IN THE HIGH COURT OF JUSTICE **No. 7942 of 2008**

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

(1) ANTHONY VICTOR LOMAS

(2) STEVEN ANTHONY PEARSON

(3) PAUL DAVID COPLEY

(4) RUSSELL DOWNS

(5) JULIAN GUY PARR

(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.A.R.L.

(3) HUTCHINSON INVESTORS LLC

(4) WENTWORTH SONS SUB-DEBT S.A.R.L.

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

Respondents

GOLDMAN SACHS INTERNATIONAL'S

SKELETON ARGUMENT

All references are in the form {Bundle/Tab/Page}

I. INTRODUCTION

1. This is the skeleton argument of Goldman Sachs International (**"Goldman Sachs"**) for the trial of Part C of the Waterfall II Application.

2. Goldman Sachs is party to the Waterfall II Application to make submissions on the proper interpretation of the term "Default Rate" in the ISDA Master Agreement. This issue is covered by Issues 11-14 and 27 of the revised Application Notice of the Joint Administrators of Lehman Brothers International (Europe) (**"the Joint Administrators"** and **"LBIE"**).

3. "Default Rate" is defined in Section 14 of the ISDA Master Agreement as follows:

   "***"Default Rate"*** *means a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum.*"

4. Goldman Sachs' position is that the definition of "Default Rate" permits a relevant payee to certify a cost of funding that takes into account any source of funding used or that could have been used to fund the **"Relevant Amount"**, including (in particular) the cost of equity funding, subject to the certification being provided rationally and in good faith. This interpretation is based on the plain language of the definition. It is also supported by the definition's commercial purpose and the factual context in which the ISDA Master Agreement was drafted and is used.

5. Goldman Sachs' position on this issue is broadly aligned with that of the First to Third Respondents (**"the Senior Creditor Group"**), though Goldman Sachs puts forward distinct arguments from those raised by the Senior Creditor Group. Goldman Sachs' position is opposed by the Fourth Respondent (**"Wentworth"**), which argues that the definition of Default Rate should be limited to permit only the certification of a cost of borrowing. Wentworth, as holder of LBIE's subordinated debt, stands to gain from minimising the amount of interest paid to senior creditors. The Joint Administrators have put forward a number of arguments on both sides of the dispute, to ensure that all relevant arguments are before the Court.

6. The remainder of this skeleton summarises the contractual and factual background to this dispute, before setting out Goldman Sachs' arguments for trial. In doing so Goldman Sachs responds to certain arguments raised by the other parties to date, though Goldman Sachs notes that the parties have permission to file responsive skeleton arguments in due course and it may raise further arguments by way of reply if appropriate.

II. RELEVANT BACKGROUND

7. The factual background to this dispute is summarised in detail in the materials filed by Goldman Sachs in the Application, including at para. 9 and the Appendix to Goldman Sachs' position paper dated 23 July 2015 {1/13/261,271}, in Goldman Sachs' reply position paper dated 4 September 2015 {1/18/423}, and in the First and Second Witness Statements of Jonathan Kelly {2/5/205},{2/7/312}. Goldman Sachs will refer to these documents as required at trial. The key points are summarised below.

Goldman Sachs' ISDA claims and the definition of Default Rate

8. Goldman Sachs entered into an ISDA Master Agreement with LBIE in September 1996. This agreement remained in force up to and after LBIE's default in September 2008. Goldman Sachs has a substantial claim against LBIE under the agreement.

9. Goldman Sachs is entitled to be paid interest on these claims pursuant to Section 6(d)(ii) of the ISDA Master Agreement.[1] As a defaulting party, LBIE is obliged to pay this interest at the "Default Rate" (see Section 14, definition of "Applicable Rate"). In the context of LBIE's administration, the Default Rate will be payable if it exceeds the rate of interest that is otherwise payable under s.17 of the Judgments Act 1938 (Insolvency Rules 1986, Rules 2.88(6), (7) and (9)).

[1] In the 1992 ISDA Master Agreement form {5/2/29}. This clause is equivalent to Clause 9(h)(ii)(2) of the 2002 ISDA Master Agreement {5/3/62}.

The relevant factual background

10. As is set out in more detail below, Goldman Sachs' case is based in part on the factual context against which the Default Rate definition was drafted. In particular, Goldman Sachs will argue that the draftsperson of the ISDA Master Agreement intended to take into account the position of financial institutions. Financial institutions fund themselves using a mix of funding that includes equity funding and other forms of regulatory capital for regulatory reasons and because of the requirements of the market. This forms a key part of the factual matrix against which the definition must be construed.

11. In this regard, Goldman Sachs relies on the following key facts.

12. ISDA was founded by financial institutions with the aim of standardising derivative documentation. The ISDA Master Agreement was the result of these efforts: it aimed to standardise the terms that dealers in derivatives expected to see in derivatives documentation.[2] The first version of the ISDA Master Agreement was produced in 1987, with a significantly revised version being issued in 1992 and a further version issued in 2002. The Master Agreement forms the highest tier of contractual documentation used in derivatives transactions, with further party-specific terms being included in the schedule to the Master Agreement and transaction-specific terms being included in a confirmations for each individual transaction.

13. Financial institutions continue to be among the principal members of ISDA and users of the ISDA Master Agreement.[3] LBIE was, of course, a financial institution itself; accordingly, all the ISDA claims in issue in these proceedings involve at least one financial institution.

14. Throughout this period, and indeed before the ISDA Master Agreement was developed, financial institutions have funded themselves from a broad range of sources. Their funding balance includes a mix of both debt and equity instruments, as well as "hybrid" instruments exhibiting features of both debt and equity.[4]

[2] Goldman Sachs' position paper dated 23 July 2015, Appendix, para. 4 {1/13/272}.

[3] Ibid, paras. 3-8 {1/13/272-273}.

[4] Examples set out in Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015 include trust preferred securities, hybrid capital, enhanced capital, contingent capital and additional tier 1 capital {7/1/188}.

15. Financial institutions use this range of funding sources for a number of reasons, including the following:[5]

(1) Financial institutions are required by law and regulation to maintain a certain level of equity capital at all times. These requirements are often referred to as "capital ratios". These ratios encompass various classes of qualifying capital of varying degrees of subordination, including common equity and preferred equity. Where a counterparty defaults under an ISDA Master Agreement and fails to pay amounts owed to a financial institution, this reduces the financial institution's equity capital accordingly. If the financial institution is to maintain its equity capital position it will be necessary for it to raise further equity funding to fill the hole in its capital position caused by the default. A financial institution may be required to fill this hole to avoid breaching legal and regulatory requirements or for other reasons. Raising ordinary unsecured borrowing is insufficient: this borrowing does not contribute to a financial institution's capital ratios because the institution's liabilities are increased by the amount borrowed. This will do nothing to bolster the institution's equity capital position or capital ratios. To the contrary, ordinary unsecured borrowing worsens such ratios.

(2) A financial institution will similarly be required to maintain a certain level of equity capital by the demands of other market participants. Sufficient capital strength is essential if a financial institution is to be perceived as a credit-worthy counterparty, capable of absorbing losses without defaulting on its obligations. Should it be perceived that a financial institution is carrying too much debt, relative to its equity, it may lose the confidence of the market. The financial crisis of 2008-2009 illustrated starkly the fate that can befall institutions that lose such confidence. It should be noted that although such requirements are particularly acute for financial institutions, given the nature of their business and their need to maintain continued access to the financial markets, they apply to a greater or lesser extent to all businesses. If any business's ratio of debt to

[5] Goldman Sachs' position paper dated 23 July 2015: para. 9 of the main position paper {1/13/261} and Sections B-C of the appendix {1/13/274-279}. See also the summary at paras. 35-47 of the Waterfall I Application judgment, at [2014] EWHC 704 (Ch); [2015] Ch 1 {6/1/22-24}.

equity is too high then it may come under market pressure to raise further equity funding.

