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

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N

(1) ANTONY 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

SENIOR CREDITOR GROUP'S SKELETON ARGUMENT FOR TRIAL (2): GERMAN MASTER AGREEMENT ISSUES

A. INTRODUCTION

1. This skeleton argument is filed on behalf of Burlington Loan Management Limited, CVI GVF (Lux) Master S.a.r.l, and Hutchinson Investors, LLC (collectively, the "Senior Creditor Group"). Although the Senior Creditor Group has not been appointed as representatives of different classes of creditors, it is advancing arguments in effect on behalf of unsecured creditors to enable the Administrators to obtain directions and the Administrators are content to act on directions given by the court on this basis.

2. The Application raises two issues in respect of the German Master Agreement for Financial Derivative Transactions (the "GMA") [5/7/306] which (due to the timing of the joint statement of the German law experts) were not addressed in the main skeleton argument, being:

   (1) Question 20:

   "20(1): Following LBIE's administration, is a creditor entitled (and if so in what circumstances) to make a "damages interest claim" within the meaning of section 288(4) of the German Civil Code (BGB) on any sum which is payable pursuant to clauses 7 to 9 of the German Master Agreement?

   20(2): If the answer to Issue 20(1) is yes, can (and if so, in what circumstances) all or part of such "damages interest claim" constitute part of "the rate applicable to the debt apart from the administration" for the purpose of Rate 2.88(9)?

   (2) Question 21:

   "If the answer to question 20 is that a further claim for damages can be included as part of the "rate applicable to the debt apart from the administration" for the purposes of Rule 2.88(9), how in such circumstances, is the relevant rate to be determined? In particular:

   (i) In circumstances where the relevant claim under the German Master Agreement has been transferred (by assignment or otherwise) to a third party is it the Damages Interest Claim which could be asserted by the assignor or the assignee which is relevant for the purposes of Rule 2.88(9)?

   (ii) Where the relevant claim under the German Master Agreement has been acquired by a third party, in what circumstances (if any) is such a third party

precluded from asserting a Damages Interest Claim under principles of German law?

(iii) Where doe the burden of proof lie in establishing a Damages Interest Claim, and what is required to demonstrate, that a relevant creditor has or has not met such requirement?

3. As at 7 October 2015, 15 claims under the GMA have been admitted for dividend in the LBIE estate totalling approximately £311 million (approximately 2.5% of the approximately £12.2 billion of admitted claims against LBIE): Lomas 13 [2/9] at [23].

4. The relevant Questions concern:

(1) The entitlement, under German law, to compensation for delayed payment of a counterparty to transactions governed by the GMA in circumstances where an automatic termination of the agreement has occurred by reason of the administration application in respect of LBIE.

(2) Whether under English law any such entitlement can constitute a "*rate applicable to the debt*" for the purpose of Rule 2.88(9).

(3) If it can, the consequences of any assignment or transfer of such an entitlement to a third party.

5. The Court will hear evidence of German law from two experts, being Professor Peter Mülbert (on behalf of the Senior Creditor Group) and Dr Fischer (on behalf of Wentworth).

(1) Professor Mülbert is a Professor of Law at the Faculty of Law and Economics of Gutenberg Research College, and Director of the Centre for German and International Law of Financial Services at the University of Mainz. He is a former visiting Professor at (amongst others) Harvard Law School and has served on (amongst other appointments) the Panel of Financial Services Experts of the Committee on Economic and Monetary Affairs of the European Parliament. He intends to give his

evidence in English, although he may be assisted on occasion by a translator if that will facilitate the giving of his evidence.

(2) Dr Fischer is a retired German judge, who held office as a judge at the Federal Court of Justice in Germany from 1990 onwards and has specialised in bankruptcy law, liability of attorneys and tax advisors, guarantees as well as the acknowledgment and enforceability of foreign decisions. He will give his evidence in German, with the assistance of a translator.

6. The experts' joint statement is at [4/13], and their respective reports are at [4/7-12][1].

B: OVERVIEW

7. The detail of the Senior Creditor's position is addressed below, reflecting the position adopted in its Position Paper [1/9/80-84].

8. In broad terms, the Senior Creditor Group contends that, under German law:

(1) LBIE's application for an administration order caused an automatic termination of the GMA and all underlying transactions.

(2) The close-out amount due pursuant to Clauses 7-9 of the GMA became immediately due upon the occurrence of the automatic termination.

(3) A creditor entitled to payment of the close-out amount is also, pursuant to the provisions of the German Civil Code ("BGB"), entitled to compensation by way of damages for late payment of such a debt

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1 In circumstances where the German law issues have developed since the experts were originally instructed, and certain issues have been modified or are no longer pursued, Professor Mülbert produced a consolidated report [4/11] which sets out his full analysis (including the content of his prior reports) in order to facilitate the Court's consideration of the issues.

provided that "default" (in the sense provided for in Section 286 of the BGB) has occurred[2].

