<u>**Claim No. 7942 of 2008**</u>

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) GUY JULIAN PARR

(as the joint administrators of the above named company)

<u>**Applicants**</u>

-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

<u>**Respondents**</u>

THIRD WITNESS STATEMENT OF

PATRICK MICHAEL MCKEE

I, **Patrick Michael McKee**, of 10 St. James Avenue, Suite 1700, Boston, Massachusetts 02116, say as follows:

1.   I am an employee of The Baupost Group, L.L.C. I am duly authorised to make this statement on behalf of The Baupost Group, L.L.C. and its managed funds and accounts (collectively, "**Baupost**"), including the Third Respondent ("**Hutchinson**").

2.   The information contained in this witness statement and its exhibit is either derived from Baupost's own knowledge, publicly available data or investor materials or, where indicated, from information supplied to Baupost by original creditors from whom Baupost purchased relevant claims. Where the information is from Baupost's own knowledge it is true, and where it is from information supplied to Baupost it is true to the best of my knowledge and belief.

3.   Pursuant to paragraph 10 of the order of Mr. Justice David Richards dated 21 November 2014 (the "**Order**"), the Court has directed that the Senior Creditor Group do, by 15 January 2015, file and serve on the Administrators, Wentworth and York evidence explaining the basis or bases upon which they or their affiliates consider that they are entitled to advance, for payment pursuant to Rule 2.88(7) of the Insolvency Rules 1986, actual claims to interest at a rate in excess of the Judgments Act Rate, together with sufficient particulars to substantiate such claims to interest and assist any expert instructed in due course in preparing their expert evidence by reference to such real claims.

4.   In compliance with the Order, Baupost (on behalf of Hutchinson as a member of the Senior Creditor Group) has produced a report (the "**Report**") which particularises, by way of example, the bases on which Baupost believes it is entitled, in the cases of three of the claims against LBIE that it owns, to interest at a rate in excess of the Judgments Act Rate. There is now produced and shown to me and marked "PMM1" a true copy of the Report.

Statement of Truth

I believe that the facts stated in this witness statement are true.

Patrick Michael McKee

15 January 2015

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN

BROTHERS INTERNATIONAL (EUROPE) (IN

ADMINISTRATION)

AND IN THE MATTER OF THE

INSOLVENCY ACT 1986

ANTHONY VICTOR LOMAS & OTHERS

– AND –

BURLINGTON LOAN MANAGAMENT &

OTHERS

THIRD WITNESS

STATEMENT OF

PATRICK MICHAEL MCKEE

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15 January 2015

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<u>**Claim No. 7942 of 2008**</u>

IN THE HIGH COURT OF JUSTICE

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EXHIBIT PMM1

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INTRODUCTION

1. Pursuant to paragraph 10 of the Order of Mr. Justice David Richards dated 21 November 2014 (the "**Order**"), the Court has requested that the Senior Creditor Group do, by 15 January 2015, file and serve on the Administrators, Wentworth and York evidence explaining the basis or bases upon which they or their affiliates consider that they are entitled to advance, for payment pursuant to Rule 2.88(7) of the Insolvency Rules 1986, actual claims to interest at a rate in excess of the Judgments Act Rate, together with sufficient particulars to substantiate such claims to interest and assist any experts instructed in due course in preparing their expert evidence by reference to such real claims.

2. The 1992 and 2002 versions of the ISDA Master Agreement each define the term "Default Rate" to mean "*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.*" The Senior Creditor Group contends that the words "*cost … if it were to fund or of funding*" are to be construed to enable the relevant payee to determine the cost of having to fund the relevant amount on the basis that most accurately captures such cost and, therefore, most accurately compensates it in respect of the same.

3. Consistent with this, the Senior Creditor Group's position is that such cost can encompass, without duplication:

   a. any and all costs to the relevant payee of being forced to fund (in the sense of extending credit to) the defaulting party in the sum of the relevant amount; and

   b. any and all costs to the relevant payee of raising an incremental sum of money equivalent to the sum of the relevant amount.

4. In compliance with the Order and by way of example, Baupost has explained in this Report the bases on which it believes it is entitled to assert claims for statutory interest at a rate in excess of the Judgments Act Rate in the cases of three claims against LBIE that it owns, each relating to an ISDA Master Agreement between the relevant original creditor and LBIE.

5. Baupost prefaces its examples with general explanations of the bases on which a relevant payee will suffer costs in (i) being forced to fund (in the sense of extending credit to) the defaulting party in the sum of relevant amount and (ii) raising an incremental sum of money equivalent to the sum of the relevant amount. In this Report we refer to (i) and (ii) respectively as the "**First Basis of Calculation**" or "**First Basis**" and the "**Second Basis of Calculation**" or "**Second Basis**", and explain each basis in turn. For the reasons set out in our explanations, the First Basis accurately captures a relevant payee's specific cost of funding with respect to its defaulted claim against LBIE, and the Second Basis accurately captures its cost of funding across all its assets.