(3) Even if a financial institution otherwise has sufficient equity capital to remain within the current limits set by law, regulation and/or other market participants, it may nonetheless seek prudently to raise further equity funding in order to deleverage, whether for prudent management reasons, to meet its perception of future market requirements and/or because it is anticipated that the regulatory regime will become more stringent. A failure to take this step, prior to it being forced upon a financial institution, may result in it being required to do so at a later stage on less attractive terms or, in extremis, be unable to do so altogether with the consequences described in paragraph 15(2) above.

16. All these features have existed throughout the period relevant to this case, including during the period in which the ISDA Master Agreement was first developed and at all times thereafter. While the details of the particular regulatory regime and market requirements have changed over time,[6] there has been no point in time at which it would not have been objectively apparent to the draftsperson and users of the ISDA Master Agreement that a financial institution counterparty might wish to fund itself using equity funding in the event of non-payment under an ISDA transaction.

17. In the event, financial institutions did in fact respond to the collapse of Lehman Brothers and the financial crisis of 2008-2009 by seeking to raise significant additional equity funding. A non-exhaustive list of examples is set out in the Appendix of Goldman Sachs' position paper, with further examples given in Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015.[7] The financial institutions which raised equity funding in 2008-2009 included Barclays, Goldman Sachs, Morgan Stanley, JP Morgan, Citigroup and Bank of America.

[6] As is summarised, as regards the regulatory regimes, in Section B of the appendix to Goldman Sachs' position paper of 23 July 2015 {1/13/274}.

[7] See Section C of the Appendix of Goldman Sachs' position paper of 23 July 2015 {1/13/275} and Goldman Sachs' response to the Joint Administrators Request for Further Information {7/1/188-189}.

III. GOLDMAN SACHS' SUBMISSIONS

18. Goldman Sachs' case is simple: the definition of "Default Rate" permits the non-defaulting party under the ISDA Master Agreement (the **"Relevant Payee"**) to certify the cost to it of funding or if it were to fund the Relevant Amount due to it on the basis of any type or source of funding that was used or could have been used to fund the Relevant Amount, subject to the limit that the cost of funding must be certified rationally and in good faith.

19. In particular, Goldman Sachs submits that:

    (1) Properly interpreted, the definition of "Default Rate" does not impose any limit on the type of funding that may be certified. This broad interpretation of the definition follows from the language of the definition, its purpose, and the factual context against which it was drafted and agreed. The arguments put forward by Wentworth and the Joint Administrators against this interpretation do not withstand analysis. These submissions cover Issues 11 and 27.

    (2) Accordingly, the limit on the costs of funding that may be certified lies not in any formal limit on the types of funding which fall within the definition. Rather, it lies in the requirement that any certification be given rationally and in good faith. These submissions cover Issues 12-14.

20. Each of these arguments is addressed below. Goldman Sachs deals with each of Issues 11-14 and 27 in the course of these submissions, thematically rather than under separate headings, but for convenience Goldman Sachs has also prepared an appendix to this skeleton argument that sets out the answers that it proposes the Court should give to Issues 11-14 and 27.

(1) The scope of the definition of Default Rate

21. The expression *"cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount"* should be given its natural meaning and not "read down" to exclude certain forms of funding: it allows the Relevant Payee to certify a cost of funding based on any source or type of

funding, without restriction merely to a cost of borrowing. It therefore permits the Relevant Payee to certify its cost of equity funding.

22. Goldman Sachs relies on three key points in support of this submission:

(a) It is supported by the ordinary and natural meaning of the language of the definition;

(b) It is supported by the purpose of the Default Rate definition; and

(c) It is the only interpretation that is consistent with the broader factual matrix against which the provision was drafted and is used.

23. Each point is developed in turn.

(a) The language of the Default Rate definition

24. The definition of Default Rate is based on *"the cost… to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount."*

25. The Relevant Payee is accordingly entitled to certify the "cost" to it of "funding" (or "if it were to fund") the Relevant Amount owed to it by the defaulting party.

26. The starting point in construing any agreement should be the ordinary and natural meaning of the words used, interpreted in context.[8] Where such language is unambiguous, the Court must apply it.[9] As the Supreme Court has recently held:

"… the reliance placed in some cases on commercial common sense and surrounding circumstances … should not be invoked to undervalue the importance of the language of the provision which is to be construed."[10]

27. The language of the definition of Default Rate is clear and unambiguous. It allows the non-defaulting party to certify the "cost" of "funding" (or if it were to fund) the Relevant Amount. Equity funding is a type of funding. It can be used to fund the

[8] *BCCI v. Ali* [2002] 1 AC 251 at para. 39 per Lord Hoffman and para. 8 per Lord Bingham; Lewison, *Interpretation of Contracts* (5th Ed), 1.07 and 5.01, referring to the so-called "golden rule"; Chitty on Contracts (31st Ed), 12-051 and 12-063.

[9] *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 W.L.R. 2900 at para. 23 per Lord Clarke.

[10] *Arnold v Britton* [2015] UKSC 36 at para. 17 per Lord Neuberger.

Relevant Amount. It has a cost. On the basis of the language of the definition the relevant payee's cost of equity funding should, accordingly, be capable of being certified as a Default Rate.

28. Wentworth and the Joint Administrators have offered arguments against this position, arguing:

    (1) As regards Wentworth, that the word "funding" should be read as being limited to "borrowing"; and

    (2) As regards the Joint Administrators, that equity funding does not have a relevant "cost" and so cannot fall within the definition.

29. Both arguments should be rejected: there is no mandate in the language of the Default Rate clause for reading *"cost…of funding"* as being limited to a party's cost of "borrowing", or for otherwise limiting the Relevant Payee's right to certify a cost of equity funding.

Wentworth's argument on the meaning of "funding"

30. Taking Wentworth's argument first:

    (1) There is nothing in the language of the definition that restricts the types of funding that may be certified. Nor is there anything in the wording that would justify interpreting "funding" as being limited to "borrowing" or that otherwise draws any distinction between debt and equity funding. The definition refers simply to "funding". Borrowing is one type of "funding", but it is far from the only type.[11] Wentworth's approach therefore requires words to be read into the definition that simply are not there. It would have been easy for the drafters, cognisant of the funding sources available to financial institution counterparties, to limit the definition and specify "a cost of borrowing" if that had been the drafters' intention, but they did not do so. Wentworth should not be permitted

[11] As a matter of language, the Joint Administrators appear to acknowledge this at para. 25(1) of their position paper of 20 August 2015 {1/17/412}.

to rewrite and restrict the definition just because it serves Wentworth's narrow interest in this case.

(2) When the ISDA form is specifically considering debt or borrowing, it uses words which clearly signal this: the definition of "Specified Indebtedness" refers to "any obligation in respect of borrowed money".[12]

(3) In any event, the definition makes it clear that the non-defaulting party may have regard to their own circumstances in certifying their cost of funding and in these circumstances it is inappropriate to approach the definition with a view to the a prior exclusion of specific forms of funding. The focus of the definition is on the funding used by the "relevant payee" to fund the "relevant amount". It is the cost of this funding that may be certified, which requires regard to be had to the circumstances of the non-defaulting party and the basis on which they funded (or could have funded) the relevant amount. If the Relevant Payee in fact used or could have used equity funding to cover the Relevant Amount, there is nothing in the definition that would require them to disregard this fact and assume (fictionally) that they had raised borrowing instead. If that had been the drafters' intention, they could simply have required payment pursuant to a standard market reference rate, but they did not.