(4) Where default has occurred, damages for late payment of the defaulted close-out amounts are determined in accordance with Sections 249(1), 252, 280(1) and (2), 286 and 288 of the BGB. Creditors are, pursuant to those provisions, entitled to make:

(a) A minimum damages interest claim at a default rate of 5% above the basic rate of interest as published by the Deutsche Bundesbank, accruing on the principal amount of the unpaid debt: Sections 247, 280, 286 and 288(1) of the BGB. This is payable irrespective of the actual loss suffered by the creditor; i.e. it is a statutory minimum rate of compensation; and

(b) A further damages interest claim for losses arising from delayed payment of an overdue debt where such losses exceed the default rate: Sections 280, 286 and 288(4) of the BGB. Such damages require the creditor to prove the existence of actual loss caused by the late payment and may, where appropriate, be expressed as a rate accruing on the amount of the unpaid debt.

(5) The statutory right to receive compensation in the form of either a minimum damages interest claim, or a further damages interest claim (where appropriately expressed as a percentage rate of interest accruing on the debt during the period of default):

(a) Forms part of the creditor's rights as at the commencement of the administration; and

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2 The Senior Creditor Group originally relied upon Clause 3(4) of the GMA rather than directly on the provisions of the BGB. However, the basic position remains unchanged since, even where Clause 3(4) of the GMA applies, its function is to make clear that the relevant provisions of the BGB continue to apply subject to a modification of the rate set out in Section 288 para 1 of the BGB.

(b) In any event, constitutes part of the "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9) of the Insolvency Rules 1986.

9. Whether "default" for the purpose of Section 286 of the BGB has occurred in respect of any payment obligation of LBIE under the GMA before, as at, or after the commencement of the administration is a question of fact, which will need to be determined on a case by case basis.

10. However, the Senior Creditor Group maintains that there is one generally applicable basis for default which it is appropriate for the Court to consider at this hearing. The Senior Creditor Group contends that default in respect of all close-out amounts due under the GMA occurred at the point when LBIE applied for an administration order (and at the same time that the close-out amount became due) on the basis that LBIE had "*seriously and definitively refused performance*" of its obligations under the GMA by reason of applying for an administration order (which application was made on the basis that LBIE was unable to pay its outstanding debts at the time of making the application).

11. The position adopted by the Senior Creditor Group in respect of Questions 20 and 21 is consistent with the answers to the similar issues raised in respect of the ISDA Master Agreements.

12. On the Senior Creditor Group's case, a party to a Master Agreement, who is entitled to payment of the close-out amount on termination, may be entitled to interest reflecting the cost to it of funding the relevant amount, whether he was a party to an English or New York law governed Master Agreement or was a party to a GMA, and in each case such interest will rank as a rate applicable to the debt apart from the administration for the purposes of Rule 2.88(9).

13. The Senior Creditor Group's position is entirely unsurprising in circumstances where the overall objective of the GMA is to replicate under German law, as best

as possible, the manner in which the ISDA Master Agreement and its close-out netting provisions in particular are intended to operate: Mülbert 3 [4/11] at [67][3].

C: THE RIGHT TO COMPENSATION FOR DELAYED PAYMENT UNDER GERMAN LAW

14. The following paragraphs set out the principal aspects of German law that are relevant to the Senior Creditor Group's case.

15. Where there is agreement between the experts, the position is noted. Where the position is not agreed, the Senior Creditor Group relies on the evidence of Professor Mülbert, which it will contend should be preferred to that of Dr Fischer.

(1) When the close-out amount falls due

16. First, the close-out amount arising under Clauses 7-9 of the GMA becomes immediately due upon the termination of the GMA triggered by LBIE's administration application (Mülbert 3 [4/11], at [65]):

(1) Section 7(2) of the GMA provides that:

> *"The Agreement shall terminate, without notice, in the event of an insolvency. An insolvency shall be given, if an application is filed for the commencement of bankruptcy*

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3 See further, for example, *Behrends, in: Zerey, Finanzderivate, 3rd Ed (2013) page 110, Margin note 6:* "*Regarding its fundamental concept and manner of functioning, the GMA does not differ from the ISDA and the EMA.*"; *Jahn in Bankreschtshandbuch, 4th Ed 2011 at para 116 n.61: "The [ISDA] Master Agreement of 1992 contains many provisions that were the model for the clauses of the GMA of 1993, but it includes significantly more comprehensive provisions on termination and damages. …."; Zenke/Dessau in: Danner/Theobald, Energierecht (8th Suppl, April 2015) para 140 Rn. 296: "The German language GMA is the equivalent to the ISDA Master Agreement and is adequate for all kinds of derivative transactions."*

There are, of course, differences in the drafting of the provisions of the GMA compared to the ISDA Master Agreements. In particular, certain provisions of the GMA are adjusted as compared to the ISDA Master Agreement in order to take into account the particular requirement of matters such as German insolvency law: see Mülbert 3 at [70]. But they do so in a manner that seeks, for example, to ensure that as similar a result as possible to the ISDA Master Agreement will be achieved.

or other insolvency proceedings against the assets of either party and such party either has filed the application itself or is generally unable to pay its debts as they become due or is in any other situation which justifies the commencement of such proceedings."

