset pricing method, 6 CAPM. It calculates the cost of equity by predicting 7 future returns required by investors through the 8 examination of historic returns. So it seeks to provide 9 a measure of the cost of equity by reference to the 10 anticipated rate of return on shareholders' investments.</p> <p>11 Starting, if I may, with two authorities that refer 12 to and apply this, if your Lordship goes to bundle 2 of 13 the authorities, the first is bundle 2, tab 48. It is 14 a decision of Mr Justice Lewison in a case called 15 Multi Veste 226 BV v NI Summer Row Unitholder BV.</p> <p>16 My Lord, just before going to the relevant passages, 17 to summarise what the case was about, it concerned the 18 proposed development of Wolverhampton town centre. The 19 developer was a company called Multi UK. The 20 development didn't go ahead because various investors 21 did not provide the contractually required guarantees, 22 and Multi UK sued for breach of contract.</p> <p>23 One of the issues that arose in assessing Multi UK's 24 claim for damages was its claim for capital. If 25 your Lordship goes on to a couple of pages from the end,</p> <p style="text-align: center;">Page 135</p>
<p>1 because those dividend payments were made voluntarily. 2 That's the word they use. To which our response is, 3 something doesn't cease to be a cost for the purposes of 4 the default rate provision merely because whether it is 5 paid or not is, to a greater or lesser extent, 6 discretionary.</p> <p>7 You wouldn't take, for example, a bonus payment paid 8 to employees on an annual basis as something which 9 wasn't a cost of the business. It plainly was. 10 Similarly, in relation to dividends, it is a cost in the 11 sense that a company has to pay them. If it doesn't, 12 then its ability to raise equity in future will be 13 substantially impaired.</p> <p>14 We say, if dividend payments amount to a cost in 15 that sense, then it is easy to measure the cost of 16 funding in respect of ordinary shares which were 17 actually issued. But, again, no difficulty arises even 18 if you're certifying the costs that would have been 19 incurred by such funding.</p> <p>20 The only difference here is that you obviously can't 21 look back and add up the dividends you have in fact 22 paid. The exercise needs to be done prospectively. The 23 short point is, it is perfectly possible for the 24 relevant payee to make a rational and good faith 25 estimation of the cost of such funding.</p> <p style="text-align: center;">Page 134</p>	<p>1 five pages back, the section starting at paragraph 255, 2 there is a heading "Finance costs", and then 3 a subheading just above 256, "Multi's cost of capital". 4 At 256: 5 "Multi's claim for damages assumes that it would 6 have bridged the funding gap by use of its own capital. 7 The case pleaded in the amended particulars of claim is: 8 "Multi would have funded any costs of 9 the development (beyond the amounts provided by the 10 consortium of banks and the NI Unitholder) through its 11 own funds, on the basis of its weighted costs of capital 12 at 5.87 per cent'. 13 "257. The weighted average cost of capital goes by 14 the acronym WACC." 15 There is then some reference to the position in 16 relation to the various entities. If your Lordship then 17 goes to 259: 18 "The next question is what rate of WACC should be 19 used. The WACC is a blended rate that takes into 20 account the cost of debt and the cost of equity... 21 "260. During the pendency of these proceedings, 22 Multi continued to advance a case based on a cost of 23 funding of 8.5 per cent; a figure to which Mr Vernooij 24 of Multi spoke in his first witness statement. 25 "261. Mr Mitchell said that established corporate</p> <p style="text-align: center;">Page 136</p>