(4) Moreover, the supposed simplicity of Wentworth's narrow interpretation, limiting the funding that can be certified to "borrowing", turns out (on closer investigation) to be illusory. It is, in fact, unclear how Wentworth intends to draw the boundaries of the definition. There seem to be two possibilities, neither of which is satisfactory:

(a) If only ordinary unsecured borrowing is to be included, then this would radically limit the range of funding options that could be certified: not only would equity be excluded, but so would a broad range of hybrid and debt funding options (including various types of subordinated borrowing) that also qualify as regulatory capital and are used by financial institutions. This would also require an even more thorough

[12] The term appears in the definition of Cross Default {5/2/25} and is itself defined at {5/2/37}.

rewrite of the definition than has been advocated by Wentworth to date, for which there is no basis whatsoever.

(b) Alternatively, it may be that Wentworth considers that some forms of hybrid and debt funding do constitute "borrowing" for these purposes. However, if this is its position then there is no sensible basis on which the Court could draw a line between what is "in" and "out" of the definition. Many forms of funding exhibit features of both debt and equity,[13] but Wentworth's approach would require the parties (or the Court) to arbitrarily distinguish between these different types of funding.

These problems are inherent in any attempt to read down the definition of Default Rate to include only certain types of funding. They are avoided by the interpretation supported by Goldman Sachs.

(5) Goldman Sachs also notes that the same interpretation approach as argued for by Goldman Sachs was taken in the very recent US decision of *Lehman Brothers Holdings Inc. and Lehman Brothers OTC Derivatives Inc v. Intel Corporation*.[14] In that case, the US Federal District Court rejected an attempt by a defaulting Lehman Brothers entity to interpret the "Loss" provisions of the ISDA Master Agreement restrictively. Intel alleged that it had sustained a loss as a result of the non-delivery by Lehman Brothers of certain Intel shares. "Loss" is defined by the ISDA Master Agreement to mean *"an amount that [a] party reasonably determines in good faith to be its total losses and costs...in connection with this Agreement"* including (amongst various other matters) *"any…cost of funding"*. The Lehman parties argued that the <u>only</u> method by which the non-defaulting party could calculate its "Loss" was to use the "fair market value" of the undelivered shares, as determined by their value at the close of the markets on the Early Termination Date. Judge Chapman rejected this argument. She noted that there was nothing in the text of the definition of Loss that *"explicitly mandates any particular calculation method or otherwise modifies the plain meaning of that first sentence of the definition"*. Intel was accordingly entitled

[13] As referred to in Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015 {7/1/188}.

[14] Southern District of New York, 16 September 2015, 1:13-ap-01340.

to select any methodology for calculating its loss that it wished, subject only to the requirement to do so reasonably and in good faith.[15]

(6) Finally, it should be noted that Wentworth itself has implicitly recognised the difficulty in sustaining any interpretation of the definition of Default Rate that excludes the certification of a cost of equity funding:

(a) It has already offered a fall-back position, whereby in *"extreme circumstances"*, such as *"where the counterparty in question [has] no access to borrowing"*, it may be possible to certify a cost of funding based on the cost of equity funding.[16] This concession acknowledges that requiring a Relevant Payee to certify a cost of funding based on borrowing, in circumstances where it had no access to borrowing, would be unworkable and arbitrary. But it renders the remainder of Wentworth's position incoherent. One only has to ask – what are "extreme circumstances" for these purposes (and, one might further ask, if not at the moment of Lehman Brothers' collapse, then when?). Either the definition is broad enough to encompass equity funding, or it is not. In any event, if it is arbitrary to require a Relevant Payee to certify a cost of funding based on the cost of borrowing when it has no access to borrowing, it is no less arbitrary to require it to do so when it has in fact not used or would not have used borrowing. The vice in each situation is the same: restricting the definition to a cost of borrowing would force the Relevant Payee to certify its cost of funding on an artificial basis and/or a basis that penalises the non-defaulting party. This problem is inherent in Wentworth's approach.

(b) It is notable that Wentworth appeared to acknowledge the weakness of its case in its *original* position paper.[17] This paper accepted that the expression *"cost…if it were to fund…the relevant amount"* generally

[15] Ibid at page 20. It should be noted that the requirement to act "reasonably and in good faith" is an express requirement of the definition of "Loss"; the equivalent for the definition of "Default Rate" is the requirement to act rationally and in good faith, as set out below.

[16] See Kirkland & Ellis's letter of 16 June 2015, para. 2 {7/1/134}. This point is noted by the Joint Administrators in their position paper of 20 August 2015 at para. 22(3) {1/17/411}.

[17] Wentworth's original position paper dated 19 September 2014 {6/15/505}.

referred *"simply to the cost which the relevant entity would incur if it were to acquire the relevant amount"*.[18] This would include "acquiring" the funds through equity funding. However, Wentworth then argued that <u>financial institutions</u> were subject to an additional limitation, whereby they could only certify a cost of funding based on their weighted average cost of borrowing. This argument was based on the allegation that the expression *"cost…if it were to fund…the relevant amount"* had *"a generally understood meaning in the banking derivatives market"*.[19] This trade usage argument was hopeless; there was no evidence for any such practice, let alone a practice of sufficient certainty to *require* the definition to be interpreted in this way, nor any basis for singling out a class of parties within the market that should be restricted in the types of funding that could be used.[20] The argument was duly withdrawn by Wentworth, shortly before it was required to give further details of the basis for its argument.[21] Its new argument, which it still advances, was that the definition should be limited to a cost of borrowing for all types of parties. Nonetheless, it is significant that Wentworth originally felt compelled to make an argument based on trade usage: it is apparent that this was necessary to get round the clear words of the definition, which otherwise would have not justified any restrictive interpretation of the expression *"cost…of funding"*.

31. There is also no merit in Wentworth's further argument, raised in its reply to Goldman Sachs' position paper, that because the Default Rate is payable for the period during which the Relevant Amount is outstanding, *"this implies that the amount funded is required to be repaid at the end of that period, which is an essential feature of borrowing, but not of equity"*.[22] This argument is misconceived for at least three reasons:

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[18] Ibid, para. 72 {6/15/530}.

[19] Ibid, para. 71 {6/15/529}.

[20] In fact, if anything, it is *more* likely that financial institutions would choose to use equity funding to fund the relevant amount, for the reasons given below.

[21] Letter of Kirkland & Ellis dated 31 March 2015 {7/1/46}.

[22] Wentworth's reply position paper of 6 August 2015, paras. 2-3 {1/16/399}.

(1) First, the fact that the Default Rate only applies for the period during which the Relevant Amount was outstanding does *not* imply that it *"is required to be repaid at the end of that period"*. In particular:

(a) Wentworth's argument pays no regard to the factual context in which the definition of Default Rate arises. Wentworth's argument assumes that the Relevant Payee will fund the Relevant Amount with borrowing that can be repaid at the same time as the Relevant Amount. However, in most ISDA defaults the duration of the period for which the Relevant Amount will be outstanding will be uncertain, both at the time that the Relevant Amount becomes due and potentially for a long time thereafter. In many defaults, the Relevant Amount is never repaid in full. The logical consequence of Wentworth's argument is therefore that the Relevant Payee will be restricted to using borrowing which can be repaid at will, since it would otherwise not be able to be sure that the funding could be repaid when the Relevant Amount was eventually forthcoming from the defaulting party. This result, which would impose very narrow limits on the scope of the Default Rate definition, cannot sensibly be said to be required by the mere fact that the Default Rate is payable only for the period for which the Relevant Amount is outstanding.