It is common ground LBIE's administration amounted to an insolvency for these purposes, and that the contract terminated upon LBIE's application for administration: Joint Statement [4/13] at [18].

(2) As a result any relevant performance obligations in respect of individual transactions under Clause 3(1) of the GMA were replaced by a single compensation claim in accordance with Clauses 8 and 9 of the GMA (the "Single Compensation Claim"): see Clause 7.3 of the GMA and Mülbert 3 at [69].

(3) A dispute exists between the experts as to when the Single Compensation Claims become due, which the Court will have to resolve. Professor Mülbert opines that the sums become immediately due upon termination. This is disputed by Dr Fischer, who maintains that the Single Compensation Claims did not become due until the netting provided under Clauses 8 and 9 of the GMA had been carried out and the calculation of the Single Compensation Claim has been performed: Joint Statement at [18]. The Senior Creditor Group will contend that Professor Mülbert's analysis, as set out below, is to be preferred.

(4) The purpose of the close-out mechanism in the GMA and of the Single Compensation Claim is to seek to place the non-defaulting party in the same economic situation as it would have been in if the individual transaction(s) had matured in the normal course: Mülbert 3 at [71]. All individual transactions would have required payments to be made by the Due Date specified in the relevant Transaction (Clause 3(1) of the GMA). The consequence of such termination is that the individual claims pursuant to Clause 3(1) are replaced by a net entitlement to compensation payable to either party i.e. the Single Compensation Claim.

(5) There is no provision in the GMA which specifies a due date for the payment of the Single Compensation Claim due under Clauses 7-9 of the

GMA. As a consequence, Section 271(1) of the BGB applies. This provides that:

"Where no time for performance has been specified or is evident from the circumstances, the creditor may demand performance immediately, and the debtor may effect it immediately."

(6) Under German law, upon an early termination of a contract for cause (as is the case with an early termination in the event of insolvency under Clause 7(2) of the GMA), a compensation claim in favour of the claimant becomes due immediately upon termination. For the claim to fall due immediately it is not necessary for the creditor to calculate the exact amount of compensation due. That approach is supported not only by the language of Section 271(1) of the BGB, but by authorities such as those concerned with claims for prepayment fees on loans, which have been held by the German Courts to be immediately due on termination even though the creditor has a choice of methods of calculating his claim, and regardless of the fact that it will take the creditor some time to determine the exact amount of his claim: see *Staudinger/Mülbert* BGB, 2015, para 490 Rn 164; OLG Frankfurt WM 2012, 2280 and 2284.

(7) The correct position is therefore that the Single Compensation Claims became due immediately upon the termination of the GMAs triggered by LBIE's administration application: Mülbert 3 at [74].

(2) Compensation for delayed payment

17. Second, all creditors who are entitled to payment of the close-out amount are also, pursuant to the provisions of the BGB, entitled to compensation by way of damages for late payment of such a debt (provided that "*default*", in the sense provided for in Section 286 of the BGB, has occurred; as to which see further below):

(1) The statutory basis for awarding damages in cases of delayed performance in general derives from Section 280(1) of the BGB, in conjunction with Sections 280(2) and 286 of the BGB. These provisions

make clear that damages for delayed performance may be sought (Section 280(2)), provided that the requirements of Section 286 (i.e. default) are also satisfied. The purpose of such damages is to make the creditor whole.

(2) Section 288 of the BGB addresses "*default interest and other damage due to default*". When default has occurred, a creditor is entitled to seek compensation in the form of:

(a) Interest at a default rate of 5% above the basis rate of interest pursuant to Section 288(1) of the BGB, irrespective of any actual loss. As Section 288(1) makes clear, all money debts must bear interest at this rate during the period of default; and

(b) Further damages in respect of actual damage suffered pursuant to Section 288(4).

See Mülbert 3 at [30]-[44] generally; Joint Statement at [4]-[7].

(3) There is a dispute between the experts as to the categorisation of the nature of the claims for damages pursuant to Sections 288(1) and 288(4): Joint Statement at [5]. Professor Mülbert maintains that both a Minimum Damages Interest Claim (pursuant to Section 288(1)[4]) and a further damages claim for actual damage (pursuant to Section 288(4)) are sub-categories of the general right to claim damages for delay in performance pursuant to Sections 280(1), 280(2) and 286:

(a) Section 288(1) provides for the statutory minimum level of damages payable irrespective of loss (Mülbert 3 at [57] and [58]; Joint Statement at [4] and [15]). It is a provision which is intended to incentivize the debtor to pay in a timely manner: Mülbert 3 at [30].

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4 Dr Fischer maintains that Section 288(1) does not confer a right to damages, but constitutes a separate type of claim not founded on the general rules of BGB, Section 280.

