Waterfall II Application

No 7942 of 2008

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

<u>CHANCERY DIVISION</u>

<u>COMPANIES COURT</u>

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

(1) ANTHONY VICTOR LOMAS

(2) STEVEN ANTHONY PEARSON

(3) PAUL DAVID COPLEY

(4) RUSSELL DOWNS

(5) GUY JULIAN PARR

(as the joint administrators of the above named company)

<u>Applicants</u>

- AND -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.À R.L

(3) HUTCHINSON INVESTORS LLC

(4) WENTWORTH SONS SUB-DEBT S.À R.L

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

<u>Respondents</u>

WRITTEN SUBMISSIONS ON BEHALF OF

THE FOURTH RESPONDENT

Capitalised terms used but not otherwise defined herein are defined in the amended application dated 9 March 2015 (the "Application") [1/1A], the 1992 MA (as defined below), and/or the 2002 MA (as defined below), unless the context requires otherwise.

INTRODUCTION

1. The LBIE insolvency estate has generated a substantial surplus, after payment of proved debts, in the region of £6.17bn to £7.72[1]bn. Insolvency Rule 2.88 requires the surplus to be used, first, to pay interest on dividends for the period between 15 September 2008 and the date of payment, at the Judgments Act Rate, or (by rule 2.88(9)) the rate applicable apart from the administration, e.g. any contractual rate to which the creditor was entitled.

2. Shortly after the administration of LBIE in September 2008, interest rates fell sharply across the world and have remained thereafter at an all-time low. The Bank of England base rate, for example, fell to 0.5% by March 2009 and has remained there since.

3. The Judgments Act Rate, however, has remained at 8% throughout the period. That represents the minimum rate of interest available to all proving creditors in the LBIE estate.

4. This application concerns the claims of creditors who claim to be entitled to a contractual rate of interest that is even greater than 8%. The main focus of the application is on the terms of the ISDA Master Agreement ("**ISDA MA**"), both the 1992 version ("**1992 MA"**) **[5/2]** and the 2002 version ("**2002 MA"**) **[5/3]**, although it also concerns other master agreements under German law.

5. The Senior Creditor Group ("**SCG**") consists of hedge funds with multiple ISDA claims (aggregating approximately £1.1bn), predominantly claims they have purchased from other parties.

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1 PWC, LBIE: Joint Administrators' Fourteenth Progress Report (March 2015 to 14 September 2015) at Page 9.

6. Goldman Sachs International ("**GSI**") is a creditor, for approximately £30m, in respect of a transaction entered into pursuant to an English law governed ISDA Master Agreement.

7. Wentworth has multiple ISDA claims (aggregating approximately £1.6bn), predominantly claims purchased from other parties. In addition, Wentworth owns the shareholders' subordinated debt interest in LBIE and Wentworth's sister company, Wentworth Sons Equity Claims S.à r.l., owns equity interests in LBIE indirectly.

8. The issues to be determined on this application are as follows:

   (1) Issues 10 to 13, relating to the interpretation of the ISDA MA as a matter of English law[2];

   (2) Issues 14 and 15, relating to the standard for a challenge to the certification by a relevant payee of its cost of funding for the purposes of the Default Rate;

   (3) Issue 19, as to the interpretation of the ISDA MA under New York law; and

   (4) Issues 20 and 21, as to the interpretation of the German Master Agreement **[5/7]**. Separate written submissions are being filed on the German law issues.

9. The parties have agreed the position in relation to Issues 16, 18 and 27 **[1/20]**. The parties have also agreed the position in relation to Issues 22 to 26 **[1/19]**, as to certain French master agreements, which have accordingly been removed from the Application.

10. In very brief summary, and as developed below, Wentworth's position on the issues concerning the ISDA MA is as follows:

    (1) **Issue 10**. The term "*relevant payee*" in the definition of Default Rate refers to the original contracting party to the ISDA MA, and not to any transferee of the

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2 Issue 17 is a live issue, but the parties agree that it is encompassed within the answer to Issues 11-15.

right to payment under Section 6(e) of the ISDA MA. (See paragraphs 39 to 77 below.)

(2) **Issue 11**. The expression "cost … if it were to fund or of funding the relevant amount" means the price which the relevant payee paid, or would be required to pay, to a counterparty to a transaction to borrow an equivalent sum in the market. (See paragraphs 78 to 223 below.)

(3) **Issue 12**. Such borrowing should not be assumed to have recourse solely to the payee's claim against LBIE, but should be assumed to have recourse to all of the relevant payee's unencumbered assets. The cost of funding the relevant amount should not include the weighted average cost on all of the relevant payee's borrowings, nor should it include any impact on the cost of the relevant payee's equity capital attributable to such borrowing. No particular tenor for the borrowing is dictated by the terms of the ISDA MA. (See paragraphs 224 to 226 below.)

(4) **Issue 13**. The cost to the relevant payee if it were to fund or of funding the relevant amount should be calculated on a fluctuating basis taking into account any changes in the relevant circumstances, with the benefit of hindsight when taking into account such changes. (See paragraphs 227 to 232 below.)

(5) **Issues 14 & 15**. A relevant payee's certification of its cost of funding for the purposes of applying the Default Rate is not conclusive. Such certification is susceptible to challenge on the basis that it (i) contains manifest error; (ii) 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); (iii) is made otherwise than in good faith; or (iv) is something other than the relevant payee's "cost … if it were to fund or of funding the relevant amount" (as those words may be construed by the Court). (See paragraphs 233 to 240 below.)

(6) **Issue 19**. The answer to each of the Issues 10-18 is the same where the relevant ISDA MA is governed by New York law. (See paragraphs 241 to 260 below.)

11. Before turning to the specific issues before the Court, it is helpful to outline the purpose and function of the ISDA MA and to summarise the provisions of the ISDA MA relating to interest.

<u>The ISDA MA</u>

12. The ISDA MA comprises a set of standard terms, carefully drafted by industry experts, for use in derivatives transactions. It is widely used throughout the world, for a large variety of different types of derivative transactions, and by a broad range of counterparties, from banks and other financial institutions involved in derivatives trading, to corporates seeking to hedge against interest or currency risks inherent in their business.

13. It is a master agreement, the terms of which are intended to apply to any and all transactions conducted between the parties to it. One of its most important aspects is close-out netting on termination, enabling the parties to terminate all contracts entered into pursuant to it at one and the same time, and to offset exposure under all such transactions so as to produce a net amount payable one way or the other. ISDA published User's Guides to the 1992 MA **[5/5]** and the 2002 MA **[5/6]**. These contain explanations for, and guidance on the operation of, much of the content of the relevant MA, and are a useful tool in the interpretation of the agreements.

14. In *Lomas v Firth Rixson*[3], Briggs J described it as

> *"…one of the most widely used forms of agreement in the world. It is probably the most important standard market agreement used in the financial world. English law is one of the two systems of law most commonly chosen for the interpretation of the Master Agreement, the other being New York law."*

[3] [2010] EWHC 3372 (Ch), at [53].

15. One of the most important objectives of the ISDA MA is to provide certainty and clarity to parties who choose to incorporate its terms, so that in often fast-moving markets they know they are able to trade out of positions that have terminated with their counterparty as quickly and efficiently as possible. In this regard, in the *Firth Rixson* case, Briggs J pointed out[4]:

> *"It is axiomatic that it should, as far as possible, be interpreted in a way that serves the objectives of clarity, certainty and predictability, so that the very large number of parties using it should know where they stand"*

16. Although the issues raised on this application concern only the rates of interest applicable under the ISDA MA, the Court is likely to be assisted by a brief explanation of its structure, in particular to identify the circumstances in which interest is provided for under it.

17. Both the 1992 MA and the 2002 MA share the same basic structure. In this brief outline, references are to the 1992 MA unless otherwise stated.

18. Section 2 contains the general obligations of the parties, including that each will make payment or delivery in accordance with the terms of the "Confirmation" (being the evidence confirming each transaction executed pursuant to the 1992 MA). Section 2(a)(iii) provides for the suspension of payment or delivery obligations of Party A if, at the time the obligation would otherwise fall due, Party B is suffering an Event of Default. Section 2(e) provides for payment of interest where a party defaults on its obligation to make a payment or delivery under Section 2.

19. Section 5 identifies a number of Events of Default or Termination Events.

20. Section 6 (headed "*Early Termination*") provides a mechanism for termination, valuation and payment following either an Event of Default or a Termination Event. Section 6(e) (headed "*Payments on Early Termination*") provides for how the sum payable by one party to the other following Early Termination is to be calculated.

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4 Above.

21. In determining the payments to be made following Early Termination, the parties have the option to choose between (a) First or Second Method and (b) Market Quotation or Loss. The First Method operates ‘one-way’, and calculates the amount due to the Non-defaulting Party. The Second Method operates ‘two-ways’, and calculates the amount due either to the Non-defaulting Party or to the Defaulting Party. Under “*Market Quotation*” the calculation of the amount due is based upon quotations for replacement transactions. Under “*Loss*” the calculation of the amount due is more broadly based on the loss (or gain) suffered by the Non-defaulting Party as a result of the termination of the relevant transactions. (See Section 6(e)).

22. The definition of both Market Quotation and Loss is aimed at arriving at a valuation of the terminated transactions as of the Early Termination Date or as soon as practicable thereafter.

23. Section 6(d)(i) requires the calculation of the amount payable under Section 6(e), and service of a notice of such amount on the other party, to take place as soon as practicable after the Early Termination Date.

24. Section 6(d)(ii) provides for interest to be paid on the sum calculated as being due from one party to the other under Section 6(e). Under the 2002 MA all provisions relating to interest are consolidated under Section 9(h). (See the following sections below for a more detailed consideration of the interest provisions under both agreements.)

25. One of the main differences between the 2002 MA and the 1992 MA, is that the 2002 MA contains only one method for calculating the amount payable following Early Termination, namely the calculation of an “*Early Termination Amount*”, which may, but is not necessarily required to, be based on quotations for replacement transactions. There is no ‘one-way’ termination option under the 2002 MA.

26. Section 7 contains a general prohibition on transfer of any interest or obligation under the agreement, with certain exceptions described more fully below.

The provisions of the 1992 ISDA MA relating to interest

27. Under the 1992 MA, interest is payable from one party to the other in a variety of situations and at a variety of different rates, all of which utilise the concept of the cost to one party or the other of funding the relevant amount.

28. Although the question at issue in this application is the meaning of "Default Rate", the draftsman has used the same underlying concept of the cost to one or other entity of funding the relevant amount within the definition of Default Rate as within the definition of all other rates applicable under the ISDA MA. As will be developed below, where the architect of a carefully drafted contract such as the ISDA MA has chosen to use the same expression in different places, it is likely that the same meaning was intended.

29. The three different rates of interest identified in the 1992 MA are as follows:

(1) Default Rate: "*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*";

(2) Non-default Rate: "*a rate per annum equal to the cost (without proof or evidence of actual cost) to the Non-defaulting Party (as certified by it) if it were to fund the relevant amount*"; and

(3) Termination Rate: "*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 such party) if it were to fund or of funding such amounts*".

30. The circumstances in which the 1992 MA requires interest to be paid, and the rates applicable in each case, are as follows:[5]

[5] See the 1992 ISDA Users' Guide, paragraph 4(f) (p.29-30) for a brief explanation of the circumstances in which the different rates are payable.

(1) Prior to the occurrence of an Early Termination Date in respect of a relevant Transaction, a party that defaults in the performance of any obligation is required to pay interest on the overdue amount, for the period from the due date of payment until the date of actual payment: Section 2(e). Such interest is payable at the Default Rate[6].

(2) Following the occurrence of an Early Termination Date, the party which is obliged to pay to the other such amount as is calculated as being due in respect of any Early Termination Date, is required to pay interest on that amount from the Early Termination Date until the date on which it is paid at the Applicable Rate: Section 6(d)(ii)[7]. The rate may be different as between (a) the period between the Early Termination Date and the date on which the relevant amount becomes payable[8], and (b) the period between the date on which the amount becomes payable and the date it is in fact paid.

(a) For the period between the Early Termination Date and the date upon which the amount becomes payable, interest is calculated:

(i) where the amount is due from a Non-defaulting Party, at the Non-default Rate;[9]

(ii) where the amount is due from a Defaulting Party, at the Default Rate;[10] and

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6 This is subject to the proviso that on the occurrence of an Early Termination Date, no further amounts under Section 2(e) shall be required to be made: Section 6(c).

7 "Applicable Rate" is defined in Section 14.

8 The amount becomes payable on the date on which the notice given to the other party of such amount became effective: Section 6(d). The date upon which a notice becomes effective depends upon the manner in which the notice was given: Section 12(a).

9 Under item (c) of the definition of Applicable Rate in Section 14, as an obligation "payable or deliverable … by a Non-defaulting Party."

10 Under item (a) of the definition of Applicable Rate in Section 14, as an obligation "payable or deliverable … by a Defaulting Party."

(iii) where the amount is due following occurrence of a Termination Event (and not an Event of Default), at the Termination Rate.[11]

(b) For the period after the date on which such amount becomes payable, interest is calculated in all cases at the Default Rate.[12]

(3) Following the occurrence of an Early Termination Date, one of the component elements in the calculation of what is due between the parties is "Unpaid Amounts" (being sums due under Section 2(a)(i), or which would have been due but for the suspension of a payment obligation under Section 2(a)(iii)). Interest on Unpaid Amounts is payable from the date on which the obligation accrued due (or would have accrued due) and the Early Termination Date, at the Applicable Rate. Thus:

(a) If the Unpaid Amount is due from a Defaulting Party, interest is payable at the Default Rate.

(b) If the Unpaid Amount is due from a Non-defaulting Party, interest is payable at the Non-default Rate.

(c) If the Unpaid Amount is due from either party in circumstances where the Early Termination Date was consequent upon a Termination Event, interest is payable at the Termination Rate.