(b) In any event, it is open to the Relevant Payee to certify a cost of funding that takes into account the costs of retiring the relevant funding. The Relevant Payee is not required to assume that it does so by "repaying" the funding, in the narrow sense of repaying a loan. The funding *might* be repaid, if the certification was based on funding through simple borrowing that is repayable at will. But it could equally be retired through other means. For example, if the Relevant Payee funds the Relevant Amount by issuing fixed term or perpetual bonds or preferred equity, it may be open to the issuer to redeem such instruments early by paying a redemption price, or by repurchasing them in the market.

These possibilities are all equally compatible with the wording of the Default Rate definition, which does not prescribe or imply any requirement for "repayment" of the sum used to fund the Relevant Amount.

(2) Furthermore, Wentworth's argument is based on a mistaken premise: it is <u>not</u> *"an essential feature of borrowing, but not of equity"* that it can be repaid at the end of the period for which the relevant amount is outstanding. Debt funding may be raised on a perpetual basis, or on a long term basis that does not entitle the Relevant Payee to repay it at an earlier date. Equally, equity funding may include a right for the Relevant Payee to redeem the issued equity against the payment of a redemption price.[23] The provisions governing the termination of a particular source of funding will be governed by its terms; they are not inherent in the *nature* of the funding.

The Joint Administrators' argument on the meaning of "cost"

32. The Joint Administrators have indicated that they intend to run an additional argument that equity funding does not have a "cost".[24] The argument would then be that equity funding is not certifiable as a Default Rate, since it does not give rise to a *"cost…of funding"* at all.

33. This submission would surprise any institution which has ever had to raise equity funding or assessed investment or transaction propositions by reference to the cost of capital involved. It is well understood that equity does carry a cost, including (as is further referred to below) by PWC itself.

34. Goldman Sachs set out its position on this issue in its response to the Joint Administrators' Request for Further Information and submits that this response should dispose of the Joint Administrators' straw man.[25] To the extent the Joint Administrators' argument is maintained at trial, it should be rejected:

[23] Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015 sets out two examples of fund-raising, by Morgan Stanley and by The Goldman Sachs Group, Inc, where preferred equity was issued with a redemption price {7/1/188-189}.

[24] Joint Administrators' position paper of 20 August 2015, paras. 23-24 {1/17/411}.

[25] Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015{7/1/187}.

(1) Equity funding carries a cost, like any other type of funding. "Cost", for these purposes, includes any sum paid or financial detriments otherwise incurred in issuing, servicing/maintaining and then retiring the funding used to fund the relevant amount. This definition is equally applicable to both debt and equity funding. The question in each case is the same: what was the cost to the Relevant Payee in having to fund the Relevant Amount.

(2) It is not necessary that the funding used for this purpose must *"gives rise to an obligation to repay the amount borrowed together with interest"*, as suggested by the Joint Administrators.[26] This is unduly narrow, and not mandated by either the term "cost" or any other part of the definition. This limitation would create a set of arbitrary distinctions between different types of funding. It would exclude, for example, the issue of perpetual debt instruments with no fixed repayment date. It would also exclude equity instruments that include a right to redeem the equity issued at a specified price, which effectively do give an option to "repay" the funding. It would also privilege "interest" payments over other forms of regular fixed payments, such as the fixed coupon payable on preferred equity, which may perform the same economic function as interest payments due on borrowing. There is no reason for arbitrarily ruling some of these forms of funding within the definition, while leaving some outside it.

(3) There are also no real difficulties in measuring the cost of equity funding. In many cases elements of the cost of such funding will be obvious, such as the fixed coupon payable on preference shares.[27] The "cost" of such types of equity funding are readily observable, just as easily as the cost of a borrowing facility may be observable. But a cost of equity can always be assessed, including by reference to well understood methodologies such as the Capital Asset Pricing Model (or "CapM"), which has been adopted by PwC (amongst others) to determine the cost of equity of various financial institutions.[28] As Judge Chapman noted in *Lehman Brothers v. Intel Corporation* (referred to above), in

[26] Joint Administrators' Position Paper dated 20 August 2015, para. 25(2) {1/17/412}.

[27] Examples are set out at pages 2-3 of Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015 {7/1/188-189}.

[28] Pages 3-4 of Goldman Sachs' response to the Joint Administrators' Request for Further Information dated 30 September 2015 {7/1/189-190}.

the context of the definition of "Loss", it is *"misplaced" "hyperbole"* to suggest that permitting non-defaulting parties to choose their own methodologies would create unacceptable uncertainty.[29] In any event, the certainty sought by the drafters of the ISDA Master Agreement was not *"the certainty that the [relevant payment] would be calculated in a particular way"*, but rather *"the certainty that the [relevant payment], once determined, would be conclusive and legally enforceable."*[30]

(4) To the extent there was any ambiguity in the meaning of the word "cost" in the abstract, it is removed by consideration of the context in which the term is used in the Default Rate definition. As is set out below, financial institutions and other parties to the ISDA Master Agreement may use equity funding to fund the Relevant Amount, and may be required to do so. As the Joint Administrators' correctly note, the meaning of the words in the clause must be construed in context.[31] Given this context, there would be no justification for adopting a narrow interpretation of the term "cost", which would exclude the costs of various types of funding and artificially restrict the relevant payee to a form of funding (borrowing) that they may not have used and potentially could never have used.

<u>The purpose of the Default Rate definition</u>

35. Goldman Sachs' interpretation of the Default Rate definition derives further support from the commercial purpose of the definition. To the extent that alternative interpretations of an agreement are available, then Courts should prefer the interpretation that is *"most likely to give effect to the commercial purpose of the agreement"*.[32]

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[29] *Lehman Brothers Holdings Inc. and Lehman Brothers OTC Derivatives Inc v. Intel Corporation* (SDNY), 16 September 2015, pages 22-23.

[30] Ibid.

[31] Joint Administrators' Position Paper dated 20 August 2015, para. 25(1) {1/17/412}.

[32] *Co-operative Wholesale Societe Ltd v. National Westminster Bank Plc* [1995] 1 EGLR 97 at 99 per Hoffman LJ, cited with approval in *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 W.L.R. 2900 at para. 23 per Lord Clarke; Chitty on Contracts (31st Ed), para. 12-057; Lewison, *Interpretation of Contracts* (5th Ed) at 2.07.

36. As has been stated by Wentworth,[33] the purpose of a right to interest is *"to compensate the person entitled to payment for having been kept out of its money."*

37. The Default Rate provision sets out a contractual scheme to achieve this purpose. Thus, if the defaulting party fails to make payment under the ISDA Master Agreement as required, it is obliged to compensate the non-defaulting party by paying to it *"the cost (without proof or evidence of any actual cost) to the relevant payee…if it were to fund or of funding the relevant amount"* plus 1%. This provision aims to put the Relevant Payee back in the position it would have been in if the defaulting party had paid the Relevant Amount on time.