(b) Section 288(4) is concerned with the actual loss suffered: see, for example, Mülbert 3 at [33] and [34]; and KG Berlin, decision of 18 February 2014 – 26a U 60/13 (juris) n. 55.

(c) Both a claim under Section 288(1) and a claim under Section 288(4) must satisfy the various requirements set out in Mülbert 3 at [29], save that it is not necessary to establish actual loss for the purpose of the Minimum Damages Interest Claim under Section 288(1)[5].

(4) Calculation of the Minimum Damages Interest Claim is simple: it can only be expressed as a percentage rate (unless default has ceased), and is expressed as a rate applied to the principal claim for the period of default: Mülbert 3 at [37], [45] and [46].

(5) Calculation of the further damages claim for actual loss entails additional steps: Mülbert 3 at [37]-[43] and [47]-[56]:

(a) The experts agree that the creditor must establish both the causal connection for the damage and its amount: Joint Statement at [8].

(b) A further damages claim for actual loss can include a one-off loss and also a continuing loss (i.e. the ongoing loss suffered by the creditor as a result of the delay in receiving its money): Joint Statement at [10].

(c) A claim in respect of a one-off loss cannot be expressed as a rate; a claim in respect of continuing loss may appropriately be expressed as a rate (Mülbert 3 at [39] and [40]) and may extend to:

(i) The costs of necessary interim financing, resulting from the delay in receiving the funds due at an earlier time; and

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5 It is not, however, possible to seek recovery for the actual loss suffered, and the Minimum Damages Interest Claim in addition: see Mülbert 3 at [59]- [64]; Joint Statement at [7].

(ii) The loss of investment return that results from not being able to (re)invest the funds due i.e. opportunity costs in a broad sense.

Mülbert 3 at [38].

(d) If the debtor has not paid the outstanding sum when the Court gives judgment on the claim for further damages for actual loss, it may not be possible or appropriate to express any continuing loss type damage as a lump sum (for example, where the loss is measured by the time value of money, or accrues at a rate over time). Such loss will, however, be capable of being expressed as a rate. The experts agree that it is customary to assert a claim for damage in the form of lost or additionally incurred interest as a rate: Joint Statement at [10].

(e) Where a further damages claim is expressed as a rate (i.e. it is a Further Damages Interest Claim as defined by Professor Mülbert), it applies to the amount of the principal claim not timely paid by the debtor; i.e. the close-out amount: Mülbert 3 at [45]-[46]. That is supported by the Joint Statement at [12] and [13], and the comment of Dr Fischer at Fischer 1 [4/8] [89]:

> "*If the damage is asserted in the form of increased interest, it will be applied to the amount for which the debtor is in default if the creditor would have invested the entire amount*[6] *at an interest rate higher than the statutory interest rate if payment had been timely. The same applies if the claim is based on the fact that the creditor had to obtain the outstanding amount at an interest rate that exceeds the statutory rate".* (emphasis added)

(f) The method of determining the rate applicable to a Further Damages Interest Claim depends on whether the creditor is calculating the concrete losses suffered or is entitled to apply a

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6 It is agreed by the German law experts that if, on the facts, only part of the close-out amount would have been invested, the further damages claim will only accrue on that part of the close-out amount: Fischer 1 at [88] and Joint Statement at [13].

simplified method of calculation as provided for in the second sentence of Section 252 i.e. a claim for profits which are considered lost because, in the normal course of events or in the special circumstances, particularly due to the measures and precautions taken, those profits could probably be expected: Mülbert 3 at [48]-[51]. Reference may in this context be made to publicly available rates on which the Court can base its estimate of loss: Mülbert 3 at [52] and [53]. Banks may use hypotheticals based on assumptions regarding their behaviour and the nature of their business such that the average interest rate charged by the bank may be taken as the applicable rate: Mülbert 3 at [54]-[56][7]. Joint Statement at [9]. Professor Mülbert maintains that this also applies to other financial institutions, including hedge funds, but this is disputed by Dr Fischer.

(3) Default

18. Third, it is necessary for a default within the meaning of Section 286 of the BGB to have occurred in order for there to be a claim for damages for delayed payment: see Section 280(2) and Mülbert 3 at [75].

(1) Section 286 of the BGB specifies the requirements for a default, being:

(a) The debtor's failure to perform when performance is due; and

(b) The giving of a warning notice (*Mahnung*) from the creditor to the debtor requesting performance (which acts as a reminder that there has been non-performance, and may induce performance),

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7 Various issues are identified by Professor Mülbert which may affect the way in which the appropriate rate is calculated depending on the services provided by the bank/type of business being conducted: Mülbert 3 at [55] and [56]. The actual rate applicable in any given case is fact specific, and there is obviously a limit to how far the Court can sensibly go in determining such issues at this trial. The Senior Creditor Group contends that the Court should be able to determine whether claims for lost profit which can be expressed as a rate are in principle recoverable as a matter of German law pursuant to Section 288(4) BGB, and if so whether they could form part of the "*rate applicable to the debt*" for the purpose of Rule 2.88(9).

save where any of the exceptions in Section 286(2) of the BGB apply: Mülbert 3 at [77].