31. In light of the above, there are numerous permutations as to which party will be required to pay interest, at what rate, on the amount or amounts owing under Section 6(e): see Annex 1 for a worked example of some of the possible permutations. As demonstrated by Annex 1, in many circumstances a single amount comprising the sum due under Section 6(e) is likely to attract (for the different periods of time the amount is outstanding or for the different components within the amount) interest

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11 Under item (d) of the definition of Applicable Rate in Section 14, on the basis that it is an amount owing by neither a Defaulting, nor a Non-defaulting Party, and thus falls within "all other cases."

12 Under item (b) under the definition of Applicable Rate.

calculated by reference to the cost of funding of one or other of the parties, or a combination of the parties.

32. A simple and common example will be where Party A suffers an Event of Default, the parties have opted for Second Method and Loss, and an amount, say £100m, is calculated as owing pursuant to Section 6(e) of the ISDA MA from Party B (the Non-defaulting Party) to Party A (the Defaulting Party). There will inevitably be a delay between the occurrence of the Event of Default, and Party B serving its calculation notice, at which point the amount becomes payable. In this case:

(1) for the period between the Early Termination Date and the date on which the amount of £100m became payable, interest on £100m will be calculated at the Non-default Rate (i.e. the cost to Party B, the paying party, if it were to fund £100m, as certified by it, plus 1%);

(2) for the remainder of the period until payment, interest is payable at the Default Rate (i.e. the cost to Party A, the payee party, if it were to fund, or of funding, £100m, as certified by it).

33. Another example is where Party A suffers a Termination Event and £100m is found due to Party B. In this case interest on £100m would be calculated as follows:

(1) For the period between the Early Termination Date and the date on which the Section 6(e) amount became payable, interest is calculated as the arithmetic mean of the cost to Party A if it were to fund or of funding £100m and the cost to Party B if it were to fund or of funding £100m (i.e. at the Termination Rate); and

(2) For the period from the date on which the Section 6(e) amount became payable and the date it was paid, interest is calculated as the cost to Party B if it were to fund or of funding £100m plus 1% (i.e. at the Default Rate).

The provisions of the 2002 ISDA MA relating to interest

34. Section 9(h) of the 2002 MA is a new section which consolidates and updates all provisions regarding interest and compensation, which were found in Sections 2(e) and 6(d)(ii) in the 1992 MA. The draftsman has retained the concept of cost of funding to either party in some cases, but in others added a new basis for calculating interest, by reference to the overnight rate offered by major banks.

35. Those rates of interest, as defined in the 2002 MA, which continue to be based on the cost of funding a particular amount by one or other party are:

(1) The Default Rate: "*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*";

(2) Termination Rate: "*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 it) if it were to fund or of funding such amounts*"; and

(3) Applicable Deferral Rate, which for certain purposes is defined as "*a rate equal to the arithmetic mean of the rate determined pursuant to clause (a) above* [being the rate offered to the payer by a major bank for overnight deposits] *and 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*." (This is referred to below as the "**Cost of Funding Applicable Deferral Rate**", to distinguish it from the definitions of Applicable Deferral Rate which refer to the overnight rates offered by banks.)

36. The principal circumstances in which the above definitions (and thus the calculation of interest by reference to cost of funding to one or other party) apply are as follows:

(1) If an Early Termination Amount is payable by a Defaulting Party, then interest is payable on the Early Termination Amount for the period from the Early Termination Date until payment at the Default Rate.

(2) If an Early Termination Amount is payable *to* a Defaulting Party, then interest is payable on the Early Termination Amount (a) from the Early Termination Date until the Section 6(e) amount becomes payable at the Non-default Rate, and (b) from the date on which the Section 6(e) amount becomes payable at the Default Rate.

(3) If an Early Termination Amount is payable consequent upon a Termination Event (as opposed to an Event of Default), then interest is payable on that amount:

(a) From the Early Termination Date until the date the Early Termination Amount is payable, at the Cost of Funding Applicable Deferral Rate; and

(b) From the date on which the Early Termination Amount is payable, until actual payment, at the Termination Rate.

37. As with the 1992 MA, under the 2002 MA a single amount payable under Section 6(e) may well attract interest rates which are calculated by reference to the cost of funding of both parties, in respect of different periods for which the amount is outstanding.

38. The various circumstances in which interest is payable under the 2002 MA, and the rates applicable in each case, are set out in comprehensive detail in Section J(8) of the User's Guide to the 2002 MA. The relevant pages are included as Annex 2 to this skeleton.

ISSUE 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.

Introduction

39. Wentworth contends that the term "*relevant payee*" refers only to LBIE's contractual counterparty, and does not extend to a third party to whom LBIE's counterparty has transferred its interest in any amount payable to it under Section 6(e) of the ISDA MA.

40. The general principle underlying both the ISDA MAs is that neither party is able to transfer any of its rights or obligations under the agreement to a third party, without its original counterparty's consent, but this is subject to limited exceptions, as explained in the next section.

The provisions of the ISDA MA relating to assignment

41. The 1992 MA contains a general prohibition on the transfer of the agreement or either party's interest or obligation in or under it, without the prior written consent of the other: Section 7.

42. There are two exceptions. The first is where the transfer is pursuant to a consolidation or amalgamation with, or merger into, or transfer of all or substantially all of its assets to another entity: Section 7(a).

43. The second exception is, by Section 7(b), that "*a party may make such a transfer of all or any part of its interest in any amount payable to it from a Defaulting Party under Section 6(e).*" It is this exception that is at issue in the LBIE administration, as the claim under Section 6(e) of many original counterparties to an ISDA MA with LBIE has been transferred during the course of the administration.

44. The purpose of the second exception is, as explained in the User's Guide to the 1992 MA, "*to allow for certain transactions in the market-place in which a party transfers amounts payable to it from a Defaulting Party under Section 6(e) as part of another financing transaction*."

45. The 2002 MA contains a similar prohibition on assignment, and exceptions, but the second exception is framed as follows: "*a party may make such a transfer of all or any part of its interest in any Early Termination Amount payable to it by a Defaulting Party, together with amounts payable on or with respect to that interest and any other rights associated with that interest pursuant to Sections 8, 9(h) and 11*".

46. The change from the 1992 MA is explained in the 2002 User's Guide (p.30) as follows:

> *"Also, Section 7 now makes it clear that a Non-defaulting Party may transfer, together with its interest in any Early Termination Amount payable by a Defaulting Party, any amounts payable with respect of that interest pursuant to Sections 8, 9(h) and 11".*

47. It is common ground that although Section 7(b) of the 1992 MA does not expressly refer to the transfer of a party's right to interest, it is implicit that the right to transfer a party's interest in any amount payable to it under Section 6(e) includes a right to interest on that amount.

<u>Relevant payee</u>

48. The concept of "*relevant payee*" appears in the 1992 MA only in the definition of Default Rate.

49. The SCG contends that the "*relevant payee*" means the person entitled to receive the relevant interest payment, whether that be a party to the agreement, or an assignee of a party's rights under Section 6(e).

50. That contention should be rejected. On the contrary, "*relevant payee*" refers to whichever of the Defaulting Party, or the Non-defaulting Party (i.e. whichever of the original counterparties to the agreement) is entitled to receive payment of the underlying amount upon which interest is payable.[13] In summary (and as developed under the following sub-headings), this is because:

(1) It is the reading of "*relevant payee*" which most naturally fits with the different contexts in which the "Default Rate" applies in the ISDA MA.

(2) It is consistent with the fact that a party to the ISDA MA can only assign payments due "*to it*" under Section 7(b).

(3) It is consistent with the purpose of the limitations on transfer being to protect the counterparties against unknown and un-bargained for credit risk.

(4) It accords with the principle that an assignment should not, in the absence of clear language to the contrary in the contract assigned, impose additional burdens on the counterparty.

(5) Any other conclusion leads to perverse consequences which cannot have been in contemplation.

(1) "*Relevant payee*" in context

51. The "*Default Rate*" is capable of applying in three distinct circumstances:

(1) Prior to an Early Termination Date, where a party defaults on its payment obligations under Section 2(a)(i): see Section 2(e).

(2) Following an Early Termination Date following an Event of Default, on the amount due by a Non-defaulting Party (or indeed either party following a Termination Event) under Section 6(e), as from the date on which the Section

13 As shown by the example at paragraph 32 above.

6(d) notice becomes effective: see paragraph (b) of the definition of Applicable Rate.

(3) Following an Early Termination Date following an Event of Default, on the amount due by a Defaulting Party under Section 6(e): see paragraph (a) of the definition of Applicable Rate.

52. In two out of those three circumstances, there is no possibility of the relevant amount to which the Default Rate is to be applied being assigned to any third party, absent the consent of the other party. That is because Section 7(b) permits a transfer only of an amount due from a Defaulting Party. "*Defaulting Party*" is defined as a party in respect of whom there has occurred an Event of Default: see Section 6(a). Accordingly:

(1) interest under Section 2(e) on amounts due under Section 2(a)(i) is payable only prior to an Early Termination Date, is therefore not due from a Defaulting Party, and is not transferrable under Section 7(b); and

(2) neither the amount due under Section 6(e) from a Non-defaulting Party, nor interest on that amount, is transferrable under Section 7(b).

53. In each of the two circumstances in which the relevant amount to which the Default Rate is to be applied is incapable of assignment, the term "*relevant payee*" can <u>only</u> refer to either party to the agreement. In other words, the draftsman has chosen the phrase "*relevant payee*" to identify which of the two parties <u>to the agreement</u> is entitled to receive the payment to which the Default Rate is to be applied.

54. There is no reason to think that the term "*relevant payee*" was intended to have a different meaning in those circumstances where the Default Rate applied to a payment which *is* transferable under Section 7(b). At the very least, the fact that the term is unambiguously intended to identify which of the two parties to the agreement is owed the relevant amount, in two out of the three circumstances in which the Default Rate is to be applied, strongly suggests that it is intended to perform the same function, and have the same meaning, in the third circumstance.

55. The alternative term *"relevant party"* would have made no sense in the context of the definition of Default Rate. Take the application of the Default Rate to an amount due under Section 6(e), payable following an Early Termination Date. That amount might be due either to or from the Defaulting Party. A definition of Default Rate which read "*the cost to the relevant party…*" would be useless, because it would not identify which of the parties to the agreement was the relevant party. Similarly, it would have made no sense to refer to the "*cost to the Defaulting Party*" or "*cost to the Non-defaulting Party*", since either of them may be owed the amount due under Section 6(e). Thus the choice of the term "*relevant payee*" is fully explained by the need to identify which of the two parties to the agreement is entitled to be paid the relevant amount.

(2) Assignment of amounts owed "to it" under Section 7(b)

56. Section 7(b) provides that a party may transfer all or any part of its interest in any amount payable "*to it*" from a Defaulting Party under Section 6(e).

57. Interest at the Default Rate on an amount due under Section 6(e) payable to a party to the ISDA MA is calculated by reference to that party's cost of funding, or if it were to fund, the relevant amount. Accordingly, the right that is transferred is the right to receive interest by reference to the original party's cost of funding.

58. The SCG's construction of "*relevant payee*", which includes any person to whom the right under Section 7(b) is transferred, would require the phrase "*any part of its interest in the amount payable to it*" to include interest at a rate calculated by reference to the (higher) cost of funding of the transferee. Such a higher rate of interest could never have been payable to the transferor. Accordingly, it is not capable of falling within the parameters of that which can be assigned under Section 7(b).

59. The SCG suggests that the wording in Section 7(b) ("*to it*") refers not to interest on the amount payable under Section 6(e) but only to the Section 6(e) amount itself. This is wrong. The definition of that which is transferable by a party under Section 6(e) of the 1992 MA is "*all or any part of its interest in any amount payable to it from a*

Defaulting Party under Section 6(e)." A party's "*interest*" in any amount payable to it under Section 6(e) encompasses the right to interest on such amount. Indeed, if the SCG's argument were correct, then there would be no right to transfer the right to interest on the Section 6(e) amount at all, given that the limited exceptions to the general prohibition on the transfer of any interest in or under the ISDA MA are those contained in Section 7(a) and (b). On the contrary, Wentworth accepts that the right to interest on the amount payable under Section 6(e) is transferable within Section 7(b), notwithstanding the lack of express reference to such interest and, accordingly, the words "*payable to it*" in Section 7(b) encompass both the principal amount and interest.

60. Although the wording of the 2002 MA is different, in that interest payable on the amount due under Section 6(e) is separately identified as being transferable, the words "*any amounts payable on or with respect to that interest*" should be read as referring to the amounts payable to the counterparty referenced by the words "*any part of its interest in any Early Termination Amount payable to it*" in the earlier part of the clause. As noted above at paragraph 46, the 2002 User's Guide refers to the additional wording in Section 7(b) as clarification of the position under the 1992 MA; there is certainly no suggestion in the 2002 User's Guide (or any other ISDA material, text book or case) that the change was intended to produce a radically different result or to impose a substantially greater credit risk on the parties to the agreement than under the 1992 MA.

(3) Limitations on transfer and protection against counterparty credit risk

61. The terms of the provisions for transfer in the 1992 and 2002 MA are set out above. The following points of principle can be made in respect of them:

(1) The general prohibition on transfer of the agreement or rights or obligations under it protects each party against new, un-bargained for and unknown risks associated with a new counterparty, in particular any credit risk associated with that new counterparty.

(2) The importance of the credit risk of the counterparty is indicated, for example, by the Merger Without Assumption and Credit Event Upon Merger provisions in Section 5, which prevent the original party being exposed to a counterparty with worse creditworthiness than expected:

(a) the "*Merger Without Assumption*" Event of Default (Section 5(a)(viii)) in the ISDA 1992 MA, applies if the entity resulting from a counterparty's consolidation, amalgamation or merger does not assume all the obligations of the original party, or the benefits of a Credit Support Document do not extend to that new party; and

(b) the "*Credit Event Upon Merger*" Termination Event (Section 5(b)(iv) of the ISDA 1992 MA), applies if the creditworthiness of any new entity arising on a consolidation, amalgamation or merger is materially weaker than the original counterparty.

