

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

- (1) ANTHONY VICTOR LOMAS**
- (2) STEVEN ANTHONY PEARSON**
- (3) PAUL DAVID COPLEY**
- (4) RUSSELL DOWNS**
- (5) JULIAN GUY PARR**

(as the joint administrators of the above named company)



Applicants

- AND -

- (1) BURLINGTON LOAN MANAGEMENT LIMITED**
- (2) CVI GVF (LUX) MASTER S.À R.L**
- (3) HUTCHINSON INVESTORS LLC**
- (4) WENTWORTH SONS SUB-DEBT S.À R.L**
- (5) YORK GLOBAL FINANCE BDH, LLC**
- (6) GOLDMAN SACHS INTERNATIONAL**

Respondents

**REPLY OPINION OF ROBERT S. SMITH TO THE
EXPERT OPINION OF NEIL B. COHEN AS TO MATTERS
OF NEW YORK LAW**

1. I, Robert S. Smith, have been instructed by Kirkland & Ellis International LLP on behalf of Wentworth Sons Sub-Debt S.à.r.l. to prepare this report addressed to the High Court of Justice (the “High Court”) to supplement my report dated June 25, 2015 (“Smith Report”). Its purpose is to respond to the report of Professor Neil B. Cohen dated July 24, 2015 (“Cohen Report”). Accordingly, this report should be read together with my previous report, and the statements (including as to my qualifications) set out at paragraphs 1 to 11 of my previous report are repeated here, *mutatis mutandis*. In light of the purpose of this report, I have not set out a summary of my conclusions. To the extent this report does not address a comment in the Cohen Report, this does not indicate my agreement or disagreement with that comment.

2. I will address Professor Cohen’s comments on the principles of New York law relevant to two issues: (1) whether, where a claim has been assigned, the ISDA Master Agreement provides for calculating the interest rate with reference to the cost of funds of the assignor or the assignee; and (2) the deference to be given to a claimant’s certification of its cost of funds.

I. The Assignor’s vs. the Assignee’s Cost

3. I said in my previous report that “[w]hen an assignment has occurred, an assignee is said to ‘stand in the shoes’ of the assignor, such that the assignee acquires no greater rights than the assignor had at the time of the assignment” (Smith Report ¶ 26). Professor Cohen acknowledges that this maxim is “frequently stated” and that it “works as a loose aphorism” (Cohen Report ¶ 50), but he also says that “the statutory law governing assignment of rights to payment”, i.e., Article 9 of the Uniform Commercial Code (“UCC”), “supplants older general aphorisms” (*id.* ¶ 47).

4. I disagree with Professor Cohen’s observations if they are intended to suggest that the “stand in the shoes” maxim is no longer good law, or is less good law, because of the enactment

of the UCC. As a general matter, the UCC did not repeal pre-existing general principles of law.

UCC § 1-103(b) makes this clear:

Unless displaced by the particular provisions of this act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other validating or invalidating cause supplement its provisions.

5. A much-cited treatise lists “rules of contract interpretation” among the “particular rules or principles of law ... not displaced by the [UCC]”. 107 N.Y. Jur. 2d Uniform Commercial Code § 12; *see also Nissho Iwai Europe PLC v. Korea First Bank*, 99 N.Y.2d 115, 121-22 (2002) (applying to a letter of credit governed by the UCC the maxim, applicable to “all written agreements”, that ambiguity arises not from silence, but from imperfect expression).

6. I see nothing in UCC 9-404(a) (quoted at Cohen Report ¶ 50) that displaces or contradicts the traditional “stand in the shoes” rule. Rather, the UCC provision appears to be a codification of that rule, which continues to apply as before.

7. Though I place less weight than Professor Cohen on the change in the law wrought by the UCC, I agree as a theoretical matter with his point that “it is the ISDA Master Agreements themselves, rather than any limitation imposed by the law of assignments of payment rights, that determines whether the relevant payee is the original counterparty or ... the current holder of the rights in question” (Cohen Report ¶ 52). In other words, it is true that the parties to an agreement could, if they chose, provide that (notwithstanding the “stand in the shoes” maxim) the effect of an assignment of an obligation would be to alter the interest rate payable. That would, however, be a most unusual provision: I have never seen a case in which an agreement was interpreted to achieve such a result, and Professor Cohen cites none. Where an agreement does not explicitly address this issue, I think it doubtful that contracting parties, presumably familiar with the “stand

in the shoes” rule, would expect an assignment to produce a change in interest rate, or that a New York court, also familiar with the rule, would be likely to interpret an agreement in that way.

8. In short, to respond to Professor Cohen’s criticism of what he takes to be my opinion “that the New York law of assignments determines or suggests the answer to the interpretive question” (Cohen Report ¶ 53): I acknowledge that assignment law does not absolutely *determine* the answer to the question of whether the assignor’s or the assignee’s cost of funds is relevant; but it does, in my opinion, strongly suggest the answer.