(2) The default occurs (Mülbert 3 at [77]):

(a) Upon receipt of the warning notice; or

(b) Upon the events occurring that give rise to one of the exceptions to the need for a warning notice (and assuming that the date for performance has also occurred by then) (see also Mülbert 3 at [98]).

(3) The exceptions to the need for a warning notice are set out in Section 286(2) of the BGB. Because the close-out amount is not payable at a particular date specified by the parties, nor is there any evidence that a reasonable amount of time for performance was specified by the parties following an agreed event, it is the third (in particular) and fourth exceptions which are relevant to LBIE's administration: Mülbert 3 at [96] and [97]. They apply where:

(a) The debtor "*seriously and definitively refuses performance*" (Section 286(2) no 3 of the BGB); or

(b) For special reasons, after weighing the interests of both parties, the immediate occurrence of default is justified (Section 296(2) no 4 of the BGB).

(4) Whether a default has occurred, and whether any of the exceptions apply, will be a question of fact in any given case. As explained in Mülbert 3 at [97]-[102], it is exception 3 that is likely to apply in the case of the LBIE administration.

(5) In terms of assessing whether there has been a serious and definitive refusal of performance within the meaning of Section 286(2) no 3 of the BGB:

(a) The refusal does not need to be made in any particular form or using particular words – it can be explicit or implicit, provided that it constitutes the debtor's final say: Mülbert 3 at [101].

(b) Whether the refusal is the debtor's "*final say*" is a question of fact that needs to be reviewed on a case-by-case basis.

(c) It is sufficient if the debtor states or conducts itself in a way where it can be implied that the debtor cannot perform at the time that performance is due or within a reasonable grace period (even if it may be able to perform at some time in the future): Mülbert 3 at [101].

(d) The refusal to perform within the meaning of Section 286(2) exception 3 can occur at, after or before the respective claim falls due, but default for the purpose of Section 286 can only occur once the claim has become due: Mülbert 3 at [102].

19. Although the question of default is fact specific, the Senior Creditor Group contends that in this case the Section 286(2) exception 3 was satisfied on a generic basis by reason of LBIE's filing for an application for administration:

(1) Professor Mülbert explains the basis on which it appears, in his opinion, that the requirements of Section 286(2) exception 3 are satisfied at [103]-[124] of Mülbert 3. Whilst a matter of fact ultimately for the Court, his analysis is illuminating as to the issues of German law raised and how they would be applied to the facts of any given case. Dr Fischer disagrees with the analysis: Joint Statement at [26].

(2) The basis on which LBIE applied for and then entered administration is described in the first witness statement of Peter Sherratt [2/1/0], the Chief Legal Officer of Lehman Brothers in Europe and Asia at the time that the application for administration was made (15 September 2008), and a director of LBIE. The application was made by the directors of LBIE (Sherratt 1 at para 1.2.1) on the basis that *inter alia*:

(a) LBIE required some US$800 million in cash to settle payments contractually due to other financial institutions within the next 24 hours (para 6.6);

(b) LBIE operated a cash sweep system whereby cash was transferred to Lehman Brothers Holding Incorporated ("LBHI") at the end of each trading day, on the expectation that, at the start of the next trading day, LBHI would transfer cash back to LBIE sufficient to enable it to meet its cash requirements (para 6.5);

(c) LBHI had refused to provide any further cash to LBIE such that LBIE was unable to pay its debts within the meaning of Section 123 IA 1986 (paras 6.7 and 7.4).

(3) The Senior Creditor Group maintains that the filing of the application for administration indicated to creditors that LBIE would not pay its outstanding debts then due, when they became due or necessarily at all. This would have included the Single Compensation Claim which became due in respect of all of the GMAs upon LBIE's filing for administration: Mülbert 3 at [103]. Such conduct suffices to establish a "*serious and definitive refusal*" within the meaning of Section 286(2) exception 3 of the BGB. Such conduct should be categorised as a serious and definitive refusal to perform for the purpose of Section 286(2) exception 3 of the BGB, and therefore sufficient to establish a default as at the point at which the application for administration was made and the Single Compensation Claim became due and payable: see, in particular, Mülbert 3 at [118] to [124].

(4) The question of whether, if LBIE had gone into administration in different factual circumstances, this would have amounted to a "*serious and definitive refusal*" is irrelevant. It is also irrelevant whether such a refusal would have arisen if LBIE had gone into insolvency proceedings under German law (see further below).

(4) Warning notices

20. The other points raised in the expert evidence regarding the occurrence of default, and service of a warning notice, are of limited relevance if the above analysis is correct. They are also, in certain respects, agreed.