(3) This is reinforced by the circumstances in which a limited right to transfer is allowed.

(4) First, a transfer with the counterparty's consent obviously does not expose the counterparty to unknown and unbargained-for credit risks, because it can review such risks relating to the new party before it consents to the transfer.

(5) Second, the ability to transfer in the context of a consolidation, amalgamation or merger presents no, or at least very limited risk, given that the permission to transfer in Section 7 is made expressly subject to any other right or remedy under the agreement, and such other rights and remedies include the right to nominate an Event of Default in the event of a Merger Without Assumption or to nominate a Termination Event, in the event of a Credit Event Upon Merger. In other words, where any transfer under Section 7 would create an adverse additional credit risk, then the counterparty is able to exercise its right to terminate.

(6) Third, the transfer of the amount which a party owes, upon its own default, to its counterparty (following the close-out netting process which occurs upon Early Termination) does not in itself expose the Defaulting Party to any new, unknown or un-bargained for credit risk. By the stage of any such transfer, by definition, all Transactions under the agreement have been terminated and reduced to a single sum payable *by* the Defaulting Party, and the transfer of the right to claim that amount to a third party involves no assumption of any additional credit risk by the Defaulting Party.

62. Accordingly, the overall purpose of the restriction on transfers, and the limited exceptions to it, is the protection of each party against unknown risks, in particular credit risks, through being forced to face, as counterparty, an unknown entity chosen solely by its original counterparty.

63. The SCG's construction of "*relevant payee*" cuts directly across that purpose. One of the risks a party undertakes when entering into the ISDA MA is the risk that it will be required to pay interest calculated by reference to the cost to its counterparty of funding the relevant amount. In this way it is exposed to the credit standing of its counterparty. That is a risk which it can manage so far as its contracting counterparty is concerned: it can choose whether or not to contract in the first place. If the rate of interest which a party has to pay upon its default depends upon the credit standing of potentially anyone to whom its counterparty transfers the right to payment under Section 6(e), then the party is exposed to wholly unknown and unmanageable credit risks.

64. It is Wentworth's construction of "*relevant payee*" which is consistent with and thus supported by the purpose of the transfer provisions.

65. This conclusion is supported by reference to the fore-runner to the 1992 MA, and the reason for the introduction of the ability to transfer the amount owing under Section 6(e).

66. The fore-runner to the 1992 MA was the 1987 Interest Rate and Currency Exchange Agreement (the "**1987 Agreement**") **[5/1]**. The 1987 Agreement contained a

definition of Default Rate that was identical to that in the 1992 Agreement, and thus required the "*relevant payee*" to certify its cost if it were to fund or of funding the relevant amount. It also contained a general prohibition on transfer of either party's rights under the 1987 Agreement, but did <u>not</u> include any provision equivalent to Section 7(b) of the 1992 MA, permitting the transfer of the net sum arising on termination following close-out netting. Accordingly, under the 1987 Agreement, "*relevant payee*" could <u>only</u> mean whichever of the parties to the 1987 Agreement was entitled to be paid the relevant amount.

67. It is permissible to have regard to the equivalent terms of the 1987 Agreement in construing the 1992 MA: see *Lomas v JFB Firth Rixson Inc*[14] at [51]-[53].

68. As noted above, the sole purpose of introducing the provision at Section 7(b) of the 1992 MA was to facilitate certain market transactions in which the amount due under Section 6(e) was transferred as part of another financing transaction. That purpose is achieved by Wentworth's construction of "*the relevant payee*". It was no part of the purpose of introducing the right to transfer the amount due under Section 6(e) to expose each party to a new, un-bargained for and unknown credit risk of any third party to whom the original counterparty chose to transfer the right to payment.

(4) Assignment ought not to impose greater burden on counterparty

69. It is a well-established principle of general law that an assignee cannot recover more against the debtor than the assignor could have recovered. See, for example, Snell's Equity 33rd Ed. at 3-027:

> *"In general, an assignee cannot recover more from the debtor than the assignor would have. The purpose of the principle is to prevent the assignment from prejudicing the debtor. This would happen if, for example, he had to pay damages to the assignee that he would not have had to pay to the assignor if the assignment had not taken place."*

70. See also Chitty on Contract, 31st Ed. at 19-074:

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14 [2013] 1 BCLC 27.

> *"A further aspect of the idea that an assignee takes an assignment "subject to equities" is the principle that an assignee cannot recover more from the debtor than the assignor could have done had there been no assignment. For example, in Dawson v Great Northern & City Ry Co*[15] *the assignment of a statutory claim for compensation for damage to land did not entitle the assignee to recover extra loss suffered by reason of a trade carried on by him, but not the assignor, that the assignor would not have suffered."*

71. The principle has been applied on a number of occasions. In *Linden Gardens Trust Limited v Lenesta Sludge Disposals Limited* 57 BLR, Staughton LJ said at page 57:

> *"But it is said in such a case the assignee can recover no more damages than the assignor could have recovered. That proposition seems to me to be well founded, it stems from the principle already discussed that the debtor is not to be put in any worse position by reason of the assignment. And it is established by Dawson v Great Northern and City Railway Company…"*

72. In *Equitas Limited, v Walsham Brothers & Company Limited* [2013] EWHC 3264 (Comm) at [127]-[133], Males J applied the principle so as to preclude an assignee from claiming damages, in its capacity as assignee, by reference to its own loss of investment returns, but instead limiting it to recovery of damages assessed by reference to the loss of investment returns of the assignor.

73. The principle is not conclusive of the question posed by Issue 10, because a party to a contract may choose expressly to assume a potentially greater obligation to an assignee of its counterparty's rights than it did to the original counterparty. There is, however, no language, let alone clear language, that would achieve that result in the ISDA MA. In the absence of clear language to contrary effect, the general principle of law provides strong support for the conclusion that "*relevant payee*" in the definition of Default Rate does not include an assignee of the right to payment under Section 6(e). That is because the general law provides an essential part of the background circumstances against which the contract is to be construed:

15 [1905] 1 KB 260.

(1) To have regard to the general law as part of the relevant background to a contract is reasonable especially in circumstances in which the parties have expressly chosen that law to govern their contract: see Lewison, The Interpretation of Contracts 5th Ed at 4.06:

"Parties do not make contracts in a legal vacuum. They always negotiate against the background of the law. It is, therefore, reasonable to suppose that they take into account the general law in reaching their ultimate consensus. And, accordingly, the proper interpretation of their agreement is properly influenced by the legal background against which it is made."

(2) The principle was applied by the Court of Appeal in *The World Symphony*[16], in construing the terms of a charterparty in order to determine whether it permitted the charterers to order the vessel to undertake a round voyage which on no view would end before the expiration of the period of the charter. Lord Donaldson M.R. (in a judgment with which the other members of the Court agreed) concluded that the charterparty did not permit such a voyage, and noted that:

"[I]t is for the parties to give expression to the terms of their bargain and this always has to be done against a background of general law and accepted principles, such as the prima facie risk of loss by delay in performance under a time-charter falls upon the charterer."

(5) Perverse consequences

74. If the relevant payee means whoever has the right to payment under Section 6(e), then the amount of interest payable would be subject to continual fluctuation depending on the cost of funding position of each successive transferee, with the cost of funding of each successive transferee being applied to the period during which it possessed the claim.

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16 [1992] 2 Lloyd's Rep 115.

75. Moreover, it would place the paying party at the mercy of debt trading conducted solely for the purpose of extracting as high a rate of interest as possible. Thus, for example, it would incentivise potential purchasers to invest in claims owed by ISDA defaulting parties via shell companies, set up in such a way so as to enable them to assert as high a cost of funding as possible. The greater the shell entity's cost of funding, the greater the interest payable by the defaulting party, and the greater the return on the purchaser's investment.

76. These perverse consequences, which cannot have been contemplated, are avoided on Wentworth's construction of *"relevant payee"*.

Conclusion

77. For the above reasons, *"relevant payee"* means whichever of the two contracting parties to the ISDA MA is entitled to receive the relevant payment, and does not extend to an assignee of the right to payment under Section 6(e).

ISSUE 11

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

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

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

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

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

Introduction

78. Wentworth and the Administrators contend that the cost to the relevant payee if it were to fund or of funding the relevant amount is to be certified by reference to the cost which the relevant payee is required to pay in borrowing the relevant amount, whether an actual cost, where the relevant payee goes into the market to raise funds, or a hypothetical cost, where it does not do so. "*Cost*" means the transactional cost, i.e. the price which is required to be paid in return for the funding for the period it is required.

79. The SCG and GSI, on the other hand, contend that the expression encompasses a far broader range of costs.

80. In particular, the SCG contends, in its revised and consolidated position paper **[1/9]**, that the expression encompasses:

(1) all and any financial outlay incurred in raising a sum of money equivalent to the relevant amount by issuing equity, e.g. legal or other professional fees for an IPO;

(2) the relevant payee's overall cost of funding (whether by debt or equity) calculated by reference to the risks associate with the business and the return required by its funders – including shareholders – in light of those risks;

(3) any changes to the relevant payee's overall cost of funding all of its assets as a consequence of raising money to fund or of funding the relevant amount;

(4) the consequences to the relevant payee of carrying a defaulted receivable on its balance sheet; and

(5) the actual or asserted cost to the relevant payee of funding a claim against LBIE.

81. GSI also contends that the cost to the relevant payee of raising equity is encompassed within the expression, and that this includes any sum paid, or other financial detriment incurred, in raising, maintaining or servicing such equity (or other) funding.

82. In construing the expression "*cost … if it were to fund or of funding the relevant amount*" (the "**cost of funding language**"), it is important to keep in mind (a) the fact that it is an expression which is deployed in the context of each of the different interest rates applied by the 1992 ISDA MA, and (b) it is applicable, depending on the context in which the particular rate is to be applied under the ISDA MA, to determine the cost to the relevant payee *and/or* the relevant payor. (The possible permutations are explained in the introduction above at paragraphs 27 to 38, and Annex 1)

83. In a document drafted as carefully as the ISDA MA, where the draftsman has used precisely the same expression in different parts of the same agreement, particularly in relation to the same concept, interest, then in the absence of an indication to the contrary, it would be surprising if he intended the expression to have different

meanings in the different parts: see, for example, *Interactive Investor Trading Limited v City Index Limited*[17], per Tomlinson LJ at [29]:[18]

> *"[T]he agreement seems to have been the subject of careful drafting and it should ordinarily be presumed that language is used consistently within the four corners of an agreement."*

84. Moreover, the draftsman would have envisaged the calculation of the relevant interest rate, at least in many cases, to be something which had to be undertaken speedily, so as to provide certainty to the parties, in the variety of situations in which the cost of funding language is employed, whether before or after termination of the agreement.

85. Wentworth's case on the meaning of the cost of funding language can be distilled into the following seven points, which are developed in turn below:

(1) The *purpose* of the cost of funding language is to define a rate of interest, and interest is fundamentally concerned with the cost of the use of money over time, i.e. the time-value of money.

(2) The contractual remedy provided to achieve that purpose is based upon *a transaction* to fund the relevant amount. The *"cost"* which is to form the basis of the rate of interest is the *"cost"* of *that* transaction. The transaction is either actual, or hypothetical – the two being mutually exclusive.

(3) The transaction is one to fund an incremental sum of money *equal to* the unpaid amount. In the case of the Default Rate "*the relevant amount*" is an amount equal to whatever amount is owed by the payor, whether an amount under Section 2(a) or Section 6(e).

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17 [2011] EWCA Civ 837.

18 See also *Re Birks* [1900] 1 Ch. 417, per Lindley LJ at p.418: "*If, then, we find it to be clear, in eleven out of twelve cases, that in using the word "issue" he means "children," what is the natural inference to be drawn in the twelfth case, where he has thrown no light upon the meaning of the word? The natural conclusion is that he uses the word in the same sense in which he has used it before. That is good sense. I do not know whether it is law, or a canon of construction, but it is good sense to say that whenever in a deed, or will, or other document, you find that a word used in one part of it has some clear and definite meaning, then the presumption is that it is intended to mean the same thing where, when used in another part of the document, its meaning is not clear*."

(4) "*Cost*" is the *price* to be paid (or which would be paid) to fund the relevant amount, not simply any financial benefit provided or detriment incurred as a result of the transaction to fund the relevant amount. In particular, any financial detriment measured in terms of change in the anticipated return for investors is irrelevant: the cost of funding language is aimed at identifying the cost of replacement funding for the period of delay in payment of the principal; the relevant payee could use such replacement funding to invest and thus make the anticipated return to its equity investors.

(5) "*Cost*" also connotes the amount or rate which the relevant payee is (or would be) *required* to pay to fund the relevant amount, as opposed to an amount or rate (if different) which the relevant payee could *choose* to pay. Wherever the relevant payee has more than one alternative funding transaction, at different prices, then it can only be said to be *required* to pay that which (taking into account all relevant considerations) is the lowest of the alternatives.

(6) The cost of funding language permits only the cost of *borrowing* the relevant amount, as opposed in particular to the cost of issuing equity. The ISDA MA provides for interest on the principal sum outstanding until the principal sum is repaid. The cost of funding language is directed at identifying the cost of a replacement for that unpaid debt for the period until it is paid. The cost of issuing equity is neither a true 'cost', because the return on equity is a mere expectation and imposes no obligation on the company to pay any certain sum, nor relative to any period, because an increase in equity is a permanent increase in capital, the return on which is not measured by reference to time outstanding.

(7) The cost of funding language excludes losses arising from LBIE's default.

<u>The seven points developed</u>

(1) Cost of funding the relevant amount: the time value of money

86. The cost to one or other party under the ISDA MA of funding, or if it were to fund, a particular sum is the basic concept employed in the ISDA MA in order to calculate

the rate of interest payable on overdue amounts. For example, Section 2(e) specifically refers to the obligation to pay "*interest*" on the overdue amount, and Section 6(d)(ii) specifically refers to "*interest*" being paid on the amount calculated as being due following an Early Termination Date. It is necessary to construe the cost of funding language in that context.