9. My opinion is not altered by the cases involving attorneys’ fees that Professor Cohen refers to (Cohen Report ¶¶ 54-55). Cases in which a party is permitted, by agreement or by applicable law, to recover attorneys’ fees differ in two important ways from claims for interest based on “cost of funds” under the ISDA Master Agreement: first, the amount of attorneys’ fees does not usually depend on the identity of the person incurring the cost; and secondly, a party seeking to recover attorneys’ fees must ordinarily produce proof of fees actually incurred, while the ISDA Master Agreement expressly permits recovery “without proof or evidence of actual cost”, based upon a party’s either hypothetical or actual cost of funds – its cost “if it were to fund or of funding the relevant amount” (ISDA Master Agreement ¶ 14, definition of “Default Rate”).

10. In an attorneys’ fee case, where the assignee proves that it has actually incurred such fees and where those fees are presumably no greater or less than what the assignor would have incurred, the assignee is seeking to enforce the same rights that the assignor would, had there been no assignment. In such a case, the rule that the assignee stands in the assignor’s shoes would be violated if the assignee were *not* permitted to recover. The California cases cited by Professor Cohen recognize this: each of them refers to the “stand in the shoes” maxim (which is part of California, as well as of New York, law) to support its conclusion that the assignee should

prevail. *See Searles Valley Minerals Operations Inc. v. Ralph M. Parson Service Co.*, 120 Cal. Rptr. 3d 487, 488 (Ct. App. 2011) (“an assignee of contact indemnification rights stands in the shoes of the indemnitee”); *Essex Ins. Co. v. Five Star Dye House, Inc.*, 137 P.3d 192, 198-99 (Cal. 2006) (quoting *Salaman v. Bolt*, 141 Cal. Rptr. 841, 847 (Ct. App. 1977)) (“As a general rule, the assignee of a chose in action stands in the shoes of his assignor”).

11. By contrast, where an assignee seeks, without proof that it has incurred any cost, to recover an interest rate based on a cost of funds that is higher than its assignor’s, its claim receives no help from the “stand in the shoes” maxim. It is my opinion, for the reasons I have explained in this and my previous report, that the maxim would tend to undermine such an assignee’s claim.

II. The Deference Owed to a Payee’s Certification

12. On the issue of how much deference is due to a payee’s certification of its cost of funds, Professor Cohen and I agree that the right of a payee to certify its cost of funds is “subject ... to the implied covenant of good faith and fair dealing.” (Cohen Report ¶ 67; *see* Smith Report ¶ 32). I said in my previous report that “[w]here a contract contemplates the exercise of discretion, the implied covenant includes a promise not to act arbitrarily or irrationally in exercising that discretion” (Smith Report ¶ 32 (quotation marks and citation omitted)). Professor Cohen does not express disagreement with this general proposition; nor does he say that the test of good faith and fair dealing is a wholly subjective one.

13. Professor Cohen does say, however, that the language of the ISDA Master Agreement at issue here “could be understood as language that does not confer ... discretion [to decide whether to take a particular action] on the non-defaulting party.” (Cohen Report ¶ 65). I find this suggestion puzzling. No doubt, if there exists but one funding cost to which a party may honestly certify, that party has no discretion under the agreement; that would be an easy case,

which a court could resolve without Professor Cohen's help or mine. But in a case where there is more than one cost of funding that could honestly be certified (and assuming that each is indeed a cost of funding within the meaning of the ISDA Master Agreement, a separate issue which I understand is in dispute), I do not see any escape from the conclusion that the certifying party has discretion in choosing among them. Where such discretion exists, it must be exercised in accordance with the rule that the party may not act arbitrarily or irrationally. See *Dalton v. Educ. Testing Serv.*, 87 N.Y.2d 384, 389, 663 N.E.2d 289, 291 (1995); Cohen Report ¶ 42; Smith Report ¶ 32.

14. Professor Cohen and I also disagree about the precedential force of the decision of the United States District Court in *Finance One Public Co. Ltd. v. Lehman Brothers Special Financing Inc.*, No. 00 Civ. 6739 (CBM), 2003 WL 21638214 (S.D.N.Y. July 11, 2003). My views on this question are adequately explained in my previous report (Smith Report ¶¶ 38-40). Here, I will only point out that Professor Cohen makes no attempt to defend on the merits the *Finance One* court's statement of the applicable rule. Nor does he cite any authority for that formulation other than *Finance One* itself. For the reasons given in my previous report, I disagree with Professor Cohen's assertion that this unpublished decision of a trial level federal court, not binding on any state court, may be characterized as "New York law" (Cohen Report ¶ 62).

III. My Duty to the High Court and Statement of Truth

15. I understand that my duty is to help the High Court on matters within my expertise. This duty is paramount and overrides any obligation to the parties from whom I have received instructions and by whom I am being paid. I have complied and will continue to comply with that duty.

16. I am aware of the applicable requirements of Civil Procedure Rules Part 35, Practice Direction 35, the Civil Justice Council Guidance for the instruction of experts in civil claims 2014, and the Practice Direction – Pre-Action Conduct.

17. I confirm that I have made clear which facts and matters referred to in this report are within my own knowledge and which are not. Those that are within my own knowledge I confirm to be true. The opinions I have expressed represent my true and complete professional opinions on the matters to which they refer.

Dated: August 13, 2015

A handwritten signature in black ink, appearing to read 'R. S. Smith', written over a horizontal line.

Robert S. Smith

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