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

	CONTENTS		Page

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**"). The members of the Senior Creditor Group through their various affiliates together hold unsecured claims against LBIE in excess of £2.75 billion.

2. 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.

3. This hearing is concerned with Questions 10 to 21 and 27[1] of the Application. These questions address the scope of interest entitlements under or in connection with certain standard form master agreements governed by English, New York or German law:

   (1) Questions 10 to 18 are concerned with the construction of the 1992 and 2002 ISDA Master Agreements (together, the "**Master Agreements**") as a matter of English law. They ask a number of questions relating to the meaning and calculation of the "Default Rate" of interest as defined in Section 14 of the Master Agreements. The parties do not suggest that the answers to Questions 10 to 18 depend on which of the two forms of Master Agreement is used.

   (2) Question 19 asks whether the answers to Questions 10 to 18 are different where Master Agreements are governed by New York rather than English law. Accordingly, the court will also need to consider the issues raised by Question 10 to 18 applying the principles of construction applicable under New York law, as well as any other relevant principles of New York law.

---

[1] Questions 17 and 22 – 26 (concerning the construction of certain French Master Agreements) have been removed from the Application.

(3) Questions 20 to 21 relate to the proper interpretation of the German Master Agreement and the German Civil Code. They are concerned with the extent of creditors' rights to claim interest on certain sums due under the German Master Agreement and whether such claims can constitute part of the "*rate applicable to the debt apart from the administration*" for the purposes of rule 2.88(9) of the Insolvency Rules 1986.

(4) Question 27 asks whether the answers to Questions 10 to 21 would be impacted where the relevant payee falls into one of three categories of counterparty (a credit institution or financial institution; a fund entity; or a corporate or other type of counterparty). All the parties agree that the answers to Questions 10 to 21 apply equally irrespective of the category of counterparty.

4. This skeleton argument addresses Questions 10 – 19[2], all of which are concerned with the meaning and effect of the Master Agreements. In terms of structure:

(1) Questions 11 to 13 are addressed first. They are concerned with the meaning and scope of the definition of "Default Rate" in the Master Agreements.

(2) Question 10 is addressed after Questions 11 to 13. This is because it is concerned with the rights of an assignee under the Default Rate provision. It is therefore addressed once the basic meaning and effect of the Default Rate provision has been considered.

(3) Questions 14 to 16 and 18 are addressed after Question 10. Questions 14 to 16 relate to the certification of the Default Rate and, in particular, the circumstances in which a certification of the Default Rate may be challenged. Question 18 asks whether a right to interest can be assigned under the terms of the 1992 Master Agreement. Subject to a narrow

---

2 The skeleton argument in respect of the German law issues will be filed separately on 26 October 2015.

dispute in connection with Question 14, the answers to Questions 14 to 16 and 18 are understood to be agreed between the parties.

(4) Question 19 is addressed last, since it involves a further consideration of the issues raised by Question 10 to 18 from the perspective of New York law.

B. THE ISDA MASTER AGREEMENT

5. Copies of the 1992 and 2002 Master Agreements are at [5/2] and [5/3], respectively. Paragraphs 6 – 24 below describe the development and basic framework of the Master Agreements. In summary:

(1) The Master Agreements are clearly and carefully drafted documents, developed over many years with the benefit of the knowledge of the market.

(2) They are designed to be used by a variety of different parties, to cover a range of transactions and to address a spectrum of commercial contexts and financial circumstances.

(3) As such, the Master Agreements use general and broad concepts, rather than rigid and narrow ones, to ensure that they are flexible enough to apply across a wide range of potential users and circumstances.

(4) At the same time, the Master Agreements incorporate contractual powers of determination and certification, which may accommodate a range of possible answers subject only to the requirements of rationality and good faith, and which limit the scope for dispute and the potential for litigation. In this way, the general concepts used in the Master Agreements operate with a high degree of finality and certainty in any particular case.

(5) Accordingly, wherever possible, the Master Agreements should be construed in a manner which ensures their terms are appropriate and relevant to the broadest range of parties, transactions and circumstances.

(1) ISDA

6. The International Swaps and Derivatives Association's ("**ISDA**") primary purpose is to encourage the prudent and efficient development of privately negotiated derivatives business.

7. ISDA has over 800 member institutions from 68 countries, including most of the world's major institutions that deal in over the counter derivatives, as well as businesses, governmental and supranational entities, investment managers, insurance companies, energy and commodities firms and international and regional banks.

8. ISDA has developed standard contractual wording and transaction architecture for market participants in the form of ISDA Master Agreements. Of the standard forms that are still in use and in issue in these proceedings:

   (1) The 1992 version of the Master Agreement was the first version that was designed in a form applicable to derivatives other than just swaps, including pure contracts for differences, caps and floors and to accommodate both financially and physically settled transactions.

   (2) The 2002 Master Agreement replicates, for the most part word for word, the provisions of the 1992 version albeit with significant changes to provisions concerning the determination of amounts due on early termination.

9. Both the 1992 and 2002 versions of the ISDA Master Agreements continue to be used, depending on the parties' preference: see *Lomas v. JFB Firth Rixson* [2010] EWHC 3372 (Ch) at [8] per Briggs J.

10. The Master Agreements, in their various iterations, are the most commonly used master agreements for over the counter derivative transactions internationally. According to statistics compiled by the Bank of International Settlements, as at the end of December 2014 the total notional amount of over the counter derivatives in existence was $630 trillion.

(2) THE ARCHITECTURE OF THE MASTER AGREEMENTS

11. The architecture of the ISDA Master Agreements is described in detail in the judgment of Longmore LJ in *Lomas v. JFB Firth Rixson* [2012] 2 All ER (Comm) 1076 at [12] and in the first instance judgment of Briggs J (at [9] – [27]).

12. The basic framework is as follows:

(1) The Master Agreements provide contractually agreed standard terms and conditions which are designed to form part, but not the whole, of the terms of any particular transaction. Their purpose is to set out provisions governing the parties' relationship that are not transaction-specific.

(2) A particular transaction is generally governed by the terms of a Confirmation, together with the Master Agreement and any Schedule appended to the Master Agreement. The Master Agreement and all Confirmations form a single agreement between the parties, albeit one which governs one or more transactions. Inconsistencies are resolved by affording priority first to the Confirmation, secondly to the Schedule and lastly to the Master Agreement itself.

(3) The Master Agreements envisage that certain provisions will only become operative if the parties make an election in the Schedule and the content of other provisions may depend on what is specified there. The Schedule also gives the parties the opportunity to add to or vary any of the terms contained in the standard form and also to include information (such as addresses for notices) which is specific to the parties.

(4) Every transaction will be subject to a Confirmation. For example, in relation to interest rate swaps, each Confirmation will identify a series of dates upon which the parties are or may be obliged to make payments to each other and will contain the formulae necessary to identify the amounts to be paid. Any fixed rate payable will be specified. Any floating rate will generally be identified by reference to a particular market formula, such as three months sterling LIBOR.

(5) The basic payment obligation of the parties is contained in Section 2 of the Master Agreement. Those payment obligations are subject to the conditions precedent specified in Section 2(a)(iii), which include that no Event of Default or Potential Event of Default has occurred and is

continuing and that no Early Termination Date has occurred or been effectively designated.

(6) Under Section 6(a) of the Master Agreements, if an Event of Default with respect to a party (the "Defaulting Party") has occurred and is continuing, the other party (the "Non-defaulting Party") may (but is not required to) designate an "Early Termination Date" in respect of all outstanding transactions. Where "Automatic Early Termination" is specified in a Schedule, an Early Termination Date will occur immediately on the occurrence of certain specified Events of Default.

(7) Events of Default are defined in Section 5 of the Master Agreements. They include a failure to make, when due, any payment required under Section 2(a)(i) (Section 5(a)) and "Bankruptcy Events" (at Section 5(a)(vii)), including where a party seeks or becomes subject to the appointment of an administrator.

(8) Where an Early Termination Date occurs, all transactions entered into pursuant to the Master Agreement are terminated. The Non-defaulting Party is entitled to determine the amount to be paid on Early Termination, in accordance with Sections 6(d) and (e). The broad effect of the provisions is to procure, as far as possible but in an accelerated form, the same economic outcome for the parties as if there had been neither an Event of Default nor an Early Termination: *Lomas v. JFB Firth Rixson* [2010] EWHC 3372 (Ch) at [18]. As such, the amount calculated as due on Early Termination may be payable by either party, dependent on which is "in the money".

(9) The termination payment formulae under Section 6(e) are not to be equated, or interpreted rigidly in accordance with, the quantification of damages at common law for breach of contract. They are contractual methods of calculating close-out positions on the termination of a derivative transaction or series of transactions: *Anthracite Rated Investments (Jersey) Ltd v. Lehman Brothers Finance SA (in liquidation)* 2 Lloyds Rep 538 at [116] *per* Briggs J.

(3) THE DRAFTING OF THE MASTER AGREEMENTS

13. The Master Agreements are designed to be utilised by a variety of different parties, ranging from financial institutions and banks to non-financial corporates and public bodies, in relation to a huge range of different transactions, from straightforward standard derivatives (such as interest rate or currency swaps) to complex and bespoke transactions.

14. In *Lehman Brothers Finance SA v SAL Oppenheim JR & CIE. KGAA* [2014] EWHC 2627 Burton J stated (at [25(iii)]) that:

> *"the ISDA Master Agreement is intended to be normative, and to apply in as many situations and with as much straightforward application as possible"*

15. The Master Agreements are drafted in a way which is designed to ensure that their provisions are appropriate and relevant in a range of different circumstances, including by using general and broad concepts, rather than rigid and narrow concepts.

16. Thus, for example, the User's Guide to the 2002 Master Agreement at 5(a) [5/6/235] explains that drafting changes to early termination provisions were introduced in order to bring greater flexibility to the Master Agreement:

> *"Close-out Amount is a payment measure developed to offer greater flexibility to the party making the determination of the amount due upon the designation and occurrence of an Early Termination Date and to address some of the potential weaknesses of Market Quotation that became apparent during periods of market stress in the later 1990s. The need for increased flexibility was highlighted during the market crises in 1998 and 1999 when many determining parties encountered difficulty in trying to obtain quotations from Reference Market-makers as required by the definition of Market Quotation in the 1992 Agreement."*

(4) CONTRACTUAL POWERS OF DETERMINATION AND CERTIFICATION PROCESSES

17. The use of general and broad concepts in the Master Agreements has the inevitable consequence that, in any particular case, there might be a range of

possible approaches available to the party that is to make the applicable determination under the agreement.

18. The Master Agreements therefore incorporate contractual powers of determination and certification which are designed to limit the scope for dispute and the potential for litigation. They do so by deferring to the determining or certifying party, whilst requiring it to act *bona fide* and rationally when applying the Master Agreements' general concepts to its particular circumstances.

19. In this way, the general concepts used in the Master Agreements operate with a high degree of finality and certainty in any particular case, whilst at the same time ensuring that the Master Agreements are flexible enough to apply across a wide range of potential users and circumstances.

20. This characteristic of the Master Agreements has been widely acknowledged. For example, in *Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance SA* [2011] EWHC 1822 (Ch) Briggs J stated (at [115]) that:

> *"the overriding control tests of commerciality and reasonableness provide a measure of flexibility within the Master Agreement sufficient to enable it to be applied across a range of different types of transaction, in an infinitely variable combination of different circumstances."*

21. For example:

    (1) Under the 1992 Master Agreement, there are two possible payment measures available to determine the amount due on Early Termination. First, Market Quotation, which involves a process of the Non-defaulting Party obtaining quotations for replacement transactions from Reference Market-makers and, second, Loss.

(2) Where Loss applies, the 1992 Master Agreement gives the Non-defaulting Party a contractual power to determine such Loss, which is to be exercised "*reasonably and in good faith*"[3].

(3) The Non-defaulting Party is the relevant decision-maker, whose determination cannot be challenged unless it is one which no reasonable Non-defaulting Party acting in good faith could have come to: *"It is essentially a test of rationality"*: *Fondazione Enasarco v Lehman Brothers Finance SA* [2015] EWHC 1307 at [53] *per* David Richards J.

22. Provisions of the Master Agreements which permit an assessment to be made by one or more of the parties therefore accommodate a range of possible answers, subject only to the requirements of rationality and good faith.