6. Against the background of our explanations of these approaches to calculation, we explain the nature and relevant characteristics of the three example claims. In each case, we then explain the basis on which it supports an entitlement to claim interest pursuant to the Default Rate provision at a rate higher than the Judgments Act Rate.[1]

7. Under each example, and whether the First or Second Basis of Calculation is used, the cost of funding exceeds a simple rate of 8% per annum. It should nonetheless be kept in mind that a cost of funding of less than 8% simple could still exceed the Judgments Act Rate. This is due to the 1% premium specified in the Default Rate definition and the effect of compounding of the Default Rate as required under Section 6 of the ISDA Master Agreement. In this respect, we refer to paragraph 85 of the eleventh witness statement of Anthony Victor Lomas ("**Lomas 11**"), which estimates that a Default Rate of 6.6% ("**Threshold Rate**") would equate, when compounded daily over the relevant period, to the Judgments Act Rate (in turn implying that the cost of funding component of the Default Rate need only be 5.6% per annum to produce a result equivalent to the Judgments Act Rate).

8. Whilst this Report sets out, for the benefit of the Court, the parties and any experts to be instructed in due course, real examples of circumstances in which it is believed that creditors of LBIE can substantiate a cost of funding for the purposes of the Default Rate definition that would yield a claim for interest greater than the Judgments Act Rate, it is important to note that

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[1] In providing examples, this Report does not purport to identify every basis upon which a cost of funding could be calculated so as to produce a claim to interest in excess of the Judgments Act Rate. For example, a financial institution subject to regulatory capital requirements restricting the basis on which it could fund itself might perform such a calculation on a basis or bases other than those identified in this Report, reflecting the requirements to which it is subject.

this Report does not seek to pre-empt a number of other issues raised by the Application. Specifically, and without limitation:

a. The examples assume that the Senior Creditor Group's positions on Questions 3, 5 and 6 are correct. However, even if any such position was incorrect, on the examples given, claims in excess of the Judgments Act Rate would still arise.

b. For ease and variation of illustration, but without prejudice to the Senior Creditor Group's position in respect of Question 10 (or any related issue), the examples assume that the original creditor in each case is the "relevant payee" for all purposes. [2] To the extent that an assignee is held to be the relevant payee for all or any part of a period in which a claim was outstanding, we would apply the methodologies set out in this Report to the assignee for that period. In this context it is important to note that, for the reasons set out in this Report, the use of the First Basis would not result in a material difference between the costs of funding of an assignor and an assignee. As stated at paragraph 75 of the Joint Administrators' position paper dated 10 October 2014, such an approach would enable the Joint Administrators to use a single cost of funding as a benchmark for assessing certificates in a given currency.

c. In keeping with the Senior Creditor Group's position in respect of Questions 12 and 13, we assume that the relevant funding would be obtained at the time of default with a term corresponding to the period of time that the claim against LBIE could reasonably be expected to remain outstanding (or, in hindsight, was outstanding). Compelling the payee to use short-term funding to fund a longer-term asset would introduce material additional risk for which it would need to be compensated. Even though short term funding tends to be cheaper than long term funding, enterprises do not generally rely on short term capital to fund long term assets (and, to the extent they do so, other sources of funding demand compensation for taking that additional risk). [3] An enterprise raising funds for an investment lasting multiple years desires certainty with respect to the availability and cost of that funding even though longer-term funding comes at a greater

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[2]   Baupost is an investment fund entity, in respect of which a similar analysis to that set out for the original creditor in our Example 3 would apply, whereas the original creditors in Examples 1 and 2 are corporate entities.

[3]   "W*ith long-term bonds being riskier than short-term bonds, investors only seem to buy them if they get some extra rate of return. Thus, long-term bonds need to offer investors more return on average*." Welch, Ivo: Corporate Finance: An Introduction, Printing Source Inc., 2014, at p. 114.

cost, and should not be forced to bear cost associated with a mismatch in term between its assets and liabilities.[4]

    d.   Without prejudice to the Senior Creditor Group's position in respect of Questions 14-17, the examples do not make any assumption as to whether any information as to a Default Rate that has been given to LBIE does or does not constitute a binding certification, what would constitute such a certification or who may provide it.

    e.   Without prejudice to the Senior Creditor Group's position in respect of Question 37, the examples do not, where relevant (as in the case of Example 3), seek to pre-empt the question of how a debt admitted in respect of an ISDA Master Agreement is to be quantified where it has been admitted on a composite basis together with debts arising under other agreements.

9.   For reasons of confidentiality, references in this Report to each original creditor have been anonymised, subject to any order the Court may in due course wish to make with respect to disclosure of underlying materials to it, or to the parties or expert witnesses.

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[4]   To see this, consider an entity which forgoes this certainty and decides to fund long-term assets with short-term liabilities, thereby creating an asset-liability term mismatch. If the asset in question has a term of five years and the enterprise elects to fund this asset with debt that has a term of only one day, then the enterprise must raise sufficient financing in the debt markets to fund the asset each and every day without fail. If, because of market conditions over the life of the investment the enterprise fails to roll over the debt even once, it will be forced to either liquidate the asset, assuming there is a liquid secondary market for the asset, or default on its debt obligation (unless it can raise additional capital). Furthermore, even if it can raise the requisite short term funding each day, if the rates at which it can borrow rise, this increase could change the financial viability of the investment that the enterprise made. Accordingly, to avoid these risks, an enterprise will need to match the term of its liabilities with that of its assets and pay the associated higher return for longer term funding (be it debt or equity). In this context, it should be noted that the true cost of funding of an enterprise that funds on a short term basis should take account of the cost of the additional risk it assumes by doing so. As this cost can be measured as the difference between short term and long term funding rates, its aggregate cost should in theory be the same as that of the enterprise that funds on a longer-term basis.