87. An essential feature of interest is that it is payable for a period, whether that period is fixed or otherwise, being the period during which the payee is deprived of its principal sum. Blackstone, in his commentaries, described interest as "*an increase by way of compensation for the use of money*".[19] Mann, Legal Aspects of Money, states (at 3.07) "*Interest has been defined as payment by time for the use of money*".

88. It is self-evident that the cost to the relevant payee if it were to fund, or of funding, the relevant amount is to be calculated by reference to the period of time during which the relevant amount is unpaid. The ISDA MA expressly refers in a number of places to interest being calculated on the basis of "*the actual number of days elapsed*": see, for example, Sections 2(e) and 6(d)(ii).

89. In *Sempra Metals*[20], Lord Nicholls said:

> *"In the ordinary course the value of having the use of money, sometimes called the "use value" or "time value" of money, is best measured in this restitutionary context by the reasonable cost the defendant would have incurred in borrowing the amount in question for the relevant period. That is the market value of the benefit the defendant acquired by having the use of the money."*

90. Similarly, in *Tate and Lyle Food and Distribution Limited v Greater London Council*[21], Forbes J, in awarding interest on damages at 1% over base rate, said (at pages 154 to 155):

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19 Blackstone's Commentaries, Book II, Ch.30, p.455.

20 [2008] 1 A.C. 561, at [103].

21 [1982] 1 WLR 149.

> *"I do not think the modern law is that interest is awarded against the defendant as a punitive measure for having kept the plaintiff out of his money. I think the principle now recognised is that it is all part of the attempt to achieve restitutio in integrum. One looks, therefore, not at the profit which the defendant wrongly made out of the money he withheld — this would indeed involve a scrutiny of the defendant's financial position — but at the cost to the plaintiff of being deprived of the money which he should have had. I feel satisfied that in commercial cases the interest is intended to reflect the rate at which the plaintiff would have had to borrow money to supply the place of that which was withheld."*

91. He went on to point out that, while it was not permissible to look at the particular attributes of the claimant, it was right to look at the nature or class of the claimant and enquire at what rates someone in that class could borrow at:

> *"I am also satisfied that one should not look at any special position in which the plaintiff may have been; one should disregard, for instance, the fact that a particular plaintiff, because of his personal situation, could only borrow at a very high rate, or on the other hand, was able to borrow at specially favourable rates. The correct thing to do is to take the rate at which plaintiffs in general could borrow money. This does not, however, to my mind, mean that you exclude entirely, all the attributes of the plaintiff, other than that he is a plaintiff … I think it would always be right to look at the rate at which plaintiffs, with the general attributes of the actual plaintiff in the case (though not, of course, with any special particular attribute), could borrow money as a guide to the appropriate interest rate … in commercial cases it seems to me that the rate at which a commercial borrower can borrow money would be the safest guide."*[22]

[22] This remains the approach in commercial cases: see *Secretary of State for the Department of Energy and Climate Change v Jones* [2014] EWCA Civ 363, per Sharp LJ at [18]: "*In commercial cases the rate of interest is usually set by reference to the short-term cost of unsecured borrowing for the relevant class of litigant, though it is always possible for a party to displace a "rule of thumb" by adducing evidence, and the rate charged to a recipient who has actually borrowed money may be relevant but is not determinative*."

92. The important difference, in the interest rate applicable under the ISDA MA, is that it *is* permissible, indeed expressly required, to have regard to the rates at which the particular payee party could borrow in the market. That difference aside, the fact that the general law regards the calculation of the time value of money as based on the rate at which the payee who has been kept out of his money could borrow in the market to replace the relevant amount, is an important starting point in construing what the draftsman of the ISDA MA had in mind in respect of provisions the purpose of which was to arrive at an appropriate interest rate.

(2) "*Cost*" is of a transaction (actual or hypothetical) to fund the relevant amount

93. For each Applicable Rate the draftsmen of the ISDA MA have used the cost of funding language to define the contractual remedy for the late payment of an amount. That language contemplates *a transaction* (either actual or hypothetical) by the party who is to certify.

94. The words "*of funding*" expressly contemplate positive action on the part of the relevant payee, i.e. the actual entry into a transaction with another to raise a sum of money in the relevant amount. Indeed, it is not possible to raise the relevant sum otherwise than by transacting with another. Merely to allocate cash already in hand would not close the funding-gap because the certifying party would still be without the cash it would have had had the unpaid amount been paid. Actual funding must, therefore, involve a transaction with another.

95. The words "*if it were to fund*" import a counterfactual to an actual funding transaction. While they remove the need for an actual transaction, the calculation must still be referable to a transaction, albeit a hypothetical one.

96. The alternatives (cost "*of funding*" or cost "*if it were to fund*") reflect the fact that a person who is kept out of his money due to an unpaid debt may choose not to replace the money, and is not required to do so in order to recover for the lost time value of that money.

97. The first alternative captures the case where the relevant payee actually funds the relevant amount, by transacting to borrow the sum in the market. The second captures

the case where the relevant payee does not actually transact, but enables it to rely on the cost it would have incurred had it done so.

98. The fact that one transaction is actual and the other hypothetical is the only difference between the two alternatives. There is nothing in the language ("*of funding*"; "*if it were to fund*") which suggests that any different concept is to be included in the second hypothetical alternative, that is not already within the first actual alternative.

99. The two alternatives are self-evidently mutually exclusive: if a party actually transacts in the market by borrowing money, then it falls within the first alternative, and there is no basis for it relying on the second. On the other hand, if a party does not actually transact, then it can only fall within the second alternative.

100. This is demonstrated by the circumstances in which "*cost of funding*" and "*cost if it were to fund*" are used in the ISDA MA.

101. The definition of "*Default Rate*" uses alternatives. It applies only where the interest so calculated is payable *to* the certifying party. In this case, either the actual or hypothetical alternative may be relevant: the party may actually borrow the amount, or it may charge the cost it would have incurred had it done so.

102. The definition of "*Non-default Rate*" uses only the hypothetical ("*cost if it were to fund*"), because it applies only where interest is payable *by* the certifying party. In this case, only a hypothetical transaction is relevant because the certifying party is to certify a rate of interest in respect of amounts owed by it. It would never need actually to borrow a sum of money equal to the relevant amount.

103. The definition of Termination Rate uses both alternatives because, depending on the circumstances, it may apply either when the certifying party is the payer, or the recipient of the relevant sum on which interest is to be calculated.

(3) Transaction to fund an amount equal to the unpaid amount

104. The transaction contemplated is to fund a sum of money *equal to* the amount owed under the ISDA MA, whether (i) a payment obligation under Section 2(a)(i), (ii) an

"*Unpaid Amount*" following an Early Termination Event, or (iii) the obligation under Section 6(d) to pay the amount calculated in accordance with Section 6(e).

105. The calculation thus pays no regard to the circumstances of the default and, in particular, to the fact that the relevant amount is owed by an insolvent company.

106. Aside from the fact that this is the natural reading of the wording, it follows logically from the fact that in some instances the certifying party is to calculate the cost of funding the relevant amount which is payable *by it*.[23] In such a case, since the certifying party is not owed anything, the "*relevant amount*" can only mean a sum of money equal to the relevant amount.

107. Importantly, cost of funding the relevant amount precludes the certifying party from basing its calculation on the riskiness, and thus value, of either the *asset* represented by the defaulted claim against LBIE, or the riskiness or value of its assets generally. Much of the arguments advanced by the SCG, in particular, to date are premised on calculating cost by reference either to the claim against LBIE, as a particular asset, or to the whole of the certifying party's portfolio of assets, one of which is the risky claim against LBIE. These matters are developed further below when addressing points arising from the SCG's and GSI's case.

(4) The meaning of "*cost*": the price to be paid (or which would be paid) to fund the relevant amount

108. The word *"cost"* is generally equated with the *price* to be paid for something,[24] certainly where, as in the cost of funding language, it is used in the context of the cost of obtaining something via a transaction. That is, it is the price which the certifying party either actually pays to the counterparty from whom it raises the relevant amount, or the price it would have paid to a counterparty had it entered into such a transaction.

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[23] This is so, for example, where the the Non-defaulting Party is required to certify the cost to it of funding an amount equal to the sum payable by it under Section 6(e) for the period between the Early Termination Date and the date the sum becomes payable.

[24] See, e.g., the Shorter Oxford English Dictionary: "*what must be given in order to acquire, produce or effect something; the price (to be) paid for a thing*"; Collins English Dictionary : *"the price paid or required for acquiring, producing or maintaining something, usually measured in money, time or energy."*

109. This interpretation of the expression is to be preferred to that contended for by the SCG and GSI, which would extend the cost of funding language to include any financial detriment incurred or that could have been incurred by the relevant payee. On their case, the only limit on the range of detriments included would appear to be that it has some causal relation with the transaction by which the relevant amount was raised. Thus, according to the SCG and GSI, the cost of funding language would include any outlay of cash to third parties (such as legal or advisory fees in relation to a debt or equity issue), any consequential detrimental effect on the certifying party's overall cost of funding its entire asset base, or the return expected by its investors, as a result of raising the additional sum, or which would have been incurred had it raised the additional sum, and any other detriment that might flow from the additional funding.

110. There are a number of reasons why this approach should be rejected, aside from the fact that the wider interpretation is at odds with the generally understood meaning of *"cost"*:

(1) Notwithstanding the widespread use of the ISDA MA over the past 30 years, there is no reference to such a broad interpretation of the cost of funding language in ISDA materials, any case or any text book dealing with the subject.

(2) The very breadth of the interpretation introduces complexity and uncertainty which is at odds with the efficient working of the mechanism of the ISDA MA.

(3) This is especially so, in light of the fact that the cost of funding language applies to certification both by the payee and the payor.

(4) The alternative interest rates provided for in the 2002 ISDA MA are inconsistent with the wider view.

(5) Further financial detriment caused by the borrowing cannot be said to be a cost of such borrowing, but is the price paid for a separate service.

(i) *No reference in ISDA materials etc.*

111. So far as the first point is concerned, as noted above, the generally accepted way of calculating compensation for the lost time value of money is by reference to what it would cost to borrow an equivalent amount in the market. It has never been the case under the general law that the calculation of interest should include any, let alone all, other financial benefits/detriments, or financial outlay to third parties, in some way caused by or connected with such borrowing in the market. The reasoning underpinning the application of a "*commercial*" rate in the Commercial Court is wholly based upon the cost of borrowing a replacement amount in the market (see paragraphs 91 to 92 above).

112. It would be a significant departure, therefore, if the cost of funding language in the ISDA MA, the purpose of which is to identify an appropriate interest rate on various types of unpaid sum, were to incorporate such broader consequences.

113. The lack of any reference to such departure, in any ISDA materials (e.g. the User's Guides), any commentary or case is therefore telling.[25] Firth refers only to the Default Rate being "*1 per cent per annum above the other party's cost of funding the sum*".[26] Hudson simply refers to the Default Rate as "*one per cent over the cost of funding that amount for each day for which payment is overdue*".[27] Henderson also provides no elaboration beyond the reference to the various rates of interest being based on one or other party's cost of funding the sum, but does explain that the addition of 1% under the Default Rate is justified (and thus probably prevents the Default Rate from being struck down as a penalty) "…*given the risks incurred by the non-defaulting party and the expectation that there will be time, effort and expense incurred in connection with the default, some of which might not be reflected or*

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[25] In a similar vein, if the SCG/GSI arguments are correct, the experience of claims for interest asserted in the Lehman insolvency to date would be highly surprising. A number of claims for interest under the ISDA MA have been asserted in the bankruptcy of LBHI in the US. Of those, the vast majority are at rates (well below 8%) that are consistent with *borrowing* rates during the relevant period: see 11th witness statement of Anthony Lomas, at [80] to [92] **[2/3]**. This is confirmed by the witness statement of Robert Bingham , at [12] to [20] **[2/2]**.

[26] Firth: Derivatives Law and Practice, at 11.022.

[27] Hudson, the Law of Financial Derivatives, at 2-121.

properly recoverable under Section 11”,[28] thus indicating that broader “expenses” incurred by the relevant payee as a consequence of non-payment are *not* otherwise included within the cost of funding language. In the Derivatives Deskbook,[29] the Default Rate is described as a rate that “*equals the cost of funds incurred by a party if it were to borrow an amount equal to the sum of the settlement amount, the net unpaid amount, and in the case of the non-defaulting party, the out-of-pocket expenses plus 1%.*” Simon James, in The Law of Derivatives[30] assumes, in a discussion on the extent to which the certification of the Applicable Rate can be challenged, that the cost of funding the relevant amount is equated to “*the rate of interest at which the non-defaulting party can borrow…*”.

114. The use of the cost of funding language in the ISDA MA (as opposed to identifying a benchmark rate, such as LIBOR or an overnight bank rate) is sufficiently explained by the fact that it was felt appropriate to reflect the fact that different counterparties would be likely to have access to borrowing at different rates.

(ii) Complexities and uncertainties

115. As to the second point, the broad interpretation proposed by the SCG/GSI would introduce considerable complexities and uncertainty.

116. In the first place the parameters of the range of potential financial detriments said to arise from additional funding are difficult to define. Moreover, it introduces potentially difficult questions of causation.

117. Thus, for example, if an entity (with a capitalisation of many billions of dollars) has an unpaid amount owing by LBIE, as a result of LBIE’s default, of $100m, the task of identifying whether any of (a) an increase in its overall cost of borrowing, (b) the return its investors require on their capital, or (c) an increase in the rate which one or other new borrower demands for further lending is a consequence of the additional borrowing is far from straightforward – if, indeed, it is possible to undertake at all.

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28 Henderson on Derivatives, at 19.21.