23. These principles were most recently recognised in the decision of the US Bankruptcy Court in the Southern District of New York in *Lehman Brothers Holdings Inc v Intel Corporation* S.D.N.Y. Sep. 16 2015, where the court held (at p.22):

> *"As the expert report of Professor Jeffrey Bruce Golden, one of the principal drafters of the 1992 ISDA Master Agreement, makes clear, the drafters desired the certainty that an Early Termination payment, once determined, would be conclusive and legally enforceable – not necessarily the certainty that the Early Termination Payment would be calculated in a particular way. As Professor Golden explains:*
>
> *…the wide discretion afforded the non-defaulting party…the considerable advantages given to the non-defaulting party, and the marked reluctance to allow second guessing of a party that determines a settlement amount can only be understood if market interest in 'certainty' and the perceived difficulties encountered in otherwise discovering facts and confirming consensus in a global marketplace are fully appreciated…setting specific fixing times or process was not the game. Neither was searching for the 'correct' or 'perfect' (or even 'best') answers. The goal was to stay within acceptable parameters based on the particular objectives of the parties. In 1992, this goal was reflected in the general terms of reasonableness and good faith. Assuming an outcome based on these principles, an early termination determination was expected to be*

3 A similar framework applies to the calculation of the Close-out Amount under the 2002 Master Agreement.

conclusive. Whether a different result might also have been reached was irrelevant."

24. A similar regime applies to the determination of interest rates payable on certain sums owed under the Master Agreements. In particular, the definitions of Default Rate, Non-Default Rate and Termination Rate each rely on a certification by the determining party, which can only be challenged on the grounds of irrationality or bad faith[4].

4 The circumstances in which a certification can be challenged are addressed in the context of Question 14.

C. THE PRINCIPLES OF CONSTRUCTION

25. The approach to the construction of commercial agreements such as the Master Agreements is well known. The legal principles are set out in the judgment in the Supreme Court of Lord Clarke JSC (with whom the other judges agreed) in *Rainy SKY SA v. Kookmin Bank* [2011] 1 WLR 2900, in particular at [21]:

> *"The language used by the parties will often have more than one potential meaning. I would accept the submission made on behalf of the appellants that the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other."*

26. In the context of the Master Agreements, the following principles are also relevant:

(1) The ISDA Master Agreement is one of the most widely used forms of agreement in the world. It is probably the most important standard agreement used in the financial world: see *Lomas v. JFB Firth Rixson* [2011] 2 BCLC 120 at [53] *per* Briggs J. Decisions about how English law interprets the ISDA Master Agreement therefore have major implications (see *KBF v. UBS* [2014] EWHC 2450 at [120]).

(2) In light of their status in the market, it is "*axiomatic*" that the Master Agreements should, *"as far as possible be interpreted in a way that achieves the objectives of clarity, certainty and predictability, so that the very large number of parties using it know where they stand"*: *Lomas v. JFB Firth Rixson ibid.* at [53] *per* Briggs J.

(3) The Master Agreements are clearly and precisely drafted documents, developed over many years with the benefit of the knowledge of the market: see *The Joint Administrators of Lehman Brothers International (Europe) v. Lehman Brothers Finance SA* [2013] EWCA Civ 188 at [87].

(4) The drafting of the Master Agreements is aimed at ensuring, among other things, that they are sufficiently flexible to operate among a range of users in an infinitely variable combination of different circumstances: *Anthracite Rated Investments (Jersey) Limited v. Lehman Brothers Finance SA ibid. per* Briggs J (at [115]). As such, caution should be taken before adopting a narrow construction of its provisions (see, for example, the Court of Appeal's rejection of a narrow interpretation of "*option rights*" in *The Joint Administrators of Lehman Brothers International (Europe) v. Lehman Brothers Finance ibid.*, at [88]).

(5) Equally, contractual powers of determination and certification processes ensure that the general concepts utilised by the Master Agreements give rise to results which are certain and (absent irrationality or bad faith) binding: see *Lehman Brothers Holdings Inc v. Intel Corporation* ibid.

D. QUESTION 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) INTRODUCTION

The issue raised by Question 11

27. Question 11 is concerned with the meaning of the definition of "Default Rate" in the Master Agreements. The question posed is whether certain matters are in principle *capable* of falling within the meaning of the words "cost of funding" as used in the definition of Default Rate.

28. The draftsman has not defined "funding" or "cost of funding" and the court should be slow to do so. Whether any given state of affairs falls within the language of the provision is, in large part, a question of fact which will usually best be determined on a case by case basis[5].

[5] See, by analogy, the potential difficulties and concerns in a case like the present one which have been identified in other cases; *Re Smalley* [1985] AC 622 at 644; *Axa Corporate Solutions SA v National Westminster Bank plc & Ano* [2010] 2 C.L.C 149 at [130] *per* Hamblen J; *Wolman v Islington LBC* [2008] RTR 6 at [11].

29. Further, in light of the status and importance of the Master Agreements, the court should be cautious about concluding that something is not capable of falling within the meaning of the words "cost of funding" in *any* of the *"infinitely variable combination of different circumstances"* in which the Master Agreements may apply: *Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance SA* ibid at [115].

The definition of Default Rate and its function

30. The Default Rate is defined as:

> "*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"*

31. The Default Rate defines the rate of interest payable to a relevant payee on certain sums due, but unpaid, under the Master Agreements[6].

32. Its basic function and purpose is to compensate the relevant payee for its lost time value of money by awarding it the "cost" that it has or would have incurred by "funding" a sum equal to the amount owed, plus 1%.

33. This makes commercial sense:

(1) The primary loss suffered by a relevant payee as a consequence of a failure to pay an amount which is due, is the benefit forgone by not being able to deploy such funds in its business from the time at which they were meant to be paid.

---

6 The most significant application of the Default Rate in the context of LBIE's administration is to sums calculated as due on Early Termination: see Section 6(e)(ii) and the definition of "Applicable Rate" in the 1992 Master Agreement and see Section 9(h)(ii)(2) and the definition of "Applicable Close Out Rate" in the 2002 Master Agreement.

(2) A reasonable payee may act, or may be treated as acting, to prevent those losses by funding an amount equal to the sums owed to it, in order to put itself into the position it would have been in if it had been paid promptly.

(3) In such circumstances, the Default Rate provides compensation by reference to the "cost" which was (or would have been) incurred by the relevant payee as a consequence of funding the amount owed.

(2) OVERVIEW OF THE SENIOR CREDITOR GROUP'S POSITION

34. The Senior Creditor Group and GSI contend that "funding" and "cost" are broad concepts which reflect the fact that the Master Agreements are intended to operate in a variety of circumstances among a range of users with a variety of funding imperatives and approaches. They should be given their ordinary and natural meaning and should not be circumscribed by limitations that are not expressed in the language of the Master Agreements.

35. As such:

(1) "Funding" includes any source or sources of funding (i.e. of raising money). It is capable of including debt funding, equity funding, funding through hybrid instruments (such as convertible debt or preference equity), repo funding or any other source or combination of sources of funding.

(2) 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.

36. The definition of Default Rate deals both with the cost to the relevant payee "*of funding*" and also the cost "*if it were to fund*" the relevant amount. The issues which arise are slightly different in the two situations:

(1) Where the relevant payee has, in fact, raised an amount equal to the sums owed, the relevant "*funding*" is the source of funding actually used. Where the relevant payee has not, in fact, raised an amount equal to the sums owed to it, the relevant "*funding*" depends on the relevant payee's rational and good faith determination of the source of funding it *would* have used if it had raised an amount equal to the sums owed. So long as the relevant payee's approach is rational and in good faith, it does not matter that a different approach to determining how it would have funded the relevant amount might also have been taken.

(2) Once the relevant payee has determined how it did or would have funded the relevant amount, it is required to make a rational and good faith determination of the "*cost*" of that funding. The relevant payee is not bound to follow any one methodology when doing so. So long as the relevant payee's approach is rational and in good faith, it does not matter that another answer might also have rationally been arrived at[7].

37. Accordingly, the Default Rate clause may accommodate a range of possible answers, subject to the requirements of rationality and good faith. This is the case irrespective of whether the relevant payee has, in fact, obtained funding in a sum equal to the relevant amount. However, the margin of deference and flexibility afforded to the relevant payee is greater where it has not done so since, in those circumstances, it is required to make a rational and good faith determination of the source of the "*funding*" it would have used as well as the "*cost*" associated with it[8].

---

7 At a CMC on 9 March 2015, the Senior Creditor Group applied for permission to adduce expert evidence in the field of corporate finance to assist the court in understanding the various sources of funding available, the costs that an entity may incur in relation to such funding sources and how such entities can and do calculate their funding costs, including the costs of equity funding. David Richards J held that he did not think that such evidence was required, and refused the Senior Creditor Group's application.

8 See, in this regard, Lomas 12 [2/8/319-397], which illustrates (albeit solely in the context of debt funding) how different results can arise depending on the basis or duration of such debt funding used by the relevant payee, or which the relevant payee determines rationally and in good faith it would have used, and the methodology for calculating the cost of such funding.

38. The certification process is an integral part of the regime. It ensures that, notwithstanding the broad concepts used in the Default Rate clause, and which are necessary for it to apply across a wide range of potential users and circumstances, determinations can be made with relative ease and certainty, without second-guessing and litigation, and will be binding so long as they have been made rationally and in good faith.

39. In contrast to the Senior Creditor Group and GSI, Wentworth and the Administrators contend that the definition of Default Rate should be construed narrowly.

(1) They both contend that "*funding*" should be read as meaning only "borrowing", irrespective of (i) the way in which the relevant payee has, in fact, funded or would have funded the relevant amount and (ii) the fact that the language used refers to cost of "funding", not "borrowing".

(2) In addition, Wentworth (but not the Administrators) contends that "cost" should be given a special, narrow, meaning in the context of the Default Rate, and should be read as referring to the "*lowest amount which the [relevant payee] would be required to pay over the relevant period*", irrespective of the actual costs incurred, or which would (in the relevant payee's rational and good faith assessment), have been incurred by the relevant payee in funding the relevant amount (see [1] of Wentworth's Supplemental Position Paper [6/16/2]).

40. The position adopted by Wentworth and the Administrators is contrary to the plain wording of the Master Agreements and is unsupported by the commercial purpose of the "Default Rate" provisions. It is inconsistent with the need to ensure that the Master Agreements operate meaningfully across a range of contexts and among a range of parties, leads to uncertainty and unpredictability and increases the potential for dispute and litigation. This is particularly the case in light of Wentworth's position on the meaning of "costs", the practical (and no doubt intended) effect of which would be to undermine the intended finality of the certification process.

(3) "FUNDING"

The language of the ISDA Master Agreement

41. The Master Agreements are carefully drafted documents, developed over many years with the benefit of the knowledge of the market. Respect should be afforded to the plain wording of the definition of "Default Rate", which allows the relevant payee to certify a cost of "*funding*" based on any source of funding and, in particular, does not limit that funding to debt funding.

42. There are a number of ways in which commercial entities may seek to fund themselves. They may utilise debt funding, equity funding, hybrid instruments (such as convertible debt or preference equity), repo funding, sale and leaseback funding or some other form or combination of forms of funding.

43. There is no justification in the wording of the Default Rate for limiting the concept of "*funding*" solely to some types of funding:

 (1) The definition of Default Rate draws no distinction between different types of funding. It refers to "*the cost…to the relevant payee…if it were to fund or of funding the relevant amount"*. Any interpretation of that clause that would limit a relevant payee's cost of funding to its cost of borrowing would have to: (i) read down the word "*funding*" to mean "borrowing"; or (ii) imply into the definition words which would achieve that result. There is no justification for either approach.

 (2) It is plain from the phrase "*the cost…to the relevant payee…if it were to fund or of funding the relevant amount"*, that the Default Rate is intended to be counterparty specific - the relevant payee is required to identify the cost which *it* incurred or would incur in funding the relevant amount. If the relevant payee did, in fact, fund such an amount through, for example, equity then, as a matter of straightforward construction, that is the relevant source of "*funding*" for the purposes of the Default Rate clause. Similarly, if the relevant payee determines rationally and in good faith that it would have funded the relevant amount through, for example, equity

funding, that is the relevant source of "*funding*" for the purposes of the Default Rate clause.

44. Accordingly, there is nothing in the wording of the Master Agreements to support the contention that "*funding*" should be read down and construed as debt-funding. For the purposes of the term "Default Rate" the word "*funding*" should be given its ordinary and natural meaning, reflecting the fact that the Master Agreements are intended to operate in a variety of circumstances among a range of users with a variety of funding imperatives.

The commercial rationale of the Default Rate clause

45. The function and purpose of the Default Rate clause is to compensate the relevant payee for its lost time value of money by awarding it the "*cost*" that it has or would have incurred by "*funding*" a sum equal to the amount owed, plus 1%. It is therefore concerned with how the relevant payee actually did replace the relevant amount ("*cost…of funding*") or the relevant payee's rational and good faith assessment of how it would have replaced the relevant amount ("*cost…if it were to fund*").

46. The only interpretation of the Default Rate which gives effect to its purpose, is one which permits the relevant payee to certify, subject to a duty to act rationally and in good faith, a cost of funding which takes into account any type of funding used or which would have been used to fund the relevant amount.