21. In short, the Senior Creditor Group contends that:

(1) There is no provision of German substantive law (whether statutory or based on case authority) which prevents a default occurring (or a warning notice having that effect) after LBIE entered administration under English law: see Mülbert 3 at [79]-[83]. Although Dr Fischer contends that a default cannot be established by serving a warning notice after LBIE entered administration, he does so by reference to the position which exists where a German insolvency proceeding has occurred (see the Joint Statement at [21]). As to this:

(a) There is no German insolvency proceeding in relation to LBIE, and any policy underlying such proceedings, or provisions applicable to such proceedings, are irrelevant.

(b) It would be bizarre if principles and policies of German insolvency law were treated as extending to an English administration, given, for example, that under English insolvency law there is no bar on the service of notices during the course of an administration which may trigger contractual rights: see, for example, *Re Olympia & York Canary Wharf Ltd* [1993] BCC 154.

(2) The requirements for the giving of a warning notice are agreed – the debtor must receive a clear, definite demand from the creditor for payment of an amount that is due: Joint Statement [22].

(3) Professor Mülbert opines that whether filing a proof of debt in the LBIE administration would satisfy the requirements for the giving of a warning notice depends on the particularities of English insolvency law, and to

what extent the agreed requirements for a warning notice would be satisfied: Mülbert 3 at [92]; Joint Statement at [23]. He also observes that such German authority as exists in relation to this question appears to be based on the particular facets of German insolvency law which separate the notion of the insolvency estate from the debtor, such that the debtor loses its power to dispose of assets (and be sued in respect of claims that are to be dealt with in the insolvency). He doubts whether or to what extent that analysis would apply to an insolvency that had the consequences of an English administration.

(4) The Senior Creditor Group contends that there is no reason why the filing of a proof in an administration could not be a warning notice: a proof of debt in an administration process is filed by a person who claims to be a creditor of the company and who wishes to recover his debt in whole or in part (Rule 2.72(1)). It is submitted to the debtor's agent, the administrator. It relates to a debt which remains due by the debtor to the creditor: the administration does not affect the underlying debt due to the creditor (*Wight v Eckhardt Marine GmbH* [2004] 1 AC 147 at [26]; *Re LBIE (Joint Administrators of LBHI v Lomas)* [2015] BCC 431 at [139] and [249]). Where the debt is due at the time that the proof is filed, the proof amounts to or can be treated as a clear and definitive demand from the creditor for payment by the debtor of an amount that is due. In contrast to what appears to be the position as a matter of German insolvency law and civil procedure, there is no principle, or underlying policy, of English insolvency law which ought to prevent the proof from amounting to a warning notice.

(5) It is common ground that a warning notice could not be given after the principal amount of the close-out amount has been paid and that, even if it was possible, such a notice would not have retrospective effect i.e.

default would only be established for the period after the notice: Mülbert 3 at [95]; Joint Statement at [25][8].

D: THE RATE APPLICABLE TO THE DEBT APART FOR THE ADMINISTRATION

22. Having considered the entitlement of a creditor to compensation for delay in respect of any close-out amount payable under the GMA as a matter of German law, Question 20(2) asks whether, if a creditor is entitled to make a "damages interest claim" on a close-out amount payable under the GMA, all or part of such "damages interest claim" can constitute (as a matter of English law) part of the "*rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9).

23. The following paragraphs proceed on the basis of the decision of David Richards J in *Re Lehman Brothers International (Europe) (In administration)* [2015] EWHC 2269 (Ch) at [179] ("Waterfall IIA")[9].

24. The Senior Creditor Group contends that such a damages interest claim can, where expressed as a rate, constitute part of the rate applicable in the sense required by Rule 2.88(9). In particular:

    (1) In light of the decision of David Richards J in *Waterfall IIA* in relation to Question 4, and subject to any appeal, the rate applicable to the debt apart from the administration is to be determined by reference to the rights of the creditor as at the commencement of the administration.

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8 It is also common ground that the question of whether a termination notice could constitute a warning notice is irrelevant in view of the automatic termination of the GMA pursuant to Clause 7(2): Joint Statement [24].

9 At a hearing on 9 October 2015, David Richards J granted permission to appeal that aspect of the Waterfall IIA judgment. The Senior Creditor Group intends to file Notices of Appeal and, pending that appeal, reserves the right to argue that the "*rate applicable to the debt apart from the administration*" includes a rate which would be applicable to the debt if the administration had not precluded the creditor from taking certain steps, and a rate which was applicable as a result of a judgment which was in fact obtained after the date of the administration order.

(2) All creditors who are parties to the GMA are entitled under the BGB to compensation for delay as set out above, dependent on the occurrence of default.

(3) It is common ground that a claim for further damage permitted by 288(4) of the BGB accrues on the date of default and can, where appropriate, be expressed as a percentage rate of interest accruing on the unpaid close-out amount for the period of default (such a claim being a "damages interest claim") (see above generally, and for example Mülbert 3 at [38(b)(i) and (ii)] [45]; Fischer 1 at [88]-[89]).

(4) Where a damages interest claim accrues as a consequence of a default arising on or before the commencement of LBIE's administration, it therefore forms part of a creditor's rights as at the commencement of the administration.