FIRST BASIS OF CALCULATION:

COST OF FUNDING THE DEFAULTING PARTY IN THE RELEVANT AMOUNT

10. A defaulted claim against LBIE is an asset belonging to the relevant payee. There is a cost to the relevant payee of holding the defaulted claim in lieu of having the funds that should have been paid to it by LBIE. Put another way, there is a cost to the relevant payee of being forced to fund LBIE in the sum of the relevant amount over the period of LBIE's default.

11. It is a fundamental (albeit not immediately intuitive) principle of corporate finance that the key determinant of the cost of funding borne is the risk and term of the asset being funded. Illustrated simply, the true cost to an enterprise of funding an investment in a risky junk bond is substantially greater than that of funding an investment in an investment grade bond, and those investing in that enterprise will demand a higher expected return if they are bearing additional risk.

12. In the case of LBIE claims, the relevant payee is forced to bear the risk associated with extending credit to an insolvent estate for an indefinite term. There is a material chance that the relevant payee will never be repaid in full, which increases the riskiness of the asset. Market participants demand a high rate of interest for bearing such risk. It is this rate that represents the true cost to the enterprise of funding LBIE over its period of default.

13. This key principle is captured in a widely understood postulate of modern corporate finance that was the subject of a Nobel Prize in economics – the Modigliani-Miller Theorem. The theorem holds that an enterprise's cost of funding an asset does <u>not</u> depend on the type of financing the firm uses to raise capital (e.g. whether the firm uses equity, debt or a mixture of the two) but instead depends on the nature of the asset itself.[5]

14. Specifically, where debt and equity investors fund an enterprise in making a new investment, the Modigliani-Miller Theorem holds that the overall cost to the enterprise of obtaining funding for that investment will remain the same irrespective of the mix of additional debt and equity employed. This is because in each case the investors are exposed to the exact same risk, namely

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[5] In practice, certain factors such as taxes and information asymmetries may give rise to different costs of funding for different enterprises. Nevertheless, the risk of the asset being funded by the enterprise is the key to understanding that enterprise's funding costs.

the risk associated with the investment that is funded. The aggregate cost to the enterprise with respect to funding that investment is therefore exactly the same regardless of its funding mix.

15. Even if an enterprise could fund the acquisition of a risky asset by borrowing money at a low interest rate (for example, because of the overall composition of its assets and the equity cushion behind the new debt), the enterprise's true cost of funding the asset is not simply equivalent to that interest rate.[6] In order to ascertain the incremental cost of funding the risky asset, one must look at the impact the risky asset (and the need to fund it) will have on the enterprise's overall cost of funding – specifically, to account for the increased cost of equity[7] resulting from the increased riskiness of the firm's assets and its greater overall leverage. In short, because the use of debt to fund the amount of a risky asset pushes more risk down to the equity, increasing the cost of such equity, looking only at the interest rate on debt used to fund a risky asset falsely represents and understates the enterprise's cost of funding with respect to that asset.

16. Consistent with these fundamental principles of corporate finance, one can accurately identify the cost to a relevant payee of being forced to fund LBIE in the sum of the relevant amount on the First Basis by reference to the cost to that relevant payee of holding its claim against LBIE as an investment, i.e. its cost of funding with respect to that asset, determined with reference to the risk and term of that asset (the First Basis).

17. It follows that, where a number of different enterprises hold an asset with an identical risk profile – namely, defaulted LBIE claims – there is unlikely (absent some market inefficiency or other external factors) to be a material distinction between their respective true costs of funding the asset. In other words, applying the First Basis to calculate the cost of funding of an enterprise in respect of a defaulted LBIE claim should not produce materially different funding costs,

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[6]   See Berk, Jonathan, and DeMarzo, Peter: Corporate Finance, Pearson Education, Inc., 2007, at p. 439. In a section appropriately entitled "Common Mistake", the authors highlight that this assumption "*ignores the fact that even if the debt is risk free and the firm will not default, adding leverage increases the risk of the equity. Given the increase in risk, equity holders will demand a higher risk premium and, therefore, a higher expected return. The increase in the cost of equity exactly offsets the benefit of a greater reliance on the cheap capital*".

[7]   The cost of equity funding with respect to an investment reflects the minimum post-debt service return on the investment that the enterprise is required to earn in order to compensate its equity funders and thus to attract and retain such funding. To ignore an enterprise's cost of equity in calculating its cost of funding would be tantamount to an assumption that an enterprise that is solely funded by equity has no cost of funding, and therefore suffers no loss by virtue of being kept out of its money. For this reason, it is misconceived to suggest that a relevant payee should calculate its cost of funding solely with reference to a rate at which it could borrow (or, for a relevant payee that is a bank, its weighted average cost of borrowing), regardless of how it is or would actually be funded. As explained in this Report, such an approach ignores the true cost of funding borne by the relevant payee with respect to the default.

irrespective of whether the enterprise holding the claim is a financial institution, a hedge fund or a corporate entity. In turn, it follows that the cost of funding of an assignee in respect of such a claim should not be materially different from the cost of funding of its assignor.

