No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE)
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

ADMINISTRATORS' SKELETON ARGUMENT

A. INTRODUCTION

1. This skeleton argument is filed on behalf of the joint administrators (the "**Administrators**") of Lehman Brothers International (Europe) ("**LBIE**") for the trial of Tranche C of the Waterfall II Application (the "**Trial**").

2. The Trial is due to start on 9 November 2015 with a time estimate of 7 to 10 days.

3. It is understood that 5 and 6 November have been set aside as reading days. The Court has been provided with a reading list identifying those documents in the hearing bundles that it would be useful for the Judge to read before the trial.

4. The pre-trial review (the "**PTR**") occurred before Hildyard J on 9 October 2015.

5. Since the PTR, the parties have been seeking to agree a timetable for the Trial (the "**Trial Timetable**"). It is hoped that an agreed Trial Timetable will be available shortly.

6. The trial bundle (the "**Trial Bundle**") consists of:

   (1) Core Bundle: key documents including the 1992 and 2002 ISDA Master Agreements;

   (2) Volume 1: Court documents and the parties' position papers;

   (3) Volume 2: witness statements;

   (4) Volume 3: the skeleton arguments;

   (5) Volume 4: evidence of New York law and German law;

   (6) Volume 5: the standard form contractual documents;

   (7) Volume 6: other materials including previous judgments;

   (8) Volume 7: correspondence; and

   (9) Volume 8: transcripts.

7. References below to the Trial Bundle are in the format: [volume/tab] or [volume/tab/page].

8. Appendix 1 to this skeleton argument seeks to identify the common ground between the parties in respect of the ISDA Master Agreements.

B. BACKGROUND

9. The Administrators' PTR skeleton argument **[3/13/4-15]** contained a "Background" section which was intended to assist the Court in putting the Tranche C issues into their broader context. To the extent helpful, the Administrators respectfully invite the Court to refer back to that skeleton argument for the background to Tranche C generally. A short summary is included below.

The surplus

10. The Waterfall II Application has been made by the Administrators in circumstances where there is a substantial surplus in LBIE's administration after paying or providing for the provable debts owed by LBIE in full. The Administrators estimate that the surplus is in the region of £7 billion.

11. In the particular factual circumstances of this case, the existence of the surplus has given rise to numerous issues on which the Administrators require guidance from the Court to enable them to proceed with the distribution of the surplus. The Waterfall II Application was issued by the Administrators so that these issues, which are holding up the distribution of the surplus, can be determined by the Court.

Statutory interest

12. The principal subject matter of the Waterfall II Application is the application of statutory interest, pursuant to rule 2.88 of the Insolvency Rules 1986 (the "**Rules**")[1] [**Core bundle/6**]. The effect of Rule 2.88 is that contractual interest for periods up to the commencement of the administration is provable but post-administration contractual interest is not. Instead, pursuant to Rule 2.88(7), interest is payable on all proved debts, whether or not they carried any entitlement to interest, from the commencement of the

[1] References in this skeleton to a Rule, are references to the provisions of the Rules.

administration[2] to the date of payment or payments of the proved debts. The interest under Rule 2.88(7) is termed "*statutory interest*" and is payable out of the surplus remaining after payment of the debts proved, before such surplus is applied for any other purpose.[3]

13. Rule 2.88(9) provides for statutory interest under Rule 2.88(7) to be payable at the greater of: (a) the rate specified in section 17 of the Judgments Act 1838 on the date when the company entered administration (the "**Judgments Act Rate**"); and (b) the "*rate applicable to the debt apart from the administration*".

14. The Judgments Act Rate on the date when LBIE entered into administration was, as it is now, 8% simple per annum. That rate, which has been significantly in excess of commonly used Sterling market benchmark rates of interest (such as LIBOR) since LBIE entered into administration in 2008, is therefore the minimum rate to which creditors are entitled under Rule 2.88(7).

15. LBIE's creditors may nevertheless seek to establish that the "*rate applicable to the debt apart from the administration*" under Rule 2.88(9) leads to a higher claim for statutory interest than that calculated at the Judgments Act Rate of 8% simple per annum.

Tranche C

16. Tranche C of the Waterfall II Application concerns the construction and effect of ISDA Master Agreements governed by English and New York law and Master Agreements for Financial Derivatives Transactions governed by German law. The Administrators face the prospect of a significant number of creditors contending that these Master Agreements make provision for the payment of interest that is payable at a "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9).

[2] It was held, in Waterfall II, Tranche A, that statutory interest accrues on all debts, including present, contingent and future debts, from the commencement of the administration and ceases to accrue after payment of final dividend. It is possible that, as regards contingent debts, that ruling will be subject to appeal.

[3] This is subject to the possibility of the Supreme Court reversing the Court of Appeal's decision in Waterfall I which determined that LBIE's liabilities under certain subordinated debt agreements are subordinated to the payment by LBIE of statutory interest. Even if the Supreme Court reverses the Court of Appeal's decision, there will still be a surplus after payment in full of the subordinated debt which will be applied in paying statutory interest.

17. The ISDA Master Agreements provide for interest, in the circumstances of the present case, at the "*Default Rate*". The "*Default Rate*" is the rate which applies, *inter alia*, in circumstances in which one of the parties (in this case LBIE) suffers an Event of Default (in this case, LBIE going into administration) and: (a) is responsible for making a payment to the Non-defaulting Party on the closing out of the transactions governed by the ISDA Master Agreement; and (b) fails to make that payment on time.

18. The Default Rate is defined by both the 1992 and 2002 versions of the ISDA Master Agreement 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*".

19. As explained further below, the Tranche C issues involve a number of issues of construction, as to (for example) the identity of the "*relevant payee*" in the case of a claim which has been transferred and the meaning of the term "*cost … if it were to fund or of funding the relevant amount*" as a matter of contractual interpretation.

20. The determination of the Tranche C issues is essential to enable the Administrators to assess creditors' claims to interest out of the surplus. As explained further below, the Administrators seek practical guidance from the Court, in the form of clear principles and guidelines, to enable them to assess creditors' claims for interest at the Default Rate.

<u>The significance of Tranche C</u>

21. A significant proportion of LBIE's debts arise under ISDA Master Agreements and the outcome of the Tranche C issues will have a significant impact on the amount of the surplus the Administrators will be required to distribute in respect of statutory interest.

22. As Mr Lomas explains in his 12th witness statement **[2/8/320]**, "*there are 854 creditors holding admitted claims in the LBIE estate, part or all of which arises under an ISDA Master Agreement or associated Long Form Confirmation. These claims represent approximately £4.4bn of £12.2bn of LBIE's total admitted claims, subject to operation of*

set off within a minority of those claims."[4] The vast majority of the ISDA Master Agreement governed claims exist under the 1992 ISDA Master Agreement.

23. At paragraph 23 of his 13th witness statement **[2/9]**, Mr Lomas states that, as at 7 October 2015, 15 claims under the German Master Agreement have been admitted in an aggregate amount of approximately £311 million.

24. As Mr Lomas explains in his 12th witness statement at paragraph 11 **[2/8/321]**:

> *"The Court's determination of the correct construction of Default Rate will set the parameters in accordance with which the LBIE ISDA Creditors may certify their cost of funding for the purposes of establishing a claim for Statutory Interest. Should it be determined that a creditor's certification may include any cost (to the extent that such cost exists) in raising equity finance (as distinct from debt finance), or that certain approaches to calculating the cost of borrowing are permissible as a matter of principle (in accordance with either the Senior Creditor Group's or Goldman Sachs International's construction), Statutory Interest may be due at a rate significantly in excess of the Judgments Act Rate. Alternatively, should it be determined that a creditor's certification must be limited to the lowest cost of funding available to a counterparty (in accordance with Wentworth's construction), it is likely that all or the substantial majority of the claimants in respect of Default Interest in respect of ISDA Claims will certify a cost of funding of lower than the Judgments Act Rate. For illustrative purposes, should the ISDA Claims of the LBIE ISDA Creditors be awarded Statutory Interest at the Judgments Act Rate of 8% simple, total liability for Statutory Interest payable in respect of the ISDA Claims will be approximately £1.7bn, accruing from 15 September 2008. The Joint Administrators estimate that, should all LBIE ISDA Creditors certify their Default Rate to be 8%, 12% or 18% compound, the total Statutory Interest entitlement of these creditors would be approximately £2.1bn, £3.7bn and £6.8bn respectively*".