38. Goldman Sachs' interpretation of the Default Rate definition would achieve this purpose. Wentworth's narrow interpretation, limiting the costs that a Relevant Payee can certify to its cost of borrowing, would not. In particular:

    (1) There can be no doubt that, as a matter of fact, a Relevant Payee may use equity funding to fund the Relevant Amount (as set out in the next section).

    (2) Goldman Sachs' interpretation of the definition would allow the cost of this equity funding to be duly certified as the Relevant Payee's cost of funding. This cost would properly reflect the Relevant Payee's costs of being kept out of its money.

    (3) By contrast, on Wentworth's approach the Relevant Payee would be forced to certify a cost of funding based on a notional cost of borrowing, irrespective of the funding sources that it actually used or could have used. As explained in paragraph 30(3) above, this would leave the Relevant Payee significantly under-compensated, in circumstances where it had raised equity funding at a higher cost.

    (4) The Joint Administrators' argument would produce an even worse result: it appears to be the Joint Administrators' case that in such circumstances the relevant payee has no cost of funding *at all*, for the purposes of the Default Rate definition, so that it would only receive a Default Rate of 1%.[34] This would

[33] Para. 59 of Wentworth's original position paper dated 19 September 2014 {6/15/524}, and paras. 78 and 88 of its revised position paper dated 11 September 2015 {1/10/133, 135}.

[34] Joint Administrators' position paper of 20 August 2015, para 25(4) {1/17/413}.

leave a party that may have actually funded the Relevant Amount using equity funding, and may be incurring significant ongoing costs in relation to that funding (such as a coupon payable on preference shares), being treated for the purposes of the ISDA Master Agreement as if it had sustained no costs whatsoever. This cannot possibly be the correct interpretation of the definition.

39. In addition, it should be noted that a narrow interpretation of the Default Rate definition would be more restrictive than the modern approach of the English Courts to claims for interest at common law. Since the House of Lords decision in *Sempra Metals Ltd v. IRC*[35] the English Courts have recognised that a party may claim interest as damages for late payment of a debt, in order to compensate the payee for being kept out of its money. In giving his judgment in *Sempra Metals*, Lord Nicholls specifically noted that such a claim was not limited to a cost of borrowing. The claim for interest could be based on any form of loss, provided it was actually incurred and could be proved:

> *"In the nature of things the proof required to establish a claimed interest loss will depend upon the nature of the loss and the circumstances of the case. The loss may be the cost of borrowing money. That cost may include an element of compound interest. Or the loss may be loss of an opportunity to invest the promised money. Here again, where the circumstances require, the investment loss may need to include a compound element if it is to be a fair measure of what the plaintiff lost by the late payment. Or the loss flowing from the late payment may take some other form. Whatever form the loss takes the court will, here as elsewhere, draw from the proved or admitted facts such inferences as are appropriate. That is a matter for the trial judge. There are no special rules for the proof of facts in this area of the law."*[36]

40. The Default Rate definition exists for the same reason as the right to claim interest for late payment at common law, namely to compensate the payee for late payment. Given this principle, it would be remarkable if the definition of Default Rate was limited to a cost of borrowing: this would require the Court to conclude that the specific contractual provision agreed to compensate the Relevant Payee for late payment was, despite being

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[35] [2008] 1 AC 561.

[36] Ibid, at para. 95.

expressed in unqualified terms, nonetheless more limited than the equivalent right at common law.[37]

41. Again, clear words would be needed to achieve this result, and derogate from the general principle that interest is intended to compensate the Relevant Payee from being kept out of its money. In fact, as set out above, the wording of the definition clearly supports the broad interpretation of the definition.

The Factual Matrix

42. Goldman Sachs' case is also strongly supported by consideration of the relevant factual matrix against which the definition of Default Rate was drafted.

43. All contractual terms must be interpreted in context, including in light of the relevant factual background. As Lord Hoffman stated in *Investors Compensation Scheme v. West Bromwich Building Society*:[38]

> *"Subject to the requirement that it should have been reasonably available to the parties…it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man."*[39]

44. Thus, *"evidence of the surrounding circumstances is admissible in all cases to place the contract in its correct setting, even where there is no ambiguity apparent on the face of the document"*.[40]

[37] The Default Rate definition does depart from the common law in certain procedural respects; in particular, it expressly removes the requirement on the Claimant to provide proof or evidence of actual cost. However, these modifications are (unsurprisingly) designed to *improve* the position of the non-defaulting party and provide certainty, not limit the basis on which it may be compensated for being paid late.

[38] [1998] 1 WLR 896

[39] Ibid at 912-913.

[40] Lewison, *The Interpretation of Contracts* (5th Ed), 3.17(b); *Chartbrook Ltd v. Persimmon Homes Ltd* [2009] UKHL 38; [2009] AC 1101 at para. 37.

45. This approach applies equally to standard form contracts such as the ISDA Master Agreement. As Lord Bingham noted in *Dairy Containers Ltd v. Tasman Orient CV (The Tasman Discoverer)* ,[41] a case concerning a standard form bill of lading:

> *"There may reasonably be attributed to the parties to a contract such as this such general commercial knowledge as a party to such a transaction would ordinarily be expected to have… The contract should be given the meaning it would convey to a reasonable person having all the background knowledge which is reasonably available to the person or class of persons to whom the document is addressed."*[42]

46. As regards the interpretation of the ISDA Master Agreement and the definition of Default Rate, the key facts include the following points (none of which is understood to be controversial):

    (1) ISDA was founded by financial institutions. Such institutions were instrumental in the development of the ISDA Master Agreement, and among its principal users.

    (2) Financial institutions are required by both regulatory rules and market requirements to maintain a certain level of equity capital at all times and to fund themselves using such funding.

    (3) Where a counterparty of a financial institution defaults under an ISDA Master Agreement and fails to pay the amounts owed, this will directly reduce the financial institution's level of equity capital. These reductions can only be reversed by raising further equity funding. Further ordinary unsecured borrowing cannot be used for this purpose.

    (4) Moreover, at least as regards the requirements of the market, these constraints apply to a greater or lesser extent to all businesses. If any business sustains losses, it may come under pressure to raise further equity funding in order to retain the confidence of the markets.

[41] [2004] UKPC 22; [2005] 1 WLR 215.

[42] Ibid, at para. 12. See also *Homburg Houtimport BV v Agrosin Private Ltd (The Starsin)* [2003] UKHL 12; [2004] 1 AC 715, at para. 73.

(5) Although the details of the applicable regulatory regimes and particular requirements of the market have varied from time to time, these requirements have applied in one form or another at all material times since before the ISDA Master Agreement was drafted.

(6) During the life of the 1992 ISDA Master Agreement form (which had itself not been updated for 5 years), and during the life of particular transactions undertaken on the form, it was foreseeable that the applicable regulatory regime might change, making it desirable to ensure that the form provided maximum flexibility in determining the "cost of funding".

47. These facts would have been objectively obvious to both the drafters and users of the ISDA Master Agreement, whether or not they were financial institutions themselves. They strongly militate in favour of an interpretation of Default Rate that would allow the relevant payee to certify a cost of equity funding. Any interpretation of Default Rate that prevented a Relevant Payee from certifying the cost of such funding would require the parties to ignore the real constraints that may apply to the non-defaulting party under an ISDA Master Agreement: it is an objective fact that financial institutions (and other parties) do use equity funding to fund their operations, and that they may be required to respond to a default under an ISDA Master Agreement by raising such funding including to reverse damage to their capital ratios. It is inconceivable that the draftsmen of the ISDA Master Agreement would have intended to force such parties to artificially ignore the role that equity plays in their funding, and instead make the false assumption that they will always fund the Relevant Amount by raising further borrowing.