<p>1 finance theory is that the cost of capital is</p> <p>2 a market-driven rate which represents the expected yield</p> <p>3 rate necessary to induce investors to commit available</p> <p>4 funds to the investment in question. I did not</p> <p>5 understand Mr Steadman to disagree. In his own report</p> <p>6 he said that a company's cost of capital as measured by</p> <p>7 WACC is a market-driven rate, being the expected rate of</p> <p>8 return the market requires to commit capital to an</p> <p>9 investment. The experts agreed that the capital asset</p> <p>10 pricing model ('CAPM') is an accepted method used to</p> <p>11 estimate a cost of equity based on market data."</p> <p>12 Then, although we get into facts, your Lordship will</p> <p>13 note, at 262, there was a difference between the experts</p> <p>14 over the cost of debt. At 264:</p> <p>15 "Once that point has been cleared out of the way,</p> <p>16 I consider that Mr Mitchell's rate of 8.2 per cent is</p> <p>17 justified both by reference to Multi's own accounting</p> <p>18 treatment and also by reference to comparable data."</p> <p>19 It may just be worth noting at this stage, 265:</p> <p>20 "Mr Gourgey objected that the NI Investors had</p> <p>21 assumed that Multi 266 would borrow money from other</p> <p>22 companies within the group at interest; and that there</p> <p>23 was no evidence to support either the making of such</p> <p>24 a charge or its amount. However, in the first place,</p> <p>25 Multi's own feasibility studies treated the cost of</p> <p style="text-align: center;">Page 137</p>	<p>1 the cash flows of a company or project is commonly</p> <p>2 referred to as the weighted average cost of capital</p> <p>3 (WACC). This represents the weighted average of the</p> <p>4 cost of equity and the cost of debt that is used to fund</p> <p>5 the company or project. The most widely utilised method</p> <p>6 for estimating the cost of equity is the CAPM, the</p> <p>7 formula for which includes an element called Beta which</p> <p>8 represents the systematic risk or volatility associated</p> <p>9 with a particular security, relative to the market as</p> <p>10 a whole."</p> <p>11 Then further explanation of what is meant by Beta.</p> <p>12 My Lord, I should just deal with Mr Justice Cooke's</p> <p>13 comment at the start of 144, where he refers to his</p> <p>14 misgivings.</p> <p>15 My Lord, just before taking your Lordship through</p> <p>16 paragraph 109, the short point, as I understand it, the</p> <p>17 judge was making is that, because this issue was being</p> <p>18 decided by a court on the balance of probabilities, he</p> <p>19 wasn't sure that CAPM effectively took the same</p> <p>20 approach.</p> <p>21 If your Lordship goes some seven lines down, towards</p> <p>22 the end of the line just above the first hole punch, in</p> <p>23 paragraph 109, the sentence beginning, "In the course of</p> <p>24 the trial":</p> <p>25 "... I expressed doubt as to the appropriateness of</p> <p style="text-align: center;">Page 139</p>
<p>1 capital as a cost; and in the second place, the</p> <p>2 partnership accounts showed sums expended ...",</p> <p>3 et cetera.</p> <p>4 That is obviously application to the facts.</p> <p>5 My Lord, one may, I hope, fairly describe this as</p> <p>6 a relatively standard sort of case in relation to the</p> <p>7 assessment of damages by reference to cost of capital,</p> <p>8 WACC, one component of which is cost of equity, and two</p> <p>9 experts agreeing that capital asset pricing model is an</p> <p>10 accepted method to estimate a cost of equity based on</p> <p>11 market data.</p> <p>12 My Lord, that is one acknowledgement in the</p> <p>13 authorities. The second is in a decision called</p> <p>14 Gul Bottlers (PVT) Limited v Nichols PLC. It is in the</p> <p>15 same bundle at tab 57. My Lord, I can deal with this,</p> <p>16 I hope, reasonably shortly.</p> <p>17 If your Lordship goes on to paragraph 144, there's</p> <p>18 a heading "Discount rate". This is Mr Justice Cooke.</p> <p>19 He says at 144:</p> <p>20 "Despite my misgivings ..."</p> <p>21 I will come back to that in a moment:</p> <p>22 "... I am prepared to proceed on the basis of the</p> <p>23 methodology used by the two experts [Mr Sequeira and</p> <p>24 Mr Wilkinson].