25. It is possible that a compound rate of below 8% per annum will produce a greater amount of interest being payable than the Judgments Act Rate. In circumstances where a creditor has a contractual entitlement to compound interest at such a rate, it is common ground that such a rate, which will apply to the creditor's claim to statutory interest, will be the rate applicable to the debt apart from the administration.

[4] The number of admitted claims in the LBIE estate has increased since Mr Lomas' 12th witness statement was filed. The Joint Administrators are preparing further evidence to provide updated data for the Court.

26. It follows that the Court's determination of the ISDA-related Tranche C issues will significantly impact upon the extent of statutory interest payable by LBIE and, in consequence, the amounts (if any) that ultimately will be available to meet non-provable claims, including currency conversion claims, and the subordinated debt claims assuming, as currently held, that these rank behind statutory interest.

27. Even putting to one side the aggregate amount of the claims to statutory interest, it is of significant practical importance for the efficient distribution of the surplus that the Administrators receive clear guidance as to how they should evaluate the cost of funding self-certified by ISDA creditors for the purposes of calculating their respective Default Rates. [5]

The Waterfall II Respondents

28. The most active Respondents in the Waterfall II litigation are: (1) the Senior Creditor Group (comprising the First to Third Respondents) (the "**SCG**"); and (2) the Fourth Respondent ("**Wentworth**"), which is the holder (amongst other things) of the subordinated debt claims against LBIE. In general terms:

    (1) The SCG's objective is to maximise the First to Third Respondents' claims to statutory interest and non-provable liabilities.

    (2) Wentworth's objective (*vis à vis* its interests in the subordinated debt) is to minimise the claims of the non-subordinated creditors to statutory interest and in respect of non-provable liabilities with a view to maximising any surplus available after payment in full of those two categories of claim – so as to make a recovery in respect of the subordinated debt.

[5] In order to assist the Court, the Administrators' team has conducted an analysis of some of the possible approaches to performing a Default Rate interest calculation by using some of the methodologies which are in issue in these proceedings. This analysis is described in the Annex to Mr Lomas' 12th witness statement at pages 1 to 20 of AVL12 **[2/8/325-345]**. The Annex is intended to assist in the illustration of some of the more significant practical implications of hypothetical counterparties adopting particular methodologies when certifying their respective costs of borrowing, including the associated impact this might have on the LBIE estate's liability for statutory interest and the Administrators' distribution of the surplus.

29. Neither the SCG nor Wentworth has been appointed as a representative of a class of creditors under CPR 19.6 or CPR 19.7. Rather, they were joined to the Waterfall II Application in the expectation that they would advance submissions that would take account of the interests of most if not all types of creditor in the estate.

30. The Fifth Respondent ("**York**") is one of five co-participants in unsecured claims against LBIE with an agreed total value of US $676.25 million. York has not advanced any arguments on Tranches B or C and (as matters stand) will not be represented at the trial of the Tranche C issues.

31. The Sixth Respondent ("**GSI**") played no role in Tranches A and B but was joined to the Waterfall II Application on 23 June 2015 for the purpose of advancing arguments in respect of Tranche C Issues 11 to 14 and 27 as per the order of David Richards J of the same date. GSI's joinder was expressly limited to "*the submission of evidence and the making of arguments* ***which do not duplicate those made by the [SCG]***" (emphasis added) [1/7/57]. GSI has claims against LBIE under an ISDA Master Agreement governed by English law.

32. Based on claims and assignments notified to the Administrators, it is the Administrators' understanding that the SCG, Wentworth and GSI hold, in aggregate, approximately 65% of the claims against LBIE which arise under ISDA Master Agreements (with approximately £1.1 billion being held by the SCG, approximately £1.6 billion being held by Wentworth and approximately £0.1 billion being held by GSI).[6]

The Administrators' role

33. The Waterfall II Application was issued by the Administrators so that issues which are holding up the distribution of the surplus can be determined by the Court.

[6] At the hearing of GSI's application to be added as a respondent to the Waterfall II Application, David Richards J. asked Leading Counsel for the Administrators to let him know what GSI's claim was worth. On instructions, Leading Counsel informed the Judge that the claim was worth approximately £80 million. In fact, the value of GSI's admitted proprietary claim is £54.75 million, £29.2 million of that admitted claim being payable under The ISDA Master Agreement. Entities in the Goldman Sachs group have acquired and hold additional non-proprietary claims in the LBIE estate

34. At each stage the Administrators have reviewed the arguments being deployed by the Respondents for the following purposes:

    (1) where the Administrators considered there to be matters of material significance which had not been raised by any of the Respondents or which give rise to an arguable alternative to a common position taken by the Respondents, the Administrators have sought to advance submissions to that effect, in order to ensure that the Court has the benefit of fully developed adversarial argument on these points;

    (2) on those issues where the Respondents are (or were) divided, the Administrators have made submissions where they have considered it necessary to do so in order to ensure that all available arguments, to the extent that such arguments are tenable and material, are before the Court; and/or

    (3) the Administrators have provided relevant further background information or evidence necessary to inform the Court.

35. On some issues in the Waterfall II Application, all the active Respondents have taken the same position and the Administrators have been content not to advance any other position because they do not consider there to be a tenable and material position to the contrary.

36. The Administrators have been, and remain, content to act on directions given by the Court without the appointment of true representative creditors. The Administrators have uploaded all the position papers and witness evidence served by the Administrators and the Respondents onto the LBIE administration website[7]. They have also uploaded, and will continue to upload, the skeleton arguments. Where issues have been agreed between the parties, the Administrators have given notice of the agreed position on the website and invited creditors to contact their team should they have any queries.

[7] It should be noted that many of LBIE's creditors are highly sophisticated entities, have been following the Waterfall applications with close attention and are well-equipped to identify whether all arguments which might affect their interests are being advanced.

37. In respect of Tranche C, the Administrators filed and served two position papers **[1/12/192-255; 1/17/404-422]** identifying additional arguments that were not being pursued by any of the Respondents and making clear that, if no Respondent advanced those arguments at the Trial, the Administrators themselves would do so.

38. It now appears from the Respondents' skeleton arguments that most of the arguments identified by the Administrators are being pursued by one or more of the Respondents and, in those circumstances, subject to some minor exceptions, the Administrators are not currently intending to advance adversarial arguments from the standpoint of any particular constituency. They will, however, keep their position under constant review, including in light of the Respondents' reply skeletons and the oral submissions made at trial.

C. THE COMMON GROUND ON THE ISDA MASTER AGREEMENTS

39. The Respondents' skeletons arguments (particularly those of Wentworth and the SCG) provide significant detail as to the background, purpose and relevant terms of the ISDA Master Agreements. It seems to the Administrators that there is a great deal of common ground between Wentworth and the SCG on these points.

40. To aid the Court's preparation for the trial of Tranche C, the Administrators have prepared Appendix 1 to this skeleton argument, which seeks to set out the points of apparent common ground between the SCG and Wentworth, based on their respective skeleton arguments.

41. Where the SCG or Wentworth have made an apparently uncontroversial statement of fact as to the ISDA Master Agreements, this has also been included in Appendix 1 even though the other has not made an equivalent statement in their own skeleton argument. Except as set out therein, the Joint Administrators agree with the statements set out in Appendix 1.

D. ISSUE 10

42. Issue 10 asks:

> "*Whether, on the true construction of the term 'Default Rate' as it appears in the ISDA Master Agreement, the 'relevant payee' refers to LBIE's contractual counterparty or to a third party to whom LBIE's contractual counterparty has transferred (by assignment or otherwise) its rights under the ISDA Master Agreement*".

43. It is important for the Administrators to know the answer to this issue because, in numerous cases, LBIE's counterparties have sold their claims against LBIE to third party purchasers, pursuant to the express transfer rights in the ISDA Master Agreements, in circumstances where the "*Default Rate*" of interest was continuing to run. The persons who will be claiming interest are those third party purchasers, in their capacity as assignees of the claims against LBIE.