48. In response to this argument, the Joint Administrators have suggested that the ISDA Master Agreement should not be interpreted in light of the *"regulatory requirements applicable to a particular class of counterparty."*[43] Goldman Sachs responds as follows to this argument:

(1) First, financial institutions are not merely a "particular class of counterparty"; they are the principal class of counterparty involved in the drafting of the ISDA Master Agreement, and amongst its principal users. The fact that financial institutions are funded and required to be funded as described above would

[43] Joint Administrators' position paper dated 20 August 2015, para. 25(3) {1/17/412}.

inevitably have been taken into account (objectively) by the draftsperson of the agreement, as forming a key part of the factual context against which that agreement was drafted and agreed.

(2) Furthermore, these circumstances would have been objectively known to all reasonable users of the ISDA Master Agreement, even if they did only directly concern the circumstances of a "particular class of counterparty". It would be obvious to all users of the ISDA Master Agreement that (a) the agreement was widely used by financial institutions and (b) financial institutions operate in a highly regulated market and are subject to regulatory and market requirements that could require them to raise equity funding if there was a default under that agreement.

(3) In any event, the potential need to use equity funding is *not* limited to financial institutions; as is set out above, any business may be required by market pressure to raise equity funding, rather than further debt, to fund the Relevant Amount.

49. Separately, Wentworth has also sought to take various forensic points regarding the particular circumstances of Goldman Sachs' own funding, which Wentworth suggests demonstrate that it is not easy to establish a *"connection"* between *"a financial institution's general funding activities and the funding of an unpaid amount under the ISDA Master Agreement."*[44] It then asserts that there are *"difficulties in establishing a sufficient link in practice between an entity's cost of raising funding for its assets/losses generally and funding the Relevant Amount for the period it is outstanding",* on the basis that this involves *"consideration of the motivation for raising funds one way or another"*. Wentworth then further asserts that only a cost of borrowing should be certifiable under the Default Rate definition, on the basis that it is *"likely that the draftsman of the ISDA Master Agreement did not intended such complexities to play a role in the determination of the Default Rate."*[45]

50. This argument is misconceived from start to finish:

[44] Wentworth's reply position paper dated 6 August 2015, paras. 4-6 {1/16/399-403}.
[45] Ibid, at para. 7 {1/16/403}.

(1) First and most obviously, the definition of Default Rate does *not* require any ascertainment of a "connection" between a particular act of fund-raising and funding the Relevant Amount. The definition expressly contemplates that the Relevant Payee may not actually fund the Relevant Amount at all: it permits it to certify a Default Rate on the basis of the cost "if it were to fund" the relevant amount. For the same reason, it is not necessary for the Relevant Payee to point to its "motivation" in raising any particular funding. This should play no part in the objective exercise in question, provided the certification is given in good faith. The premise of the argument is therefore wrong.

(2) In any event, the difficulties in showing a relevant connection between a particular act of fund-raising and funding the Relevant Amount are grossly overstated (as Judge Chapman noted in relation to supposed uncertainty in the *Intel* case cited above). For example, Wentworth suggests that a fund raising of $10 billion *"cannot plausibly be said to have been raised to fund the cost of an unpaid amount of $86 million, which represents the claim of GSI against LBIE"*.[46] But this is a non-sequitur. The fact that a large sum is raised in no way prevents part of that sum from being used to fund the Relevant Amount, and including the cost of that funding within its certification for the purposes of its Default Rate. This is obvious as a matter of fact. As a matter of law, precisely such an approach was taken by the Relevant Payee in *Lehman Brothers Finance SA v. SAL Oppenheim Jr & CIE, KGAA*[47], where the Court applied a Default Rate of 12% to a €2.96 million claim based on an 11% cost of funding incurred by its parent entity under a $450 million credit facility.

(3) Furthermore, Wentworth's case appears to be that the Relevant Payee can only certify a cost of funding based on a particular act of borrowing that precisely matches the amount of the Relevant Amount. There is no textual or commercial justification for such a restriction and it plainly does not reflect the realities of how financial institutions (and other businesses) fund themselves, whether by debt or equity. Furthermore, as with Wentworth's parallel argument that the funding must be borrowed for precisely the same term as the period for which

[46] Ibid, at para. 5(2) {1/16/400}.
[47] [2014] EWHC 2627 (Comm).

the Relevant Amount is outstanding (as to which see para. 31(1) above), this restriction would also be unworkable in practice: the size of the Relevant Amount may be in dispute until long after the relevant default, so it would be a matter of exceptional serendipity that the Relevant Amount would ever be funded by a loan of equivalent size (or duration).

(4) Regardless of the points set out above, it is also submitted that the details of one particular financial institution's funding position cannot be determinative of the correct interpretation of the definition of Default Rate. This definition appears in a standard form agreement. Facts that are generally known to the relevant audience for the agreement may be relevant to its interpretation, as set out above. However, the specific circumstances of any particular party are, in principle, irrelevant to the interpretation of such an agreement.[48]

(5) Finally, the actual points raised by Wentworth regarding Goldman Sachs' funding are replete with errors. Though they could only even be arguably be relevant upon certification by Goldman Sachs of its Default Rate, the details of the correct position are set out in para. 13(4) of Goldman Sachs' reply position paper of 4 September 2015.[49]

51. Accordingly, the factual context of financial institutions' funding arrangements, which demonstrates that they may be required to use equity funding to the relevant amount due under the ISDA Master Agreement, militates strongly in favour of an interpretation of the Default Rate definition that entitles a Relevant Payee to certify the cost of that equity funding.

(2) The restraints on the relevant payee's right to certify a cost of funding: rationality and good faith

52. For the reasons given above, Goldman Sachs submits that the definition of Default Rate does not place any limit in principle on the type of funding that may be certified as the relevant payee's *"cost…of funding…the relevant amount"*. Equity funding, debt

[48] See Lord Millett in *AIB Group (UK) Ltd v. Martin* [2001] UKHL 63; [2002] 1 WLR 94, at para. 7; Lewison, *The Interpretation of Contracts* (5th Ed), at 3.18.

[49] {1/18/427}.

funding and hybrid instruments adopting elements of both types of funding may all inform the certification, if appropriate on the facts.

53. This is not to say, however, that the right to certify a cost of funding is entirely unconstrained. Appropriate limits are supplied by the requirement that any cost of funding be certified rationally and in good faith.

54. It is common ground that such requirements apply to definition of Default Rate.[50] The Default Rate must be based on the rate selected by the relevant payee, *"as certified by it"* and *"without proof or evidence of any actual cost"*, such that there are therefore no express limits on the basis on which the certification can be given and the certification will generally be conclusive. However, there is much authority to the effect that, faced with an apparently unfettered right to exercise a contractual right, a term will nonetheless be implied that the right will be exercised rationally and in good faith.

55. Goldman Sachs adopts, in this regard, the summary of the relevant law offered by Rix LJ in *Socimer International Bank Ltd v. Standard Bank London Ltd*:[51]

> *"It is plain from these authorities that a decision-maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to Wednesbury unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria…"*[52]

56. Goldman Sachs accordingly submits that the two touchstones for the certification of the Default Rate by the Relevant Payee are rationality (in the sense of Wednesbury

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[50] See the Senior Creditor Group's revised position paper of 31 August 2015, para. 14 {1/9/78} and Wentworth's revised position paper of 11 September 2015, paras. 91-92 {1/10/136}.