SECOND BASIS OF CALCULATION:
COST OF RAISING A SUM OF MONEY EQUAL TO THE RELEVANT AMOUNT

18. Consistent with the principles outlined above, the true cost to an enterprise of funding a specific asset is the cost of funding attributable to that asset, rather than the cost of funding attributable to all of its assets. Thus, the cost of funding for a specific asset of an enterprise that holds only that asset will be the same as the cost of funding for that same asset of an enterprise that also holds many other assets. The latter enterprise may have a higher or lower overall cost of funding than the former for all of its assets (depending on whether those assets are on average more or less risky than the specific asset), but its cost of funding attributable to the specific asset should be the same as the former's. In other words, the true measure of a relevant payee's cost of funding attributable to a defaulted LBIE receivable will be its cost of funding with respect to that asset rather than all of its assets.

19. An alternative, albeit less precise way of measuring cost of funding, would be to look at the enterprise's overall cost of funding across all of its assets, and attribute that blended cost to the amount in question (the Second Basis). In this context many of the same principles discussed above (the allocation of that cost between debt and equity and the importance of taking account of the latter) are relevant when calculating an overall cost of funding for the enterprise. Using this approach, one would examine the way the enterprise has obtained funding for all purposes (i.e., what percentage is debt rather than equity funding), estimate the funding cost of each component and, based on this analysis, calculate the enterprise's overall blended cost of funding. The result is the enterprise's weighted average cost of capital ("**WACC**"), being the cost of funding a portfolio of all the enterprise's existing investments.[8]

20. Having calculated a relevant payee's overall WACC in this way, therefore, one can use this calculation to measure the cost to the relevant payee of raising an incremental sum of money equivalent to the relevant amount. Although a cost of funding calculated on the Second Basis fails to isolate the specific cost of funding attributable to the defaulted LBIE claim in the way that the First Basis does, the Second Basis accurately captures a relevant payee's average cost of funding across all of its assets (including its defaulted claim against LBIE). This is likely to

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[8]   "*[WACC] is the cost of capital that reflects that risk of the overall business ... we interpret [WACC] as the expected return the firm must pay to investors to compensate them for the risk of holding the firm's debt and equity together…*" Berk and DeMarzo (see note 6 above, at p. 259). For the same reasons discussed in the context of the First Basis, the WACC calculation reflects the fact that it is the enterprise's overall cost of funding that is relevant, and not just its cost of debt (whether marginal or weighted average).

produce a conservative result (i.e. to understate the true cost of funding) where, as will often be the case, the defaulted LBIE claim is riskier than (on average) the other assets of the relevant payee, and thus entails a higher cost of funding than the relevant payee's average cost across all its assets.

21. By contrast to the First Basis, where the Second Basis is adopted there are likely to be distinctions between the respective costs of funding of different relevant payees even though they each hold an asset with an identical risk profile – namely, a defaulted LBIE claim – because the other activities of such enterprises are taken into account in assessing their cost of funding. In turn, it follows that the cost of funding calculated on the Second Basis of an assignee in respect of such a claim may be materially different from the cost of funding of an assignor calculated on the same basis.

EXAMPLE 1 – CORPORATE ENTERPRISE

Nature of the Enterprise and Claim

22. The original creditor ("**OC1**") is an English company which forms part of, and whose business is to provide treasury services to, a major corporate group that manufactures and sells products internationally and reported approximately £3bn in adjusted operating profit in 2014.

23. The relevant claim arose under a 1992 ISDA Master Agreement, pursuant to a termination notice served shortly after LBIE's administration. The claim was assigned to the purchaser, a Baupost special purpose vehicle, in late 2009 in accordance with the provisions of the ISDA Master Agreement. In 2012, the purchaser and LBIE agreed to stipulate the claim at approximately £9,000,000. As a result, dividend distributions were made on the claim as set out on page 69 of Lomas 11, reaching 100 pence in the pound as at 30 April 2014.

24. We explain below why OC1 (assuming it remained the "relevant payee" for the purposes of the ISDA Master Agreement) should be entitled to claim interest pursuant to the Default Rate provision at a rate of higher than 8% simple per annum, regardless of whether its entitlement is asserted on the basis of the First or Second Basis of Calculation discussed above.

First Basis of Calculation

25. As discussed above, the precise way to calculate an enterprise's true cost of funding is with reference to the underlying asset that is being funded. In the case of an asset that is a claim against LBIE in the sum of the relevant amount, the cost of funding such a claim equates to the return required by the market to fund such an asset (or an asset of similar riskiness), and does not depend on the characteristics of the enterprise (or of the funding mix (debt or equity)) that is required to fund the asset.

26. The following sources and methodologies can be drawn upon in order to calculate such a cost:

    a. As noted above, the cost of funding an asset is commensurate with the level of risk associated with the asset in question. By looking at the yield on corporate bonds of comparable risk we can establish a benchmark for the true cost of funding with respect to an unsecured claim against LBIE. Specifically, such a cost can be calculated based on

the Barclays U.S. Corporate Debt and U.S. High Yield Corporate Indices[9] by looking at debt securities with a similar credit quality to LBIE (based on Moody's ratings).[10] Given that LBIE had already defaulted at the time of termination, the Ca-D index is most analogous to the credit quality of an unsecured claim against LBIE.[11] The Ca-D yield was in excess of 20% from the end of June 2007 until mid-September 2009 (and in excess of 20% again after August 2011). For corporate debt rated one rating higher (Caa), the yield to maturity was approximately 16% on 15 September 2008 rising to a high of 32.8% on 16 December 2008. The yield to maturity on Caa corporate obligations only fell persistently below 10% after December 2012.