47. In this regard, the Default Rate clause can only operate meaningfully across the range of potential users of the Master Agreements and their individual circumstances if it is capable of including equity funding since, whether or not any particular form of funding is, or would be, available to or used by a relevant payee at a particular time depends on myriad factors, including market conditions, the nature and imperatives of the relevant payee's business, regulatory demands and capital maintenance requirements.

48. For example:

(1) Regulatory requirements may prevent a relevant payee from funding the relevant amount, in whole or in part, otherwise than by equity funding:

(a) All regulated financial institutions are required by law and regulation to maintain a certain amount of equity capital against their assets (i.e. a "capital ratio"). Capital ratio requirements have applied since before the 1992 Master Agreement was drafted and at all material times since.

(b) The regulatory framework requires that such financial institutions must hold a certain amount of equity capital against assets funded on the balance sheet. As additional assets are funded, or losses are incurred, financial institutions may be restrained from introducing further debt into the funding mix and may only be able to raise further funds through equity.

(c) The Master Agreements were plainly drafted taking account of the position of such financial institutions and their funding imperatives. Thus:

(i) Financial institutions are major users of the Master Agreements and participated in the formation of ISDA and the processes by which the 1992 and 2002 forms were drafted.

(ii) The capital regulation of financial institutions has influenced the evolution of the Master Agreements. For example, certain changes made to the close-out provisions in the 2002 Master Agreement were introduced specifically because "*the provisions of the 1992 Master Agreement did not produce a closing out which met regulators' requirements with regard to the capital base of the market participants*": *The Joint Administrators of Lehman Brothers International (Europe) v. Lehman Brothers Finance SA* ibid. at [10], [88].

(d) It is inconceivable that the draftsman would have intended for the Default Rate to operate other than meaningfully in circumstances where the relevant payee is a financial institution and in a manner which is divorced from the context in which financial institutions operate.

(2) Even where regulatory requirements do not require the relevant payee to raise additional sums by way of equity funding, it may be commercially necessary or reasonable for the relevant payee to do so. For example:

(a) There may be a commercial imperative to raise equity funding where the default in payment has worsened the relevant payee's financial position to such an extent that, unless it raises equity to fill the gap, counterparties are unwilling or reluctant to trade with it or may only do so on commercially unviable or on onerous or unattractive terms.

(b) Most companies seek to maintain a certain debt / equity ratio. Those ratios are set at a particular level for a variety of valid commercial reasons particular to the relevant entity. It may be commercially reasonable for a relevant payee to seek to maintain that ratio by raising a mix of debt and equity funding in response to a payment default, for example because incurring additional debt without a corresponding amount of additional equity raises the risk of it being unable to meet its obligations.

(c) It may appear to the relevant payee that the indebted-party may never pay the relevant amount, or might only do so at some indeterminate point in the future. In those circumstances, it may be necessary or reasonable for the relevant payee to fill the gap left by non-payment on a permanent basis. It may be rational and appropriate for it to do this through the use of equity funding.

49. In contrast to the Senior Creditor Group's and GSI's position, there is no sensible reason why the Default Rate clause should operate in the manner contended for by Wentworth and the Administrators:

(1) Where the relevant payee, acting rationally and in good faith, funded or determines that it would have funded the relevant amount through equity funding, hybrid instruments or a combination of sources of funding, there is no commercial justification for the Default Rate to provide compensation by reference instead to the cost of debt funding. That is, there is no reason for the Default Rate to require compensation to be assessed by reference to a cost which the relevant payee did not incur, or could, or would not have incurred, as opposed to one which it actually or would have incurred.

(2) Equally, if the relevant payee was not entitled to certify, subject to a duty to act rationally and in good faith, a cost of funding that takes into account any type of funding used or which would have been used to fund the relevant amount, then it would not be fully or accurately compensated for the costs which it actually or would have incurred, contrary to the purpose and function of the Default Rate.

50. Further, any interpretation of the definition that was limited to debt funding would be unworkable in practice. Many enterprises use both equity and debt funding, but there is not always a strict division between debt and other types of funding. For example, parties to the Master Agreements may issue hybrid instruments or preference equity to fund the relevant amount, which may contain elements characteristic of both debt and equity funding. The position adopted by Wentworth and the Administrators is likely to give rise to definitional issues and a degree of uncertainty, which is contrary to the regime envisaged by the Master Agreements, and result in arbitrary distinctions.

51. The Default Rate provision is intended to compensate a relevant payee for the cost of funding the gap left by non-payment. The Senior Creditor Group's and GSI's position is consistent with that purpose, and ensures that such provision is applicable and relevant to the full range of potential users. By contrast,

Wentworth's and the Administrators' positions undermine the purpose of the Default Rate provision since they mean that, in certain cases and for certain users, that provision would determine compensation by reference to a cost which the relevant payee did not incur and would not have incurred and, conversely, would not provide compensation for the cost which they actually incurred or which they rationally and in good faith determined that they would have incurred.

(4) "COST OF FUNDING"

52. The Default Rate provision entitles the relevant payee to certify, rationally and in good faith, the "*cost*" of funding the relevant amount. Such cost is capable of including all costs borne by the relevant payee in funding or if it were to fund the relevant amount, including sums paid, benefits provided or financial detriment incurred in maintaining, raising or servicing the relevant type of funding.

53. It is nonsensical to suggest that, if an entity chooses actually to fund the non-receipt of funds by way of raising equity rather than borrowing, it has not incurred any cost of funding in the relevant sense.

54. All sources or combination of sources of funding have costs associated with them, and a variety of established methods exist to measure such costs. For example:

    (1) The cost of debt funding includes a calculation of the return to be provided to the entity's lenders on their debt investments, which represents the compensation that the market demands in exchange for providing debt funding to the relevant entity. It also includes all costs borne by the relevant payee in acquiring and servicing such funding, including, for example, any professional costs and fees paid by the funded party.

    (2) Similarly, the cost of equity funding reflects a calculation of the return to be provided to the entity's shareholders on their equity investments, which represents the compensation that the market demands in exchange for providing equity funding to the relevant entity. It also includes all

costs borne by the relevant payee in acquiring and servicing such funding, including, for example, any professional costs and fees paid by the funded party.

(3) The cost of all of an entity's funding (its "cost of capital") is a calculation of the return to be provided to all of the entity's investors (debt and equity) on their investments, which represents the compensation that the market as a whole demands in exchange for providing funding to the relevant entity.

55. A number of well-established methods exist for measuring such costs, which are used by companies, accountants and other commercial parties. For example:

(1) In the case of the cost of equity, the most commonly used model for assessing the cost of equity funding is the capital asset pricing model ("CAPM") which is recognised by both the academic and commercial communities and is used by investment analysts, utility regulators, corporate planners, companies and government officials. CAPM calculates the cost of equity by predicting the future returns required by investors through the examination of historic returns. CAPM therefore provides a measure of the cost of equity by reference to the anticipated rate of return on shareholders' investment. The prevalence of CAPM as a method for calculating the cost of equity has been recognised by the courts. For example, in *Multi Veste 226 B.V. v NI Summer Row Unitholder* [2011] EWHC 2026 (Ch) at [261] Lewison J noted that "*the experts agreed that the capital asset pricing model ("CAPM") is an accepted method used to estimate a cost of equity based on market data"*. In *Gul Bottlers (PVT) Limited v Nichols plc* [2014] EWHC 2173 (Comm) at [145] Cooke J described CAPM as constituting "*The most widely utilised method for estimating the cost of equity"*.

(2) In the case of an entity's combined debt and equity funding, WACC (weighted average cost of capital) is frequently used[9]. WACC constitutes a

9 See McKee 3 at [19] and, generally, the illustrations of the "Second Basis of Calculation" provided in McKee 3.

well-established framework for calculating the average cost of all of an entity's different sources of funding (debt and equity). WACC is computed by calculating an average of each of these costs, weighting each component according to what portion of the total funding is contributed by that particular type of funding. The prevalence of WACC as a calculation method has been recognised by the courts. For example, WACC is commonly used in a compensatory context where it is necessary to assess the present value of future losses to a particular entity. Specifically, WACC is used as the appropriate discount rate for accelerated payment, reflecting the fact that the time value of money to an entity should be calculated with reference to its cost of capital; see, for example *Multi Veste 226 B.V. v. NI Summer Row Unitholder* ibid at [255] – [266]; and *Gul Bottlers (PVT) Limited v. Nichols plc* ibid at [109], [144]–[146] and [152].

(5) "AS CERTIFIED BY IT"

56. While there are a number of methods for measuring the cost of various sources of funding, it is inherent in the definition of Default Rate that the relevant payee is not bound to follow any one methodology. As with the Non-defaulting Party's determination of the applicable early termination amount, a relevant payee's determination of its cost of funding may accommodate a range of possible answers, subject to the requirements of rationality and good faith.

57. The certification process is therefore an integral part of the regime. It gives a contractual right to the relevant payee to determine (without proof or evidence of actual cost to it) its cost of funding and *"explicitly precludes an issue of fact contest with regard to the proper default rate"*: *Finance One Public Company Limited v Lehman Brothers Special Financing Inc* [2003] WL 21638214 of July 11 2003. In this way, the Master Agreements limit the scope for dispute and the potential for litigation by ensuring that, notwithstanding the need for subjective assessment required by the Default Rate clause, determinations can be made with relative ease and certainty and, absent irrationality or bad faith, will be final.

(6) ADMINISTRATORS' AND WENTWORTH'S ARGUMENTS

The Administrators' Argument

58. In their Position Paper [1/17/404-422], the Administrators contend that "*there is no cost of equity in the relevant sense*" (at [24]) and that, if a relevant payee cannot fund the relevant amount by borrowing, there would be no "*cost…if it were to fund or of funding the relevant amount*" and the Default Rate for that counterparty would simply be 1% per annum (at [25(4)]).

59. The Administrators do not contend that entities financed solely by equity necessarily have no funding cost at all. Nor could they sensibly do so. If that were the case, companies would never borrow money, because equity funding would have no cost, and equity investors would never invest, because there would be no expected returns.

60. Nor, however, is there any textual, commercial or other justification for construing the Default Rate clause in a way which treats the costs of equity funding as not a cost "*in the relevant sense*" and thus as irrelevant:

(1) To do so would be to ignore the fact that an entity's cost of equity funding is treated as economically relevant by banks and other commercial entities when assessing their funding costs (i.e. the cost to the entity of the sources of funding, including equity funding). For example, a bank's funding costs, which includes its cost of equity funding, is an important and readily available metric for a bank since it is used to work out a bank's pricing for trades and may affect a wide range of economic variables, with important implications for both monetary and financial stability.

(2) To do so also ignores the fact that the economic significance of the cost of equity funding is recognised by the courts through, for example, their acceptance of the use of an enterprise's WACC as determining the appropriate discount rate when assessing the present value for that enterprise of future losses.

(3) The Administrators acknowledge (at [25(4)]) that the effect of their argument is that a relevant payee that had no access to borrowing would only be entitled to Default Rate interest at the rate of 1% per annum. The implication of that argument is that, if the effect of the default on the relevant payee's financial condition and ability to borrow is that the non-defaulting party is now viewed as such a bad credit risk that it can only borrow at 15%, the relevant payee is entitled to use that number to calculate the Default Rate. But if the default has such a devastating impact on the relevant payee's creditworthiness that it cannot borrow at all, it gets 1%. In other words, on the Administrators' argument the defaulting party is better off if its default destroys the relevant payee's ability to borrow than if it simply impairs it. Such a result cannot have been intended by the draftsman of the Master Agreements.

(4) Further, the concept of cost of funding, as used in the Default Rate clause, is concerned with an on-going process (funding) which has (or may have) certain on-going costs associated with it. As a matter of commercial reality, the on-going cost of equity funding includes the return that an entity pays to its shareholders in exchange for providing it with funding. It is plainly a "cost of funding" in the relevant sense.

61. The Administrators' position fails to take into account the significance of the certification process to the determination of a relevant payee's cost of funding. If and to the extent that there is uncertainty as to the "correct" calculation of an entity's cost of equity funding in any particular case, it is resolved through good faith and rational certification.

Wentworth's Argument

62. In support of its contention that "funding" means "debt funding", Wentworth contends that the Default Rate clause "*implies that the amount to be funded is required to be repaid at the end of the period, which is an essential feature of borrowing, not of equity*" (see [3] of Wentworth's Reply to GSI's Position Paper [1/16/399]).

63. However, the Default Rate clause implies no such thing. Not only is there no linguistic justification for such a limitation, but in addition:

(1) Although the Default Rate must be paid for the period for which the relevant amount is outstanding, it in no way follows that the relevant amount can only be funded by term funding of a matching duration. It makes no sense to construe the Default Rate in that way in circumstances where the relevant payee will almost never know how long the relevant amount will be outstanding.