</p> <p>25 "145. The discount rate that was used to discount</p> <p style="text-align: center;">Page 138</p>	<p>1 using a capital asset pricing model (CAPM) in</p> <p>2 calculating a discount rate to be applied, putting to</p> <p>3 one side simply a discount for the accelerated receipt</p> <p>4 of profits which is plainly required. The effect of</p> <p>5 what the experts sought to do was to value the contract</p> <p>6 rights as at the time of breach rather than simply</p> <p>7 assess the revenue stream and expenses incurred in</p> <p>8 obtaining it over the life of the contract. To my mind,</p> <p>9 valuing a contract at a particular date would take</p> <p>10 account of the uncertainties which lay in the future and</p> <p>11 which would be factored in. The court's task however</p> <p>12 is, on the balance of probabilities, to decide how the</p> <p>13 contract would have worked out, taking into account</p> <p>14 those uncertainties in deciding what would, on the</p> <p>15 balance of probabilities, have taken place. The capital</p> <p>16 valuation on day 1 of a contract will not, therefore,</p> <p>17 necessarily equate with the lost profits assessed by the</p> <p>18 court on the balance of probabilities, discounted for</p> <p>19 accelerated receipt on that date. The parties and the</p> <p>20 experts appeared to take the view that, as long as</p> <p>21 proper account was taken of the uncertainties in</p> <p>22 determining the lost revenue stream, it did not matter</p> <p>23 much which route the court adopted."</p> <p>24 My Lord, that issue is obviously irrelevant for</p> <p>25 present purposes. The court is not assessing damages.</p> <p style="text-align: center;">Page 140</p>

<p>1 It is not trying to assess them by reference to what, on 2 the balance of probabilities, would have occurred. So 3 I can leave that on one side.</p> <p>4 What one gets, obviously, from 145, subject to that 5 point, is a recognition of the discount rate used to 6 discount cash flows commonly referred to as WACC, 7 representing the weighted average of the cost of equity 8 and the cost of debt used to fund the company or 9 project, and that the most widely utilised method of 10 estimating cost of equity is CAPM, the formula for which 11 includes an element called Beta, et cetera.</p> <p>12 MR JUSTICE HILDYARD: CAPM is an estimate based on a model, 13 and it is based on a generality rather than a particular 14 requirement, isn't it? That is one of the things that 15 Mr Justice Cooke is worried about in paragraph 152, 16 where he says:</p> <p>17 "The very nature of these disputes shows the 18 limitations of the CAPM method when applied to the 19 present case because it seeks to evaluate various 20 company-related risks rather than looking at the net 21 revenue stream which would, on the balance of 22 probabilities, have been realised."</p> <p>23 It is a proxy. It is a model. It isn't a costing.</p> <p>24 MR DICKER: My Lord, I accept it is a proxy or a model. 25 I wouldn't accept that it is not capable of being</p> <p style="text-align: center;">Page 141</p>	<p>1 didn't, it is hypothetical, at least with the factual, 2 you know what it does cost, but with CAPM, you don't. 3 Even if you do raise funds, you don't actually know what 4 the cost is. You just can estimate into the future, 5 using models or proxies, what your funding cost mix is 6 like from the point of view of future planning. It is 7 a proxy, isn't it? It is a tool, rather than something 8 you can certify, "I swear to God that my costs were 9 such", even in the actual scenario.</p> <p>10 MR DICKER: If you have actually raised equity, then one 11 approach, if you are certifying now, would be to look at 12 the dividends you have in fact paid.</p> <p>13 MR JUSTICE HILDYARD: That would be a guide. I mean, one 14 definition, as I understand it, and I think it reflected 15 something you said to me, is the amount that the company 16 has to pay to retain its share price at the level it was 17 notwithstanding the additional shares that it has 18 issued. One can understand it as a concept, but one 19 wouldn't like to put a price on it.</p> <p>20 MR DICKER: My Lord, in our respectful submission, companies 21 and financial institutions operate on the basis that one 22 can and does need to put a price on its cost of capital, 23 including its cost of equity, for the simple reason that 24 if it doesn't do so, it doesn't know what to charge for 25 particular transactions, it doesn't know whether or not,</p> <p style="text-align: center;">Page 143</p>