29 Practising Law Institute, Sylvie A. Durham, at §5.9.2.

30 Informa Law, 1999, at p.233.

118. If it is possible to identify *some* causal link, the likelihood is that there are other causes as well – particularly where it occurs at a time of market disruption such as that caused by the collapse of Lehman. The task of disentangling what additional cost may be laid at the door of the additional borrowing is likely to be impossible.

119. The difficulties are great enough when an entity actually does go into the market to borrow. If it does not do so, but is left to calculate the possible additional financial detriments of a hypothetical borrowing transaction, then they are greater still.

120. If that were not enough, the broader interpretation does not stop there, because in order for a comprehensive calculation of the financial consequences of the additional borrowing to be made, any *benefits* received (with all of the attendant difficulties of identification and causation) must logically be taken into account as well (as the SCG acknowledge in paragraph 1(1) of the further information dated 28 September 2015).

121. GSI implicitly acknowledges these difficulties in suggesting that it is possible to fall back on certain financial models. These involve yet more complexity and uncertainty. Insofar as they have been explained, the models are multi-factorial and, ultimately, rely upon a professional's judgment as to whether another investor might demand a higher return on its investment in light of any increase in leverage resulting from the relevant amount being borrowed.

122. Even if the hypothetical exercise required to certify such a broad and unlimited construction of "*cost*" were possible, it is so burdensome a task that it cannot have been contemplated by the draftsmen of the ISDA MA in order to produce a rate of interest, which is intended to compensate for the time-value of money. Indeed, the range of detriments which the SCG and GSI would include are a long way from the concept of a payment in return for a sum of money for a period, which is the essential element in computing the time value of money.

(iii) Range of circumstances in which cost of funding language deployed

123. These difficulties are exacerbated by the fact that the cost of funding language applies either to the payor or payee, or in some cases both of them.

124. For example (by reference to the examples in Annex 1), where Party A suffered an EoD and a Termination Amount of £100m is due *to* Party A, then interest is payable by Party B, for the first period (up to the date of the calculation notice) at the Non-default Rate (based on the cost *to Party B* of funding £100m) and thereafter at the Default Rate (based on the cost *to Party A* of funding £100m).

125. The obvious purpose of this is that although Party B owes the £100m from the Early Termination Date, it cannot possibly pay it prior to the calculation notice being served, so for the period up to that date it would be unfair if the interest rate should be based on the potentially higher cost which Party A (the defaulting party) would face in borrowing that sum. In contrast, once it has received the calculation statement, any delay in payment of £100m is its fault, and it is fair that Party A is compensated for that delay by reference to the cost to it of borrowing an equivalent sum in the market.

126. Where Party B (who *owes* £100m) is certifying the cost *to it* of funding £100m, if, as the SCG and GSI contend, the cost of funding language encompasses any and all financial detriments that would be suffered by Party B if it were to raise £100m, then Party B would be failing to comply with the contractual requirements unless it sought, in good faith and on a rational basis, to include every such detriment. If it did not do so, it would (on the SCG's and GSI's case) wrongly *reduce* the interest rate it was required to pay to Party A for the relevant period.

127. This is an especially unrealistic exercise for Party B, as the Non-defaulting Party to undertake. It is by definition hypothetical, since Party B is the paying party. It requires a counter-intuitive, if not perverse, incentive: namely to explore all the ramifications of borrowing £100m and include all financial detriments to which that gives rise, for the purpose of *increasing* the amount of interest Party B would need to pay.

128. An unrestricted concept of *"cost"* also creates a problem in relation to the Termination Rate, which is the arithmetic mean of each party's cost of funding (as certified by each of them). The interest to which the payee party is entitled is again dependent at least in part upon the payor party certifying a cost which includes all the consequential financial detriments to the payor party if it were itself to borrow the

relevant amount. To omit any financial detriment incurred would (by reduction of the arithmetic mean) understate the *"cost"* and deny part of the contractual right to interest.

129. To allow as *"cost"* of funding any financial detriment, provided it has at least some causal connection to the funding transaction, therefore, produces an unworkable construction for two of the three Applicable Rates.

(iv) 2002 ISDA MA

130. In the 2002 MA the draftsmen have introduced, alongside the cost of funding language, rates of interest defined by reference to over-night lending rates.[31] For example:

(1) Interest on amounts owed *by* the Non-defaulting Party, following an Early Termination Date, is payable at the Non-default Rate, defined in terms of "*a rate offered to the Non-defaulting Party by a major bank in a relevant interbank market for overnight deposits*"; and

(2) Upon the occurrence of an Illegality Termination Event (under Section 5(b)(i)), then amounts which would otherwise be due are postponed until after a Waiting Period of three business days (Section 5(d)), and interest is payable during that period at the "*rate offered to prime banks by a major bank in a relevant interbank market for overnight deposits in the applicable currency*": Section 9(h)(i)(3)(B), and limb (b) of the definition of Applicable Deferral Rate.

131. Wentworth contends that these additions, in particular the change to the Non-default Rate, were limited in scope, and did no more than change the nature of the borrowing that could be relied upon in asserting a rate of interest.

31 See pp.32-36 of the 2002 User's Guide at Annex 2 for a succinct explanation of the different interest rates, and the circumstances in which they are payable under the 2002 MA.

(1) In the case of the Non-default Rate, it was changed from the rate (without restriction) at which the Non-defaulting Party could borrow, to the overnight rate at which it could borrow from a major bank in the relevant market.

(2) In the case of the Applicable Deferral Rate, the change was from the rate at which *the party* could borrow (without restriction) to an objective rate available in the market to a prime bank.

132. The limited scope of the change is supported by the fact that there is no indication in the User's Guide to the 2002 MA that any prior right to calculate the cost of funding the relevant amount on the basis of a broad range of financial benefits and detriments consequent upon the funding transaction was being removed. That would have been a seismic change in the interest entitlement of the Defaulting Party. The 2002 User's Guide, however, (at p.32) states merely that "*Section 9(h) is a new Section in the 2002 Agreement that consolidates and updates all provisions regarding interest and compensation which were found in Sections 2(e) and 6(d)(ii) of the 1992 Agreement and adds provisions to deal with certain consequences of an Illegality or Force Majeure Event*."

133. In the absence of any intention to make such a seismic change, the more natural characterisation is that the 2002 MA *retained* the underlying concept that the rates of interest payable under it were to be calculated by reference to the rate at which sums could be borrowed in the market, but merely confined the ambit of such rates to an overnight rate offered by a major bank.

134. This conclusion is supported by the fact that in various circumstances the 2002 MA requires the Applicable Rate to be calculated as the arithmetical mean of (a) the cost to one part if it were to fund or of funding the relevant amount and (b) the overnight rate offered to the other party by a major bank. Although not conclusive, this is more consistent with the assumption that the basic parameters of (a) and (b) are the same; i.e. they are both intended to identify the cost, as in transaction price, of borrowing to each of the parties.

(v) *Extraneous detriments are a cost of a separate service*

135. A further reason for excluding much of the wider 'financial detriments' of raising funding which the SCG/GSI would include is that it falls outside the definition of *"cost"* because it is paid as the price for a wholly separate service. This covers any cash outlay in favour of third parties. For example, payment for legal fees is a cost of a separate service, namely legal advice; and a fee paid to accountants for advice as to the most tax efficient structure of the loan, or a fee paid to merchant bankers in connection with an issue of shares, debt or hybrid instruments is also paid for a separate service.

136. The services received reflect a distinct benefit that is consumed and which has a price reflective of that benefit. The expense is the value of legal, advisory or other services such as underwriting, not the price of a sum of money equal to the unpaid amount.

(5) The meaning of "*cost*": the amount the relevant payee is required to pay, not that it could choose to pay

137. It is important, in considering the meaning of the definition of Default Rate, to distinguish between (a) the correct subject matter of the relevant payee's certificate and (b) the circumstances in which that certificate can be challenged.

138. Wentworth accepts that the circumstances in which the relevant payee's certificate can be challenged are limited, broadly where the relevant payee acts otherwise than reasonably and in good faith. Those concepts do not exist in a vacuum, however. It is in certifying its <u>cost</u> that the relevant payee is required to act reasonably and in good faith.

139. It is helpful in illustrating this point to contrast the definition of Default Rate with a hypothetical alternative – one in which the rate was defined simply as "the cost to the relevant payee if it were to fund or of funding the relevant amount" (i.e. the only difference being the absence of certification). In this hypothetical alternative, it is obvious that *"cost"* as a concept requires definition, because it is the *"cost"*, as opposed to some other concept, which determines the rate of interest.

140. The addition of the certification requirement does not alter the fact that *"cost"* as a concept requires definition, because what is to be certified is *"cost"*, and not some other concept. It just means that the obligation of the relevant payee is limited to certifying what it reasonably and in good faith believes to be that cost.

141. Indeed, the concepts of good faith and rationality have to be anchored to some objective concept. If the relevant payee is permitted to certify whatever 'number' it should choose to pay (or could have chosen to pay) in return for funding, then a challenge based upon a lack of rationality or good faith has little to bite on, because the exercise is rooted in a free choice of the relevant party.

142. In fact, the use of the word *"cost"* implies something which the relevant payee is *required* to pay, as opposed merely to something it *could* have paid or chose to pay. If the relevant payee certified an amount (as the cost to it of funding the amount) which was higher than that which it was required to pay, that would not represent a *"cost"*. To take an extreme example: if the relevant payee could have borrowed the relevant amount (thereby actually obtaining a substitute for the defaulted debt) at a rate of 0.01%, but could also have raised the sum by way of some other form of funding (assuming it is within the meaning of the cost of funding language) at a rate of 10%, it is only the former which represents the *"cost"* of funding.

143. For this reason, Wentworth submits that GSI's construction is wrong. GSI's construction permits a certification on the basis of whatever funding source the relevant payee *could* have used provided that it would *not* have been irrational to use that source by reason of the fact that the relevant payee would *never* in fact have funded the relevant amount in that way. In this respect, see GSI's Reply Position Paper at paragraph 17 **[1/18]**:

> *"As Goldman Sachs explains in its position paper, the non-defaulting party may certify any basis of funding that they <u>could</u> have used. But, given the requirement to do so in good faith and rationally, the non-defaulting party cannot certify a basis of funding that they <u>might never</u>*[32] *have actually used,*

[32] The phrase "*might never*" is inherently contradictory.

and to that extent certify a cost that they "would" have used." (Emphasis added and references omitted)

144. GSI's construction enables a certification on the basis of the *highest* cost to the relevant payee, i.e. whatever it "*could*" have paid, limited to only proof of irrationality on the ground that the relevant payee "*might never*" have funded the amount in a particular way. Within that range the relevant payee can select the most expensive funding option, which is the *opposite* of what a rational relevant payee would do if it were in fact to fund the relevant cost.

(6) "*Cost*" is of borrowing, not equity

145. Both the SCG and GSI contend that cost of funding includes the cost of raising the relevant amount in consideration for issuing equity, as well as the cost of borrowing the relevant amount.

146. This argument should be rejected. The cost of funding language equates "*cost*" to the price which has to be paid to fund an amount equal to the unpaid amount for the period it is outstanding. Costs associated with the issue of equity do not satisfy this requirement.

147. As noted above:

(1) each of (i) the Default Rate, (ii) the Non-default Rate and (iii) the Termination Rate is a calculation designed to identify an appropriate interest rate to be imposed on one or other party under the ISDA MA;

(2) interest is compensation for the time value of money – i.e. for one party being kept out of its money for the period between default and payment; and

(3) it is an essential feature of cost of funding language that:

(a) "*cost*" is what has to be paid to fund the amount; and

(b) *"cost"* is that relating to the period for which the unpaid amount, for example "*the relevant amount*", is outstanding.

148. These essential features mean that only the price of borrowing can be considered a "*cost*". Only borrowing imposes an obligation to repay, or to pay interest, and it is only in respect of borrowing that the cost relates to the use of the money for a period of time.

149. By contrast the bundle of rights conferred by a share is of a fundamentally different nature to a debt. In *Borland's Trustee v Steel* [1901] 1 Ch 279 at 288, Farwell J said:

> *"A share is the interest of a shareholder in the company measured by a sum of money, <u>for the purpose of liability in the first place, and of interest in the second,</u> but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s. 16 of the Companies Act, 1862 . The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money settled in the way suggested, but is <u>an interest measured by a sum of money</u> and made up of various rights contained in the contract<u>, including the right to a sum of money of a more or less amount.</u>*" (Emphasis added)

150. This passage was approved by the Court of Appeal in *Re Paulin* [1935] 1 KB 26 and by the House of Lords in *IRC v Crossman* [1937] AC 26. In *Grays Timber Products Ltd v Revenue and Customs Commissioners* [2010] 1 W.L.R. 497, Lord Walker referred to Farewell J's definition of a share as the "*classic definition*". As did Lord Millett in *Inland Revenue Commissioners v Laird Group plc* [2003] 4 All ER 669 at 677 and the majority of the High Court of Australia in *Pilmer v Duke Group Ltd (in liq)* (2001) 180 ALR 249 at 255.

151. Farwell J's classic definition highlights three aspects of a share that differentiate it from debt:

(1) It is a measure of the *liability* of the contributory.

(2) It is an *interest* in the company subject to the contract between the company and its members inter se.

(3) The right to money is only "to a sum of money of a more or less amount", recognising the uncertain nature of a shareholder's entitlement to income or a return of capital on a winding up.

152. If one takes the most basic and common form of a share – the ordinary share in a limited company – from the perspective of the shareholder, any particular return on equity is merely in the nature of an *expectation,* while from the perspective of the company, it would be a misuse of language to describe that expected return as any form of *"cost"* that has to be paid. A return of capital, whether in the form of income (a dividend) or a return of capital in a winding up (a surplus) is fundamentally uncertain. Capital maintenance,[33] now reflected in statutory rules, precludes the payment of a dividend on an ordinary share unless there is sufficient distributable profit (an accounting figure) and, even if that should be satisfied, the company in fact has to have the cash to pay any dividend which the directors, in their discretion, might see fit to declare. There is no right to any amount – let alone a rate – that might be enforced as something the company has to pay. Without any breach of any obligation a company might refuse to pay a dividend either because it has no cash, no sufficient reserves or a reason not to declare a dividend. For this reason, Farwell J did not express any definite monetary entitlement in his classic definition.