44. The definition of "*Default Rate*" (which is set out in paragraph [18] above) refers to the "*cost ... to the relevant payee (as certified by it)*". The term "*relevant payee*" gives rise to the dispute which is at the heart of Issue 10: is the "*relevant payee*" for the purposes of determining the "*Default Rate*" the transferor (i.e. the original counterparty) or the transferee?

    (1) The SCG contends that the term "*relevant payee*" refers to whichever entity or person was or is entitled to receive payment of the relevant amount from LBIE from time to time, to the period of such entitlement, whether this is the original counterparty to the ISDA Master Agreement or any transferee (SCG's skeleton argument, [90]-[123]) **[3/2/47-64]**. Therefore, for the period before the transfer, according to the SCG's argument, the "*relevant payee*" is the transferor; whilst, for the period after the transfer, the "*relevant payee*" is the transferee.

    (2) Wentworth contends that the term "*relevant payee*" is always the original contracting party to the ISDA Master Agreement and is not a reference to any transferee of the right to payment (Wentworth's skeleton argument, [39]-[77]) **[3/3/14-25]**. According to Wentworth's argument, the identity of the relevant payee does not change as a result of any assignment of rights. Therefore, on

Wentworth's case, even after an assignment, when the relevant amount is payable to the assignee, the "*relevant payee*" for the purposes of determining and certifying the "*Default Rate*" is still the assignor (notwithstanding that he is no longer entitled to receive payment).

(3) GSI's joinder did not extend to Issue 10.

(4) The Administrators had identified additional arguments in their original position paper **[1/12]** but, in the light of the very detailed treatment of the points by Wentworth in its skeleton argument, they do not presently consider that there is any longer a need for them to make submissions on Issue 10.

E. ISSUE 11

45. Issue 11 asks:

> "*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 assets; and/or*
>
> *(4) The actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE*".

46. This is a key issue for the Administrators, as they wish to be guided by the Court on the proper construction of the contractual words "*cost ... if it were to fund or of funding the relevant amount*". To enable creditors to formulate and certify their claims for interest at

the Default Rate, and in order to enable the Administrators to assess whether they are properly payable or not, the parties require practical guidance from the Court as to the proper meaning of these words.

47. Without such guidance, the Administrators will be faced with the prospect of engaging in many years of further litigation with creditors in which the individual claims of creditors to interest at the Default Rate are determined by the Court, with the outer limits of what can fall within the Default Rate definition being determined in a piecemeal fashion on a case by case basis.

48. Not only would that extend the duration of the administration and reduce the amount of the surplus available for distribution, but it would be a course which is inconsistent with the public policy of having financial markets test cases determined, even where there is no present cause of action between the parties to the proceedings, where authoritative guidance from the Court is needed[8].

49. The essence of the question posed by Issue 11 is a request for the Court to identify the essential characteristics of the contractual term "*cost ... if it were to fund or of funding the relevant amount*" (as to which, see paragraph [65] below).

50. Issue 11 presents a series of different possibilities and asks whether, on the proper construction of the contractual words, the definition of "*Default Rate*" is capable of including one or more of them.

Issue 11(1)

51. Issue 11(1) asks whether the contractual words are capable of including the actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount. All of the parties agree that the contractual words are capable of including such a cost. The difference between the parties is that Wentworth contends that the contractual words are limited to such a cost:

[8] See the *Guide To The Financial List* issued on 1 October 2015 at paragraph 9.

(1) The SCG's position is that the expression is capable of including the actual or asserted cost to the relevant payee of borrowing the relevant amount (SCG's skeleton argument, [27]-[68]) **[3/2/16-35]**.

(2) GSI adopts the same position as the SCG (GSI's skeleton argument, [18]-[51] and Appendix) **[3/4/7-25, 33-34]**.

(3) Wentworth's position is that the expression means the price which the relevant payee paid, or would be required to pay, to a counterparty to a transaction to borrow an equivalent sum in the market for the period required "*taking into account all relevant considerations*" (Wentworth's skeleton argument, [78]-[223], especially [85(5)] and [137] et seq.) **[3/3/26-73]**. According to Wentworth's argument, the contractual concept, properly construed, can be no wider than this.

52. If the Court concludes that Wentworth's position on Issue 11(1) is correct, the Administrators respectfully invite the Court to address the question whether, if a creditor has no access to borrowing to fund the relevant amount, its Default Rate is 1% and, if not, how its Default Rate is to be calculated in those exceptional circumstances.

Issue 11(2)

53. Issue 11(2) asks whether the contractual words are capable of including 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. This is the point at which the Respondents' positions diverge more sharply:

(1) The SCG's position is that, subject to the relevant payee's obligation to certify in good faith and rationally, the contractual expression is capable of being construed as widely as formulated in Issue 11(2). According to the SCG's argument, funding includes any source of funding and the cost of that funding includes all costs borne, or which would have been borne, by the relevant payee as a consequence of funding the relevant amount (SCG's skeleton argument, [27]-[68]) **[3/2/16-35]**.

(2) GSI adopts the same position as the SCG. It contends that the expression does not impose any limit on the type of funding that may be certified (GSI's skeleton argument, [18]-[51] and Appendix) **[3/4/7-25, 33-34]**.

(3) Wentworth, by contrast, contends that the contractual expression cannot be construed to include 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. Wentworth's position is that the contractual expression is limited to the price which the relevant payee paid, or would be required to pay, to a counterparty to a transaction to borrow an equivalent sum in the market for the period required (Wentworth's skeleton argument, [78]-[223]) **[3/3/26-73]**.

<u>Issue 11(3)</u>

54. Issue 11(3) asks whether the contractual words are capable of including 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 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. This is another point of dispute:

(1) The SCG's position is that the contractual expression is capable of being construed as widely as formulated in Issue 11(3). According to the SCG's argument, subject to the obligation to certify in good faith and rationally, the determination of the cost of funding may take into account the consequences for the relevant payee of carrying a defaulted LBIE receivable on its balance sheet (SCG's skeleton argument, [27]-[68]) **[3/2/16-35]**.

(2) GSI adopts the same position as the SCG. It contends that the expression is capable of including all of these factors (GSI's skeleton argument, [18]-[51] and Appendix) **[3/4/7-25 and 33-34]**.

(3) Wentworth, by contrast, contends that the contractual expression cannot be construed to include these factors and that the contractual term must be construed in

a more limited way, as set out above (Wentworth's skeleton argument, [78]-[223]) **[3/3/26-73]**.

Issue 11(4)

55. Issue 11(4) asks whether the contractual words are capable of including the actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE. It seems that no party is contending that the contractual expression should be construed in this way.

    (1) Although the SCG is contending in respect of Issue 11(3) that the determination of the cost of funding may take into account the consequences for the relevant payee of carrying a defaulted LBIE receivable on its balance sheet (SCG's skeleton argument, [27]-[68]) **[3/2/16-35]**, the SCG is not maintaining any free-standing argument in respect of Issue 11(4).

    (2) GSI does not adopt a position on Issue 11(4) (GSI position paper, [10(4)]) **[1/13/266]**.

    (3) Wentworth contends that Issue 11(4) should be answered in the negative (Wentworth's skeleton argument, [78]-[223]) **[3/3/26-73]**.

The Administrators' position on Issue 11

56. Whilst the Administrators had identified a number of additional arguments in their reply position paper **[1/17/404-422]**, it now appears that Wentworth will be advancing those arguments. Accordingly, on the assumption that Wentworth does not change course at the Trial, the Administrators do not presently propose to make any substantive submissions of an adversarial nature in respect of Issue 11.