(5) Even if, contrary to the Senior Creditor Group's case, the default were to occur (and the claim were to accrue) after the commencement of LBIE's administration, the entitlement to damages arising under the BGB applies to the debt proved (i.e. the close-out amount) and is part of a creditor's rights as against LBIE at the commencement of the administration. In those circumstances, the pre-existing nature of the right to damages arising under the BGB is such that the Court's existing analysis of Question 4 of the Waterfall IIA proceedings is not determinative of whether such a right to compensation constitutes "*part of the rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9).

(6) Therefore, the claim permitted by section 288(4) of the BGB (like any entitlement to interest under sections 288(1) and (2) of the BGB) is capable of constituting part of the "*rate applicable to the debt apart from the administration*" for the purposes of Rule 2.88(9).

25. The above is correct irrespective of whether the applicable rate has yet to be assessed or quantified (whether by a court or agreement):

(1) The damages interest claim is no different, in this respect, from any other right to interest whose value is uncertain or undetermined as at the date of administration. For example:

(a) A right to a variable rate of interest existing as at the date of the administration is capable of constituting the "*rate applicable to the debt apart from the administration"*, even though the applicable rate (or the value of that right) has not been fixed as at that date; or

(b) A right to interest (whether under a statute or contract) calculated by reference to the cost of funding the relevant amount for the period it is outstanding is capable of constituting the "*rate applicable to the debt apart from the administration"*, even though the applicable rate (or value of that right) has not been assessed or fixed as at the date of administration. No steps need to be taken to establish that right, as opposed to assessing or quantifying the applicable rate.

(2) The fact that an element of contingency may exist in relation to the determination of the quantum or value of a damages interest claim is not sufficient to prevent it from being a "*rate applicable to the debt apart from the administration*" in the relevant sense.

(3) This is illustrated by the position of admitted provable debts which are contingent as at the date of administration. In relation to such debts, interest runs from the date of administration at the rate applicable to the debt apart from the administration, even though the interest entitlement is subject to the same contingency as the debt: see *Waterfall IIA* ibid. at [225].

(4) The same analysis can apply even where the default has not occurred prior to administration: the right under the BGB exists, even though the applicable rate is subject to the contingency of the default occurring and determination of the quantum or value of the damages interest claim.

26. In its position paper (at [108] [1/10]) Wentworth contends that the existing ruling on Question 4 means that, even where a default was triggered at the commencement of LBIE's administration, if a court has not determined the *value* of the creditor's entitlement to interest by date of the commencement of administration it cannot be a "*rate applicable to the debt apart from the administration"* within the meaning of Rule 2.88(9). This is incorrect:

(1) The issue considered in the context of Question 4 had nothing to do with whether a right to interest of an uncertain or undetermined value as at the date of administration constituted part of the "*rate applicable to the debt apart from the administration"*.

(2) That issue was considered (and answered in the affirmative) in the context of Question 5 (addressing, among other things, the position of variable rates of interest (at [27]-[29] of the Judgment), in relation to which it was agreed that a variation in rates during the course of the administration could be taken into account when assessing the "greater" of two potentially applicable rates for the purpose of Rule 2.88(9)) and Question 7 (addressing the determination of the *"rate applicable to the debt apart from the administration"* in the context of debts which are contingent at the date of administration, and holding that interest applied from the date of administration even in respect of a contingent debt: [187]-[225] of the Judgment).

(3) The issue considered in the context of Question 4 was whether the "*rate applicable to the debt apart from the administration"* in rule 2.88(9) includes (particularly with reference to foreign judgments) a "*judgment rate on a judgment obtained after the commencement of the administration or the judgment rate which would apply to a debt if the creditor had obtained judgment for it but did not in fact do so"* (see *Waterfall ILA* ibid [243(iv)] [173]).

(4) In other words, in Question 4 the court was being asked to consider whether the "*rate applicable to the debt apart from the administration"* could be determined not only by reference to a creditor's rights as at the commencement of the administration but also by reference to any rights

which the creditor could have, or did in fact, acquire *after* the date of administration.

(5) In the context of rights pursuant to a judgment, David Richards J held that "*The words "the rate applicable to the debt apart from the administration" cannot be read as including a hypothetical rate which would be applicable to a debt if the creditor took certain steps"* but that "*the rate applicable to the debt apart from the administration is to be determined by reference to the rights of the creditor as at the commencement of the administration"*: *Waterfall ILA* ibid at [177] and [181].

(6) Accordingly, the distinction drawn by David Richards J in the context of Question 4 is between rights which have an existing legal foundation as at the date of administration on the one hand and rights which have no existing legal foundation as at the date of administration on the other. A right to interest payable on a foreign judgment obtained after the administration would not, on the Judge's analysis, constitute an existing right at the date of administration. In contrast, a pre-existing right under a statutory provision to interest on contractual rights if default occurs is, on the Judge's analysis, a right existing at the date of the administration.

