Waterfall II Application

No 7942 of 2008

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

(1) ANTHONY VICTOR LOMAS

(2) STEVEN ANTHONY PEARSON

(3) PAUL DAVID COPLEY

(4) RUSSELL DOWNS

(5) JULIAN GUY PARR

(as the joint administrators of the above named company)

Applicants

- AND -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.À R.L

(3) HUTCHINSON INVESTORS LLC

(4) WENTWORTH SONS SUB-DEBT S.À R.L

(5) YORK GLOBAL FINANCE BDH, LLC

Respondents

REVISED POSITION PAPER ON BEHALF OF THE FOURTH RESPONDENT ON ISSUES 11, 12 & 13

Introduction

The terms of Issues 11 & 12 have changed substantially. They reflect various arguments that the SCG wish to advance. Wentworth's position on these revised issues is set out below, in advance of the SCG having set out its own position on them. Although the terms of Issue 13 have not changed, Wentworth's position on this issue is repeated. Wentworth reserves the right to reply to the SCG's position once it is made clear in relation to these revised issues.

Capitalised terms used but not otherwise defined herein are defined in the Waterfall II Application dated 12 June 2014 (the "Application"), unless the context requires otherwise.

Issue 11

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

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

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

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

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

1. The expression includes the actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount, subject to the fact that the use of the word "*cost*" indicates that the expression refers to such amount as the counterparty would be *required* to pay in funding the amount. In other words, where there are a range of amounts (all other things being equal) it refers to the lowest amount which the counterparty would be required to pay over the relevant period. Any amount over and above the lowest amount that a relevant payee would be required to pay represents, not a *cost*, but an amount paid voluntarily.

2. The expression does not 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. The expression is limited to the cost of funding the *relevant amount*, and is not concerned with the cost to the relevant payee of funding an asset or assets.

3. The expression does not include the actual or asserted cost to the relevant payee to fund or of funding and/or carrying on its balance sheet an asset and/or of any profits and/or losses incurred in relation to the value of the asset, including any impact on the cost of its borrowings and/or its equity capital in light of the nature and riskiness of that asset. The expression is limited to the cost of funding the *relevant amount*, and is not concerned with the cost to the relevant payee of funding an asset or assets.

4. The expression does not include the actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE. The expression is limited to the cost of funding the *relevant amount*, and is not concerned with the cost to the relevant payee of funding an asset or assets.

Issue 12

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

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

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

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

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

i. overnight funding; or

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

iii. funding for some other duration?

5. The type of borrowing that is encompassed within the concept of the cost "*if it were to fund ... the relevant amount*" is not limited to borrowing assumed to have recourse solely to the relevant payee's claim against LBIE. The expression requires the relevant payee to certify its cost of funding the relevant amount, i.e. an amount equal to the value of its claim against LBIE, not the actual claim itself.

6. The over-arching requirement is that cost to the relevant payee if it were to fund the relevant amount is (as set out above) the lowest amount which the relevant payee would be required to pay if it were to raise funds in the relevant amount. Subject to that requirement, in a case where the weighted average cost on all of the relevant payee's borrowing is a reasonable proxy for the cost if it were to fund the relevant amount, then the relevant payee can certify a rate based on such weighted average cost.

7. Subject to the SCG providing clarification of this head, the cost of funding does not include any impact on the cost of the relevant payee's equity capital attributable to such borrowing.

8. The cost of funding may be calculated on the basis of overnight funding, term funding to match the duration of the claim to be funded, or funding of some other duration, provided that it complies with the over-arching requirement that it is a rational and good faith estimate of the lowest available cost to the counterparty.

9. The cost of funding should in any event reflect changes in available rates over the period of funding.

10. The Default Rate is defined as "*a rate per annum equal to*" the cost to the relevant payee of funding the relevant amount, to which is added 1% per annum. The rate so arrived at is then to be compounded daily under Section 6(d)(ii). In order to comply with the requirement for daily compounding the "*rate per annum equal to*" the cost of funding must itself be arrived at without including any element of compounding when calculating the cost of funding to the relevant payee. Any other result would involve 'double-compounding', which is inconsistent both with the requirement that the

relevant rate of interest be compounded daily and the underlying principle that interest is intended to compensate a party for being kept out of its money.

11. Accordingly, where the relevant payee's cost of funding is based on a stated annual rate of interest in respect of term borrowing with less than yearly compounding, the "*rate per annum equal to the cost...*" is to be based on the stated annual rate of interest and not the effective annual rate of interest derived from that stated rate.

Issue 13

Whether the "cost (without proof or evidence of actual cost) to the relevant payee (as certified by it) if it were to fund 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).*

12. The "*cost [etc]*" should be calculated on a fluctuating basis, taking account of changes in the relevant circumstances of the relevant payee.

13. For example, if the rate per annum equivalent to the cost of funding to a relevant payee for the first year the relevant amount was outstanding was 'X%', but for the second year the rate per annum equivalent to its cost of funding was '½ X%', then the Default Rate for the first year is different to that for the second year.

14. The Default Rate means "*a rate per annum equal to the cost [etc]...*", to which is added 1% per annum. Accordingly, irrespective of how a particular counterparty calculates its cost of funding the relevant amount, the Default Rate must be expressed as an annual percentage rate, i.e. a rate derived from the cost of funding as certified by the relevant payee.

15. Interest is payable for the period from the Early Termination Date until the date of payment (Section 6(d)(ii) of the 1992 ISDA Master Agreement, and Section 9(h)(ii)(2) of the 2002 ISDA Master Agreement).

16. Neither the 1992 nor the 2002 ISDA Master Agreement contains any requirement as to the time at which the Default Rate is to be calculated or certified (in contrast to the requirement that the amount payable under Section 6(e) is to be calculated and stated to the counterparty on or as soon as reasonably practicable following the occurrence of an Early Termination Date: Section 6(d)(i)).

17. In circumstances where the relevant payee has actually incurred the cost of funding the relevant amount, that cost can only be known, and the per annum rate to be derived from it can thus only be calculated, at the end of the period.

18. Similarly, where the relevant payee has not actually incurred the cost of funding the relevant amount, the cost if it were to have funded the relevant amount can only be known, and the per annum rate to be derived from it can thus only be calculated, at the end of the period.

19. In either case, when calculating the cost – at the end of the period – of funding the amount for that period, the true cost can only be captured by calculating the cost from time to time on a fluctuating basis. To adopt any other approach would not capture the true cost, and would be inconsistent with the underlying purpose of an award of interest, to compensate the payee for being kept out of its money.

20. To take the example referred to above, if the cost of funding was based on a snapshot of funding for the first year, the resulting calculation would greatly overstate the cost to the relevant payee, and would not reflect accurate compensation for the payee being kept out of its money. Conversely if it was based on a snapshot of funding during the second year, it would understate the cost, and thus fail adequately to compensate the payee for being kept out of its money.

ANTONY ZACAROLI QC

DAVID ALLISON QC

ADAM AL-ATTAR

South Square

3-4 South Square

Gray's Inn

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