(2) There is nothing to prevent the relevant payee from raising long or short duration borrowing or equity or any other sort of funding to fund the relevant amount, or prevent the relevant payee from determining the cost of doing so for the relevant period. Such a process is entirely consistent with the language and purpose of the Default Rate clause, provided the approach is rational and in good faith.

(3) Further, where it appears that the relevant amount could be outstanding for an indefinite period (as was initially thought to be the likely position in relation to LBIE), or would only be paid at some indeterminate point in the future, one rational and good faith response would be for the relevant payee to fill the funding gap on a permanent basis and do so through the use of equity funding.

(4) The distinction Wentworth seeks to draw between the respective durations of equity and debt funding is inaccurate. Equity funding can be raised for a limited period, as in the case of preference shares which need to be redeemed on a certain date, or any shares which are subsequently redeemed or repurchased. Conversely, borrowing can be raised on different bases, with more or less open-ended terms for repayment, such as bonds with no maturity date (so-called perpetual debt).

64. Wentworth (but not the Administrators) also contends that "*cost*" should be given a special, narrow, meaning in the context of the Default Rate, and should be read as referring to the "*lowest amount which the [relevant payee] would be required to pay over the relevant period*", irrespective of the actual cost incurred by the relevant payee in funding the relevant amount (see [1] of Wentworth's Supplemental Position Paper [6/16/569]). Wentworth contends that "*any amount over and above the lowest amount is not a cost but an amount paid voluntarily*" (see [1] of Wentworth's Supplemental Position Paper).

65. Wentworth's contention is incorrect:

(1) The determination of the Default Rate turns on how the relevant payee actually did replace the relevant amount ("*cost…of funding*") or the relevant payee's good faith and rational assessment of how it would have replaced the relevant amount ("*cost…if it were to fund*"). In this regard, there is no reason to assume that an entity which did or which determines that it would have funded the relevant amount other than at the lowest cost available in the market would invariably be acting irrationally or in bad faith. It may be rational and in good faith for a relevant payee to take other terms or the impact on its overall capital structure or access to future funding into account, and not just the amount of the coupon, when deciding how to fund or determining how it would fund the relevant amount.

(2) Wentworth's position is unsupported by the language of the Default Rate clause. The definition of Default Rate entitles the relevant payee to certify the "*cost*" that it did or would have incurred in funding the relevant amount. Any interpretation of that clause that would limit a relevant payee's "cost" of funding to the "*lowest amount which the [relevant payee] would be required to pay*" would have to: (i) read down the word "*cost*" to mean "lowest cost"; or (ii) imply into the definition words which would achieve that result. There is no basis for either approach in the language used in the clause.

(3) Wentworth's position is inconsistent with the purpose of the Default Rate clause. The purpose of the Default Rate clause is to compensate a relevant payee for the cost of funding the gap left by non-payment. Wentworth's position defeats this purpose since it would mean that a relevant payee might not be entitled to receive compensation in respect of the cost which it actually or would have incurred in funding the relevant amount.

(4) Wentworth's position is based on an unsustainable distinction between a "*cost*" which, according to Wentworth, means "lowest cost", and an "amount paid voluntarily" which, according to Wentworth, is any cost that, with hindsight, is determined to be in excess of the "lowest cost". The amount of interest actually payable or which would have been payable on debt funding (for example) represents a cost of such funding even if such debt funding might, hypothetically, have been obtained at a lower rate of interest.

(5) Wentworth's position leads to consequences that the draftsman cannot sensibly have intended. For example, it is not clear what steps it is said the relevant payee is required to take in order to determine the lowest cost of funding or what this might involve. Is the relevant payee, for example, only entitled to the cost of secured funding, on the basis that the cost of secured lending is likely to be lower than the cost of unsecured lending? If so, is the relevant payee also obliged to use a particular form of secured lending, whether fixed or floating, and over what assets? Is the relevant payee also obliged to agree to terms which are commercially onerous and which it would not normally agree to, because that will lower the interest rate charged?

(6) Wentworth's position gives rise to practical difficulties and is premised on the assumption that it is always possible to identify the irreducible minimum cost of funding. It is not clear whether, on Wentworth's case, the relevant payee is required to determine the lowest cost of funding at the time of default, at the time of certification or at the time of payment or whether it is required to do so with or without the benefit of hindsight.

Irrespective of how these sub-issues might be resolved, they are likely to give rise to practical difficulties, impose additional administrative costs and make the process of determining the Default Rate burdensome and complicated for the relevant payee, contrary to the function and purpose of the Default Rate.

(7) Wentworth's position runs contrary to the regime envisaged by the Master Agreements. As with the process for determining the amount of an early termination payment, the certification process relating to the determination of interest on that payment is intended to ensure that determinations of the Default Rate can be made with relative ease and certainty and will be final, absent irrationality or bad faith. The practical effect of Wentworth's position would be to undermine that certainty and finality, since it would mean that even a good faith and rational certification would be open to challenge on the basis that it might be possible to identify a lower cost of funding. Wentworth's position involves an illegitimate attempt to permit the paying party to challenge a certification, not on the basis that it was irrational or in bad faith, but because it was not, by reference to some undefined measure, the lowest cost of funding.

(7) CONCLUSIONS ON QUESTION 11

66. The Senior Creditor Group's and GSI's position reflects the plain wording and commercial purpose of the "Default Rate" provision. It respects the flexibility of the Default Rate provision, enabling it to operate in a meaningful way in a variety of contexts and to a range of potential users. It is consistent with the aims of certainty and predictability, enables determinations to be made quickly and with relative ease and limits the scope for dispute and litigation, by ensuring that good faith and rational determinations of the Default Rate are final and binding.

67. By contrast, the Administrators' and Wentworth's position depends on reading down the ordinary and natural meaning of the Default Rate provision or reading in words which are not there, in circumstances where there is no reason why the Default Rate clause should operate in the manner contended for by them. It

would also introduce uncertainty and unpredictability by giving rise to definitional issues and, in the case of Wentworth's position on the meaning of "cost", replace the finality of the certification process with an illegitimate inquiry into the lowest cost of funding available to the relevant payee. It would require the relevant payee to "certify" a cost of funding that bears no necessary relationship to the manner in which it did fund or would have funded the relevant amount and is inconsistent with the way in which entities do, in fact, fund themselves and calculate the costs of that funding. It should be rejected.

68. In the circumstances, the Senior Creditor Group contends that the Question 11 should be answered as follows:

(1) As regards Questions 11(1) and (2), subject to the relevant payee's obligation to certify its cost of funding in good faith and rationally, the expression *"cost (without proof or evidence of actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount*" is capable of including the actual or asserted cost to the relevant payee of raising money to fund the relevant amount by whatever means and may include shareholder funding as well as, or in the alternative to, borrowing or other forms of funding.

(2) As regards Question 11(3), subject to the relevant payee's obligation to certify its cost of funding in good faith and rationally, the determination of the costs referred to above may take into account the consequences for the relevant payee of carrying a defaulted LBIE receivable on its balance sheet, as where (for example) the relevant payee's cost of borrowing or cost of shareholder funding is increased as a consequence of having a LBIE receivable on its balance sheet.

(3) As regards Question 11(4), the expression *"cost (without proof or evidence of actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount*" is not capable of including the actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE (except in the manner referred to in connection with the answer to Question 11(3)).

E QUESTION 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 funding for some other duration?

(1) INTRODUCTION

69. The issues raised by Question 12 arise in circumstances where the relevant payee has not, in fact, raised an amount equal to the sums owed and has decided rationally and in good faith that it would have done so, in whole or in part, through debt funding.

70. As explained in the context of Question 11:

(1) Where the relevant payee has not, in fact, raised an amount equal to the sums owed to it, the relevant "*funding*" depends on the relevant payee's rational and good faith determination of the nature of funding it *would* have used if it had raised an amount equal to the sums owed. So long as the relevant payee's approach is rational and in good faith, it does not

matter that a different approach to determining how it would have funded the relevant amount might also have been taken.

(2) Once the relevant payee has determined how it would have funded the relevant amount, it is required to make a rational and good faith determination of the "*cost*" of that funding. So long as the relevant payee's approach is rational and in good faith, it does not matter that a different approach to determining that cost might also have been taken.

71. The court is being asked to determine Question 12 in the abstract. As such, it is being asked to decide whether it would be irrational or in bad faith for any relevant payee, irrespective of its particular circumstances:

(1) To determine that it would have obtained debt funding on either of the bases identified by Question 12(1) or for any of the durations identified by Question 12(4); or

(2) To calculate the cost of such debt funding in a particular way (Question 12(2)) or by taking into account particular categories of cost (Question 12(3)).

(2) THE SENIOR CREDITOR GROUP'S POSITION

72. Any of the bases identified in Question 12 is capable of forming part of a valid (that is, a rational and good faith) determination by a relevant payee of its cost of funding depending on the facts and circumstances.

Question 12(1)

73. Question 12(1) asks whether, in circumstances where the relevant payee rationally and in good faith determines that it would fund the relevant amount by debt funding, it should be assumed that such funding has recourse solely to the relevant payee's claim against LBIE or to the rest of the relevant payee's unencumbered assets.

74. As to this:

(1) Where a relevant payee has unencumbered assets, a decision that it would have funded the relevant amount with debt funding that has recourse to the whole of its unencumbered assets is likely, depending on the particular facts and circumstances, to be a rational and in good faith determination.

(2) However, the precise nature and extent of such debt funding may depend on the particular circumstances of the relevant payee. Such circumstances may influence or determine, for example, whether such funding could or would have been secured or unsecured, depending on whether or not the relevant payee is constrained by covenants in existing debt facilities or its commercial circumstances more generally. Such matters may also influence or determine other terms of such funding, including the nature of any covenants likely to be required and its likely duration. All such factors are capable of affecting the relevant payee's rational and good faith determination of the precise nature of such debt funding, and in turn its cost.

(3) It is materially less likely to be rational and in good faith in most cases for a relevant payee to determine that it would have funded the relevant amount with debt funding that has recourse solely to the unpaid LBIE receivable. However, it may be rational and in good faith for the relevant payee to have decided that it would have done so where it has no other unencumbered assets.

Question 12(2)

75. Question 12(2) asks whether, in circumstances where the relevant payee rationally and in good faith determines that it would fund the relevant amount by debt funding, the cost of such funding should: (a) include the incremental cost to the relevant payee of incurring additional debt against its existing asset base; or (b) include the weighted average cost on all of its borrowings.

76. As to this:

(1) The Default Rate clause requires the relevant payee to make a rational and good faith determination of the cost to it if it were to raise an additional sum of money equal to the "*relevant amount*". It therefore requires the relevant payee to make a rational and good faith determination of its incremental cost of funding in relation to the additional funding it determines, rationally and in good faith, it would have obtained.

(2) So long as the relevant payee's determination of such incremental cost of funding is rational and in good faith, it is binding. It does not matter that a different (but similarly rational) approach to determining that cost might also have been taken.

(3) Depending on the facts and circumstances, there are a number of potentially permissible ways for a relevant payee to make a rational and good faith determination of its incremental cost of funding (whether debt funding, equity funding or any combination of the two).

(4) For example, depending on the particular facts and circumstances, a relevant payee that determines, rationally and in good faith, that it would have obtained debt funding may determine its incremental cost of debt funding by reference to the coupon that it determines, rationally and in good faith, would be charged to it over the relevant period, along with any professional costs and fees that might also be payable.

(5) Equally, depending on the particular facts and circumstances, it may be rational and in good faith for the relevant payee to determine its incremental cost of debt funding by reference to the average cost of all its borrowing. This will be the case where, for example, the relevant payee rationally and in good faith determines that the average cost of its existing debt is equivalent to the incremental cost of incurring additional debt.

(6) The same proposition holds true with respect to any combination of debt and equity funding that the relevant payee rationally and in good faith determines that it would have raised. For example, if the relevant payee rationally and in good faith determines that it would have funded the relevant amount through a mixture of debt and equity in a proportion sufficient to maintain its existing debt / equity ratio, it may be rational and in good faith for the relevant payee to determine the incremental cost of such funding with reference to its weighted average cost of capital or "WACC" (i.e. on the basis explained at McKee 3 [19], [20] (and illustrated at [28], [38], [49]) [2/4/190-204]).

Question 12(3)

77. Question 12(3) asks whether, in circumstances where the relevant payee rationally and in good faith determines that it would fund the relevant amount by debt funding, the cost of such funding should include any impact on the cost of the relevant payee's equity capital attributable to such borrowing.

78. As to this:

(1) Depending on the particular facts and circumstances, it may be rational and in good faith for the relevant payee to include in its determination of its cost of funding any impact obtaining additional funding has on the cost of other sources of funding.

(2) Even where a relevant payee determines that it would have funded the relevant amount through debt funding, the cost to it of doing so can include additional costs resulting from its increased leverage, including an increase in its overall cost of borrowing or an increase in the cost of its equity capital. This is because increased borrowing increases risk to shareholders and thereby increases its cost of equity; see McKee 3 [15] [2/4/188].