57. There are two particular points which the Administrators wish to bring to the Court's attention.

58. First, in respect of the argument by GSI that the regulatory capital requirements of regulated financial institutions are part of the factual matrix against which the ISDA Master Agreements should be construed, the Administrators draw the Court's attention to an authority which does not yet seem to have been identified by any of the parties. This is the decision of Briggs J in *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718 (Ch), in a decision which was upheld by the Court of Appeal. Briggs J identified the submissions that were advanced to him:

> "*[17] Mr Nash made a number of additional submissions in support of LBSF's case on construction … The first was that I should approach the interpretation of the Master Agreement upon the basis of a matrix of fact which included an awareness that the capital adequacy requirements of most bank participants in ISDA agreements were such as to prohibit the inclusion of what are known as 'walk-away clauses'…*
>
> *[18] … Mr Nash submitted that, because in the vast majority of contracts incorporating the ISDA Master Agreement , one or both parties will be banks, with regulatory requirements as to capital adequacy, an understanding that such requirements precluded walk-away clauses would be part of the background knowledge 'reasonably available to the person or class of persons to whom the document is addressed'…*"

59. Briggs J rejected that argument for the following reasons:

> "*[23] For present purposes I am prepared to assume, but without deciding, that the interpretation of Section 2(a)(iii) for which Carlton contends … would make it a walk-away clause, and that those responsible for its appraisal in a regulated bank may generally be assumed to have thought otherwise, to the extent that they gave the matter any conscious consideration.*
>
> *[24] But that assumption comes nowhere near justifying the inclusion, as part of the relevant matrix of fact, of the regulatory and capital adequacy underlay for the proposition that a regulated bank would be unlikely to intend to contract under the Master Agreement on the basis that Section 2(a)(iii) was a walk-away clause. My reasons follow.*
>
> *[25] First, it is by no means typical that both parties to a Master Agreement will be banks, let alone regulated banks. More typically, banks will sell swaps and other financial derivatives on ISDA terms to non-bank customers which, like Carlton and all the respondents in the Firth Rixson case, will as consumers of those derivatives, leave the regulatory capital implications of their sale by regulated banks to be dealt with by the banks, rather than investigated as a matter of mutual interest or concern.*

[26] Using Lord Bingham's language in the Dairy Containers case, the "person to whom the document is addressed" in a typical bank/customer swap transaction is not the bank but the customer. The bank will typically be a member of ISDA and the proponent of the Master Agreement as containing the terms governing the swap. Of course, the customer may well be a sophisticated commercial enterprise, but I consider it unrealistic to suggest that non-bank customers as a class should be regarded as having the banks' regulatory capital concerns as part of the 'background knowledge which is reasonably available' for the purposes of construction. Thus while I accept Mr Nash's submission that it may be insufficient for a particular member of the class of person to whom a document like the Master Agreement is addressed to plead ignorance of some reasonably available background facts, the application of the objective approach of the Privy Council in Dairy Containers takes his case no further…

[28] Secondly, Mr Nash's submission comes unacceptably close to an attempt to treat as part of the matrix of fact the subjective intentions and expectations as to the meaning of the contract likely to be entertained by one class of typical party, i.e. regulated banks. It is no part of the function of the admissibility of the matrix of fact to be used in that way."

60. Secondly, the Administrators wish to ensure that the debate in respect of the proper construction of the contractual words is conducted on terms that will provide real assistance to the Administrators in the performance of their duties in respect of the distribution of the surplus.

61. In this context, the Administrators have two particular concerns.

62. First, the Administrators are concerned by the suggestion from the SCG and GSI that the Court should not 'read down' the contractual words by defining them or spelling out what they mean (SCG's skeleton argument [34] and [37]) **[3/2/18-19]**, (GSI's skeleton argument [21] and [59]) **[3/4/7-8 and 31]**. The Administrators are concerned that such an approach would undermine the purpose of Tranche C, which is to obtain the Court's guidance on the Tranche C issues in order to enable the Administrators to address the obstacles which stand in the way of a distribution of the surplus. The parties have always proceeded on the basis that the issues in Tranche C, including Issue 11, raise questions of construction, which are properly capable of being decided without reference to the facts of any particular case.

63. If the Court is persuaded that the words have a narrower meaning than that for which the SCG or GSI contend, then it would assist the Administrators for the Court to make that

clear in its judgment. As explained above, it is of critical importance to the Administrators that the Court provides as much practical guidance in addressing these issues as is possible. They wish to be able to distribute the surplus at the earliest opportunity while minimising the cost of the process.

64. Secondly, the Administrators are concerned that the debate between the Respondents in terms of "*debt*" versus "*equity*" will not always be a helpful or illuminating one. It seems that even the true meaning of those terms may be subject to argument. For example, GSI contends that there is no clear-cut division between debt and equity: it says that many instruments of modern corporate financing are hybrid instruments which share characteristics of both. Wentworth's response is to say that the *"equity-like"* characteristics of hybrid instruments must be stripped out so that only the *"debt-like"* aspects remain, but this task could present difficulties for the Administrators, particularly as the relevant instrument might have been entered into outside this jurisdiction giving rise to even greater difficulties in identifying the characteristics of foreign law governed obligations.

65. To address these concerns, the Administrators consider that it would be particularly helpful for the Court to consider the following points in respect of the construction of the contractual concept of "*cost … if it were to fund or of funding the relevant amount*" which derive from the skeleton arguments filed by the Respondents:

    (1) whether the relevant 'cost' must involve the incurring of an obligation (whether actual or hypothetical) to pay a sum of money;

    (2) whether any such obligation must be incurred when obtaining the funding and as part of the bargain entered into to obtain such funding;

    (3) whether a cost is incurred if any payment obligation is itself discretionary;

    (4) whether a cost is incurred if the amount of any payment obligation is itself discretionary;

(5) whether the cost must be the cost of funding the relevant amount to address the cash shortfall caused by the non-payment, or whether it can be the cost of funding some other amount for other or wider purposes;

(6) whether the cost of funding the relevant amount includes any loss of profits or consequential losses resulting from the non-payment of the relevant amount;

(7) whether the cost of funding the relevant amount includes any professional or arrangement fees incurred by the relevant payee in putting the funding in place; and

(8) whether the cost of funding includes only the lowest cost of funding available to the relevant payee on reasonably acceptable terms.

66. By considering these points, the Administrators consider that the Court could provide helpful practical yardsticks to assist the Administrators and the creditors in obtaining a proper understanding of the meaning and application of the contractual words.

67. The Administrators' observations in respect of these points are set out below.

(1) Whether the relevant 'cost' must involve the incurring of an obligation (whether actual or hypothetical) to pay a sum of money

68. It would be of great assistance for the Administrators to know whether the contractual concept of a 'cost' involves an obligation to pay a sum of money, i.e. a price.

69. This issue arises from Wentworth's submission that a cost involves an obligation to pay a sum of money in discharge of a price (Wentworth's skeleton argument, [108]-[136]) **[3/3/34-42]**. By contrast, the SCG appears to contend that a cost does not have to involve a monetary obligation to pay a price, or even the incurring of a financial detriment.

70. In considering this point, the Administrators have identified some further authorities which they invite the Court to consider in this context.

71. In *Ferrier v. Scottish Milk Marketing Board* [1937] AC 126, Lord Atkin said at 130:

> "*'Costs of operating the scheme' in ordinary language must mean expenditure or liability which, if not recouped, would fall upon the board; they cannot include, in my opinion, sums which represent no expenditure or liability of anyone but which are levied upon all milk producers*".

72. Lord MacMillan held at 137:

> "*The critical words in the present case — 'the costs of operating the scheme' — are, in my opinion, quite inapt to cover the compensatory levy which the appellant challenges. That the respondents obtain a lower price for milk sold for manufacturing purposes than is obtained for milk sold in the liquid market is doubtless the case. But this is an incident of the scheme, not a 'cost' of operating it. They have not incurred any 'cost' by selling milk in the manufacturing market. There has been no disbursement on their part. At most it can only be said that they have received a less return for the milk of which they have so disposed than they would have received if they had disposed of it in the liquid market. But I cannot find any justification ... for construing the words 'the costs of operating the Scheme' as including this difference of price*".

73. In *Litherland Urban District Council v Liverpool Corporation* [1958] 2 All ER 489, Harman J appears to have accepted at 492 that "*cost"* ordinarily means the same thing as "*expenditure*" as a matter of everyday language.

74. In *Ex p Brierley, Re Elvidge* (1947) 47 NSWSR 423, Jordan CJ held at 427 that the word "*cost*" generally means the price paid for a thing or the expenses incurring in bringing into existence, or obtaining, a thing.

(2) Whether any such obligation must be incurred when obtaining the funding as part of the bargain entered into to obtain such funding

75. It would be of real practical assistance for the Administrators to know whether, according to the definition of "*Default Rate*" (properly construed), the cost must be incurred at the same time as the obtaining of the funding, as part of the bargain entered into to obtain the funding.