153. In other words, there is no rate or amount that can be described as a *"cost"* in relation to the most common form of equity, the ordinary share. The expectation of a particular return on the part of equity investors in a hedge fund similarly does not

[33] The classic exposition of capital maintenance is *Trevor v Whitworth* (1887) 12 App. Cas. 409, 423 per Lord Watson. It too recognises that the right to a return on capital is in the nature of an expectation: "*Paid up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at all; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of its business*." The modern rules of capital maintenance are now to be found in a detailed legislative framework. For a summary of that framework see Palmer's Company Law at 4.104-4.106.

constitute a *"cost"* in this sense.[34] Although preference shares differ in material respects from ordinary shares, they nevertheless share the fundamental characteristics of equity, not debt: see further below at paragraph 214.

154. This renders an expected return on equity particularly inapposite as a foundation for calculating a rate of interest to be applied to an unpaid amount of debt, for the period that such debt remains outstanding. This alone justifies the conclusion that the draftsman of the ISDA MA did not have the return on equity in mind in defining the different interest rates by reference to the cost of funding, or if it were to fund, the relevant amount.

155. There are however further features of share capital which undermine the suggestion that the expected return on equity might be considered a *"cost"*:

(1) In those circumstances where equity capital can be redeemed[35], it involves the return of the capital invested, the use of which has involved no *"cost"* to the company. Redemption at par does not even compensate the investor for the time-value of the money.[36] It involves simply giving back a sum equivalent to the money invested.

(2) Equity capital can also be written off in the light of losses incurred or in order that capital should represent assets in fact held.[37] A capital reduction means that the company will have had the use of the money invested, for which it may never have paid any dividend or other return. A write-off of capital does

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34 Cf. *Bond v Barrow Haematite Steet Co* [1902] Ch 353, 363 *per* Farwell J: "*Interest is not an apt word to express the return to which a shareholder is entitled in respect of shares paid up in due course and not by way of advance. Interest is compensation for delay in payment and is not accurately applied to the share of profits of trading, although it may be used as an inaccurate mode of expressing the measure of the share of those profits.*"

35 A company may only purchase or redeem shares out of profits available for distribution or the proceeds of a special issue for that purpose: see Palmer's Company Law at 4.106 and 6.801.

36 A company may for example reduce fully paid up £10 shares to £5 shares, returning £5 per share: see Palmer's Company Law at 4.316.

37 For a summary of the applicable rules see Palmer's Company Law at 4.318 to 4.320. A write-off of capital is to reflect a permanent loss, not a mere temporary diminution of an asset's value: see *Re Jupiter House Investments (Cambridge) Ltd* [1985] 1 W.L.R. 975, 978.

not even involve a *"cost"* to the company in the form of compensation to be paid to the shareholder.

156. There is also a further – and more subtle – difference between debt and equity which suggests that the draftsmen of the ISDA MA cannot have intended a return on equity to be *"cost"*:

(1) A debt can be repaid at any time by an unconditional tender of the amount owed. Depending upon the terms of the debt there may be pre-payment costs and other charges for early payment.

(2) A debt incurred to fund the relevant amount can, therefore, be repaid at the point the unpaid amount ceases to be outstanding.

(3) By contrast, equity cannot usually be redeemed at the will of the company. A repurchase or redemption might be agreed in advance or at the option of the shareholder in certain instance. An ordinary share is however usually conceived of as an interest in the company and a permanent increase in its capital.

(4) If, therefore, a return on capital should be *"cost"*, it is a *"cost"* which will in most cases continue to be incurred even *after* the relevant amount ceases to be outstanding. This is because, if a *"cost"*, any return in the form of dividends or otherwise would continue unless and until the company undertook the relatively extraordinary steps necessary to compel redemption – to eject its members from the company – or the circumstances permitted reduction to write-off an entire class of shares for losses incurred.

(5) The fact that in relation to the most common form of equity – an ordinary share – a return on capital might be paid after the unpaid amount ceases to be outstanding is a further indication that the draftsmen of the ISDA MA cannot have intended a certification based upon an expected return on equity.

157. So far as this last point is concerned, Wentworth does not suggest (as GSI seem to think) that the tenor of any funding must 'match' the period for which the relevant amount is outstanding. While in the vast majority of cases, where interest is likely to be payable for a short period only, 'matching' is perfectly possible based on overnight funding for that period, in those cases where the Defaulting Party is in an insolvency process, then, in view of the uncertain period of delay, matching may be difficult, although it may well still be most rational to fund based on overnight rates due to the lower cost and in view of such uncertainty. Wentworth's argument however is not that the tenor of funding should match the period the unpaid amount is outstanding, or indeed any period. It is that shares are ordinarily conceived of as an interest in the company and a permanent increase in its capital. If a return on capital is a *"cost"*, it is *"cost"* that will continue to be incurred *after* the unpaid amount is outstanding. By contrast, borrowing is available for the period of time until it is repaid. Moreover, the cost of borrowing is intrinsically linked to its tenor, whereas the cost of equity is not.

158. It is no answer to this to point to features of certain types of equity issue which do not necessarily share all of the typical characteristics of equity (such as shares issued with an agreed redemption date, or the hybrid instruments described in GSI's position paper **[1/13]** and response letter to the Administrator's request for further information dated 27 August 2015 **[7/1]**).

159. The fact that *some* part of a particular instrument has characteristics equivalent to that of borrowing merely demonstrates that in a case where an entity did, or could have, issued hybrid instruments *in order to fund the relevant amount*, the price paid by that entity in relation to those instruments may *in part* be relevant for determining the cost to it of borrowing the relevant amount. That does not mean that to the extent that the instruments bear characteristics of equity, the price relevant to that part is also relevant to the determination of interest payable under the ISDA MA.

160. In other words, the fact that some *part* of a bundle of rights negotiated in relation to an issue of shares might be in the nature of a debt does not mean that any return expected in relation to a share can be described as a *"cost"*. As the High Court of Australia explained in *Pilmer v Duke*, adopting Farewell's J classic definition:

"Once issued, a share comprises "a collection of rights and obligations relating to an interest in a company of an economic and proprietary character, but <u>not</u> constituting a debt"".[38] (Emphasis added)

161. Wentworth suggests that, in light of the other elements in the true construction of the cost of funding language (not least the requirement that the price paid must represent a cost, or something that had to be paid, rather than something that the relevant payee chose to pay), it is highly unlikely that the sort of hybrid instruments GSI describes would be relevant as something which any entity in fact issued for the purpose of raising the relevant amount, or could properly point to as a transaction at a price it would have had to pay in order to raise the relevant amount.

(7) Losses consequent upon LBIE's default are outside the cost of funding language

162. It appears to be GSI's case that it is necessary for the certifying party to take account of the nature and circumstances of LBIE's default in calculating the cost to it of funding the relevant amount.[39] GSI's position paper also contains various references to factoring in the cost to a financial institution of replenishing equity caused by a default which causes it to incur a loss.

163. If and to the extent that this forms part of the SCG's or GSI's case, it should be rejected.

164. Aside from the fact that such consequential losses would be excluded for similar reasons to the exclusion of further financial detriment caused by the raising of additional funding, any detriment caused by the counterparty's default would have no connection to the cost of raising a sum of money as substitution for the amount owed by the defaulting party.

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38 Cf. Heesh v Baker (2008) 67 ACSR 192 in which Barrett J rejected the suggestion that the expected return on a redeemable preference share could be treated as either a contingent debt or a non-contingent obligation the company had to meet. Barrett J approached the question of whether all or part of the bundle of rights imposed an obligation the company had to pay as one of construction.

39 Paragraph 7(2) of GSI's position paper.

165. Whether it could be claimed as part of the "Loss" (to the extent Loss was identified as the method for calculating the close-out amount) is a separate question, although Wentworth would contend that such a consequential detriment would in any event not be recoverable, due to the exclusion of any claim for consequential losses in Section 6(e)(iv) of the ISDA MA.

Response to aspects of the SCG's and GSI's case

166. Most of the case advanced by the SCG and GSI is answered by the seven points advanced above. In this section of the skeleton, particular aspects of the SCG's and GSI's case are addressed, under the following headings:

(1) cost to the relevant payee of funding a claim against LBIE and/or carrying a defaulted receivable on its balance sheet;

(2) cost of funding (including debt and equity funding) all of the relevant payee's assets;

(3) cost of equity; and

(4) the (ir)relevance of capital adequacy requirements imposed on certain financial institutions.

(1) Cost of funding a claim / carrying a defaulted receivable on a balance sheet

167. The alleged relationship between these elements and the cost of funding language appears from 11(5)(b) and (c) of the SCG's revised position paper **[1/9]**. Its case, now, is that:

(1) The determination of the cost to the relevant payee if it were to fund or of funding the relevant amount "may take account of the consequences for the relevant payee of carrying a defaulted LBIE receivable on it balance sheet". It provides as an example of this, "*where the relevant payee's cost of borrowing or cost of shareholder funding is increased as a consequence of carrying a defaulted receivable on its balance sheet*"; and

(2) That determination can include "the actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE", although this is said to be limited to the manner described in (1) above.

168. In its original position paper **[6/14]**, the SCG contended that the cost of carrying a defaulted LBIE receivable on its balance sheet and/or the cost of funding a claim against LBIE could be the *sole* basis of the cost if it were to fund or of funding the relevant amount. Its current position is that these elements cannot form the sole basis of, but are nevertheless relevant to, its cost of funding the relevant amount.

169. It is necessary, in order to address the revised position, to understand how the case was originally put by the SCG and, more importantly, the evidence on which it was based, at least part of which evidence is still relied on.

170. The SCG's case was originally based on a corporate finance theory as to the cost of funding of assets, known as the Modigliani-Miller Theorum. This was explained in the exhibit to the third witness statement of Patrick McKee ("**McKee 3**") **[2/4]**. As there explained, the theory was expressed in two ways.

171. The first basis (the "**McKee First Basis**")[40] holds that the true cost of funding is to be determined by reference to *the asset funded*, rather than by reference to a firm or company's capital structure (i.e. its blend of debt or equity funding). Investors are said to demand a relatively greater return for investing in a riskier asset than a less risky asset *irrespective* of how a firm or company is funded.

172. A simplified example of the McKee First Basis is a one-asset company. However that company is funded (by debt or equity) the return expected by its investors is said to correlate directly to the asset held. It is in *that* asset the investors have invested *via* the one-asset company. The expected return will, it is said, be determined by reference to the riskiness of the asset, not the capital structure of the company.

173. McKee 3 describes the McKee First Basis variously as follows:

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40 Exhibit PMM1 to the third witness statement of Patrick McKee. **[2/4]**

(1) The costs in "*being forced to fund (in the sense of extending credit to) the defaulting party*". (paragraph 5)

(2) "*It is a fundamental … principle of corporate finance that the key determinant of the cost of funding borne is the risk and term of the asset being funded. Illustrated simply, the true cost to an enterprise of funding an investment in a risky junk bond is substantially greater than that of funding an investment grade bond, and those investing in that enterprise will demand a higher rate of return if they are bearing additional risk."* (paragraph 11)

(3) The cost is calculated "*by reference to the cost to that relevant payee of holding its claim against LBIE as an investment, i.e. its cost of funding with respect to that asset, determined with reference to the risk and term of that asset.*" (paragraph 16)

(4) *"It follows that, where a number of different enterprises hold an asset with an identical risk profile – namely, defaulted LBIE claims – there is unlikely (absent some market inefficiency or other external factors) to be a material distinction between their respective true costs of funding the asset*". (paragraph 17)

174. On this hypothesis, which is said to be derived from a theory posited by a number of economists, the unpaid amount is a defaulted debt and so the cost to fund that asset must be assessed by reference to what the asset would have to yield to attract an investment, i.e. what the entity would have to pay given its riskiness. This is what is meant by "*the cost of funding a claim against LBIE*".

175. The second basis (the "**McKee Second Basis**") is premised upon the McKee First Basis insofar as it shares the view that the cost of funding an asset – in terms of the return the asset has to yield to be funded - is to be assessed by reference to the asset. It differs from the McKee First Basis as it looks to the *average* cost to fund *all* the relevant payee's assets.

176. The McKee Second Basis is described as follows:

(1) *"[A]n alternative, albeit less precise way of measuring cost of funding, would be to look at the enterprise's overall cost of funding across all of its assets, and attribute that blended cost to the amount in question*". (paragraph 19)

(2) Under this approach "*one would examine the way the enterprise has obtained funding for all purposes (i.e. what percentage is debt rather than equity funding), estimate the funding cost of each component and, based on this analysis, calculate the enterprise's overall blended cost of funding*". (paragraph 19)

(3) This is referred to as the enterprise's weighted average cost of capital ("**WACC**"), interpreted as "*the expected return the firm must pay to investors to compensate them for the risk of holding the firm's debt and equity together…*" (footnote 8)

(4) "*Although a cost of funding calculated on the Second Basis fails to isolate the specific cost of funding attributable to the defaulted LBIE claim in the way that the First Basis does, the Second Basis accurately captures a relevant payee's average cost of funding across all of its assets (including its defaulted claim against LBIE*)". (paragraph 20)

177. As noted above the McKee First Basis and McKee Second Basis share in common the fact that they aim to calculate the cost to the relevant payee of funding its *assets*, whether the defaulted LBIE receivable alone (the McKee First Basis) or all of the relevant payee's assets including the defaulted LBIE receivable (the McKee Second Basis).

178. The fact that the two McKee bases share the same underlying features is expressly acknowledged at paragraph 19 of McKee 3: "*many of the same principles discussed above (the allocation of cost between debt and equity and the importance of taking account of the latter) are relevant when calculating the overall cost of funding for the enterprise*".