Average Annual Yield of Barclays's US Corporate Debt

Year	Aaa	Aa	A	Baa	Ba	B	Caa	Ca-D
2006	5.4%	5.5%	5.7%	6.1%	7.4%	8.2%	10.5%	20.2%
2007	5.3%	5.5%	5.7%	6.1%	7.4%	8.3%	10.3%	22.3%
2008	5.3%	5.8%	6.7%	7.3%	9.8%	12.8%	17.6%	42.7%
2009	4.6%	4.7%	5.8%	7.2%	10.3%	12.2%	18.5%	28.7%
2010	3.2%	3.3%	4.0%	4.7%	7.1%	8.4%	11.4%	16.3%
2011	2.9%	3.0%	3.7%	4.4%	6.5%	8.0%	11.0%	17.6%
2012	2.1%	2.2%	2.9%	3.7%	5.9%	7.4%	10.8%	24.8%
2013	2.6%	2.2%	2.8%	3.6%	5.1%	6.5%	8.9%	29.6%

Source: Barclays Live.

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[9] These are widely-used indices provided by Barclays. The U.S. Corporate Index tracks "the Investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market," Barclays, "U.S. Corporate Index," 13 March 2013. The U.S. Corporate High-Yield Index tracks "the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds," Barclays, "U.S. Corporate High-Yield Index," 20 June 2012.

[10] See, e.g., Moody's, "Moody's Rating Symbols & Definitions", June 2009, p. 8 ("*Such ratings . . . reflect both the likelihood of default and any financial loss suffered in the event of default*.")

[11] In assessing the credit quality of an unsecured claim against LBIE, a floor rate would be the rate charged for post-petition finance obtained by LBIE. This is because the risk associated with funding LBIE's post-petition financing (with its priority over pre-administration unsecured claims) will by definition be well below the risk to a counterparty of funding LBIE under a defaulted ISDA Master Agreement. Although the rate at which LBIE obtained post-petition financing is not publicly available, we expect it to have been well in excess of the Judgments Act Rate. A useful comparator in this respect is the rate charged on debtor-in-possession (DIP) financing obtained by LBIE's parent LBHI after it commenced bankruptcy proceedings. The rate charged on LBHI's DIP financing, which was fully funded at par, was 6%-7% plus the LIBOR rate. The LIBOR rate in September 2008 was approximately 3.1%. The DIP financing rate in September of 2008 was therefore approximately 9.1%-10.1%.

Descriptive Statistics of Barclays's US Corporate Debt

Description	Aaa	Aa	A	Baa	Ba	B	Caa	Ca-D
Number of Issues	53	357	2,063	2,566	791	898	452	16
Returns Modified Duration	8.62	6.23	6.95	7.28	4.79	3.55	2.96	2.73
Duration (Mod. Adj.)	8.65	6.28	7.05	7.35	4.84	3.66	3.09	3.03
Yield to Worst	2.61%	2.23%	2.71%	3.28%	4.12%	4.79%	6.56%	24.80%
Maturity	15.17	8.85	10.19	11.08	7.16	6.30	5.94	4.45
Coupon	3.67%	3.09%	4.33%	5.07%	6.14%	7.23%	8.68%	9.76%

Notes: Select statistics data are as of June 30th, 2014.
Sources: Barclays Live.

b. We can use the Caa and Ca-D weighted average yield for 2008 and 2009 of 19.8% as a reasonable estimate of OC1's cost of funding in respect of its unsecured claim against LBIE in the sum of the relevant amount. This approach entails a conservative estimate, as Ca-D corporate debt considered alone would result in a significantly higher rate. Further evidence of the conservative nature of this choice is evidenced by the fact that LBIE claims were trading at distressed levels through 2009, indicating the high level of risk associated with these positions.[12] If, notwithstanding the Senior Creditor Group's position in respect of Questions 12 and 13,[13] one were instead to consider the weighted average yield over the period since the administration date, the yield would be 13.4% – well above the Judgments Act Rate.[14]

c. An alternative methodology would be to observe that an unsecured claim against LBIE is similar in risk to other assets funded by hedge funds that focus on investing in distressed securities. By looking at the returns of these hedge funds we can measure the average returns and by extension the cost of funding associated with these types of assets. Hedge Fund Research Database publishes the HFRI Distressed Restructuring Index which tracks the returns realised by hedge funds investing in distressed assets. Specifically, the index tracks hedge funds that "*employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at*

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[12]   Based upon broker pricing data.
[13]   See paragraph 8(c) above.
[14]   This assumes the claim was outstanding in its entirety over the period; in reality, the exact average would vary depending on the timing of distributions for each claim.

significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings."[15] This index earned an annualised return from January 1990 through August 2008 of 19.11%.[16]

27. Using all or any of these methodologies will yield a cost of funding for OC1 with respect to its claim against LBIE that materially exceeds the Judgments Act Rate. Specifically, OC1 can, acting in good faith and rationally, calculate a cost of funding of at least 13.4%.