[51] [2008] 1 Lloyd's Rep 558.

[52] Ibid, at para. 66.

unreasonableness, encompassing a requirement to avoid *"arbitrariness, capriciousness and perversity"*) and good faith (encompassing the need to act honestly).[53]

57. These limitations serve to deal with any concern that the Relevant Payee may abuse the breadth of the Default Rate provision, or otherwise certify an indefensible Default Rate:

(1) If the Relevant Payee purports to certify a Default Rate on a basis that no reasonable party would have adopted, this would not be rational. This is the answer to the argument, raised by Wentworth, that the Relevant Payee must certify the *"lowest amount which the counterparty is required to pay over the relevant period"*, *"all other things being equal"*.[54] In particular:

(a) To the extent that Wentworth suggests that this proposition is inherent in the meaning of *"cost…of funding"*, this is clearly wrong: the question of whether a Relevant Payee has certified a higher cost of funding than it was required to pay is not a matter going to the scope of the definition of Default Rate. Wentworth's real complaint is that such a certification would not reflect the Relevant Payee's genuine cost of funding, not that it is not a certification of a cost of funding at all.

(b) Instead, the force of this argument lies in the fact that a certification of an excessively high cost of funding, greater than that which the Relevant Payee actually had to incur, may not be given rationally or in good faith. As a matter of principle, this argument may be run on appropriate facts. However, in considering such an argument it is essential that a generous ambit of discretion is given to the Relevant Payee. It is for the Relevant Payee to assess whether, faced with two funding options with different nominal rates, *"all other things"* <u>are</u> *"equal"*. Plainly, the Default Rate definition was not intended to allow or indeed encourage the defaulting party to bring a challenge in circumstances where there could be

[53] Goldman Sachs notes that a similar approach has been taken in at least one US federal decision: in *Finance One Public Co v. Lehman Brothers Special Financing* (Southern District of New York), 30 June 2003, where Judge Motley refused to allow an argument that the Default Rate certified under the ISDA Master Agreement was exaggerated, given that "the ISDA explicitly precludes an issue of fact contest with regard to the proper default rate with the phrases *"without proof or evidence of any actual cost"* and *"as certified by it"*, unless (under New York law) the certified rates were tainted by *"bad faith, fraud, gross negligence or contravention of public policy."* These requirements broadly accord with the requirement of rationality and good faith set out above.

[54] Wentworth's revised position paper of 11 September 2015, paras. 69 and 89-90 {1/10/130,136}.

reasonable disagreement as to which funding option offered the best value. The objective was to avoid rather than promote further disputes. Nor would it be appropriate to analyse various funding options by reference merely to their nominal interest rates. The interest rate is only one term against which the suitability of a funding proposal must be assessed, alongside myriad other factors including its duration, any applicable covenants, any subordination associated with the funding, the creditworthiness and public standing of the counterparty. As the Joint Administrators have noted, the Relevant Payee must therefore have a *"margin of appreciation"* in selecting an appropriate basis of funding. Provided it makes a good faith choice from within the range of reasonable options open to it, no challenge to its certification may be brought.[55]

(2) To like effect, the Relevant Payee would not be entitled to certify a cost of funding that had been prepared irrationally or in bad faith, on the grounds that it was based on a source of funding that the Relevant Payee would never (acting rationally and honestly) have chosen to use.[56]

(3) Nor would it be possible to certify a cost of funding for which there was simply no evidential basis at all.[57]

58. The constraints of rationality and good faith also provide the answer to Issues 12(2)-(4)[58] and 13, regarding the various bases on which a cost of funding might be calculated:

(1) As is set out above, the definition of Default Rate does not itself restrict the basis on which a relevant payee is entitled to certify its cost of funding.

(2) Accordingly, as regards Issues 12(2)-(4), the Relevant Payee may:

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[55] Joint Administrators' Position Paper of 20 August 2015, para. 25(5) {1/17/413}.

[56] See Goldman Sachs reply position paper of 4 September 2015, para. 17 {1/18/430}.

[57] This appears to have been the reason why the certified Default Rate was rejected in *Lehman Brothers Finance SA v. SAL Oppenheim Jr & CIE, KGAA* [2014] EWHC 2627 (Comm) (see paras. 52-53).

[58] Though Issue 12 only expressly relates to the cost of debt funding, the same approach applies to the cost of equity funding. Goldman Sachs understands that Issue 12(1) is now agreed: the relevant payee's funding should be assumed to have recourse solely to all the relevant payee's unencumbered assets.

(a) Certify its cost of funding by reference to the incremental cost of raising additional funding or by reference to the weighted average cost of all its funding (Issue 12(2));

(b) Take into account in such cost of funding the impact on the relevant payee's cost of regulatory capital including equity capital (Issue 12(3)); and/or

(c) Rely on the cost of overnight funding, or term funding matching the duration of the time for which the relevant amount was owed, or funding of some other duration (Issue 12(4)).

(3) The constraint on the Relevant Payee's flexibility to certify its cost of funding on these bases lies not in any formal limit in the definition of Default Rate, but rather in the requirement that its certification must be made rationally and in good faith. For example:

(a) A relevant payee may rationally and in good faith treat its weighted average cost of its existing funding as being equivalent to its cost of funding the Relevant Amount, though it need not do so.

(b) Similarly, since the raising of additional funding could have an impact on the cost of the Relevant Payee's equity capital, it may be rational and in good faith for the Relevant Payee to take into account that impact in certifying its cost of funding. However, the Relevant Payee may only do so if it could rationally conclude that raising further funding would have such an effect, and takes account of that effect on a basis that falls within the range of reasonable options.

(c) To like effect, the Relevant Payee may certify a cost of funding based on funding of any duration (whether overnight funding, funding matching the period for which the Relevant Amount was due, or some other basis), provided that it rationally and in good faith used or could have used such funding to fund the Relevant Amount. The Joint Administrators' suggestion that funding with a matching term may

never be certified,[59] on the basis that it was uncertain whether repayment in full would be forthcoming, is therefore too restrictive. In the case of the LBIE default it may well be improbable that such funding would ever have been used by the Relevant Payee, given the uncertainty as to whether the Relevant Amount would actually be repaid (and if so when), but it is not impossible.[60]

(4) Issue 13 can be answered on a similar basis:

(a) This issue concerns whether the Relevant Payee's cost of funding should be determined by reference *to "the relevant payee's circumstances on a particular date"*, or "*on a fluctuating basis taking into account any changes in the relevant circumstances"*.

(b) Goldman Sachs submits that these two options offer a false choice. Either option is permissible, provided that the certification is given in good faith and rationally.[61]

(c) This will necessarily involve an element of hindsight: assuming that the certification is given at the end of the relevant period, the Relevant Payee will have to certify a cost of funding based on what they actually did or could have done to fund the Relevant Amount during this period.

(d) In circumstances where the certification is given on the "if it were to fund" basis this will, in turn, require the Relevant Payee to have regard to what they would have done in all the facts and circumstances (including market conditions) applying at the time of the default, and at all times thereafter. If, for example, the Relevant Payee could (based on what it knew at the time) have reasonably have decided to initially fund the relevant amount with term funding of a particular duration and/or at

[59] Joint Administrators position paper of 20 August 2015 at paras. 30(2)-(3) {1/17/418-420}.