179. Indeed, there is no difference between the McKee First Basis and the McKee Second Basis in respect of a one-asset company. Each basis is based upon the cost of funding an asset, measured in terms of the return the asset would have to yield for it to be funded, i.e. for it to be invested in given its riskiness.

180. Wentworth contends that for this reason alone, neither basis is relevant or appropriate in determining the cost "*if it were to fund or of funding the relevant amount*". The exercise required by the definition of Default Rate is focused on the cost of raising funding in a sum equal to *the relevant amount*, and is not concerned with the cost to the relevant payee of funding its assets, whether a single asset or all of its assets.

181. In correspondence subsequent to serving its revised position paper, the SCG has indicated that it does not now contend that "*cost if it were to fund or of funding the relevant amount*" can be calculated *solely* with reference to costs incurred or sustained by the relevant payee in funding a claim against LBIE.[41] and has more recently indicated that it no longer relies on paragraphs 10-12 or 16-17 of McKee 3.[42]

182. Nevertheless, the SCG does still contend that:

> "*[A]n assessment of the costs that would have been (or are in fact) incurred or sustained by the relevant payee in raising an incremental sum of money equivalent to the relevant amount may take account of the consequences for the relevant payee of carrying a defaulted LBIE receivable on its balance sheet.*"[43]

183. Moreover, the SCG has not abandoned the McKee Second Basis which, as noted above, is premised on at least some of the reasoning underlying the McKee First Basis.

184. Accordingly, the flaws in the McKee First Basis are identified below, before considering the McKee Second Basis.

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41 Letter from Freshfields of 4 September 2015.**[7/1]**

42 Letter from Freshfields of 28 September 2015. **[7/1]**

43 Letter from Freshfields of 4 September 2015. **[7/1]**

185. As noted above, the argument underlying the McKee First Basis, and the SCG's contention that cost of funding the relevant amount includes the cost of funding a claim against LBIE/carrying the defaulted receivable on its balance sheet, wrongly equates the concept of funding the "*relevant amount*" with funding the particular asset constituted by the defaulted receivable.

186. Wentworth contends that the Court's reaction to this at the CMC on 19 March 2015 was correct. As recorded at pages 86 to 88 of the transcript, in response to the SCG's submissions, the Judge said:

> *"[T]he payee is not being forced to extend credit to an insolvent estate, it is being forced to obtain the money for itself…*
>
> *[H]e is not being asked to fund the defaulted claim. He is being asked to fund the relevant amount…*
>
> *You are not funding an asset here. You are funding an absence of cash…*
>
> *I'm not concerned with the riskiness of assets. If you're looking -- supposing the counterparty is one of the primary banks in the world, a prime US bank, and LBIE has defaulted on a swap with it. It's owed a million dollars. The concern is how much is it going to cost that US prime bank to fund the relevant amount. The relevant amount I think we're agreed is a million dollars. Nothing to do with LBIE, is it?…*
>
> *I really don't at the minute understand what LBIE has to do with this. LBIE is the defaulting party, it has failed to pay money. The focus is now on the counterparty. How much is it going to cost the counterparty to replace that money?"*

187. This is true whether the cost of funding the claim against LBIE, or the cost of carrying the defaulted receivable on the relevant payee's balance sheet is relied on directly (under the McKee First Basis) or indirectly as part of the calculation of the cost of

raising an incremental sum of money (as the SCG says in Freshfields' letter of 4 September 2015).

188. The SCG's argument is impossible to reconcile with the fact that the cost of funding language is used not only where the certifying party is owed money, but also where the certifying party owes money. In the latter case, the only possible meaning of the "*relevant amount*" is a sum with a numerical value equal to the principal on which interest is to be paid.

189. For example, where a sum is due under Section 6(e) *from* the Non-defaulting Party to the Defaulting Party, interest is payable at the Non-default Rate for the period between the Early Termination Date and the date on which the Section 6(e) notice is effective. Default Interest is calculated as the amount, certified by the Non-defaulting Party, equal to the cost to it if it were to fund the relevant amount. By definition, this refers to funding an amount *owed by* the certifying party.

190. The same is true wherever the Termination Rate applies to a particular sum, since it necessarily involves the cost of funding that amount being certified *both* by the payer and payee.

191. As noted in the introduction above, it would be very surprising if the draftsman had intended precisely the same language ("*cost if it were to fund or of funding*" a particular sum) in various places in the ISDA, each designed to arrive at an appropriate interest rate to compensate for late payment, to have carried a different meaning in those different contexts.

192. The fact that "*cost if it were to fund*" the relevant amount, is capable of applying equally to a party obliged to *pay* the sum in issue, as to a party entitled to *receive* it, demonstrates that concepts such as the cost of carrying a defaulted receivable on the relevant payee's balance sheet, or the cost of funding a claim against LBIE have no part to play in determining the "*cost … if it were to fund or of funding the relevant amount*".

193. The SCG's argument also fails to reflect that cost of funding and cost if it were to fund are mutually exclusive alternatives, the first contemplating an actual transaction and the second a hypothetical one where the relevant party does not in fact transact to fund the relevant amount. The cost to the relevant payee of carrying a defaulted receivable on its balance sheet is a cost incurred without it having to do anything, since it arises automatically from the fact of the non-payment by the Defaulting Party. It is purely the consequence of not being paid.

194. Moreover, it would arise *irrespective* of any new transaction which the Non-defaulting Party entered into when it actually does fund the relevant amount. Thus, if the Termination Amount is £100m, and the Non-defaulting Party goes out to borrow £100m, that new transaction has no impact on the cost to the Non-defaulting Party of "*carrying the defaulted sum on its balance sheet*" or of "*being forced to extend credit to the Defaulting Party*". In balance sheet terms, the new asset (£100m borrowed from the market) is matched by the new liability (the obligation to repay £100m to the market) and has no impact on the 'cost' to the Non-defaulting Party of carrying on its balance sheet the distressed receivable owed by LBIE.

195. Moreover, this cost could never engage the second, hypothetical, alternative (cost "*if it were to fund*"). That is because it is a cost which is incurred in every case, automatically upon the Defaulting Party's default. There are no circumstances in which it is merely a hypothetical cost. This indicates that it is not a type of cost that falls within the definition of Default Rate, since that definition contemplates a cost which could either actually, or hypothetically, be incurred.

196. The fallacy underlying this aspect of the SCG's case is that it is identifying a consequential cost to the Non-defaulting Party of LBIE's default, and not the cost to the Non-defaulting Party of funding the relevant amount. The former has nothing to do with, and the latter everything to do with, identifying the time value of money from the perspective of the certifying party. Put shortly, if there is a cost to the Non-defaulting Party at all due to increased leverage by reason of holding a defaulted claim, it is an aspect of consequential loss arising as a result of LBIE's default, and not part of the price of substitute finance.

(2) Cost of funding all of the relevant payee's assets

197. The SCG's revised position paper states that the costs that are, or would be, incurred in raising an incremental sum of money equivalent to the relevant amount can reflect the relevant payee's overall cost of debt and equity funding, calculated by reference to the risks associated with its business and the return required by it funders in light of such risks.

198. It appears that this is intended to reflect the McKee Second Basis, the characteristics of which are set out above at paragraph 176.

199. As noted there, the main difference between the McKee First Basis and the McKee Second Basis is that, while the McKee First Basis has regard solely to the cost of funding the particular, distressed asset (the unpaid LBIE receivable) the McKee Second Basis has regard to the cost of funding the relevant payee's whole portfolio of assets.

200. On this basis, the distressed nature of the receivable, and the fact that the relevant payee is being forced to fund a claim against LBIE and carrying a defaulted receivable on its balance sheet are relevant factors, but they are diluted by the fact that the distressed asset is but one among many of the relevant payee's assets.

201. This argument of the SCG (as with the McKee Second Basis) is flawed because:

(1) It wrongly conflates the cost to the relevant payee of funding its assets as a whole with the cost to it of raising an incremental sum equal to the relevant amount for the period it is outstanding.

(2) A relevant payee's WACC, even if it is measured in a way that does not look at the funding of an asset in the terms of the McKee First Basis or the McKee Second Basis, is necessarily based on *historical* costs and not the cost of a new transaction to fund the relevant amount.

(3) Insofar as a relevant payee's WACC would incorporate the cost of equity, it wrongly characterises the anticipated return of its equity investors as a *"cost"* of funding the relevant amount.

(i) Funding assets not the relevant amount

202. First, the concept of funding an entity's portfolio of assets as a whole bears little or no relation to the cost of raising an incremental sum of money for a particular period or periods. The cost at which an entity can raise money to fund all its assets, as the SCG note (paragraph 11(5)(d) of its revised position paper **[1/9]**), depends upon the return which investors will demand when considering an investment in it, and this in turn will be based primarily on the nature of the assets themselves, and risks associated with them. It will also reflect the risk which the investor is prepared to take relative to other investors (i.e. its priority relative to others).

203. The focus of such an enquiry, being on the nature and riskiness of the entity's *assets* is as much divorced from the concept of the cost of funding a replacement for the money owed to the entity by the defaulting party as is the cost of funding one particular asset, *viz.* the defaulted claim. The draftsman cannot have intended by words the natural meaning of which is to permit compensation by way of the cost of a substitute for the amount unpaid to allow a relevant payee to certify whatever was the average return its investors demanded of it for their investment.

204. It is true that the cost at which the relevant payee, in the circumstances existing at and following LBIE's default, could borrow a sum equivalent to the relevant amount might well be affected by similar factors: in that a lender is likely to demand a higher price from a borrower with a higher credit risk. Such potential differences are deliberately reflected in the fact that it is the cost of funding to one or other of the parties that is referenced in the definition. But the two are not the same.

205. This is well illustrated by the examples contained in McKee 3 in relation to the McKee Second Basis. In the first example, the average cost of debt is 6.1%, but the cost of equity is 10.4%. By taking the weighted average of debt/equity funding, the entity arrives at a cost of funding of 8.7%. Given the information in the example, the

inherent likelihood is that the entity could have borrowed the relevant amount at 6.1% or less, such that using the weighted average cost of equity and debt produces a markedly different outcome.

206. It is also dramatically illustrated in the case of GSI which, as explained in more detail below, was in fact able to borrow at the relevant time many billions of dollars at rates of interest ranging from 0.01% to 1.10%, yet seeks to contend it is entitled to rely upon its equity funding costs to certify a rate in excess of the 8% statutory rate.

(ii) WACC is historical

207. WACC may be conceived of as a blend of a payee's various funding sources. A simple example would be an average of the interest rate on two or more existing loans. This is referred to as "**WACC1**" to differentiate it from the SCG's conception of WACC articulated in the McKee Second Basis, i.e., the cost of funding assessed in terms of the expected return of the relevant payee's investors looking to all of a payee's assets, "**WACC**2".

208. WACC1 (and for that matter WACC2) is outside the scope of the contractual remedy because it is premised on *historical transactions*, not a transaction to be entered into after the default to close the funding gap. As a matter of construction of the cost of funding language, there is no conceptual connection between the cost of funding the relevant amount and any historical transactions that might be reflected in a payee's WACC.

(iii) Wrongly includes equity

209. An essential feature of this aspect of the SCG's and GSI's case is that funding an entity's portfolio of all its assets typically includes a significant element of equity funding. This is important to them because it is said that the equity element of funding is invariably much higher than debt funding because an equity investor will in general expect a higher return than a debt investor because of the relative priority ranking as between them.

210. As to this, for the reasons set out above under the heading *"Cost" is of borrowing, not equity* (paragraphs 145 to 161 above), the return expected on equity has no bearing on the *"cost"* to be certified, because it is divorced from what has to be paid to raise a sum of money for a period or periods of time. It involves no obligation on the funded entity to pay for the sum raised and, if a *"cost"*, would ordinarily involve the continuance of such *"cost"* after the relevant amount had been paid.

(3) Cost of equity

211. The SCG and GSI contend that the cost of equity is relevant in two contexts. First, in the sense that a relevant payee might raise an incremental sum of money to fund the relevant amount by issuing equity; second, in the sense that an entity's cost of funding its assets generally comprises, among other things, the cost of equity issued by it, and that raising a sum of money may impact negatively on the entity's overall cost of funding.

212. The main arguments against inclusion of cost of equity, in respect of both contexts, are already set out above.

213. GSI contends (paragraph 8(5) of its position paper) that a distinction between borrowing and equity funding is unworkable in practice because of the possibility that entities may issue hybrid instruments in return for funding. Wentworth's principal response to this is that:

(1) the hybrid nature of an instrument, i.e. one that includes elements of equity and elements of debt, does not undermine the fundamental differences between raising money by issuing equity and borrowing;

(2) nor does it preclude the elements of the price paid by the institution for the instrument that reflect a cost of borrowing, and those that reflect a cost of equity being disentangled.

214. These points are developed in this section, in relation to certain of the types of instrument GSI describes in its further information. An example of an instrument conferring a right that may be construed as a debt is dealt with in paragraphs 158 to

161 above. It will depend in each case upon the true construction of the issue whether a right to redeem at a premium relative to the par value paid can be said to constitute a debt. The remaining examples of so-called 'hybrid' instruments are:

(1) preference shares, i.e. shares which enjoy a priority as to income (dividends) relative to ordinary shareholders;

(2) convertible bonds, i.e. which convert to equity upon a bondholder's election; and

(3) share warrants, i.e. which require an issuance of ordinary shares at the election of a warrant holder to be issued at a pre-agreed strike-price.

<u>(i) Preferred shares.</u>

(a) A preferred share differs from an ordinary share insofar as it carries an entitlement to be paid a fixed dividend (fixed at a rate relative to the par value) in *priority* to any dividend to be paid to ordinary shares.

(b) Depending on the terms of issue, there may an ability to participate beyond that fixed dividend or in any surplus on a winding up.