Question 12(4)

79. Question 12(4) asks whether, in circumstances where the relevant payee rationally and in good faith determines that it would fund the relevant amount by debt funding, the cost of such funding should be calculated based on obtaining: (a) overnight funding; or (b) term funding to match the duration of the claim to be funded; or (c) funding for some other duration.

80. As to this:

(1) The answer depends on the relevant payee's rational and good faith determination of the nature of funding it *would* have used if it had raised an amount equal to the sums owed.

(2) For the reasons stated in the context of Question 11, there is no basis in the Master Agreements for limiting the types of funding encompassed within the definition of Default Rate.

81. The Senior Creditor Group, GSI and Wentworth accordingly all agree that, depending on the particular facts and circumstances, it may be rational and in good faith for a relevant payee to determine that it would have funded the relevant amount on the basis of overnight funding, long term funding, term funding to match the duration of the claim to be funded or funding for any other duration.

82. So far as the Administrators' position is concerned:

(1) The Administrators agree that it would not always and invariably be irrational or in bad faith for a relevant payee to determine its cost of funding on the basis of the cost of overnight funding or funding for any other duration (Administrators' Position Paper at [30(4)] [1/17/420]).

(2) The Administrators contend, however, that, in the context of LBIE's administration, it would invariably be irrational or in bad faith for a relevant payee to determine its cost of funding on the basis of obtaining

term funding to match the duration of the claim to be funded since no relevant payee could have known at the outset of LBIE's Administration that LBIE's unsecured debts would ultimately be paid in full or how long that would take to occur (Administrators' Position Paper at [30(2)-(3)]).

(3) The Senior Creditor Group 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. However, that fact tends to demonstrate why, in the context of LBIE's Administration, it could be rational and in good faith for a relevant payee to determine that it would have obtained long duration funding (including equity funding).

F QUESTION 13

Whether 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" 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.

(1) SENIOR CREDITOR GROUP'S POSITION

83. Question 13 is concerned with whether the relevant payee is required to make a determination of the Default Rate by reference to its circumstances on any particular date. It is also concerned with the extent to which events occurring after the relevant Early Termination Date can or should be taken into account by the relevant payee when determining the applicable Default Rate.

84. The definition of Default Rate deals both with the cost to the relevant payee "*if it were to fund*" and also the cost "*of funding*" the relevant amount. The issues raised by Question 13 need to be considered in each of these situations.

85. Where the relevant payee has not, in fact, raised an amount equal to the sums owed to it, then:

(1) As explained in the context of Question 11, when certifying the Default Rate the relevant payee is required to make a rational and good faith determination of the funding it would have used (including the basis and duration of such funding) if it had raised an amount equal to the sums owed. It is then required to make a rational and good faith determination of the cost of such funding.

(2) When determining the funding it would have used (including the basis and duration of such funding), the relevant payee is required to determine

what it would have done on the date the early termination amount fell due and, where applicable, at all times thereafter. This follows from the fact that, where an Early Termination Date has occurred, the Default Rate compensates the relevant payee for delayed payment of the early termination amount by awarding the annual cost of funding that amount over the period for which it is outstanding.

(3) When certifying its cost of funding, the relevant payee is required to determine the cost it would have incurred in connection with such funding. As to this:

(a) Depending on the particular facts and circumstances, it may be rational and in good faith for the relevant payee to take into account events occurring between the Early Termination Date and the date of certification. This is likely to be the case where the relevant payee determines (rationally and in good faith) that such events shed light on the cost it would have incurred in connection with the relevant funding. For example, where the relevant payee has validly determined that it would have funded the relevant amount through overnight funding and where its overnight funding costs have fluctuated or changed between the Early Termination Date and the date of certification it may be rational and in good faith for the relevant payee to take such changes into account when certifying its cost of funding.

(b) Equally, depending on the particular facts and circumstances, it may be rational and in good faith for the relevant payee not to take into account events occurring between the Early Termination Date and the date of certification when certifying its cost of funding. This is likely to be the case where the relevant payee determines (rationally and in good faith) that such events do not shed any light on the cost it would have incurred in connection with the relevant funding. For example, where the relevant payee has validly determined that it would have funded the relevant amount through long-term funding and where the period of that funding has not expired at the date of certification, it may be rational and in good faith for the relevant payee not to take such changes into account when certifying its cost of funding.

86. Where the relevant payee has, in fact, raised an amount equal to the sums owed to it then, when it comes to certifying the Default Rate, it must determine the cost of such funding. Depending on the particular facts and circumstances, a rational and good faith determination may take into account, or may not take into account, events occurring between the Early Termination Date and the date of certification, depending on the relevant payee's assessment of whether such events do or do not shed any light on the cost of the funding used.

87. For the avoidance of doubt, and contrary to the characterisation of the Senior Creditor Group's position at [31(1)] of the Administrators' Position Paper, the Senior Creditor Group does not contend (and has never contended) that the relevant payee can certify its cost of funding by reference to a historic date because this would give rise to a high cost. A retrospective calculation designed to create the highest possible cost is not a rational or good faith determination of the Default Rate.

(2) WENTWORTH'S POSITION

88. Wentworth (but no other party) contends that the relevant payee may only certify the Default Rate "*at the end of the period*" (i.e. once the early termination sum has been repaid in full) and calculated from time to time on a fluctuating basis (Wentworth's Revised Position Paper, [17]; [18]; [19] [1/10/112-113]). According to Wentworth, this is because the "true cost" of funding the relevant amount can only be known at the end of the relevant period.

89. Wentworth's contention is incorrect:

(1) Wentworth position is unsupported by the language of the Default Rate clause. Neither the 1992 nor the 2002 Master Agreement contains any requirement or limitation as to the time at which the Default Rate is to be

calculated or certified. If the Master Agreements intended to require certification to take place on or after a particular date, they would have said so in terms (see, in this regard, 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)).

(2) Wentworth's position undermines the aims of certainty and finality. If the Default Rate could only be certified after the early termination amount has been paid in full, there would be no means of providing certainty as to the amount of interest accruing under the Master Agreements from time to time, which may be necessary for a variety of reasons, or to know, in advance and with certainty, the financial consequences of a continued delay in payment.

(3) Wentworth's position is premised on an incorrect characterisation of the purpose and function of the Default Rate clause. Contrary to Wentworth's position, the Default Rate clause is not concerned with identifying the supposed "*true cost*" of funding the relevant amount, in the sense of there being only one "right" amount, still less does it require any certification to be provided solely at the end of the period. As explained in the context of Question 11, it is concerned instead with rational and good faith determinations by the relevant payee and, in the interests of achieving certainty and finality and limiting the scope for dispute and the potential for litigation, may accommodate a range of possible answers subject to the requirements of rationality and good faith.

G QUESTION 10

Question 10: 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.

90. The Senior Creditor Group contends that, on the true construction of the term "*Default Rate*", the "*relevant payee*" refers to whichever entity or person was or is entitled to receive payment of the Early Termination Amount (or "*relevant amount*") from LBIE from time to time and to the period of such entitlement.

91. For the reasons set out below, that construction is the only construction of the relevant phrase which is consistent both with the language used and with the commercial purpose of payment of interest at the Default Rate.

(1) QUESTION 10 IN CONTEXT

92. LBIE's entry into administration amounted to an Event of Default for the purpose of both the Master Agreements ([5/2] and [5/3]) entitling the counterparty to designate an Early Termination Date, alternatively the immediate occurrence of an Early Termination Date by reason of Automatic Early Termination where applicable (Section 6(a) of the Master Agreements).

93. Payments due upon the occurrence of an Early Termination Date are governed by Sections 6(d) and 6(e) of the Master Agreements. Those provisions give rise to a payment obligation defined as the Early Termination Amount in the 2002 Master Agreement, or measured in accordance with Section 6(e) of the 1992 Master Agreement (by reference to the concepts of "*Market Quotation*" or "*Loss*", and either the First or Second Method of payment).

94. Interest is payable on the amount due pursuant to Section 6(e) of the Master Agreements at the "*Applicable Close-out Rate*" (Section 9(b)(3)(ii)(2) of the 2002 Master Agreement) or the "*Applicable Rate*" (Section 6(d)(ii) of the 1992 Master Agreement).

95. Where the amount due pursuant to Section 6(e) remains outstanding for the period after the Early Termination Date and that amount is payable by the Defaulting Party, such interest is payable at the Default Rate[10].

96. The amount due pursuant to Section 6(e) of the Master Agreements will not, however, always be payable to the original contracting party.

97. Section 7 of the Master Agreements is concerned with transfer. Section 7 of the 2002 Master Agreement [5/3/59] provides:

> *"Subject to Section 6(b)(ii)[1]* [i.e. Transfers to Avoid Termination Events] *and to the extent permitted by applicable law, neither this Agreement nor any interest or obligation in or under this Agreement may be transferred (whether by way of security or otherwise) by either party without the prior written consent of the other party, except that:-*
>
> *(a) A party may make such a transfer of this Agreement pursuant to a consolidation or amalgamation with, or merger with or into, or transfer of all or substantially all of its assets to, another entity (but without prejudice to any other right or remedy under this Agreement); and*
>
> *(b) A party may make such a transfer of all or any part of its interests in any Early Termination Amount payable to it by a Defaulting Party, together with any amounts payable on or with respect to that interest and any other rights associated with that interest pursuant to Sections 8* [Contractual Currency]*, 9(h)* [Interest and Compensation] *and 11* [Expenses].
>
> *Any purported transfer that is not in compliance with this Section 7 will be void."*

Section 7 is in identical terms in the 1992 Master Agreement [5/2/31], save that (i) the words "*and to the extent permitted by applicable law*" do not appear in the first line and (ii) the language of sub-paragraph (b) differs, being "*a party may make such*

10 Limb (b)(ii)(2) of the definition of Applicable Close-Out Rate in the 2002 Master Agreement; limb (b) of the definition of Applicable Rate in the 1992 Master Agreement. A general explanation of the Interest and Compensation provisions found in the 2002 Master Agreement is contained in Section I.8 of the User's Guide to the 2002 ISDA Master Agreement [5/6/243].

a transfer of all or any part of its interest in any amount payable to it from a Defaulting Party under Section 6(e)".

98. Section 7 provides that a counterparty to whom an amount is due pursuant to Section 6(e) of the Master Agreements may transfer all or any of its interests in the amount payable, and associated rights (including interest thereon[11]), and may do so without the consent of the Defaulting Party[12].

99. It is in this context that Question 10 arises. It raises the issue of the meaning of the phrase "*relevant payee*" in the definition of Default Rate in circumstances where such a transfer has occurred.

100. The Court is required to determine whether, in those circumstances, the use of the phrase "*relevant payee*" in the definition of Default Rate:

(1) Refers only to the original contractual counterparty (as the Administrators and Wentworth contend). If that is the case, the Default Rate requires the assignee to certify the original contractual counterparty's cost of funding the relevant amount for the entire period for which that amount is outstanding[13]; or

(2) Refers to whoever is entitled to receive the relevant amount from time to time (as the Senior Creditor Group contends). If that is the case, the Default Rate requires the assignee to certify the cost of funding of whichever entity or person is entitled to payment of the Section 6(e) amount from time to time.

---

11 Question 18 raises the question of whether there is power pursuant to Section 7 to transfer any contractual right to interest under the Master Agreements. It is common ground that there is such a power. This conclusion is supported by the explanation provided in Section H of the User's Guide to the 2002 Master Agreement [5/6/30].

12 Such transfer will take effect as a matter of English law as an assignment of rights rather than a novation. The beneficiary of such a transfer is therefore referred to in this skeleton argument as the assignee.

13 Question 16 addresses the question of whether it is only the relevant payee who is able to certify its cost of funding, or whether anyone expressly or impliedly authorised by the relevant payee can do so, and what should be done if the relevant payee is incapable of providing such certification.

101. A similar issue arises in relation to the Master Agreements where they are governed by New York law and in relation to the German and French master agreements.

(2) THE LANGUAGE USED

102. Both the 1992 and 2002 Master Agreements define the term "Default Rate" ([5/2/34] and [5/3/68]) 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*". (emphasis added).

103. The Master Agreements provide no definition of the phrase "*relevant payee*"[14].

104. As a matter of language, "*relevant payee*" in the Default Rate clause is capable of being read and should be construed as meaning whichever person or entity was or is entitled to receive payment of the "*relevant amount*" from time to time:

(1) The word "*payee*" should carry its ordinary meaning of "*a person to whom payment is, or is to be, made*" (Stroud's Judicial Dictionary 8th ed.);

(2) The word "*relevant*" suggests that, in respect of any outstanding amount, there may be two or more potential payees such that it is necessary to identify the payee who is most closely connected to, or appropriately associated with, the payment in question (by reason of being the payee entitled to receive the payment from time to time).