<p>1 a proper way of estimating one's cost of equity and, 2 therefore, cost of funding.</p> <p>3 Again, taking it in stages, does funding include 4 equity? If it does, is there a cost of equity? We say, 5 plainly, yes; it would be absurd otherwise. Thirdly, 6 how do you measure it? Now, what's been described as 7 a common method of measuring something which, on this 8 hypothesis, does have a cost, is CAPM. CAPM, as 9 Wentworth point out in their skeleton argument, is open 10 to comment, as Mr Justice Cooke himself commented, 11 although we would say in a slightly different context on 12 a slightly different issue.</p> <p>13 But that all comes down, in our respectful 14 submission, to whether or not the relevant payee has 15 made a rational and good faith estimate of its costs of 16 funding.</p> <p>17 If, because of the nature of CAPM it is either 18 irrational or not good faith in the circumstances to do 19 so, then the certification will not be conclusive.</p> <p>20 If it is an appropriate method of valuing it, 21 whatever its limitations may or may not be, then it is, 22 and that is an end to the question.</p> <p>23 MR JUSTICE HILDYARD: I suppose what I am worrying about is, 24 in the case of a borrowing, an actual borrowing, and its 25 counterfactual, the cost of borrowing, though you</p> <p style="text-align: center;">Page 142</p>	<p>1 if it charges a sum, necessarily it is going to make 2 a profit or a loss.</p> <p>3 My Lord, there plainly are differences between 4 measuring the cost of borrowing, at least in a normal 5 case, and cost of equity. In our respectful submission, 6 those don't go to the question of whether funding 7 includes equity funding, and nor do they support 8 a submission that there is either no cost of equity or 9 no relevant cost of equity.</p> <p>10 One may have uncertainties, prospectively at least, 11 in relation to cost of borrowing, depending on how the 12 interest rate provision is worded, from a simple example 13 of LIBOR-plus, when one has to make a guess as to what 14 LIBOR will be in the future, or where, for whatever 15 reason, particular payments are made contingent, the 16 process of borrowing may, itself, have its own 17 complexities.</p> <p>18 My Lord, again, in our respectful submission, what 19 one shouldn't do is start, as it were, with a sort of 20 paradigm case of borrowing and say, "Every step I move 21 away from that, I'm moving away from what the draftsman 22 had in mind", because, in our respectful submission, 23 that's not where the draftsman started. He started with 24 something much broader. And trying to shoehorn 25 everything to see whether you can shoehorn everything</p> <p style="text-align: center;">Page 144</p>

<p>1 into the concept of borrowing wouldn't be right; even</p> <p>2 less would it be right to say that, if and to the extent</p> <p>3 you can't, or there seem to be difficulties, or</p> <p>4 differences, that means it can't be within the phrase.</p> <p>5 It is simply not, in our submission, the way the</p> <p>6 draftsman has approached this.</p> <p>7 Those two authorities, as I say, in traditional</p> <p>8 damages cases, identify weighted average cost of capital</p> <p>9 and have no difficulty saying there are two components</p> <p>10 of it, cost of equity and cost of debt, and this is how</p> <p>11 people habitually measure cost of equity. Of course</p> <p>12 there are issues, because it is not as certain as</p> <p>13 interest rates on borrowing often are, but it doesn't</p> <p>14 mean you can't measure it and it doesn't mean someone</p> <p>15 can't make a rational and good faith estimation of it.</p> <p>16 As I said, financial institutions couldn't operate if</p> <p>17 that were the case.</p> <p>18 MR JUSTICE HILDYARD: I very much take your point that the</p> <p>19 future is uncertain, as it were, and that ultimately</p> <p>20 people peer into it and have to make an assessment, but</p> <p>21 I'm just wondering whether the draftsman really intended</p> <p>22 that the measurement should be a model or proxy of</p> <p>23 something absolutely immeasurable in accurate terms.</p> <p>24 All CAPM provides is a tool, model or proxy, considered</p> <p>25 sufficiently satisfactory by those with the direction of</p> <p style="text-align: center;">Page 145</p>	<p>1 that sort of uncertainty was accounted for as part of</p> <p>2 this process.