Second Basis of Calculation

28. As discussed generally above, an alternative approach to calculating an enterprise's cost of funding with respect to a claim against LBIE is to disregard the fact that an investment in such a claim is particularly expensive to fund, and to assume instead that the cost of funding in this instance is the same as the average cost to the enterprise of funding all of its existing assets. Again, there is a well-established framework for doing so which involves identifying each of the different sources of capital (for example senior debt, junior debt, preferred equity and common equity) and looking at its respective cost. The enterprise's WACC can then be computed by calculating an average of each of these costs, weighting each component according to what portion of the total funding is contributed by that particular type of funding.

29. This basis of calculation assumes that a new asset on a firm's balance sheet would be funded in the same way (on average) as all of the other assets are funded. The use of WACC methodology reflects the fact that enterprises cannot and do not fund their assets solely with debt but must use some other sources of capital as well.[17]

30. The WACC for OC1 as of 23 September 2008 can be calculated based on publicly available information. We have set out our calculation below, which implies a cost of funding of 8.7%.[18]

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[15] HFRI Hedge Fund Indices (https://www.hedgefundresearch.com/pdf/HFRI_formulaic_methodology.pdf).

[16] HFR provides the net return for the funds. These returns have been translated to gross returns assuming the common fee structure of 2% management fee and 20% performance fee using the following: Gross Returns = Net Returns / (1 – 20%) + 2%.

[17] It should be noted that OC1 clearly felt that it had too much debt relative to its equity shortly before the time of LBIE's default, as it actually raised equity in June 2008 to pay down debt. Thus, an assumption that it would have chosen to increase its leverage by borrowing in order to fund assets runs contrary to its actual behaviour.

[18] This method of calculation was endorsed by OC1's management team in an annual report applicable to the period ending 7 days after the termination date, where they explained that when evaluating projects they discounted

WACC Calculation	
Average Cost of Debt	6.1%
Weight of Debt	41%
Cost of Equity	10.4%
Weight of Equity	59%
WACC	**8.7%** [19]

Details of Cost of Equity	Value	Source
Risk Free Rate	4.66%	Bloomberg
Beta	0.71	Bloomberg
Market Risk Premium	8.11%	
Cost of Equity	**10.41%**	

	Value 9/23/08	% of TEV	Source
Total Debt	£12,236	41%	2008 annual report
Market Cap	£17,861	59%	Bloomberg
TEV	**£30,097**	**100%**	

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expected future cash flows using "*an average pre-tax discount rate of 9.7%, in line with the Group's weighted average cost of capital*".

[19] Note that WACC is often calculated incorporating an after-tax cost of debt. This however would not be appropriate here because the cost of funding that we are seeking to calculate is pre-tax and will be subject to taxes. We are trying to consider what rate of post-petition interest is required on a pre-tax basis and hence we must calculate a cost of debt on a pre-tax basis also. In fact if we were to be more precise, the cost of equity reflected in the calculation above should be increased significantly to reflect a pre-tax cost of equity. In this calculation we are conservatively using an after-tax cost of equity, but reserve the right to incorporate the appropriate pre-tax equity calculation.

Cost of Debt	Maturity	O/S Sept 2008	Yield	Source
Bank Loans		£7,421	5.4%	2008 annual report
4.25% notes	2008	£491	5.2%	
7.125% notes	2009	£338	4.0%	
6.875% notes	2012	£357	7.8%	
5.125% notes	2013	£410	6.4%	
4.375% notes	2013	£981	7.5%	
7.25% notes	2014	£592	7.7%	
4.0% notes	2015	£366	7.0%	
5.5% notes	2016	£470	8.1%	
6.25% notes	2018	£210	8.2%	
8.125% notes	2024	£600	8.4%	
Total Bonds		£4,815	7.2%	2008 annual report, Bloomberg
Total Debt		£12,236	6.1%	2008 annual report, Bloomberg

31. OC1's WACC at the relevant time, therefore, exceeded the Judgments Act Rate and comfortably exceeded the Threshold Rate.

EXAMPLE 2 – CORPORATE ENTERPRISE

Nature of the Enterprise and Claim

32. The original creditor ("**OC2**") is a fast-growing agrochemical company with operations in the US, Asia, Europe, Latin America and Africa, specialising in crop protection and life sciences. In 2008 it was acquired by a private equity firm.

33. The relevant claim arose under a 2002 ISDA Master Agreement between OC2 and LBIE dated 12 March 2008, pursuant to a termination notice served shortly after LBIE's administration. The claim was assigned to the purchaser, a Baupost special purpose vehicle, in 2009 in accordance with the provisions of the ISDA Master Agreement. The claim was stipulated in late 2012, for approximately £40,000,000. As a result, dividend distributions were made on the claim as set out on page 69 of Lomas 11, reaching 100 pence in the pound as at 30 April 2014.

34. We explain below why OC2 (assuming it remained the "relevant payee" for the purposes of the ISDA Master Agreement) would be entitled to claim interest pursuant to the Default Rate provision at a rate of higher than 8% simple per annum, regardless of whether its entitlement is assessed on the basis of the First or Second Basis of Calculation discussed above.

