Waterfall II Application

No 7942 of 2008

<u>IN THE HIGH COURT OF JUSTICE</u>

<u>CHANCERY DIVISION</u>

<u>COMPANIES COURT</u>

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) GUY JULIAN PARR

(as the joint administrators of the above named company)

<u>Applicants</u>

- AND -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.À R.L

(3) HUTCHINSON INVESTORS LLC

(4) WENTWORTH SONS SUB-DEBT S.À R.L

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

<u>Respondents</u>

WRITTEN REPLY SUBMISSIONS ON BEHALF OF

THE FOURTH RESPONDENT

This reply adopts the definitions used in Wentworth's written submissions dated 16 October 2015, unless a term is defined herein or the context requires otherwise.

1. This reply addresses only a few of the points made in the skeletons served by the SCG and GSI. The remainder of the points are either foreshadowed in Wentworth's written submissions or will be addressed as necessary at the hearing.

<u>Issue 10</u>

Original counterparty

2. The SCG (see, for example, its skeleton at [115]) contends that it would be commercially sensible for the term "*relevant payee*" to include an entity where a transfer of the whole Agreement is made pursuant to a consolidation, amalgamation or merger within Section 7(a) of the ISDA MA. For this reason, it contends that "*relevant payee*" cannot be limited to the original counterparty.

3. This contention misunderstands Wentworth's case. As stated in paragraph 39 of Wentworth's written submissions, Wentworth's case is that relevant payee means LBIE's contractual counterparty, as distinct from the entity to whom the right to payment under Section 6(e) has been transferred. As the SCG recognised in its position paper[1], the relevant distinction is between (i) a party to the agreement and (ii) a person to whom the right to payment under Section 6(e) has been transferred. Where (as in paragraph 50 of Wentworth's written submissions) reference is made to the "*original*" counterparty, that is intended as a reference to either the Defaulting Party or the Non-Defaulting Party in contradistinction to the person to whom the right to payment of the Section 6(e) amount has been transferred. It is not intended to exclude a party who has become a party to the Agreement pursuant to the operation of Section 7(a).

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1 **[1/9/72]**, paragraph 10(4).

Issue 11

The range of transactions conducted under an ISDA MA

4. The SCG's skeleton is replete with references to the broad concepts used in the ISDA MA, and to the fact that its interpretation needs to take account of the fact that it is used for the broadest range of parties, transactions and circumstances: see, for example, paragraphs 5, 13-16, 20-23, 29.

5. It is important to note, however, that all of the materials relied on by the SCG in this context relate to aspects of the ISDA MA *other than* the definition of Default Rate (or the other rates of interest based on the cost of funding language). Most relate to the calculation of the Section 6(e) amount, i.e. the amount due upon termination of the agreement: see, e.g., the *SAL Oppenheim* case at [14] of the SCG's skeleton, the User's Guide excerpt at [16], the *Anthracite* case at [20] and the *Intel Corporation* case at paragraph [23].

6. The broad range of uses, and types of transactions, to which the ISDA MA is applied explains the broad and flexible approach taken to calculation of Loss (under the 1992 MA) or the Close-out Amount (under the 2002 MA). This application is, however, not concerned with those provisions, but with the definition of the Default Rate of interest. That definition is a constant, applicable irrespective of the nature of the underlying transactions, and whose component parts (being the cost to one or other of the parties of funding the relevant amount) have nothing to do with the nature of the underlying transactions.

7. Accordingly, the Court will gain no assistance, in construing the definition of Default Rate, from considering the broad range of circumstances in which, or transactions in connection with which, the ISDA MA is used.

Cost as the amount which a party is required to pay

8. The SCG, at [65], suggest that Wentworth's case that cost equates to what a party is *required* to pay is inconsistent with the limitations on the ability to challenge the

certification process. This is not so. Wentworth does not contend, for example, that a certificate would be open to challenge merely by showing that there was another rate at which the relevant payee could have borrowed which was cheaper than that upon which its certificate was based.

9. As explained in Wentworth's submissions (at [137]-[145]), the rationality standard is not to be applied in a vacuum. In asking whether the relevant payee has acted rationally, there has to be something against which its conduct can be assessed, and that thing is the "*cost*" to it of funding the relevant amount. Wentworth's contention is simply that "*cost*" imports that which <u>has</u> to be paid in exchange for the funding and, in combination with the standard of rationality and good faith, this requires the relevant payee to apply its mind to that which it would have to pay. Measured against "*cost*", in this sense, the rational person seeks to minimise the amount it has to pay. That is not to say, however, that the relevant payee is to exclude from that exercise other factors, such as whether, although secured borrowing would be at a lower rate, it would create other prejudice which made it rational for the relevant payee to certify a rate for unsecured borrowing.