76. This issue arises from Wentworth's reliance on the concept of a ***transaction*** to fund the relevant amount (Wentworth's skeleton argument, [93]-[103]) **[3/3/32-34]**.

77. This is to be contrasted with the position adopted by the SCG and GSI, which is (apparently) that dividends on ordinary shares can be a cost of funding.

78. In the case of ordinary shares, there is, at least as a matter of English law, no legally enforceable obligation to pay dividends. Rather, a shareholder is entitled to a dividend if, and only if, a dividend is duly declared. This is discretionary: Article 30(2) of the current version of Table A provides: "*The company may by ordinary resolution declare dividends*". The company is not under a legal obligation to do so.

79. It is not clear to the Administrators, despite having made requests of the SCG and GSI for further information relating to this issue (the responses to which are at **[7/1/178-181]** and **[7/1/187-192]**), what it is that is said to constitute a "***cost*** *of equity*" for these purposes and how the issuance of ordinary shares, for example, is said to give rise to any liability on the part of the issuer (as opposed to creating an expectancy in favour of the shareholders) at the time that the shares are issued.

80. In addition to the relevant authorities on this point cited by Wentworth in paragraphs 149 to 153 of its skeleton argument **[3/3/45-47]**, the Administrators draw the Court's attention to *Irvine v Irvine (No.1)* [2007] 1 BCLC 349 at 421 per Blackburne J:

> "*Mr Todd submitted, correctly, that in law the divisible profits of a company belong to the company itself (as part of its property) and not to its shareholders and that the only right or entitlement of a shareholder in relation to any dividend (absent any rights attaching the shares set out in the company's articles – and there were none in the case of CIHL) is that conferred by the provisions of Table A (incorporated with modifications, as I have mentioned, into the articles of CIL and also into those of CIHL), in particular regs 114 to 122. So far as material, those provisions only entitle shareholders to such dividends as may be declared by CIHL in general meeting and then only up to an amount not exceeding that recommended by the directors (see reg 114) or, in the case of an interim dividend, as may be paid by the directors (see reg 115)*".

(3) Whether a cost is incurred if any payment obligation is itself discretionary

81. It would also be of real practical assistance for the Administrators to know whether, according to the definition of "*Default Rate*" (properly construed), the payment constituting the "*cost*" (or the incurring of the obligation to make it) can be discretionary,

in the sense of being something that the person making it chooses to do, without being under any enforceable obligation to do it.

82. This issue arises from Wentworth's submission that a cost is the amount that the relevant payee is required to pay, not that it could choose to pay (Wentworth's skeleton argument, [137]-[144]) **[3/3/42-44]**.

83. The Administrators note that, in many cases involving borrowing, the relevant obligation to pay a cost may be an absolute obligation, such as an obligation to pay 5% per annum in any event for as long as any part of the loan is outstanding.

84. However, even in the case of borrowing, the obligation to pay the cost may, in some cases, be contingent or conditional. For example, a coupon on bonds payable only when the issuer is profitable for two consecutive quarters.

85. A purely discretionary payment may be in a different category.

86. It would be of real assistance for the Administrators to know whether a discretionary payment, such as the declaration and payment of dividends on ordinary shares, could constitute a "*cost … if it were to fund or of funding the relevant amount*" for the purposes of the definition of "*Default Rate*".

(4) Whether a cost is incurred if the <u>amount</u> of any payment obligation is discretionary

87. This is a further point in respect of which it is hoped that the Court will be able to provide practical assistance to the Administrators.

88. It arises in connection with the debate between the parties in respect of dividends on ordinary shares, the quantum of which is a matter for the board, and raises similar questions to those considered under (3) above. The focus here however is not on the discretionary nature of the incurring of the liability to pay, but on the fact that the ***amount*** of the payment is at the discretion of the relevant payee.

89. A fixed price for funding (for example, 5% per annum) is properly capable of being described as a cost. The same is true of a price that is ascertainable on the basis of fixed rules (for example, 2% above LIBOR). By contrast, an amount which the relevant payee decides, in its discretion, to pay would seem to be in a different category. Dividends on ordinary shares are a case in point. The ***amount*** of the dividend is within the discretion of the board, which, even if it chooses to declare a dividend, may decide to distribute all, or only part of, the distributable profits made during the relevant period. The amount of the distributable profits distributed by way of dividend will depend on an almost infinite number of factors.

90. It would therefore be of real utility to the Administrators for the Court to consider whether, as a matter of construction, the "*cost ... if it were to fund or of funding the relevant amount*" for the purposes of the definition of "*Default Rate*" is capable of including a payment of such ***amount*** as may be awarded to the funder in the exercise of the relevant payee's discretion.

(5) Whether the cost must be the cost of funding the relevant amount to address the cash shortfall caused by the non-payment, or whether it can be the cost of funding some other amount for other purposes

91. This is another point on which the Court's construction of the contractual words would provide real practical assistance to the Administrators.

92. The issue arises in connection with Wentworth's contention that the contractual words envisage a transaction to fund a sum of money equal to the amount owed under the ISDA Master Agreement (Wentworth's skeleton argument, [104]-[107]) **[3/3/33-34]**.

93. Like the other points in respect of Issue 11, the issue is an issue of construction in respect of the contractual words, which provide that the relevant cost is the cost "*if it were to fund or of funding* ***<u>the relevant amount</u>***" (emphasis added). The relevant amount is the amount that has not been paid. The question arises whether the cost of funding the relevant amount is the cost of funding that amount or whether it can be the cost (or a proportionate part of the cost) of funding a larger amount or a multiple of the cost of funding a smaller amount.

94. It may be helpful to consider a practical example of a case in which (a) the relevant amount is $10 million, (b) the relevant payee's cost of borrowing $10 million is 5% per annum, and (c) it would cost 10% per annum for the relevant payee to borrow the substantially larger sum of $100 million. In such a case, it might be said that the relevant payee's cost if it were to fund or of funding the relevant amount of $10 million is 5% per annum and that the Default Rate is therefore 6% per annum. The question is whether, in those circumstances, the relevant payee could rely on its cost of borrowing a sum that is materially in excess of the relevant amount to claim a Default Rate of 11% per annum. It would be of real assistance for the Court to provide guidance to the Administrators as to the true position in such a case.

95. In this regard it would also be helpful for the Court to consider whether there must be a causal link between the cash flow deficiency caused by LBIE's non-payment of the specific sum due under the ISDA Master Agreement and the funding to remedy that particular cash flow deficiency.

96. Put another way, the question is whether the relevant cost is the cost of funding the relevant amount for the purpose of remedying the cash shortfall produced by the non-payment of the relevant amount, or whether it is the cost of raising funds for other or general purposes.

(6) Whether the cost of funding the relevant amount includes any loss of profits or consequential losses resulting from the non-payment of the relevant amount

97. It would be of real practical assistance for the Administrators to know whether, properly construed, the relevant payee's "*cost ... if it were to fund or of funding the relevant amount*" could include any loss of profits or consequential losses resulting from the non-payment of the relevant amount.

98. This issue arises in connection with Wentworth's contention that losses consequent upon LBIE's default are outside the cost of funding language (Wentworth's skeleton argument, [162]-[164]) **[3/3/50-51]**.

99. The question for the Court is essentially whether, on the proper construction of the contractual words, the relevant payee's right to receive the Default Rate is or includes a right to claim damages by way of compensation for any loss of profits or consequential losses resulting from non-payment of the relevant amount.

100. The Administrators consider that it may be relevant for the Court to consider, in this context, the closely related question of whether, under the ISDA 1992 Master Agreement, a party's losses resulting from the non-payment of the relevant amount are capable of falling within the definition of "*Loss*". As to this:

(1) According to the definition of "*Loss*" in Section 14, the "*Loss*" amount payable under Section 6(e) will include the Non-defaulting Party's "*total losses ... in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, including any loss of bargain*".

(2) In respect of Loss, the "*objective is to ascertain what amount is necessary to put that party in the position it would have been in if the terminated transactions had been fully performed (i.e. on the assumption that no Event of Default would have occurred)*": Firth, *Derivatives Law & Practice*, paragraph 11-142, citing *Lomas v JFB Firth Rixson Inc* [2012] 2 All ER (Comm) 1076 and *Pioneer Freight Futures Co Ltd v TMT Asia Ltd* [2011] 2 Lloyd's Rep 96 at paragraphs 109–117.