First Basis of Calculation

35. As discussed above, the precise way to calculate an enterprise's true cost of funding is with reference to the underlying asset that is being funded. In the case of an asset that is a claim against LBIE in the sum of the relevant amount, the cost of funding such a claim equates to the return required by the market to fund such an asset (or an asset of similar riskiness), and does not depend on the characteristics of the enterprise that is required to fund the asset.

36. For the reasons explained in paragraph 17 above, OC2 could use all or any of the methodologies discussed in paragraph 26 above to calculate a cost of funding on the First Basis with respect to its claim against LBIE that materially exceeds the Judgments Act Rate. Specifically, OC2 could, acting in good faith and rationally, calculate a cost of funding of at least 13.4%.

37. In supplying LBIE with information relating to its cost of funding, OC2 elected instead to utilise the Second Basis of Calculation, as discussed in detail below.[20]

Second Basis of Calculation

38. As discussed above, an alternative approach to calculating an enterprise's cost of funding with respect to a claim against LBIE is to disregard the fact that an investment in such a claim is particularly expensive to fund, and to assume instead that the cost of funding in this instance is the same as the average cost to the enterprise of funding all of its existing assets.

39. In connection with the preparation and submission of the applicable proof of claim, OC2 calculated that its cost of funding for the purposes of the Default Rate definition was 10.4%. Its calculation was based on an analysis prepared by the adviser to its principal equity funder and financial sponsor, who was well-positioned to determine OC2's cost of funding.

40. Separate calculations were performed for funding markets in Japan, New York and England (OC2 operates in over 100 countries and determined that those three were the most relevant equity markets). The results were then averaged to yield an overall WACC. Details of the calculations are set forth in the table below.

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[20]   As previously noted, such discussion is without prejudice to the question of whether OC2, in providing such information, gave a valid and binding certification in that respect.

WAAC Calculation	Japan	US	UK	Average	Note
Cost of Debt	9.3%	9.3%	9.3%		(1)
Corporate Tax Rate	42%	42%	42%		(2)
After-Tax Cost of Debt	5.4%	5.4%	5.4%		
Weight of Debt	35%	35%	35%		
Cost of Equity	14.8%	11.1%	13.2%		
Weight of Equity	65%	65%	65%		
WACC	**11.5%**	**9.1%**	**10.5%**	**10.4%**	

Details of Cost of Equity					
Risk Free Rate	1.30%.	2.42%	3.22%		(3)
Unlevered Beta	0.83	0.83	0.83		(4)
Levered Beta	1.09	1.09	1.09		
Market Risk Premium	12.40%	8.00%	9.20%		
Cost of Equity	**14.80%**	**11.13%**	**13.24%**		

% Debt	35%	35%	35%		(5)
% Equity	65%	65%	65%		
TEV	**100%**	**100%**	**100%**		

(1)   Based on OC2's global credit agreements in place during 2009.
(2)   OC2 uses an after-tax cost of debt in its WACC calculation. Given that the Default Rate gives rise to a pretax receivable, it would also have been reasonable for OC2 to omit this term.
(3)   Based on 2005 - 2007 market conditions.
(4)   Based on average unlevered beta across nine publicly traded agricultural chemicals firms.
(5)   At the time, OC2's financial projections called for the ratio of debt to total capitalisation to materially reduce. This is typical of a company that has been purchased in a leveraged buyout, in which the initial purchase price is heavily debt-funded, and the debt is then paid down out of operating cash flow over a number of years. OC2 averaged its projected annual debt to total capitalisation ratios over the period of 2009 through 2018, which resulted in a ratio of 35%.[21]

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[21]   Given its preference to reduce debt over time, if it had to raise new funding it follows that OC2 would not have elected to increase its leverage by borrowing in order to fund assets, but rather would have preferred to raise equity.

41. OC2's WACC at the relevant time, therefore, exceeded the Judgments Act Rate and comfortably exceeded the Threshold Rate.

EXAMPLE 3 – FUND

Nature of the Enterprise and Claim

42. The original creditor ("**OC3**") was an alternative strategy fund and one of a number of funds managed by a leading discretionary, multi-product global investment manager ("**OC3 IM**") based in London and founded in 1995. OC3 IM managed approximately US$30bn for various investors including pension funds, private banks, Sovereign Wealth funds and high net worth individuals. The funds, including OC3, invested in equity, credit and convertibles, multi-asset investments and fixed income across a variety of geographical locations, and used LBIE for a significant amount of their prime brokerage business. Each fund was managed according to a distinct investment strategy, including equity long-short, mixed-asset long-short, multi-strategy arbitrage, convertible bond, macro and credit long-short. The funds were not, however, in the business of holding illiquid distressed debt.

43. OC3's claims against LBIE arose under a combination of a 1992 ISDA Master Agreement dated 1 September 2004, a Contract for Differences Master Agreement dated 31 August 2004, an International Prime Brokerage Agreement dated 18 October 2004 and a Master Institutional Futures Customer Agreement dated 27 August 2004, each between LBIE and OC3. A significant portion of its total claim is attributable to the ISDA Master Agreement component.[22]

44. A Baupost special purpose vehicle acquired an indirect contingent economic interest in the claim in 2011. All of OC3's unsecured and client money claims were subsequently stipulated on a composite basis for approximately US$30,000,000 and transferred outright to Hutchinson (the Third Respondent) in early 2014. As a result, a full dividend distribution of 100 pence in the pound was made as at 30 April 2014.