</p> <p>3 Now, we say that it is not fundamentally different</p> <p>4 from the sort of issues that may arise in relation to</p> <p>5 estimating your cost of equity. The company needs to</p> <p>6 get in funds. It needs to know how much it costs it to</p> <p>7 get in those funds to know which route to use. It has</p> <p>8 a working metric of what its cost of debt is. It has</p> <p>9 a working metric of what its cost of equity is. It</p> <p>10 invariably has a working metric as to what its weighted</p> <p>11 average cost of capital is.</p> <p>12 As I said, companies, particularly financial</p> <p>13 institutions of the sort who enter into derivative</p> <p>14 contracts subject to ISDA masters --</p> <p>15 MR JUSTICE HILDYARD: It is, in the draftsman's view,</p> <p>16 sufficient to satisfy your working metric?</p> <p>17 MR DICKER: Yes. This is not, as I think Professor Golden</p> <p>18 said -- if your Lordship has looked, as I understand</p> <p>19 your Lordship might have looked at Judge Chapman's</p> <p>20 judgment -- this is not necessarily about achieving the</p> <p>21 right, the perfect --</p> <p>22 MR JUSTICE HILDYARD: I admit I cheated. I looked at your</p> <p>23 extract from it. I will look at the full judgment.</p> <p>24 MR DICKER: I think Mr Foxton is keen, and I'm happy to let</p> <p>25 him do that.</p> <p style="text-align: center;">Page 147</p>
<p>1 the company for future planning purposes. But it is not</p> <p>2 a result, is it? It is a model.</p> <p>3 MR DICKER: It may be a result, in the sense that it may</p> <p>4 have important consequences for --</p> <p>5 MR JUSTICE HILDYARD: It will result in them deciding one</p> <p>6 way or the other, but it is not a sum certain or even</p> <p>7 thought to be certain. It is simply a model which is</p> <p>8 the product of evaluating various company-related risks</p> <p>9 rather than looking at the net revenue stream which</p> <p>10 would on the balance of probabilities have been</p> <p>11 realised.</p> <p>12 MR DICKER: Your Lordship's assumption is, as I understand</p> <p>13 it, that there is a qualitative difference, and perhaps</p> <p>14 maybe a difference in nature between, on the one hand,</p> <p>15 cost of borrowing and, on the other hand, cost of</p> <p>16 equity.</p> <p>17 If one goes back and considers a relevant payee, the</p> <p>18 counterparty suffers an event of default, there is an</p> <p>19 early termination date, and it has to at that stage</p> <p>20 certify its cost of borrowing. It doesn't know how long</p> <p>21 the transaction is going to be outstanding for. There</p> <p>22 is a prospective element there, and a necessary</p> <p>23 uncertainty. It nevertheless has to make a rational and</p> <p>24 good faith assessment and provide a certificate</p> <p>25 accordingly. But the draftsman plainly envisaged that</p> <p style="text-align: center;">Page 146</p>	<p>1 But there are other examples in the master agreement</p> <p>2 where the draftsman hasn't sought to achieve perfection.</p> <p>3 Market quotation, for example. If one goes out, one</p> <p>4 tries to -- one gets a series of quotations. There</p> <p>5 isn't a mechanism about, you know, "You have to approach</p> <p>6 the following five banks in this order". There is</p> <p>7 a mechanism of sorts there, but it doesn't necessarily</p> <p>8 achieve perfection either, any more than calculation of</p> <p>9 loss does, any more than does certification of</p> <p>10 the default rate.</p> <p>11 As I say, I am conscious -- your Lordship's desire</p> <p>12 to ensure certainty, it plainly reflects something very</p> <p>13 important for the draftsman. Our submission, however,</p> <p>14 is he chose to achieve that, as I said, through the</p> <p>15 certification route, not through a sort of anxious</p> <p>16 worrying about drawing the line between one type of</p> <p>17 funding and another or whether cost was lowest cost or</p> <p>18 any of those -- if I may respectfully say -- the way all</p> <p>19 of us lawyers tend to approach problems like this is</p> <p>20 much more of a commercial, "We have someone, there has</p> <p>21 been a default, he needs to provide a certificate, give</p> <p>22 me a good faith and rational estimation of what your</p> <p>23 cost is", and that's sufficient.</p> <p>24 If I may say this, this isn't an issue that appears</p> <p>25 to have been litigated anywhere else. I mentioned that</p> <p style="text-align: center;">Page 148</p>