[60] More plausibly, though still improbably, the relevant payee may have funded the Relevant Amount using funding that the Relevant Payee was entitled to terminate on a date of its choosing (for example if it had the right to repay borrowing on a date of its choice, or to exercise an option to redeem equity funding or otherwise call back callable instruments), in which case the Relevant Payee may rationally certify a cost of funding that assumes that the funding was held for the precise term that the Relevant Amount was outstanding.

[61] This approach appears (subject to one qualification, dealt with below) to be consistent with that promoted by the Joint Administrators in their position paper of 20 August 2015 at para. 33 {1/17/421}.

a particular rate (including a fixed term and/or a fixed rate), before switching to use overnight funding on a fluctuating basis at the expiry of that period, it may certify its cost of funding accordingly.

(e) However, what the Relevant Payee cannot do is construct a certified cost of funding that ensures the maximum possible Default Rate, by assuming that the Relevant Payee would have at all times chosen the most expensive funding available, if it did not actually use such funding and could not rationally (based on its then knowledge) have entered into such transactions at the time. Such a certification would neither be rational nor in good faith.

(f) Goldman Sachs understands this position to be broadly consistent with that of the Joint Administrators,[62] save that the Joint Administrators suggest that a certification of a cost of funding given on the "if it were to fund" basis may only be based on the circumstances applying at the date the Relevant Amount was originally due, and not later.[63] The suggestion appears to be that the particular method of funding that would have been chosen at the outset of the relevant period must apply for the entire period. It would be open to a Relevant Payee to certify their cost of funding on this basis and it may well be appropriate for them to do so, but the Relevant Payee should not be forced to assume that it would have chosen a method of funding at the outset of the relevant period that never changed thereafter.

59. In all of this, Goldman Sachs invites the Court to be wary of allowing the Joint Administrators or Wentworth to introduce questions surrounding certification (or facts relating to Goldman Sachs' particular position, as Wentworth has already sought to do) into this construction exercise. The two should not be confused, and in particular the Court should resist the temptation offered by these parties to somehow work backwards from the certification stage into the exercise of construing the meaning of the ISDA Master Agreement.

[62] Joint Administrators position paper of 20 August 2015 at para. 33 {1/17/421}.
[63] Ibid, at para. 33(2) {1/17/421}.

<u>IV. CONCLUSION</u>

60. For the reasons given above, it is respectfully submitted that the Court should conclude that the definition of Default Rate permits a Relevant Payee to certify cost of funding based on any type of funding, subject to the requirements of rationality and good faith. It should answer Issues 11-14 and 27 in the form set out in the Appendix to this skeleton argument.

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APPENDIX: GOLDMAN SACHS' ANSWERS TO ISSUES 11-14 AND 27

Goldman Sachs sets out below its proposed answers to each of Issues 11-14 and 27.[64]

Issue 11

Is the meaning that should be given to the expression "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount" capable of including:

(1) The actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount; and / or

(2) The actual or asserted average cost to the relevant payee of raising money to fund or of funding all its assets by whatever means, including any cost of raising shareholder funding; and / or

(3) The actual or asserted cost to the relevant payee to fund or of funding and / or carrying on its balance sheet an asset and / or of any profits and / or losses incurred in relation to the value of the asset, including any impact on the cost of its borrowings and / or its equity capital in light of the nature and riskiness of that asset; and / or

(4) The actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE?

Goldman Sachs' answer to Issue 11

11. The expression *"cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount"* is capable of including:

[64] Goldman Sachs notes that certain of the issues (and in particular Issue 11(1) and (2) and 12) may assume a narrower range of answers than those advanced by Goldman Sachs in its position paper and developed in the submissions set out above. The parties have confirmed, however, that they do not take any point that Goldman Sachs' arguments are beyond the scope of the current issues.

(1) The actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount, or through funding of any other type, including debt funding, equity funding, funding exhibiting features of both debt and equity, or funding from a combination of a number of different sources;

(2) The actual or asserted average cost to the relevant payee of raising money to fund or of funding all its assets by whatever means, including any cost of raising shareholder funding; and

(3) The actual or asserted cost to the relevant payee to fund or of funding and / or carrying on its balance sheet an asset and / or of any profits and / or losses incurred in relation to the value of the asset, including any impact on the cost of its borrowings and / or its equity capital in light of the nature and riskiness of that asset.

Issue 12

If and to the extent that the "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund…the relevant amount" includes a cost of borrowing:

(1) Should such borrowing be assumed to have recourse solely to the relevant payee's claim against LBIE or to the rest of the relevant payee's unencumbered assets?

(2) If the latter, should the cost of funding include the incremental cost to the relevant payee of incurring additional debt against its existing asset base or should it include the weighted average cost on all of its borrowings?

(3) Should such cost include any impact on the cost of the relevant payee's equity capital attributable to such borrowing?

(4) Is the cost to be calculated based on obtaining:

(i) overnight funding; or

(ii) term funding to match the duration of the claim to be funded; or

(iii) funding for some other duration?

Goldman Sachs' answer to Issue 12

12. In the case of the cost of all types of funding (including borrowing, but also including equity and other types of funding):

    (1) The relevant funding should not be assumed to have recourse solely to the relevant payee's claim against LBIE. It may have recourse to the rest of the relevant payee's unencumbered assets, if appropriate;

    (2) The cost of funding may include the incremental cost to the relevant payee of raising additional funding against its existing asset base or the weighted average cost of all of its funding;

    (3) Such cost may include any impact on the cost of the relevant payee's equity capital attributable to such funding; and

    (4) The cost may be calculated based on obtaining:

        (i) overnight funding;

        (ii) term funding to match the duration of the claim to be funded; or

        (iii) funding for some other duration.

Issue 13

Whether the "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount" should be calculated:

(i) by reference to the relevant payee's circumstances on a particular date; or

(ii) on a fluctuating basis taking into account any changes in the relevant circumstances (and if so, whether the benefit of hindsight applies when taking into account such changes),

in each case, whether or not taking into account relevant market conditions.

Goldman Sachs' answer to Issue 13

13. The *"cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount"* may be calculated:

    (1) By reference to the relevant payee's circumstances on a particular date, or on a fluctuating basis taking into account any changes in the relevant circumstances, subject to the requirement to certify the cost of funding rationally and in good faith;

    (2) In each case taking into account relevant market conditions, as well as any other relevant facts or circumstances; and

    (3) In light of hindsight, insofar as any certification given by the relevant payee at the end of the relevant period will be based on what the relevant payee actually did or could have done to fund the relevant amount throughout the relevant period.

Issue 14

Whether a relevant payee's certification of its cost of funding for the purposes of applying the "Default Rate" is conclusive and, if not, to what it is subject. In particular whether, in order for a payee's certification to be deemed conclusive, a relevant creditor is under any duty to act:

(i) reasonably;

(ii) in good faith and not capriciously or irrationally; or

(iii) otherwise than in its own interests.

Goldman Sachs' answer to Issue 14

14. A relevant payee's certification of its cost of funding for the purposes of applying the Default Rate is conclusive, other than in circumstances where it:

    (i) is made irrationally; or

(ii) is made otherwise than in good faith.

Issue 27

Whether, and if so how, the answers to questions 10 to 26 would be impacted where the "relevant payee" is:

(i) a Credit Institution or Financial Institution;

(ii) a Fund Entity; or

(iii) a corporate or other type of counterparty.

Goldman Sachs' answer to Issue 27

27. The answers to questions 10 to 26 are not impacted by whether the relevant payee is a Credit Institution, Financial Institution, a Fund Entity, a corporate or any other type of counterparty.[65]

[65] It is understood that this answer is agreed between the parties.