(7) Consider, by way of analogy, a creditor A who is owed a contractual debt carrying interest to be calculated in accordance with a particular formula which A asserts entitles him to 12% interest per annum. A's debt is outstanding at the commencement of the administration. There is a dispute as to the correct application of the contractual mechanism, which is resolved by the Court after the commencement of the administration, and determines that A is entitled to 10% per annum. The effect of the Court's decision is to assess or quantify properly the value of the interest entitlement which has always existed. Following the ruling on Question 4, A is entitled to interest at 10% on the basis that it is a rate applicable to the debt apart from the administration, notwithstanding the steps taken post administration to assess or quantify the value of the interest entitlement.

(8) The right to interest under section 288 of the BGB exists as at the date of administration. Where a default occurs before or on the commencement of administration, the rate is applicable at the commencement of the administration even if the value of the right is uncertain or unquantified as at that date. Even where it does not, the entitlement to damages arising under the BGB applies to the debt proved (i.e. the close-out amount) and is part of a creditor's rights as against LBIE at the commencement of the administration.

E: QUESTION 21 AND ASSIGNMENT

27. The German law issues related to assignment, and Question 21, are of limited scope.

28. In particular, the German law experts agree that, where the damages interest claim is included in the transfer, a "*hybrid*" approach should be applied whereby the damage interest claim would be calculated by reference to the transferor's losses for the period prior to the transfer and by reference to the transferee's losses for the period post transfer (see Mülbert 3 [4/11] [125] and Fischer 1 [4/8] [94, 96]; Joint Statement [4/13] at [29]-[31]).

29. The principal point of dispute between the experts is whether, after assignment (and assuming that there is a claim to compensation/interest for the period following default), the transferee is entitled to claim damages by reference to its actual losses under Section 288(4) of the BGB, irrespective of whether those losses exceed those of the transferor. Whilst Dr Fischer accepts that loss is calculated by reference to the transferee's losses for the period post transfer, he maintains that there is a cap on those losses which prevents a claim being asserted for any greater damage than the transferor would have suffered: Joint Statement at [31]. Professor Mülbert disagrees that there is any such restriction. The same broad themes identified in relation to Question 10 underlie this issue.

30. The Senior Creditor Group contends that (based on the evidence of German law at Mülbert 3 [125]-[146]):

    (1) Any Damages Interest Claim which has been assigned will be calculated by reference to the transferor/assignor's losses for the period prior to the transfer and by reference to the transferor/assignee's losses for the period following the transfer (irrespective of whether the effect is that the debtor pays more as a consequence of assignment): Mülbert 3 at [125] and [130].

(2) This is because any assignment pursuant to Section 398 sentence 2 of the BGB has the effect that "*the new creditor steps into the shoes of the previous creditor*".

(3) As a matter of German law, this provision should be interpreted as meaning that the transferee/assignee is the only person able to claim damages, and, for the period following the assignment, that he is only able to claim compensation for those losses that he incurred himself: Mülbert 3 at [130] and Palandt, BGB 74th Edition 2015: "*The claim for compensation of damages, as a result of complete assignment in the event of breaches of duties, is calculated based on the person of the Assignee.*"

(4) In this regard, Professor Mülbert's opinion reflects the prevailing opinion in German legal literature, where only a few authors take a contrary point of view: Mülbert 3 at [138].

(5) Furthermore, Professor Mülbert emphasises (in parallel with the distinction drawn by the Senior Creditor Group under both English and New York law) the difference between an assignment which imposes different and increased legal burdens on a debtor (which is not permitted), and one which involves an increased burden by reason of the application of the same legal entitlement to the particular factual circumstances of the assignee (which is permitted): Mülbert 3 at [139] and [140]. The debtor was always liable to pay damages pursuant to the terms of the BGB, and the assignment does not alter that liability. The particular damage which can be recovered must, however, take into account the factual position of the assignee.

31. The remaining points on Question 21 can be dealt with shortly and are largely agreed:

(1) A third party will be precluded from asserting a damages interest claim if such a claim arose prior to the assignment and was not transferred to the third party by an (express or implied) assignment agreement, or the

assignment did not extend to any future (potential) damages interest claim: Mülbert 3 at [132] and [141]; Joint Statement at [27] and [28].

(2) The burden of proof in establishing a damages interest claim lies with the claimant: Mülbert 3 at [133], Joint Statement at [33].

(3) The damages are calculated in the same manner as set out above in respect of Question 20, save that damages are calculated by reference to the assignor's position for the period pre-assignment, and the assignee's position for the period post-assignment: Mülbert 3 at [144]; Joint Statement at [31] (subject to the dispute concerning the cap on the transferee/assignee's recoveries).

(4) The mere fact that a transferee/assignee asserting a damages interest claim was aware of the debtor's default prior to the assignment does not preclude the transferee from asserting the claim: Mülbert 3 at [145], Joint Statement at [32].

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26 October 2015

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Gray's Inn

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

WATERFALL II DIRECTIONS APPLICATION

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