10. The suggestion that Wentworth's construction denies the margin of appreciation the relevant payee is intended to enjoy is wrong for these reasons.

11. In addition the SCG has not explained how its acceptance (in Issues 14 and 15) that a relevant payee might issue an invalid certificate, if it were to certify a matter other than its cost of funding (or if it were to fund) the relevant amount, is to be reconciled with its criticism of Wentworth's submission that "*cost*" has to have some objective content as much as all the other components of the cost of funding language (such as "*the relevant amount*"). That language has to be construed a whole.

GSI's mis-characterisation of Wentworth's 'fall-back' case on cost of equity

12. GSI, at [30(6)], contends that Wentworth implicitly recognises the difficulty in excluding cost of equity because of a "*concession*" in correspondence, which GSI suggests was that in extreme cases, where the counterparty has no access to

borrowing, it may be possible to certify a cost of funding based on the cost of equity funding.

13. This point is based on a mis-reading of the relevant letter, dated 16 June 2015 from Kirkland & Ellis ("**K&E**") **[7/1/134]**. It was a response to a letter from Freshfields for the SCG dated 28 May 2015. In paragraph 2, K&E provided confirmation to the SCG that Wentworth's case was that <u>only</u> cost of borrowing was included within the definition of Default Rate. The remainder of paragraph 2, which makes the point that a certificate could only ever rationally rely on a cost of equity in extreme circumstances, was prefaced with "*if that is wrong*" – clearly indicating that it was only relevant if Wentworth's case – that cost of funding did not include cost of equity – was wrong.

Cost of funding where the relevant payee cannot borrow

14. The Administrators ask for the court's guidance on how a relevant payee should certify its cost of funding where it cannot borrow, on the assumption that Wentworth is correct in contending that cost of funding the relevant amount means the cost of borrowing the relevant amount.

15. Wentworth is not aware of an instance in relation to the LBIE administration where this has occurred. The circumstances would be, as the Administrators note, exceptional, and particularly unlikely in the context of LBIE, given the sophistication of its counterparties. They are not circumstances which the draftsman of the ISDA MA is likely to have had in mind, and the possibility of such circumstances occurring should not drive the approach to construction of the relevant provisions.

16. It is important to note that, if ever an issue at all, it is capable of arising whether or not Wentworth is right in contending that cost of funding equates to cost of borrowing. Even if that is wrong, and cost of funding includes cost of raising funds by issuing equity, the theoretical problem remains of the relevant payee who cannot raise funding at all, whether that be by borrowing or issuing equity.

17. This additional question arises because the definition of Default Rate operates by reference to a transaction, via which the relevant amount is raised. The definition thus assumes that a transaction is possible, and does not on its face provide an answer where that assumption breaks down.

18. It is likely in any event to be difficult to provide a generic answer, without knowing the precise circumstances which prevent the relevant payee from having access to borrowing. The answer may differ, depending on the circumstances, for example depending on whether the inability to raise funds is due to an external event, such as emergency legislation prohibiting transactions, or is due to the financial straits in which the relevant payee finds itself. The issue is best left to be resolved if and when it arises in the context of an actual claim.

19. In the event that an answer is required, notwithstanding the absence of any particular fact pattern in which the issue has arisen, there are two possible answers.

20. First, as the Administrators have suggested, a relevant payee who cannot borrow has no cost of funds, so that the Default Rate is 1%. (This would not necessarily preclude the relevant payee from otherwise recovering interest, for example at a commercial rate in proceedings to recover the unpaid amount.)

21. Second, the definition assumes that the relevant payee is in a position to transact so that, in that rare case where the relevant payee cannot do so, the cost to it “if it were to fund” the relevant amount is the cost to it on the basis that the assumption is correct, i.e. ignoring the restraints which mean that it is incapable of transacting. The result would be the calculation of an interest rate on the basis undertaken in the context of commercial court proceedings: i.e. a market rate that would be available to entities like the relevant payee (see paragraphs 90-92 of Wentworth’s written submissions).

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