(3) It might be said that losses arising from the default and consequential termination of the transaction will ordinarily fall within the broad scope of the "*Loss*" clause and that, by contrast, the interest rate payable under the "*Default Rate*" serves the different purpose of compensating the payee for the late payment of the close-out amount. It could be said that this latter purpose is inconsistent with any attempt to include, in the calculation of the Default Rate, any losses arising from the termination of the transaction, which properly fall within the "*Loss*" clause.

(4) However Wentworth contends that consequential detriment is not recoverable as part of "*Loss*" due to the exclusion in Section 6(e)(iv) of the 1992 ISDA Master Agreement (Wentworth's skeleton argument, [165]) **[3/3/51]**.[9]

101. In the context of the debate about the meaning of "*Default Rate*" (and, in particular, whether those words do or do not include, as a matter of construction, any loss of profits or consequential losses resulting from the non-payment of the relevant amount), it would therefore be very helpful for the Administrators if the Court could consider the interrelationship between the "*Loss*" measure of the close-out amount and the concept of the "*cost ... if it were to fund or of funding the relevant amount*".

102. It would also be helpful if the Court could consider the same point in respect of the 2002 ISDA Master Agreement, which, rather than referring to the 'loss' of the Non-Defaulting Party, provides instead for a "Close-out Amount" in Section 14. The Close-Out Amount in the 2002 ISDA Master Agreement involves the concept of "*replacing or … providing ... the economic equivalent of ... the material terms*" of the terminated transaction. The Court is therefore asked to consider whether the types of losses that the SCG and GSI seek to claim as part of the Default Rate are actually claimable as part of the Close-Out Amount and, if not, what implications this has for the parties' arguments.

(7) Whether the cost of funding the relevant amount includes any professional or arrangement fees incurred by the relevant payee in putting the funding in place

103. This is another point on which the Administrators require the Court's assistance to enable them to deal with creditors' claims to interest at the Default Rate.

104. It arises from the debate between the SCG and GSI on the one hand and Wentworth on the other hand as to whether professional or arrangement fees incurred in putting the funding into place fall within the contractual words, properly construed.

(1) Wentworth contends that professional fees are a cost of professional services, not a cost of funding. Wentworth's case is that the cost of funding is the consideration

[9] The same question would arise in connection with Section 6(e)(v) of the 2002 ISDA Master Agreement.

payable to the lender for the time value of money, i.e. the interest (Wentworth's skeleton argument, [135]) **[3/3/42]**.

(2) The SCG and GSI appear to disagree [**7/1/178-181 and 187-192]**.

105. It would be of real practical benefit if the Court could resolve this point.

(8) Whether the cost of funding includes only the lowest cost of funding available to the relevant payee on reasonably acceptable terms

106. Finally, the Administrators would also be greatly assisted if the Court could rule on Wentworth's argument that the cost must be the lowest cost.

107. Wentworth's argument is that, as a matter of construction, a cost of a thing cannot include any element above or beyond the price which is necessarily incurred to obtain it.

108. This issue is particularly important in circumstances where, as illustrated by the Annex to Mr Lomas' 12th witness statement at pages 1 to 20 of AVL12 **[2/8/325-345]**, different types of funding available in the market may give rise to vastly different costs. In the case of Counterparty C **[2/8/334]**, for example, Hypothetical 4 (short term floating rate (O/N) + CDS (6M) + Liquidity premium (Nil)) gives rise to a Default Rate of 5.6% per annum, whereas Hypothetical 6 (Long term fixed (known coupon) + CDS (5Yr) + Liquidity premium (Nil) gives rise to a Default Rate of 11.3% per annum.

F. <u>ISSUE 12(1)</u>

109. Issue 12(1) asks:

> *"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?"*

110. This issue seems to be agreed:

(1) Wentworth has said that, when determining the hypothetical cost of borrowing the relevant amount, the lender should be assumed to have recourse to the relevant payee's assets generally and not solely to its claim against LBIE (Wentworth's skeleton argument, [225(1)]) **[3/3/74]**.

(2) GSI agrees with Wentworth (GSI's skeleton argument, Appendix) **[3/4/35]**.

(3) The SCG has said that when determining the hypothetical cost of borrowing the relevant amount, the lender should ordinarily be assumed to have recourse to the relevant payee's assets generally and that recourse limited to the relevant payee's claim against LBIE would be appropriate only where the claim against LBIE is the relevant payee's only asset (SCG's skeleton argument, [73]-[74]) **[3/2/37-38]**. However, in that latter case, the relevant payee's claim against LBIE represents the entirety of the relevant payee's assets; and the SCG's proviso therefore appears to involve a distinction without a difference.

G. ISSUE 12(2)

111. Issue 12(2) is:

> "*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:*
>
> ...
>
> *(2) ... 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 its borrowings?*"

112. This Issue is not agreed and the Respondents have adopted divergent positions:

(1) The SCG's position is that the relevant payee should make a rational and good faith determination of its incremental cost of funding which may be by reference to

weighted average cost of all its borrowing or capital (SCG's skeleton argument, [75]-[76]) **[3/2/38-40]**.

(2) GSI adopts the same position as the SCG. It says that 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. (GSI's skeleton argument, [52]-[59]) **[3/4/25-31]**.

113. Wentworth adopts a different view: it says that the relevant contractual wording is inconsistent with a measure of that "*cost*" in terms of an incremental (increase) to an average cost of borrowing or the weighted average cost on all its borrowings (Wentworth's skeleton argument, [225(2)]) **[3/3/74]**. As set out above, Wentworth's position is that the expression refers to the price which the relevant payee paid, or would be required to pay, to a counterparty to a transaction to borrow an equivalent sum in the market for the period required "*taking into account all relevant considerations*" (Wentworth's skeleton argument, [78]-[223], especially [85(5)] and 137 et seq.) **[3/2/26-73]**.

114. The Administrators had identified what appeared to be additional arguments in their position paper on Issues 11-13 **[1/17/404-422]** including that the "cost" of funding is the cost of funding the additional amount required as a result of non-payment (and not the cost of funding the existing debt of the relevant payee, which is irrelevant) **[1/17/417]** but, in the light of the arguments now advanced by Wentworth in its skeleton argument, which mirror the arguments contained in the Administrators' position paper on Issues 11-13, it appears that all tenable and material available arguments are being advanced on Issue 12(2) and, in the circumstances, there is no longer any need for the Administrators to add anything in the nature of adversarial argument.

H. ISSUE 12(3)

115. Issue 12(3) is:

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

116. Issue 12(3) is closely related to Issue 11 and, for the reasons identified above in respect of Issue 11, it is important for the Administrators to understand whether the impact on the cost of the relevant payee's equity capital is properly part of the "*Default Rate*" as a matter of construction.

117. The Respondents are adopting divergent positions:

(1) The SCG's position is that, depending on the particular facts and circumstances, it may be rational and in good faith for the relevant payee to include in its determination any additional impact that obtaining additional funding has on the cost of other sources of funding (SCG's skeleton argument, [77]-[78]) **[3/2/40]**.

(2) GSI adopts a very similar position. It says that, subject to the requirement to act in good faith and rationally, the "*cost*" may take into account any impact on the relevant payee's cost of regulatory capital including equity capital attributable to raising the additional funding (GSI's skeleton argument, [52]-[59]) **[3/4/25-29]**.

(3) Wentworth adopts the opposite stance. It argues, consistent with its position on Issue 11, that the "*cost*" in the definition of "*Default Rate*" cannot be construed to include any impact on the cost of the relevant payee's equity capital attributable to such borrowing (Wentworth's skeleton argument, [225(3)]) **[3/3/75]**.

118. The Administrators had identified arguments in their reply position paper **[1/17/404-422]** but, in the light of the arguments advanced by Wentworth in its skeleton argument, it appears that all tenable and material available arguments are being advanced on Issue 12(3) and, in the circumstances, there is no longer any need for the Administrators to add anything in the nature of adversarial argument.