105. The definition of Default Rate refers to the cost "*to the relevant payee*" and not to a, or the relevant, "*party*".

(1) "*Relevant payee*" ought as a matter of construction to bear a different meaning from "*party*".

---

14 By contrast, for the purpose of Section 6(f) of the 2002 Master Agreement, "*Payee*" (capitalised) is given a specific meaning [5/3/58].

(2) The use of the phrase "*relevant payee*" in the context of the Default Rate is to be compared to the drafting of the definition of Termination Rate, which refers instead to "*party*", and provides for the payment of (emphasis added):

> "*a rate per annum equal to the arithmetic mean of the cost (without proof or evidence of any actual cost) to each* *__party__* *(as certified by each party) if it were to fund or of funding such amounts*".[15]

106. Had it been the draftsman's intention to refer only to the original counterparty, that could and, in light of the precision with which the Master Agreements are drafted, would have been made clear.

107. This is particularly the case in circumstances where the Master Agreements permit a Section 7 transfer to take place without the consent of the Defaulting Party and envisage that any Default Rate may therefore be payable to a person other than the original counterparty, where:

(1) The Master Agreement is transferred pursuant to a consolidation or merger with or into, or a transfer of all or substantially all of its assets to, another entity; or

(2) The Early Termination Amount is transferred to a person other than the original counterparty.

108. The Administrators refer to the fact that under the Master Agreements there are circumstances in which interest is payable at the Default Rate by one *party* to the agreement to the other *party* to the agreement.

---

15 That the draftsman chose to refer to "*each party*" may, in this instance, reflect the fact that the defined term requires reference to two people for the purpose of conducting the calculation (i.e. it is based on an arithmetic mean of the cost to each party if it were to fund or of funding the relevant amounts), and the fact that this was regarded as an efficient method of drafting (Wentworth suggests "*more economical and less cumbersome*" at [38] of its Reply Position Paper). However, whatever the reason, the relevant point for present purposes is that, in the context of the Default Rate, the draftsman chose not to use the term "*party*", but rather "*relevant payee*".

109. However, contrary to the Administrators' suggestion, these provisions support the Senior Creditor Group's position and indicate that "*relevant payee*" is meant to carry its ordinary meaning of a person to whom payment is to be made:

(1) The 1992 and 2002 Master Agreements contain separate provisions governing interest payable before and after the designation of an Early Termination Date.

(2) The provisions requiring payment of interest at the Default Rate prior to the designation of an Early Termination Date uniformly specify, in terms, that such interest will be paid "*to the other party*" (see Section 2(e) of the 1992 Master Agreement; Section 9(h)(i) of the 2002 Master Agreement).

(3) By contrast, the provisions requiring the payment of the Default Rate *after* the designation of an Early Termination Date – the situation here – uniformly *omit* any such reference (see Section 6(d)(ii) of the 1992 Master Agreement; Section 9(h)(ii) of the 2002 Master Agreement).

(4) This distinction corresponds to the fact that the Default Rate on amounts due after designation of an Early Termination Date may be payable to a "*payee*" who is not a "*party*" by virtue of the freedom to assign without counterparty consent under Section 7(b) of the Master Agreements.

110. The Senior Creditor Group's construction of "*relevant payee*" for the purpose of the Default Rate therefore reflects the ordinary meaning of the actual words used by the draftsman, and is consistent with the language and terminology used elsewhere in the Master Agreements.

111. Furthermore, the premise of Wentworth's and the Administrators' reliance on the concept of "*party*" is in any event incorrect. It is not the case that every reference to "*party*" in the Master Agreements is necessarily limited to the original contracting parties. For example:

(1) A transfer by reason of consolidation, amalgamation or merger for the purpose of Section 7(a) of the Master Agreements may mean that the

original "*party*" ceases to exist or has no ongoing interest in the agreement (even though it continues to govern outstanding Transactions). "*Party*" as used elsewhere in the Master Agreements must in such a scenario be capable of extending to the transferee following such a transfer;

(2) A transfer pursuant to Section 7(b) of the 2002 Master Agreement may include all or any part of the original counterparty's interest in any Early Termination Amount, as well as "*any other rights associated with that interest pursuant to Sections 8, 9(h) and 11*":

(a) Where that has occurred, the right of any "*party*" to receive payment in the Contractual Currency (and any corresponding obligation to refund an excessive payment) pursuant to Section 8 ought to be capable of extending to the assignee. "*Party*" for the purpose of, for example, Section 8(d) ought also to extend to the assignee as the entity which will have suffered any loss if payment is not made in the Contractual Currency; and

(b) The obligation of a Defaulting Party under Section 11 to indemnify and hold harmless the other "*party*" for and against all reasonable out-of-pocket expenses, including legal fees, execution fees and Stamp Tax incurred by such other "*party*" by reason of the enforcement and protection of its rights under this Agreement must, in light of the express reference to Section 11 in Section 7(b), be capable of extending to the assignee's own legal fees, execution fees and other reasonable out-of-pocket expenses.

112. In circumstances where the Master Agreements have been drafted so that they may be governed by English or New York law, giving effect to the ordinary meaning of the language used should be of particular importance:

(1) This is consistent with the approach under English law that it is axiomatic that such agreements should as far as possible be interpreted in a way that achieves the objectives of clarity, certainty and predictability.

(2) It is particularly important in the context of New York law, given the importance placed on the meaning of the language used by the parties and, in the absence of any ambiguity, on the exclusion of background evidence outside of the contract itself (see Question 19 below).

113. There is nothing in the drafting of the Master Agreements which suggests that, as a matter of language, "*relevant payee*" cannot or should not bear its ordinary meaning as set out above.

(3) COMMERCIAL SENSE

114. The Senior Creditor Group's approach to the meaning of "*relevant payee*" is the only construction that makes commercial sense within the scheme of the Master Agreements as a whole, and in light of the purpose of the interest provisions:

(1) The Default Rate is concerned with identifying the appropriate level of compensation payable in respect of the delayed payment of certain sums due under the Master Agreements. It does this by awarding the "*cost*" that has or would be incurred in "*funding*" the amount which has not been paid.

(2) Before a Section 7(b) transfer, it makes sense for the Default Rate to provide compensation by reference to the original counterparty's cost of funding: in such circumstances it is the original counterparty who has been deprived of the benefit of timely receipt of the payment, and who suffers any corresponding loss.

(3) Where there has been a Section 7(b) transfer, the Early Termination Amount is payable to the assignee and not the original contracting party. In such circumstances, it does not make sense for the Default Rate to continue to provide compensation by reference to the original counterparty's cost of funding. It is the transferee and not the transferor who is now being deprived of timely receipt of the monies due.

(4) It is therefore logical that the "*relevant payee*" would be the person entitled to receive such sums at any given time. Prior to transfer, this person is the transferor. After the transfer it is the transferee who is now being deprived (and continues until payment to be deprived) of the benefit of timely receipt of the payment, and who suffers any corresponding loss.

(5) There is no good commercial reason for the Default Rate to provide compensation by requiring an assignee to certify the original counterparty's cost of funding potentially in respect of a period of years after the original counterparty has disposed of its interest in the relevant amount and in circumstances where the real cost of the Defaulting Party's continued failure to pay is now being borne by the assignee.

(6) If Wentworth's and the Administrators' construction of "*relevant payee*" was correct, the consequence would be that an assignment between a Non-Defaulting Party with a high cost of funding, and an assignee with a lower cost of funding, would require the payor to continue to pay the Default Rate based on the high cost of funding, irrespective of the fact that such cost was no longer being borne by the assignor and irrespective of the fact that the assignee was suffering loss at a lower level (reflecting its lower cost of funding).

(7) There is no unfairness or lack of commerciality in construing "*relevant payee*" to mean the person entitled to payment of the sum on which the Default Rate is payable from time to time.

(8) If the original contracting parties wish to avoid this possibility, assignment could have been prohibited or made subject to a requirement for consent in every instance. The Defaulting Party can also avoid any continuing liability to pay the Default Rate (including any risk of paying cost of funding by reference to the assignee's position) by paying what it owes.

115. The position is the same where a transfer occurs under Section 7(a) by consolidation or amalgamation with, or merger with or into, or transfer of all or substantially all of the original counterparty's assets to, another entity. In such a situation, it would also be commercially sensible for the new entity to be treated as the "*relevant payee*" and entitled to recover its cost of funding, even though it was not the original counterparty.

116. The fact that the construction for which the Senior Creditor Group contends is not contrary to commercial sense is confirmed by the approach under German and French law in respect of their master agreements, in respect of which the same issue arises:

(1) The Senior Creditor Group contends that, as a matter of German law, provided that the Damages Interest Claim has been included in the transfer to the third party, such a claim will be calculated by reference to the assignor's losses for the period prior to the transfer and by reference to the assignee's losses for the period following the transfer: Mulbert 2 at para 125 [4/11/272]. This is the case even if the effect is that the debtor may have to pay more as a consequence of the assignment: *ibid*. The Court is required to determine this question as Issue 21 and, in this regard, Wentworth's expert accepts that "*From the date of the assignment, the emergence of damages claims must be assessed from the position of the assignee*" (see para 4 of Dr Fischer's Report at [4/8/125]). He also acknowledges that, despite his own views on the issue, the prevailing view in legal literature is that the debtor must also bear any larger losses incurred by the assignee (see para 96(a) of Dr Fischer's Expert Report at [4/8/152]).

(2) Issues relating to the French law master agreements are not before the Court, Wentworth and the Senior Creditor Group having agreed the approach that the Administrators should adopt on the basis that any disputes were not economically material or sufficient to justify the Court resolving the issues. But there was, again, expert evidence in relation to certain of the French law master agreements (the position differing depending on the language used) which supported the recovery by the assignee of its own losses post assignment even if they would have exceeded the losses of the assignor: see the evidence of Professor Synvet at paras 39-41 of his first report and paras 13-19 of his reply report.

(4) GENERAL PRINCIPLES OF ASSIGNMENT

117. Wentworth in its Position Paper at [38] seeks to support its position regarding the meaning of "*relevant payee*" by referring to general principles relating to the law of assignment. For the reasons set out below, such principles do not assist but are, in any event, consistent with the Senior Creditor Group's position.

118. First, as noted above, the Master Agreements may bring about results which differ materially, and in some cases radically, from those which would have arisen at common law absent the contractual provisions contained therein; see paragraph 12(9) above.

119. What is key is what the parties have, as a matter of construction, agreed. It would be wrong to approach the question of construction by assuming that the parties intended to mirror any general principle of common law, or that they are to be treated as having done so unless they indicated the contrary. This is particularly important in circumstances like the present case where:

(1) The Master Agreement may be governed by New York law, rather than by English law.

(2) Even where the Master Agreement is governed by English law, the parties may have little or no knowledge or understanding of common law

principles of assignment and there is no reasonable basis for treating them as if they did.

120. Second, and in any event, the result contended for by the Senior Creditor Group is consistent with general principles:

(1) The proposition that an assignee cannot recover greater damages than would be recoverable by the assignor (as expressed in *Dawson v Great Northern & City Railway Co* [1905] 1 KB 260; *Offer-Hoar v Larkstone Ltd* [2006] EWCA Civ 1079 at [38] to [42], [48] to [53], [75] to [83] and [86]) is necessarily subject to the terms of the contract and the assignment.

(2) If a contract, properly construed, is intended to be of benefit to all parties who may subsequently acquire an interest in the contractual rights because the original parties anticipated future assignments, the original parties cannot complain about the existence of claims for loss suffered by the assignees. In every such case, a question arises as to the scope of the rights created by the original contract which are the subject of the assignment.

(3) An assignment of contractual rights may be such as to limit the ability of the assignee to recover anything other than the loss that the assignor would have suffered: see, for example, *Linden Garden Trust Ltd v Lenesta Sludge Disposals Ltd* (1992) 57 BLR 57 (CA) at 92 (the assignee was only able to recover for the assignor's loss, and evidence of its own loss would only assist in quantifying the assignor's loss).

(4) Alternatively, the contractual rights assigned may in substance be such that the measure of recoverable damages varies over time and depends on the factual position of the particular assignee. Thus, for example, where the contractual rights assigned pursuant to a contract contain an agreed quantification mechanism (applicable whether or not there has been assignment), such that the amount contractually payable may vary from time to time by reason of the circumstances then existing, the fact that an assignee may claim a greater amount by reference to the contractually

agreed quantification mechanism than the assignor could have claimed if there was no assignment is entirely consistent with the general principle. If the contract does not prevent assignment, there can be no objection to the operation of the contractual mechanism as it applies to the assignee. In such a case, there is no relevant "*prejudice*" arising from the assignment: the assignee is not recovering damages "*greater*" in any relevant sense, rather it is simply recovering the damages that are provided for by the contractual mechanism contained in the original agreement.