<p>1 even in relation to calculation of loss there have 2 historically been extraordinarily few reported 3 decisions, given the volume of transactions of 4 the master agreement and how long it has been around. 5 We say that is simply because the mechanism which the 6 draftsman chose achieved certainty in the way I have 7 described and didn't seek to give potential arguments 8 for lawyers to spend time arguing over.</p> <p>9 Now, this is obviously an unusual case. The sums at 10 stake are so huge. We don't have an ongoing 11 counterparty. We have parties whose interests conflict. 12 One sometimes feels, if those around me may forgive it, 13 that the case naturally encourages one to seek to deal 14 with issues in a greater degree of detail than 15 perhaps -- certainly in relation to this -- the 16 draftsman really envisaged. He had something quite 17 simple in mind.</p> <p>18 My Lord, I was going to say just a little more, 19 a short point on weighted average cost of capital, 20 because there is, if I may say, an analogy potentially 21 with the present case.</p> <p>22 As your Lordship knows, it is calculated as an 23 average of cost of debt and cost of equity, weighting 24 each component in accordance with how much they make up 25 the whole and, as your Lordship knows, often applied by</p> <p style="text-align: center;">Page 149</p>	<p>1 permissible and sensible and right in that context and 2 for it not to be perfectly rational and good faith an 3 approach in the present context, or capable of being so.</p> <p>4 My Lord, I had some short submissions, but probably 5 longer than the 30 seconds I have left --</p> <p>6 MR JUSTICE HILDYARD: Don't worry about the 30 seconds. If 7 it is something you would like to deal with in five or 8 ten minutes, or whatever, do that. If you feel you 9 would be better in the morning, do that.</p> <p>10 MR DICKER: If your Lordship wouldn't mind, can I do the 11 latter? I am ahead of myself, so I don't think there 12 should be any difficulty finishing within the time 13 allotted.</p> <p>14 MR JUSTICE HILDYARD: Right.</p> <p>15 MR DICKER: My Lord, subject, I suppose, to this one point: 16 having, as it were, given you my submissions on cost of 17 equity, that it is a cost and, in very general terms, 18 how it is measured, how it is capable of being 19 measured -- I am conscious that I think Mr Foxton is 20 going to deal a little bit with some of the capital 21 instruments, particularly those that relate to Goldmans, 22 but if over and above your Lordship would find it 23 helpful to have a textbook summary of cost of equity, 24 how it is measured, we can certainly provide one. 25 I have one which I think was produced by two or three</p> <p style="text-align: center;">Page 151</p>
<p>1 the courts, often applied in a compensatory context, 2 where there is a payment that should be made in the 3 future, trying to work out what the present value of 4 that payment is now.</p> <p>5 When you discount that future sum back to the 6 present, the court's view is that it would be 7 inappropriate to discount it back solely by a party's 8 cost of borrowing because that would overcompensate it, 9 the discount would be too low, the sum that it got today 10 would then earn it more than it was entitled to receive 11 in the future.</p> <p>12 The appropriate discount rate, essentially 13 reflecting the time value of money going from the past 14 to the present, is the weighted average cost of capital, 15 which includes both cost of debt and cost of equity.