I. <u>ISSUE 12(4)</u>

119. Issue 12(4) is:

> "*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:*
>
> ...
>
> *(4) Is the cost to be calculated based on obtaining:*
>
> *(i) Overnight funding;*
>
> *(ii) Term funding to match the duration of the claim to be funded; or*
>
> *(iii) Funding of some other duration?*"

120. Issue 12(4) now appears to be largely agreed:

    (1) The SCG says that, depending on the circumstances, it may be rational and in good faith to certify on any of these bases (SCG's skeleton argument, [79]-[82]) **[3/2/41-43]**.

    (2) GSI says that the cost may be calculated based on any of these bases (GSI's skeleton argument, [52]-[59]) **[3/4/25-31]**.

    (3) Wentworth appears to agree. It says that no particular tenor is prescribed for any transaction to borrow the relevant amount (Wentworth's skeleton argument, [225(4)]) **[3/3/75]**.

121. The only live point on Issue 12(4) arises in connection with the Administrators' contention in their position paper on Issues 11-13 **[1/17/404-422]** that, since no relevant payee could have known how long it would take for LBIE to make payment in full, the actual length of that period (as opposed to a good faith estimate of it) is not something which could properly be taken into account by any counterparty performing a rational certification for these purposes (see paragraphs 27(5)(iii) and 30(2)-(3) of the Administrators' position paper on Issues 11-13) **[1/17/415 and 418-420]**.

(1) The SCG agrees with the Administrators on this point: it "*agrees that no relevant payee could have known that LBIE's unsecured debts would ultimately be paid in full or precisely how long that would take to occur*" (SCG's skeleton argument, [82(3))] **[3/2/42]**.

(2) GSI takes a different view. Whilst agreeing that, 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)*", GSI contends that this is "*not impossible*" (GSI's skeleton argument, [58(3)(c)]) **[3/4/29]**.

122. GSI's contention is wrong:

(1) When LBIE entered administration, it was not anticipated that the general body of unsecured creditors could be paid in full.

(2) It was not until early 2012, as a result of progress made by the Administrators in resolving the LBIE estate, that the possibility of a surplus started to be discussed in the market.

(3) On 26 November 2012, the Administrators gave notice of their intention to pay a first interim dividend of 25.2 pence in the pound[10].

[10] Paragraph 65 of Schedule B1 to the Insolvency Act 1986 permits the administrator of a company to make distributions to creditors of the company, with the permission of the court where the creditors are neither secured nor preferential. Once an administrator gives notice of an intention to make a distribution, the administration is

(4) In their ninth progress report for the six month period to 14 March 2013, published in April 2013, the Administrators provided for the first time illustrative outcome estimates indicating a potential surplus in an illustrative high case scenario.

123. The reality, therefore, is that, contrary to GSI's suggestion, no relevant payee could have known that LBIE's unsecured debts would ultimately be paid in full or precisely how long that would take to occur. It follows that the actual length of that period (as opposed to a good faith estimate of it) is not something which could properly be taken into account by any counterparty performing a rational certification for these purposes.

124. The Court is asked to conclude that, on the particular facts of this case, contrary to GSI's contention, borrowing to match the precise length of time in which the debt was outstanding is not an appropriate type of funding for these purposes.

J. <u>ISSUE 13</u>

125. Issue 13 is:

> "*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*".

126. This raises issues of real practical importance for the Administrators where a creditor certifies its cost of funding on the *"if it were to fund"* basis.

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commonly referred to as a distributing administration. Detailed provisions related to the making of distributions to creditors by administrators are contained in Rules 2.68-2.105. The Administrators received the Court's permission to make such distributions by Order dated 2 December 2009.

127. Whilst previously it seemed that the parties were adopting divergent views, it is now apparent that their positions have converged to the point where there seems to be no real disagreement on Issue 13. In particular, the SCG is not pursuing what had been described as its ‘snapshot’ argument; and Wentworth is no longer saying that the certification can take place only after payment in full.

128. The common ground seems to be that a relevant payee is not entitled to use hindsight to say how it would have obtained funding (e.g. the type and duration of funding it would have used); rather, that determination must be made as at the position when the need to obtain the funding arose, ignoring subsequent events. However, the facts of subsequent events must be taken into account to calculate the costs that would have arisen as a result of those (hypothetical) funding decisions.

129. The parties describe this position using slightly different language, but it seems that they share the view of the common ground described above:

(1) The SCG says that, when determining the funding it would have raised (including the basis and duration of that funding), the relevant payee should certify on the basis of what it would have done on the date the early termination amount fell due and, where applicable, at all times thereafter. The SCG says that events which shed light on the cost it would have incurred can be taken into account (SCG’s skeleton argument, [83]-[89]) **[3/2/43-45]**.

(2) GSI says that the cost of funding may be calculated by reference to the payee’s circumstances on a particular date or on a fluctuating basis taking into account any changes in relevant circumstances and relevant market conditions. GSI also says that hindsight may be applied insofar as any certification 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 (GSI’s skeleton argument, [52]-[59]) **[3/4/25-31]**.

(3) Wentworth says that the cost of funding should be calculated on a fluctuating basis taking into account any changes in the relevant circumstances, with the benefit of

hindsight when taking into account such changes (Wentworth's skeleton argument, [227]-[232]) **[3/3/77-78]**.

130. The Administrators do not presently consider there to be any other sensible arguments that could be pursued and invite the Court to give them guidance as to the extent to which hindsight can be relied upon when certifying the cost a relevant payee would have incurred if it had sought to fund the relevant amount.

K. <u>ISSUE 14</u>

131. Issue 14 asks:

> "*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*".

132. The parties are agreed that the relevant payee's certification is conclusive, save in certain circumstances.

133. The parties are agreed that the certification must be performed in good faith and reasonably, in accordance with the standard identified by the Court of Appeal in *Socimer International Bank Ltd (In Liquidation) v Standard Bank London Ltd (No.2)* [2008] Bus LR 1304.

134. On this basis, the parties agree that the relevant payee's certification may be challenged on the basis that it was performed:

    (1) In bad faith;

    (2) Unreasonably in the *Wednesbury* sense;

(3) Capriciously; or

(4) Irrationally.

135. There seems to be no dispute that in certifying its cost of funding, the relevant payee is permitted to act in its own commercial interests.

136. There are two areas of disagreement.

137. The first relates to the concept of 'manifest error'. It seems that the parties are agreed on the *substance* of the point: the Administrators and the Respondents agree that a certification will be void if it is obviously erroneous, i.e. where there is an error that is manifest. However, the SCG and GSI take the view that manifest error is a species of *Wednesbury* unreasonableness, rather than a free-standing category (SCG's skeleton argument [127]) **[3/2/65]**, (GSI's skeleton argument [55]-[56]) **[3/4/26-27]**.

138. The Administrators consider that it would be helpful for the Court's answer to Issue 14 to identify manifest error as a free-standing category of defect in the certification. It is possible to conceive of circumstances in which a party, acting in good faith and in a manner that cannot be characterised as *Wednesbury* unreasonable, makes a slip in a calculation or inadvertently copies down a number incorrectly. If it is obvious that the payee has simply made a mistake, it appears to be agreed that the certification should not stand. Since there is no doubt that manifest error will vitiate a calculation, the Administrators consider that it would be helpful for the Court to so declare.

139. The second area of dispute relates to the precise scope or ambit of the *Socimer* standard of reasonableness and good faith. In summary, GSI has contended that the *Socimer* standard of reasonableness and good faith applies not only to the relevant payee's *application* of the contractual words but also to the relevant payee's *interpretation* of the contractual words.

140. This dispute emerged when the parties were attempting to prepare an agreed formulation of the proposed declaration in respect of Issue 14. In the course of those discussions, the

Administrators suggested the wording should record that a relevant payee's certification will not be conclusive if it is "*something other than the relevant payee's "cost ... if it were to fund or of funding the relevant amount" (as those words may be construed by the Court)*" **[7/1/166-171]**.

141. GSI disagreed with this suggestion and contended that, even if the relevant payee's certification departs from the proper construction of the contractual words, as determined by the Court, it could continue to be binding and would not necessarily be susceptible to challenge. GSI explained its position as follows in paragraph 15(3) of its PTR skeleton **[3/14/5-6]**:

> "*Goldman Sachs also disagrees that there is any separate ground of challenge on the basis that the certification "something other than the relevant payee's "cost ... if it were to fund or of funding the relevant amount" (as those words may be construed by the Court)." The proper interpretation of the definition of Default Rate is, of course, relevant to a challenge on rationality or good faith grounds. To the extent that no reasonable party could have believed that a certification fell within the definition of Default Rate as properly interpreted, or did not in fact honestly believe that it did so, the certification could be challenged accordingly. However, if a certification is rationally and honestly considered to fall within the definition, no challenge should be possible*".