(5) To put it another way, there is a difference, as was said by Millett LJ in *L/M International Construction Inc (now Bovis International Inc) and another v The Circle Ltd Partnership* 12 July 1995 at 14, between the heads of damage which can be recovered (which are subject to the general principle at common law) and the measure of damage (which is not).

121. *Lordsvale Finance plc v Bank of Zambia* [1996] 3 All ER 156 concerned a provision for calculating the default rate formula in a syndicated loan agreement (which was expressly based on a debt cost of funding component for each lender, namely "*the cost as determined by such Bank of obtaining dollar deposits (from whatever source or sources it shall think fit) to fund its participation in the unpaid sum for such period or periods as the Agent may from time to time determine*"). The definition of "*Bank*" included any of its assignees. The specific issue was whether, where the loan in question had been acquired by the claimant by way of assignment at a discount, interest should be calculated based on the face amount of the debt or, as the Defendant argued, on the amount paid by the assignee (see 164c-e). No point appears to have been taken as to whether the Plaintiffs were entitled to determine their own cost of obtaining dollar deposits, or were limited to the cost of the original Bank in that respect. On the contrary, the Defendant's arguments proceeded on the basis that the assignee's costs were relevant, but had to be calculated with reference to the discounted amount actually paid for the loan (see 164b). There is no indication in the judgment of Colman J that the assignee was not entitled to claim default interest based on its own cost of obtaining dollar deposits.

122. As noted above, the remedy for the contractual counterparty if it did not want to expose itself to the potential of a higher cost of funding being certified by an

assignee pursuant to the terms of the agreement was to modify the terms of the Master Agreement in order to prevent assignment without its consent. Alternatively, as in the case of certain of the LMA standard form documentation, the position of the assignee could be addressed expressly and recovery from the contractual debtor could be limited to the same extent that it would have been liable if there had not been an assignment[16]. LBIE did not take such steps and cannot complain about the consequences of not having done so.

(5) WENTWORTH'S AND THE ADMINISTRATORS' POSITIONS

123. None of the arguments raised in opposition to the Senior Creditor Group's position leads to the contrary conclusion:

(1) Wentworth's first argument (at paragraph [59] of its Position Paper) is based on the assertion that the purpose of a right to interest is to "*compensate the person entitled to payment for having been kept out of its money*". Wentworth argues that the calculation of interest by reference to the cost of funding of the particular counterparty entitled to payment "*reflects the fact that it is that counterparty which has been kept out of its money*". However:

(a) Wentworth's argument ignores the fact that, following an assignment, the person entitled to payment is the assignee, not the original counterparty.

(b) Wentworth's argument also has the commercial consequence of treating an original counterparty which has assigned its claim – and who therefore no longer has any economic stake in the determination of the Default Rate – nevertheless as the "*relevant payee*" whose certification is required (even if such certification can be made on its behalf by the assignee).

16 See, for example, Clause 29(2)(f) of the LMA Senior Facilities Agreement (Leverage) which applies where there has been a change of lender.

(2) Wentworth's second argument (at paragraphs [62] – [64] of its Position Paper) is based on the express prohibition on assignment of rights under the 1992 and 2002 Master Agreements without the counterparty's consent. Wentworth argues that the "*prohibition on assignment of rights without consent protects each party from exposure to the credit risk of third parties other than their specifically chosen counterparty*" and that "*the protection afforded by Section 7 would be greatly reduced if "relevant payee" meant any third party to whom the right to payment under Section 6 was assigned*". However:

(a) Wentworth's argument ignores the fact that, by expressly providing that a right to payment from a Defaulting Party can be assigned without transfer of the entire agreement and without the Defaulting Party's consent, Section 7 of the Master Agreements is intended to provide less protection to a party in default.

(b) This is further reflected in the use of the phrase "*relevant payee*" (as opposed to the more commonly used term "*party*" or the specially defined term "*Payee*") in the definition of Default Rate, which corresponds to the fact that a right to payment from a Defaulting Party can be assigned without transfer of the entire agreement and without the Defaulting Party's consent.

(3) Wentworth's third argument (at paragraph [68] of its Position Paper) is based on the terms of Section 7(b) of the Master Agreements. As to this:

(a) Under the 1992 Master Agreement, an assignment is permitted by a party of "*any amount payable <u>to it</u> from a Defaulting Party*" (Wentworth's emphasis). Wentworth contends that the use of the phrase "*payable to it*" indicates that an assignee can only require such amounts as the original counterparty would have been entitled to.

(b) Wentworth's reliance on the "*to it*" language of Section 7(b) in the 1992 Master Agreement is misplaced. Neither Section 6(e) of that agreement (the only section cited in Section 7(b)), nor Section

7(b) itself expressly addresses the issue of interest. Rather, where the amount payable under Section 6(e) upon early termination is assigned under Section 7(b), the assignee's right to interest on that amount results from Section 6(d)(ii), which provides, in substance, that interest on the Early Termination Amount calculated under Section 6(e) will be paid "*together with*" that amount – without any limitation on the person or entity to whom this combined payment will be made.

(c) The position is made express under the 2002 Master Agreement, which provides that a party is entitled to transfer its interest in any Early Termination Amount "*payable <u>to it</u> by a Defaulting Party, together with any amounts payable on or with respect to that interest…*" (Wentworth's emphasis). Although the phrase "*to it*" follows and qualifies the phrase "*Early Termination Amount payable*", the phrase does *not* appear after the word "*payable*" in the subsequent phrase "*all amounts payable on or with respect to that interest and any other amounts associated with that interest…*". An assignment under Section 7(b) of the 2002 Master Agreement clearly refers to *any* right to interest associated with the assigned right to the Early Termination amount, and not simply a right to interest *"payable to it*" (i.e. the original counterparty). The same is true of rights in respect of currency losses under Section 8 and expenses under Section 11, both of which expressly pass to the assignee under Section 7(b).

(4) Both Wentworth (at paragraph [67] of its Position Paper) and the Administrators (at paragraph [68.6] of their Position Paper) contend that if the "*relevant payee*" includes an assignee then there is potential for abuse. For example, the Administrators suggest that there would be potential for abuse where an existing counterparty effected an assignment to a special purpose vehicle with a high cost of funding:

(a) The suggestion appears to be that if an assignee is entitled to certify and receive a high cost of funding for Default Rate purposes, it will receive an additional sum which can be shared between it and the assignor, and that this possibility leads to the potential for abuse.

(b) Certification must, however, be rational and in good faith. Any risk of a deliberately excessive cost of funding is catered for by such requirements.

(c) Furthermore, an assignee with a high cost of funding will need to receive a correspondingly high Default Rate to compensate it for its high cost of funding. There is therefore no "*windfall*", so far as such an assignee is concerned, which it can share with the assignor. If the assignee does not receive its cost of funding, it will suffer a loss for which it will not be compensated.

(d) Accordingly, there should be no benefit for an assignor in effecting an assignment to an entity with a high cost of funding relative to any other entity, and no or no realistic potential for abuse arises.

(e) Correspondingly, if an assignor with a high cost of funding assigns to an assignee with a low cost of funding, the Default Rate will (on the Senior Creditor Group's construction) reduce so as to reflect that lower cost of funding. Wentworth and the Administrators may perceive the likelihood in the present case to be that assignees will certify costs of funding at a rate higher than the original contractual counterparty. But in other cases, the consequence of their argument will be to require the payor to pay the Default Rate at a level that exceeds the actual cost of funding, and therefore loss, being suffered by the assignee if that cost of funding is lower than the cost of funding of the original contractual counterparty.

(f) Ultimately, and in any event, there is no reason to conclude that those involved in drafting the Master Agreements would have had such concerns in mind, or that, as a result, they intended to ensure that the assignee could only recover the assignor's cost of funding.

H QUESTIONS 14, 15, 16, 18

124. The answers to Questions 14 to 18 are understood to be agreed between the parties, subject to a potential but apparently narrow dispute in connection with the formulation of the answer to Questions 14 and 15.

125. Question 14 asks whether a relevant payee's certification of its cost of funding is conclusive and, if not, what it is subject to. Question 15 asks whether, 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 set out in that question applies (being reasonableness; good faith and not capriciously or irrationally; or otherwise than in its own interests), where does the burden of proof lie in establishing, and what is required to demonstrate, that a relevant payee has or has not meet such requirement?

126. The parties are agreed that a relevant payee's certification of its cost of funding is conclusive other than in circumstances where it is made irrationally (in the sense of being arbitrary, capricious, perverse or a decision to which no reasonable person having the relevant discretion could have subscribed) or otherwise than in good faith.

127. This is based on the following summary of the relevant law as stated by Rix LJ in *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] Bus LR 2304 at [66]:

> *"It is plain from these authorities that a decision-maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to Wednesbury unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria…"*

128. However, Wentworth and the Administrators have suggested in correspondence that the answers to Questions 14 and 15 should also record that a relevant payee's cost of funding can be challenged where it is subject to "*manifest error*".

129. The Senior Creditor Group's present understanding, based on the correspondence to date, is that neither Wentworth nor the Administrators are suggesting that "*manifest error*" adds anything to the test of rationality and good faith or that a rational and good faith certification by the relevant payee of its cost of funding could be challenged on a separate ground of "*manifest error*".

130. In these circumstances, there is no need for the answers to Questions 14 or 15 to include any reference to "*manifest error*" and such a reference should be excluded, to avoid confusion.

QUESTION 19

Question 19: Whether the answers to questions 10 to 18 above (or any of them) is different if the underlying Master Agreement is governed by New York rather than English law.

131. The Senior Creditor Group contends that Questions 10 to 18 should be answered in the same way as set out above where the Master Agreements in question are governed by New York law rather than English law.

132. All of the reasons identified above are equally applicable as a matter of language and commercial rationale where the Master Agreements are governed by New York law.

133. Furthermore, there are certain aspects of New York law which support the arguments advanced by the Senior Creditor Group in respect of Questions 10-18 above, in particular Questions 10, 11, 14 and 15.

134. In circumstances where the Master Agreements are intended to be capable of being governed by either English or New York law, these principles of New York law lend weight to the English law analysis.

(1) NEW YORK LAW MATERIALS

135. The Senior Creditor Group and Wentworth have respectively adduced expert evidence of New York law in the form of reports from Professor Neil Cohen [4/2] and the Hon Robert S. Smith (Ret'd) [4/1 and 4/3]. The New York law experts have also produced a Joint Statement [4/4] (the "NY JS").

136. Pursuant to the PTR directions, and as agreed between the parties, the New York law witnesses will not attend for cross-examination. Any points of dispute regarding New York law will be dealt with by submissions.

(2) RELEVANT PRINCIPLES OF NEW YORK LAW

Principle 1: the importance of the language used/the four corners doctrine

137. A Court will interpret a New York law governed contract as written, since its words are considered the best evidence of the parties' intent: NY JS at para 4 [4/4/72a]; Smith Rep at para 15 [4/1/7].

138. When the parties set down their agreement in a clear, complete document, their writing will be enforced in accordance with its terms: *ibid*. See also Cohen Rep at para 27 [4/2/32].

139. As Professor Cohen observed at Cohen Rep, para 32, "*in construing a contract a court should be concerned 'with what the parties intended, but only to the extent that they evidenced what they intended by what they wrote…*" *Raleigh Assoc v Henry*, 302 NY 467 at 473 (1951)

140. This principle is often referred to as the four corners rule or doctrine (Cohen Rep at para 33). Absent ambiguity, the Court cannot have regard to extrinsic evidence when seeking to determine the parties' intent: NY JS at para 5 [4/4/72a][17].

141. Ambiguity is a question of law, and will only be found to exist if the meaning of the words used in the contract is not made clear by an examination of the contract as a whole: NY JS at paras 5 and 6 [4/4/72a]. The meaning of ambiguity can be further ascertained from the respective experts' reports:

    (1) Extrinsic evidence is not admissible to create an ambiguity in an otherwise unambiguous contract: Cohen Rep at para 33, *Brad H v City of New York*, 17 NY 3d 180 at 186 (2011).

---

17 In this respect, New York law is different from English law, to the extent that the latter construes the wording of the contract in the light of the background facts known or reasonably available to the parties.

(2) Judge Smith has stated that the Court will consider if the words have a single obvious meaning, or whether (read in the context of the agreement as a whole) there is a clear answer to the interpretive issue presented (see, for example, the Smith Rep at paras 18, 20 and 21, and *Bethlehem Steel Co v Turner Constr Co.,* 2 NY 2d 456 at 460).

(3) Professor Cohen also refers to the *Bethlehem* case at para 37 of the Cohen Rep [4/2/34], and cites the passages emphasising that no ambiguity exists when the understanding of one party to a contract "*strain[s] the contract language beyond its reasonable and ordinary meaning*" and the contract is "*otherwise clear, unequivocal and understandable when read in connection with the whole contract*".