</p> <p>16 So when you are measuring the time value of money, 17 it is -- I won't submit humdrum, but perfectly orthodox 18 to measure that time value of money in that context by 19 reference to weighted average cost of capital, including 20 cost of equity. We are essentially measuring the same 21 time period, we are just doing it from a date in the 22 past to the present date. The period may be identical 23 in length. The issue is exactly the same: what's the 24 time value of money? We say there is no justification, 25 no logic in the court saying WACC is perfectly</p> <p style="text-align: center;">Page 150</p>	<p>1 partners of PwC, so it may not be an entirely inapposite 2 document, if your Lordship would find that --</p> <p>3 MR JUSTICE HILDYARD: I don't know what to say about this. 4 Does anyone object to my having a look at this? The 5 actual expert resource is not considered appropriate, 6 and that is a matter which has been decided. I have 7 done my own little bits of inadequate research into the 8 concepts. I can peer at this textbook and see if it 9 comforts me or frightens the life out of me.</p> <p>10 MR DICKER: I wonder whether it would be appropriate to let 11 your Lordship have a copy.</p> <p>12 MR JUSTICE HILDYARD: Everyone knows what it is.</p> <p>13 MR ZACAROLI: We have no idea what this is. If my Lord is 14 being asked to glance through hundreds of pages of 15 a textbook, we would rather like to know which pages you 16 are being directed to.</p> <p>17 MR JUSTICE HILDYARD: I think I had better do homework of 18 a different sort --</p> <p>19 MR DICKER: I wasn't suggesting it as homework, because 20 I don't think it would be appropriate to show 21 your Lordship without --</p> <p>22 MR JUSTICE HILDYARD: I misunderstood. Tell them what you 23 want me to read, and when I get the green light I will 24 do so. Otherwise, I will remain in ignorance.</p> <p>25 Is there any other homework you would like me to do?</p> <p style="text-align: center;">Page 152</p>

<p>1 MR DICKER: No, I think is the answer.</p> <p>2 MR JUSTICE HILDYARD: I notice on the timetable -- I do</p> <p>3 apologise for the fact that there are two days when I am</p> <p>4 not sitting, but I notice in consequence that</p> <p>5 Wentworth's submissions, principal submissions, in other</p> <p>6 words, spilled over by an hour into the 16th. You are</p> <p>7 all content with that, are you? I mean, you don't want</p> <p>8 me to try to make time in order to swallow up that hour</p> <p>9 over the next two days? I should say that I find it</p> <p>10 interesting but difficult, and, therefore, I think very</p> <p>11 long days may be counterproductive. But if everyone</p> <p>12 thought that it would be of great benefit, then I would</p> <p>13 certainly consider that.</p> <p>14 MR DICKER: My Lord, I think for our part we are entirely in</p> <p>15 your Lordship's hands. There is the point that my</p> <p>16 learned friend Mr Trower made in relation to the German</p> <p>17 law. I suspect the timetable may end up moving more</p> <p>18 quickly, particularly when we come to replies, and there</p> <p>19 may then be a gap. Whether or not it will move</p> <p>20 sufficiently quickly as well over the next two days to</p> <p>21 enable Wentworth to finish their opening this week I am</p> <p>22 less sure.</p> <p>23 MR JUSTICE HILDYARD: Right. Shall I leave it this way:</p> <p>24 I have signalled that if you think it would be</p> <p>25 beneficial or ensure that we complete everything in</p> <p style="text-align: center;">Page 153</p>	
<p>1 time, then you must tell me, because I could add half an</p> <p>2 hour on in the morning or half an hour on later,</p> <p>3 including tomorrow if it was half an hour later. I will</p> <p>4 really leave it to you.</p> <p>5 I hope I have indicated flexibility but one residual</p> <p>6 concern, lest one's attention is not as complete in the</p> <p>7 last half hour as in the first.</p> <p>8 Mr Zacaroli, you will consider that?</p> <p>9 MR ZACAROLI: My Lord, we will. It really depends how fast</p> <p>10 we go in the next day or so.</p> <p>11 MR JUSTICE HILDYARD: Yes. And you will let me know whether</p> <p>12 the textbook is something that may assist or not.</p> <p>13 I will let you discuss that. So 10.30 tomorrow. Thank</p> <p>14 you.</p> <p>15 (4.19 pm)</p> <p>16 (The hearing was adjourned until</p> <p>17 Tuesday, 10 November 2015 at 10.30 am)</p> <p>18</p> <p>19</p> <p>20</p> <p>21</p> <p>22</p> <p>23</p> <p>24</p> <p>25</p> <p style="text-align: center;">Page 154</p>	

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