45. We explain below why OC3 (assuming it remained the "relevant payee" for the purposes of the ISDA Master Agreement) should be entitled to claim interest pursuant to the Default Rate provision at a rate of higher than 8% simple per annum, regardless of whether its entitlement is asserted on the basis of the First or Second Basis of Calculation discussed above.

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[22] As previously noted, the discussion in this Report does not pre-empt, and is without prejudice to the Question 37 issue of how a debt admitted in respect of an ISDA Master Agreement is to be quantified where it has been admitted on a composite basis together with debts arising under other agreements.

First Basis of Calculation

46. As discussed above, the precise way to calculate an enterprise's true cost of funding is with reference to the underlying asset that is being funded. In the case of an asset that is a claim against LBIE in the sum of the relevant amount, the cost of funding such a claim equates to the return required by the market to fund such an asset (or an asset of similar riskiness), and does not depend on the characteristics of the enterprise that is required to fund the asset.

47. For the reasons explained in paragraph 17 above, OC3 could use all or any of the methodologies discussed in paragraph 26 above to calculate a cost of funding on the First Basis with respect to its claim against LBIE that materially exceeds the Judgments Act Rate. Specifically, OC3 could, acting in good faith and rationally, calculate a cost of funding of at least 13.4%.

48. Support for a cost of funding materially exceeding the Judgments Act Rate is readily observable in the case of OC3, by reference to actual efforts it made to raise funding on the security of its LBIE claims. Together with other funds managed by OC3 IM, OC3 was not in the business of holding illiquid distressed debt, as illiquid investments conflicted with flexible redemption rights it offered its investors. As a result, OC3 sought to divest itself of illiquidity risk in respect of its LBIE claim. Specifically, in July 2009 OC3 attempted to obtain non-recourse financing with respect to its exposure to LBIE (i.e., to raise cash solely upon the recourse to the asset, being its claims against LBIE, without personal recourse to OC3).[23] However, OC3 found that no third party was willing to finance it (or, put another way, to fund the underlying risk represented by its claims against LBIE) on such non-recourse terms.[24]

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[23]   It was reasonable for OC3 and its affiliated funds to seek to borrow on the basis that the lender's recourse was limited to their LBIE claims and not to the fund's other assets. This is because general recourse funding would have raised the funds' cost of equity and other debt capital by increasing the debt to equity ratios of the funds.

[24]   Subsequently, in 2011 and 2012, OC3 and its affiliated funds were able to enter into a series of transactions in which the funds effectively sold the economic benefit of their unsecured LBIE claims, including claims under ISDA agreements, to Hutchinson. Hutchinson's investment was premised (as disclosed to OC3) on the basis that the underlying risk associated with the claims was such that it would require a rate of return on the transaction in the high teens per annum, necessitating a substantial discount to the then estimated recovery value on the claims. In order to sell its interest on that basis, OC3 must have concluded that the economic cost to it of continuing to hold its LBIE claim was greater than the cost to it of divesting itself of its exposure on a discounted basis. For OC3 to have made the sale it must have believed that its cost of funding the relevant amount exceeded the high return that it was foregoing by selling it to Hutchinson at the price that it did.

Second Basis of Calculation

49. As discussed above, an alternative approach to calculating an enterprise's cost of funding with respect to a claim against LBIE is to disregard the fact that an investment in such a claim is particularly expensive to fund, and to assume instead that the cost of funding in this instance is the same as the average cost to the enterprise of funding all of its existing assets.

50. The cost of equity of an investment fund such as OC3[25] reflects the cost of raising investor funding. Investor funding for an investment fund is analogous to equity funding for a corporate enterprise, as the investors bear the residual risk of changes in the value of the fund net of its debt. The cost of equity for an investment fund is the return that the fund must pay in order to persuade investors to leave their money invested in the fund as opposed to withdrawing it and investing it elsewhere (a good measure of this is the return that an investor could earn at a comparable fund).

51. In September 2008, OC3 did not have any borrowings. Accordingly, its cost of funding under the Second Basis was entirely its cost of investor funds.

52. From its inception in September 2004 through December 2008, OC3 delivered its investors an annualised return, net of fees, of 10.7%. According to public filings, between 1997 and 2008 the weighted average annual return for all funds managed by OC3 IM, net of fees, was 10.5%, and the equivalent figure for "alternative strategy funds", of which OC3 was one, was 12.4%. Returns at this level are consistent with those offered by comparable investment funds. In light of historic performance, an investor in OC3 in 2008 would have had a reasonable expectation of continuing to earn this level of return. Accordingly, OC3's WACC was in the range of 10.5% to 12.4% at the time of LBIE's default.

53. OC3's WACC at the relevant time, therefore, exceeded the Judgments Act Rate and comfortably exceeded the Threshold Rate.

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[25]   OC3 is organised as a Cayman limited company, but we will use the terminology of "investor" and "fund" rather than "shareholder" and "company" for consistency with other types of investment vehicle.