142. New York courts tend to take a narrow view of what constitutes ambiguity, even when there is disagreement about a contract's meaning: NY JS at para 6 [4/4/72b]. Specifically:

(1) There is a distinct tendency in New York decisions to hold contractual language to be unambiguous, even where that characterisation may be debatable (Smith Rep at para 17 [4/1/8]). Professor Cohen agrees that the Courts have demonstrated a narrow view of what constitutes ambiguity, even where there is disagreement about the meaning of a contract (Cohen Rep at para 34) [4.2.34];

(2) Decisions holding contract to be ambiguous are surprisingly few, although they do exist (Smith Rep at para 17 [4/1/8]);

(3) No New York state or federal court has held in any reported decision that any of the standard provisions of the 1992 Master Agreement or its successor, the 2002 Master Agreement, is ambiguous (Smith Rep at para 19 [4/1/8]).

143. The fact that the parties to a contract advance differing interpretations of a contract does not, by itself, make it ambiguous: NY JS at para 7 [4/4/72a].

Principle 2: the implied covenant

144. All contracts contain an implied covenant of good faith and fair dealing, which requires that neither party do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract: NY JS at para 8 [4/4/72a].

(1) Professor Cohen observes that, in many cases, the formulation of the principle is best defined by its opposite; i.e. it is breached when there is bad faith: see Cohen Rep at para 40 [4/2/35].

(2) Professor Cohen also emphasises that the operation of the principle is subject to the terms of the contract, and that "*the principle cannot add to, detract from or alter the terms of the contract itself*": Cohen Rep at para 41 [4/2/35], referring to inter alia *Granite Partners, LP v Bear Stearns & Co* 17 F. Supp 2d 275 at 306 (SDNY).

145. If and to the extent that a contract confers a discretion on one party, the obligation of good faith and fair dealing includes a promise not to act arbitrarily or irrationally in exercising that discretion: NY JS at para 8 [4/4/72a].

146. The burden of proving non-compliance with the covenant of good faith and fair dealing rests on the party that asserts non-compliance: *ibid.*

Principle 3: absurdity is to be avoided

147. An interpretation that renders the parties' agreement absurd is to be avoided: NY JS at para 9 [4/4/72a].

148. Both experts describe the principle as requiring consideration of whether the commercial consequences of the interpretations proffered by the parties would render the agreement unreasonable or absurd: Smith Rep at para 22 [4/1/9]; Cohen Rep at para 22 [4/2/31].

Principle 4: an assignee is subject to all of the terms of the agreement between the assignor and the account debtor

149. Principle 4 reflects the terms of Section 9-404(a), Article 9 of the New York Uniform Commercial Code (the "NY UCC"): NY JS para 13 [4/4/72c].

150. The Master Agreements determine the meaning of the term "*relevant payee*" as used in those agreements, and there is no principle of New York law which prevents "*relevant payee*" from extending to the cost of funding of an assignee: NY JS at para 17 [4/4/72e].

(3) QUESTIONS 10- 18

151. The above principles support the position adopted by the Senior Creditor Group in respect of Questions 10-18 as a matter of English law, and the position is at least as strong as a matter of New York law in respect of the answers to those Questions, in particular Questions 10, 11, 14 and 15.

Questions 10 and 11

152. Principle 1 (the four corners doctrine) suggests that there is little scope under New York law to depart from the ordinary meaning of the language used, and that the elements of the phrase "*cost (without proof of evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount*" relevant to Questions 10 and 11 should bear such a meaning. The Court is not permitted to add to, limit, or modify the language actually used in the agreement.

153. There is no sufficient ambiguity in the language used (in the restricted sense that ambiguity is understood as a matter of New York law) to justify stepping outside the four corners of the document, and (for the reasons advanced above) the construction argued for by the Senor Creditor Group is both reflective of the language used and commercially coherent.

154. It is notable that the New York courts have never concluded that any provision of the ISDA Master Agreements is ambiguous in the required sense.

155. There is no credible basis to suggest that the Senior Creditor Group's construction comes close to breaching the requirements of principle 3 (absurdity is to be avoided).

156. Principle 2 (the implied covenant of good faith) provides further support for the Senior Creditor Group's approach to both questions 10 and 11, and the meaning of both cost of funding and "*relevant payee*", on the basis that it would operate to limit the potential for abuse when identifying the relevant cost of funding: see Cohen Rep at para 70 [4/2/42].

157. As to principle 4 (an assignee is subject to the terms of the agreement between assignor and account debtor), although the experts disagree to some extent as to the implications of Section 9-404(a) of the NY UCC and its interplay with the "*stand in the shoes*" maxim (see NY JS paras 14-16):

(1) They are agreed that "*relevant payee*" could extend to the assignee if that is what the parties intended (see Smith Reply Rep at para 7 [4/3/66]);

(2) The question turns on the meaning of the Master Agreements as properly interpreted.

158. Such dispute as there is appears to be in substance very similar to Wentworth's reliance on the general principle of assignment in English law (an assignee cannot recover greater damages that the assignor) and the Senior Creditor Group's response.

159. Judge Smith is seeking to rely on a general maxim to assist with the interpretation of a provision of a particular contract, and Professor Cohen is pointing out that the "*stands in the shoes*" maxim is a loose aphorism that is sufficient in some contexts, but is not a precise statement of a legal rule (see Cohen Rep at paras 50-53 [4/2/38]). The relevant rule is reflected in Section 9-404(a) of the NY UCC and, ultimately, the only question is what the language of the agreement means.

160. For similar reasons to those set out in paragraphs ** above, the Court should prefer Professor Cohen's approach. The presumptive meaning of the maxim

"*stands in the shoes*" does not assist the Court in determining what the parties actually agreed, and that is what Section 9-404(a) of the NY UCC directs the Court to consider. Furthermore:

(1) Judge Smith does not identify any New York case where, if the contract would otherwise have been read as permitting calculation of an amount by reference to the factual position of the assignee, the legal maxim of "*stand in the shoes*" was relied upon to negate such an interpretation;

(2) The cases cited at paras 26 and 27 of the Smith Report [4/1/11] are self-evidently distinguishable: none concerns anything like a contractual provision which itself provides for calculation of the remedial amount based on the factual circumstances of the assignee from time to time;

(3) Nor does Judge Smith provide a good reason why New York law would or should adopt a restrictive approach to such a clause. On the contrary, he accepts that it is open to the parties to agree that the phrase "*relevant payee*" bears the meaning that the Senior Creditor Group contends (NY JS at para 17 [4/4/72e], Smith Reply Rep at paras 7 and 8). He does not explain why the legal maxim upon which he relies should "*strongly suggest the answer*" to the interpretative issue posed when, for the reasons set out above in respect of Question 10, there are very good commercial reasons why "*relevant payee*" would refer to the person entitled to payment of the Early Termination Amount from time to time;

(4) By contrast, Professor Cohen does identify a line of cases where the assignee's costs (i.e. of attorney fees) have been recovered from the original counterparty without regard to whether they were greater than the assignor's fees would have been: see Cohen Rep at paras 54-57. He draws the same distinction at Cohen Rep para 54 [4/2/39] as was identified in respect of the Question 10 analysis under English law i.e.:

> "*When the terms of the assigned contract are applied in the context of enforcement of remedial provisions of that contract by the assignee, <u>it is not the case that those terms</u>*

will invariably generate the same measure of recovery as when applied in the context of enforcement by the assignor." (Emphasis added)

(5) Judge Smith's answer to this point (see Smith Reply Rep at paras 9-11 [4/3/67]), namely that such costs do not normally depend on the identity of the assignee, and that they are cases where fees have actually been incurred, does not meet the substance of this argument:

(a) An assignee's choice of lawyer may well lead to greater legal fees being incurred than had the assignor instructed lawyers: there is no reason to presume (as Judge Smith appears to do at para 10 of the Smith Reply Rep [4/3/67]) that "*those fees are presumably no greater or less than what the assignor would have incurred*";

(b) The fact that the Default Rate provision operates both in respect of actual and hypothetical cost of funding is not, with respect, a distinction of substance; and

(c) Judge Smith fails to address the fact that there is a parallel to be drawn with the costs cases because both are concerned with enforcing such provisions in a manner that will make the assignee whole even if its costs are, as a matter of fact, greater than those of the assignor[18].

Questions 14 and 15

161. The common position in respect of New York law in large part reflects the stance adopted by the Senior Creditor Group in respect of these issues when analysed as a matter of English law:

---

18 Reliance is also placed by Judge Smith on the weight that a New York court would place on the "rule" that an interpretation should be disfavoured that places a party at the mercy of another or permits one to take unfair advantage of the other (see NY JS at paras 10 and 18 [4/4/72c and 72e]). Again, it is unclear why, if assignment is permissible, there is anything unfair if the operation of a contractually agreed method for calculating the Default Rate leads, post-assignment, to a higher level of interest being payable. What distinguishes this type of case from most others is the original counterparty's agreement to a mechanism for assessing default interest by reference to the particular factual position of the assignee at the relevant time.

(1) A challenge to certification would have to be based on a breach of the implied covenant of good faith and fair dealing, and the burden is on the party challenging the certificate: NY JS at paras 8 and 20 [4/4/72b and 72g].

(2) To the extent that a certifying party has a discretion as to the method (or cost) of funding in determining funding costs, such discretion must not be exercised arbitrarily or irrationally: NY JS at paras 20 and 21 [4/4/72h].

162. Although it appears (see the NY JS at para 22 [4/4/72h]) that there is a dispute as to the weight that a New York Court would give to the Federal Court's decision in *Finance One v LBSF* 2003 WL 21638214 (SDNY 11 July 2003), and in particular to the statement that "*the ISDA explicitly precludes an issue of fact contest with regard to the proper default rate*", that dispute may be less substantive than appears. Taking into account the agreed position between the experts that the fetter on the certification process is, like that under English law, a requirement that the certifying party act in good faith and (to the extent that they are exercising a discretion[19]) not arbitrarily or irrationally, it would appear clear that:

(1) There is no scope for a factual dispute in the sense of whether or not the certifying party identified a single "*right*" cost of funding;

(2) Unless the certifying party is exercising a form of discretion, the only basis to challenge the certificate would be bad faith (i.e. that there was

19 Whether or not the correct interpretation of the certification clause was that it did involve the exercise of discretion was left by Professor Cohen to the Court: see Cohen Rep at para 65 [4/2/41]. He identifies the possibility of a Court distinguishing the Master Agreements from agreements which confer a discretion on a party to decide whether to take a particular action, rather than, as in the case of the Default Rate definition, the right to make a factual determination (with an appropriate degree of deference to the decision maker) such that the only standard of challenge, in the case of a factual determination, would, in substance, be bad faith (i.e. breach of the good faith and fair dealing standard). Judge Smith disagrees and maintains that the only construction open to the Court is one which acknowledges that there is a discretion being exercised: see Smith Reply Rep at para 13 [4/3/68].

breach of the good faith and fair dealing standard). Whether formulated as "bad faith" or "fraud, gross negligence or contravention of public policy" as in the *Finance One* decision is unlikely to be material; and

(3) There may be a dispute of "*fact*" in the sense of whether or not the certifying party acted in bad faith, or (to the extent that they were exercising a discretion) arbitrarily or irrationally as those concepts are to be understood as a matter of New York law. But it is difficult to see that such an approach is, in substance, any different to the *Socimer* approach adopted in English law.

163. Furthermore, although it is suggested by Judge Smith that an interpretation that places one party at the mercy of another, or permits one party to take unfair advantage of the other, is to be disfavoured (see Smith Rep at para 23 [4.1.10] and NY JS at para 10 [4/4/72h]):

(1) It is unclear how or why the certification process as argued for by the Senior Creditor Group could be described as a process which falls foul of such an interpretation; and

(2) The better view, as indicated by Professor Cohen, is that the implied covenant of good faith and fair dealing will largely prevent situations arising in which a party would be able, or allowed, to take such an unfair advantage (Cohen Rep at paras 43 and 44) [4/2/36].

164. The above points suggest that it is clear that it is at least no lower a hurdle to challenge a certificate given for the purpose of the Master Agreements as a matter of New York law as compared to English law.

ROBIN DICKER QC

RICHARD FISHER

HENRY PHILLIPS

South Square 16 October 2015

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

SENIOR CREDITOR GROUP'S SKELETON ARGUMENT
FOR TRIAL (PART C)

Freshfields Bruckhaus Deringer LLP
65 Fleet Street, London, EC4Y 1HS
Tel: 0207 9364000
Solicitors for CVI GVF (Lux) Master S.a r.l.

Ropes & Gray LLP
5 New Street Square, London, EC4A 3BF
Tel: 0203 1221100
Solicitors for Hutchinson Investors LLC

Schulte Roth & Zabel LLP
One Eagle Place, London, SW1Y 6AF
Tel: 0207 0818000
Solicitors for Burlington Loan Management Limited