142. According to GSI's argument, it would seem that a relevant payee who misconstrues the definition of Default Rate can only be challenged if its mistaken interpretation was: (a) so unreasonable that no reasonable person could have considered it to be correct; or (b) lacking in good faith.

143. This theme re-emerges in GSI's skeleton argument for the Trial, particularly in paragraphs 52 to 59 **[3/4/25-31]**, in which GSI repeatedly proceeds on the basis that the interpretation of the contractual words is constrained only by the *Socimer* standard of reasonableness and good faith.

144. The Administrators invite the Court to reject GSI's approach. First, as a matter of law, GSI's argument is wrong. The relevant payee does not have a discretion as to how to interpret the contract. The Administrators rely on *Mercury Communications Limited v. DGT* [1994] CLCC 1125, in which Hoffmann LJ (as he then was) concluded that:

"*Where the decision-maker is asked to decide in accordance with certain principles, he must obviously inform himself of those principles and this may mean having, in a trivial sense, to 'decide' what they mean. It does not follow that the question of what the principles mean is a matter within his decision-making authority in the sense that the parties have agreed to be bound by his views. Even if the language used by the parties is ambiguous, it must (unless void for uncertainty) have a meaning. The parties have agreed to a decision in accordance with this meaning and no other. Accordingly, if the decision-maker has acted upon what in the court's view was the wrong meaning, he has gone outside his decision-making authority*".

145. The House of Lords ([1996] 1 WLR 48) agreed with this approach. As Lord Slynn put it at 58-9:

> "*What has to be done in the present case … depends upon the proper interpretation of the words "fully allocated costs" which the defendants agree raises a question of construction and therefore of law, and "relevant overheads" which may raise analogous questions. If the Director misinterprets these phrases and makes a determination on the basis of an incorrect interpretation, he does not do what he was asked to do.*"

146. Secondly, it would be unhelpful on a practical level if every relevant payee could decide for itself what the contract might mean: this would give rise to an inconsistent approach, which the Administrators consider would be unworkable in practice and wholly unfair in the context of a rateable distribution of the surplus to pay statutory interest. The Administrators submit that the task of construing the contract is a task for the Court and that neither the test in *Socimer* nor the concept of *Wednesbury* rationality has any part to play in that context.

L. <u>ISSUE 15</u>

147. Issue 15 is:

> "*If the answer to question 14 is that the relevant payee's certification of its cost of funding is not conclusive and one of the requirements in (i) to (iii) set out in that question applies, where does the burden of proof lie in establishing, and what is required to demonstrate, that a relevant payee has or has not met such requirement?*"

148. The answer to Issue 15 is largely agreed. The agreed position is that the defaulting party (if it seeks to challenge the relevant payee's certification of its cost of funding) bears the

burden of proving, on the balance of probabilities, that the relevant payee's certification has not met the relevant requirements. The remainder of Issue 15 will turn on the outcome of Issue 14; and therefore the wording of the answer to Issue 15 is not agreed and is not in the Statement of Agreed Positions.

149. The Court will be invited to give directions to the Administrators in accordance with the agreed position.

M. ISSUE 16

150. Issue 16 asks whether only the relevant payee (in accordance with the meaning of such term determined pursuant to Issue 10 above), or another party (whether authorised by the relevant payee or not) can provide certification of the cost of funding and, if the former, what the position should be if the relevant payee is not capable of providing such certification (for example because it has been wound up or dissolved).

151. The Respondents for the purposes of this Issue are the SCG and Wentworth. This is not one of the Issues in respect of which GSI was joined.

152. Issue 16 is also agreed. The agreed position is that the relevant payee and anyone expressly or impliedly authorised by the relevant payee can provide certification of the cost of funding and where such certification is not possible, the Court will put itself in the shoes of the relevant payee to determine what decision it would have made had it determined its cost of funding properly (Statement of Agreed Positions, [1/20]).

153. The Court will be invited to give directions to the Administrators in accordance with the agreed position.

N. ISSUE 18

154. Issue 18 asks whether the power of a party under section 7(b) of the 1992 ISDA Master Agreement to transfer any amount payable to it from a Defaulting Party under Section 6(e) without the prior written consent of that party included the power to transfer any contractual right to interest under that agreement.

155. The Respondents for the purposes of Issue 18 are the SCG and Wentworth. This is not one of the Issues in respect of which GSI was joined.

156. Issue 18 is agreed. The agreed position is that the power of a party under section 7(b) does include the power to transfer any contractual right to interest under that agreement (Statement of Agreed Positions, [1/20]).

157. The Court will be invited to give directions to the Administrators in accordance with the agreed position.

O. ISSUE 19

158. Issue 19 is:

> "*Whether the answer to questions 10 to 18 ... is different if the underlying Master Agreement is governed by New York rather than English law*".

159. The Respondents for the purposes of Issue 19 are the SCG and Wentworth. This is not one of the Issues in respect of which GSI was joined.

160. In a technical sense, Issue 19 is agreed: the SCG and Wentworth both say that answer to each of Issues 10-18 is the same where the relevant ISDA MA is governed by New York law (SCG's skeleton argument, [131]-[164]) **[3/2/66-76]**, (Wentworth's skeleton argument, [241]-[260]) **[3/3/82-86]**.

161. However, this apparent agreement conceals major differences, because the SCG and Wentworth do not agree in respect of the answers to Issues 10 to 16 and 18 as a matter of English law: the various differences between them have been identified above.

162. This disagreement spills over into the New York law position. Accordingly, the Court will be required to consider all of the issues it has considered as a matter of English law a second time around but, this time, dealing with them as issues of construction applying the principles of construction which apply under New York law.

163. The SCG and Wentworth have both filed expert evidence **[4/1; 4/2; 4/3]** going to those principles and a joint statement of agreed and non-agreed issues on matters of New York law was served on 30 September 2015 **[4/4]**. The New York law experts will not be attending the Tranche C trial to be cross-examined because, as regards the approach to construing the ISDA Master Agreements as a matter of New York law, there is no dispute between them. They do differ as to how they say New York law is to be applied. However, the application of the principles of construction is a matter for this Court and so it is not necessary for the Court to hear live evidence from the experts.

164. The Administrators consider that all material and tenablepositions are being advanced by the SCG and Wentworth and do not intend to present adversarial argument in respect of the New York law issues.

P. ISSUE 27

165. Issue 27 asks:

> "*Whether, and if so how, the answers to questions 10 to 17 and 18-21 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*".

166. The answer to Issue 27 is now agreed. The agreed position is that the contracts mean the same for everyone: the answers 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 (Statement of Agreed Positions [1/20]).

167. The Court will be invited to give directions to the Administrators in accordance with the agreed position.

Q. GERMAN LAW ISSUES

168. Issues 21 and 22 concern Master Agreements governed by German law.

169. The German law issues can be summarised as follows:

(1) Issue 20 concerns: (i) whether, and in what circumstances, following LBIE's administration, a creditor with a claim under the German Master Agreement would be entitled to make a "*damages interest claim*" within the meaning of section 288(4) of the German Civil Code on any sum which is payable pursuant to the close-out provisions (clauses 7 to 9) of the German Master Agreement; and, if it can, (ii) whether (and if so, in what circumstances) all or part of such "*damages interest claim*" can constitute part of "*the rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9).

(2) Issue 21 poses questions relating to: (i) how, if both of the questions raised in Issue 20 are answered in the affirmative, the "*damages interest claim*" is to be quantified in circumstances in which the relevant claim under the German Master Agreement has been transferred (by assignment or otherwise) to a third party; and (ii) the burden of proof in establishing a "*damages interest claim*".

170. The SCG and Wentworth have both filed expert evidence going to matters of German law **[4/7] to [4/13]**. A joint statement of the German law experts in German has been filed and an English translation is to be filed imminently. The SCG and Wentworth will cross-examine each other's expert witness.

171. The German law issues will be addressed in separate skeleton arguments in due course.

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