(c) Whatever the precise bundle of rights, on day 1 after issue, a preferred shareholder cannot say he has any *right* to be paid a return any more than an ordinary shareholder can. He can only say that he expects a certain level of profit and that, if achieved, he can claim priority relative to an ordinary shareholder.

(d) Expressed in other words, the 'preferred' bit of preferred stock is a relatively better entitlement to income as compared to an ordinary share, not an "*absolute*" one. Palmer's Company Law describes preference shares as follows, at 6.101[44]:

[44] See also *Prudential Assurance Co Ltd v Chatterley-Whitfield Collieries Ltd* [1949] AC 512, 520-521 in which Viscount Maugham, in the context of capital reduction described the preferred shareholders'

"As their name implies, preference shares usually carry some preferential rights in relation to other classes of shares, particularly in relation to ordinary shares. There are no rigid rules but the preferential rights usually relate to the payment of dividends and/or priority as to repayment of capital on a winding up."

(e) Relative to a debt, the return on a preferred share is as much in the nature of an expectation as the return on an ordinary share. The right to dividend is described in Palmer's Company Law at 6.110 under the heading "*No absolute right to dividend*":

"Preference shares almost always carry a preferential right to a fixed dividend. This is expressed as a percentage of the nominal value of the share. Thus, e.g. there can be 6 per cent preference shares.

But like all dividends this right only applies if there are distributable profits lawfully available to the company. The right is not to a dividend but to preferential treatment if and when one is distributed. That in turn depends upon the terms of the articles as to whether this right only arises when a dividend is declared."[45]

(f) Even if preference shares have a right to participate in surplus profits, i.e. in addition to a fixed priority as to dividend, it is accepted that preference shares may be repaid by means of a capital reduction, allowing companies to *frustrate* any expected return on preferred shares in response to changes in fiscal or financial regimes.[46] Palmer's Company Law summarises the position as follows at 6.122:

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rights as "*rights of priority*" as compared to ordinary shareholders and in terms of their "*relative expectations of income yield*"; *Beck v Weinstock* (2013) 297 ALR 21, in which the High Court of Australia held that a preference share was a share with some entitlement in priority to another class of share, whether or not that other class was issued or simply defined in the company's articles.

45 See also Gore-Browne on Companies, Vol. 1 at [5]. The entitlement to dividend on a preferred share, like an ordinary share, is ordinarily made subject to the discretion of the board of directors or the company in general meeting: *Bond v Barrow H'matite Haematite Steel Co* [1902] 1 Ch 353, 362 per Farwell J. See also *Re Buenos Ayres Great Southern Railway Co Ltd* [1947] 1 All ER 729, 741 per Romer J. The rights of a preference shareholder are distinct from a debenture-holder with a right to interest expressed to be payable only out of profits, for which the whole of the profits so far as is necessary must be applied for this purpose: see *Heslop v Paraguay Central Co* (1910) 54 SJ 234.

46 See *House of Fraser v AGCE Investments Ltd* [1987] AC 387, HL *per* Lord Keith approving *Re Saltdean Estate Co* [1968] 1 WLR 1844 *per* Buckley J.

"Changes in the fiscal and financial regimes may prompt companies to repay their preference shares by means of a reduction of capital. It is now well established that such a risk is an integral part of the preferred share's rights."

(g) The suggestion that preferred shareholders might in any way be considered debenture-holders was rejected as long ago as 1889. In *Birch v Cropper* (1889) 14 App Cas 525, Lord Macnaghten declined to hold that preferred shareholders were entitled to either "*a return of their capital, with 5 per cent. interest up to the day of payment*" or "*the capital value of a perpetual annuity of 5 per cent*". He said, at 546:

"The ordinary shareholders say that the preference shareholders are entitled to a return of their capital, with 5 per cent. interest up to the day of payment, and to nothing more. That is treating them as if they were debenture-holders, liable to be paid off at a moment's notice. Then they say that at the utmost the preference shareholders are only entitled to the capital value of a perpetual annuity of 5 per cent. upon the amounts paid up by them. That is treating them as if they were holders of irredeemable debentures. But they are not debenture-holders at all."[47]

(ii) Convertible bonds.

(a) A convertible bond is a debt for which a coupon is payable until that bond is converted to equity at which point there is no obligation to pay and so no *"cost"* from that point.

47 By his observation in *Re Isle of Thanet Electric Co* [1950] Ch 161 that, over the passage of time the position of preference shareholders has "*become somewhat more approximated to…that of debenture holders*" Lord Evershed MR did not in any way erode the distinction between debt and equity. The readiness of the court to accede to a reduction of capital of preferred stock (such that it might be 'repaid') does not alter the fundamentally uncertain nature of the return on the equity investment.

(iii) Share warrants.

(a) If a company should issue warrants the exercise of which requires the company to issue shares at discount to the then market price, there is no *"cost"* to the company. A company has no interest in its shares.

(b) There cannot even be said to be *"cost"* because the company could (but for the warrants) have issued the same shares without discount. As explained above, any issue of shares involves no *"cost"* to the company because there is no obligation to pay any return on capital.

215. None of these examples undermines the key distinction between borrowing and equity. Some *part* of a given bundle of rights might properly be a *"cost"*; however, that does not mean that other parts of that bundle are also a *"cost"*. For instance, to say that the return on equity issued upon the conversion of a bond must be a *"cost"* *because* the coupon on the bond before conversion is a *"cost"* is nonsense as a matter of logic. Moreover it fails to recognise that a *"cost"* in the context of the cost of funding language picks out only that which has to be paid for an amount equal to that unpaid for the period it is outstanding.

(4) Irrelevance of capital adequacy requirements applicable to certain financial institutions

216. GSI was joined to the trial of Part C for the purpose of making non-duplicative arguments to those of the SCG from the *perspective* of a financial institution regulated by certain capital adequacy and other regulatory requirements. GSI claims that those requirements should properly be considered part of the relevant background to the construction of the ISDA MA so as to inform its construction.

217. As explained at paragraph 9(d) of its position paper, GSI's argument is that:

(1) Financial institutions are subject to regulations requiring them to maintain adequate capital ratios.

(2) This would have been known to the draftsman of the ISDA MA.

(3) If a financial institution is looking to maintain or improve its capital ratios "*and it sustains losses*", it may need to raise new equity "*in order to maintain the confidence of its regulators and market participants*".

(4) This is "*all the more so where default occurs at a time when financial institutions are in a deleveraging cycle … such as was the case in September 2008. In such a market a loss could not be funded using borrowing…*".

(5) For this reason, "*cost if it were to fund or of funding the relevant amount*" includes:

(a) "*the costs to the payee of raising equity capital to fund the loss caused by the default*";

(b) "*the cost, including the cost of equity, of funding the residual defaulted claim on its balance sheet*"; and

(c) "*any impact on the payee's cost of borrowing and/or equity arising from the nature and riskiness of that claim*".

218. This argument should be rejected. In the first place, the ISDA MA is a standard form agreement applicable to various parties including those who are not financial institutions and, as such, cannot be construed on the footing that its terms have been drafted in the light of special requirements applicable only to some potential users. In this respect, in *AIB Group (UK) Plc v Martin* Lord Millett said:

> *"A standard form is designed for use in a wide variety of different circumstances. It is not context-specific. Its value would be much diminished if it could not be relied upon as having the same meaning on all occasions. Accordingly the relevance of the factual background of a particular case to its interpretation is necessarily limited. The danger, of course, is that a standard form may be employed in circumstances for which it was not designed. Unless the context in a particular case shows that this has happened, however, the interpretation of the form ought not to be affected by the factual background."*

219. Even if relevant background for the purposes of construction, the argument is flawed for a number of reasons, most of which are set out above:

(1) It falls far outside the concept of cost as the price of transacting to obtain funding in the relevant amount.

(2) The anticipated return of investors on their equity holding is not a *"cost"* in the sense used within the cost of funding language. The fact that a financial institution might – for entirely unrelated purposes – identify its cost of funding its assets by reference to such anticipated equity return is irrelevant.

(3) Even if a "*cost*", the anticipated return on equity is not a cost related to the time value of money, and thus falls outside the range of permissible costs for the purposes of calculating an interest rate for the period the relevant amount is outstanding.

(4) Insofar as it is contended that a financial institution is prompted to raise new capital as a consequence of LBIE's default, then if anything the costs associated with that constitute loss consequential upon LBIE's default (which are in any event irrecoverable as Loss), and have nothing to do with funding the relevant amount for the period it is outstanding.

(5) Insofar as it is contended that a financial institution is prompted to raise new capital as a consequence of either (a) general market conditions or (b) considerations of prudence in light of its perspective of what its counterparties expect, then any costs associated with it are even further removed from the concept of the cost of raising funding to replace the unpaid receivable from LBIE, for the period it remains unpaid.

(6) The cost associated with raising equity capital is fundamentally an aspect of funding the entity's *assets*, which has nothing to do with the question what it would cost the entity to raise a sum equal to the relevant amount for the period it remains outstanding.

(7) Even if a causal link could be established between raising capital and the Defaulting Party's default, the most that could be said is that the cost of raising such capital is a consequential cost of the default.

220. GSI's own position, in 2008, provides a vivid demonstration of the gulf between concepts of the cost of issuing equity and the cost of funding the relevant amount. As to this:

(1) GSI's claim against LBIE under the 1992 MA is for a Section 6(e) amount agreed in the sum of $86m.[48]

(2) Following the conversion of GSI's parent, Goldman Sachs Group, Inc ("**GSGI**"), to a "*bank holding company*" after the collapse of Lehman Brothers, GSGI and GSI were able to access cheap funding from the Federal Reserve Bank of New York, as stated in GSGI's press release and the Federal Reserve's press release both dated 21 September 2008. There were a number of facilities available, for example:

(a) The primary credit facility for depositary institutions allowed borrowing at rates between 2.25% and 0.5% in the period 15 September 2008 to February 2010, with the rate being 0.75% thereafter.

(b) The primary dealer credit facility allowed borrowing at rates between 2.25% and 0.5% in the period 15 September 2008 to 18 February 2010.

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48 GSI contend that this is irrelevant since it is yet to certify any Default Rate. It has, however, already asserted a Default Rate under the same ISDA MA, in proving against the LBHI bankruptcy estate in New York as guarantor of LBIE's obligations. In so doing it asserted a simple rate of interest at between 0.07162% and 3.78069%, inconsistent with any suggestion that its cost of funding the relevant amount incorporated its cost of issuing equity (see the witness statement of Johannes Weber, at paragraphs 15 and 18) **[2/6]**. It should also be noted that CarVal – one of the members of the SCG – has (since the commencement of the Waterfall litigation) itself asserted Default Rates in the estate of LBHI which expressly rely solely on a cost of borrowing (and, it is to be noted, expressly rely on the cost of borrowing of the original party, not the transferee, in conflict with the SCG's submissions in this case), and in any event are considerably less than the 8% threshold below which none of the arguments advanced by the SCG or GSI make any difference, given the high rate of interest payable under Rule 2.88 irrespective of any contract between the parties (see the letter from Kirkland & Ellis International LLP dated 21 September 2015). **[7/1]**

(c) The single-tranche term repurchase programme allowed borrowing via a series of repo transaction at rates that range between 1.10% and 0.01%. Pursuant to this programme, in the period October to December 2008, Goldman, Sachs & Co borrowed a sum of about US$41bn at rates of between 1.10% to 0.01%.

(3) GSGI (*not* GSI) issued $15.8bn of preferred and ordinary stock on 24 September 2008 ($10bn) and 14 April 2009 ($5.8bn).

(4) The capital ratios of GSGI[49] were at all times far in excess of those required by regulators in the United States and Europe, as stated in GSGI's published accounts and filings with the Securities and Exchange Commission (SEC), for example its capital ratios (based on risk weighted assets) were:

As of Date	Tier 1 Capital Ratio	Total Capital Ratio
Nov 08	15.6%	18.9%
Dec 09	15.0%	18.2%
Dec 10	16.0%	19.1%
Dec 11	13.8%	16.9%
Dec 12	16.7%	20.1%
Dec 13	16.7%	19.9%
Dec 14	13.8%	16%

(5) Federal Reserve Board regulations required bank holding companies such as GSGI to maintain a minimum tier 1 capital ratio of 4% and a minimum total capital ratio of 8%, which ratios relate to the internationally agreed Basel accords.

(6) The above matters, relevant to GSI's position, illustrate that:

(a) The relevant amount will often be of insubstantial value compared to a financial institutions assets base, even if a Section 6(e) amount. It will

49 The above information has been extracted from GSGI's 10-K filings with the SEC, specifically: 2009, pp.93-96; 2010, p.205; 2011, p.171; 2012, p.180; 2013, p.194; 2014, pp.203-204; and 2015, pp.194-196.

likely be of relatively trivial value if the unpaid amount is other than a Section 6(e) amount.

(b) A financial institution will likely have access to a variety of funding sources from which it might raise funding for its assets generally.

(c) A financial institution will likely also have a number of options in order to maintain compliance with a capital ratio, even in the face of a serious default on a debt asset. This logically follows from what a ratio is; it is a relation between two items. To maintain a given capital ratio, a loss caused by a default can be met by a reduction of leverage or other risky assets, and/or it can be met by an increase in capital.

(d) In this respect, GSI has in fact highlighted that the imposition of higher capital requirements can and has been met by a number of responses by financial institutions, including deleveraging and asset disposals:

"The new capital requirements being foisted on them have added a substantial further cost burden that they will need to cover…[They] have triggered a flurry of responses ranging across the introduction of large scale asset disposal programmes, aggressive cost reduction programmes, business and product rationalisations including curbs on new business growth, pricing adjustments and changes to an array of commercial and operation practices particularly in the areas of collateralisation and settlement." Banking Industry Reform, a new equilibrium, Part I, published by PwC, August 2012 at page 7

(e) The fact that a financing decision might, therefore, take into account capital ratios as one factor suggests that any capital requirement will not necessarily be determinative of either a decision to raise money or as to how best to do so, in particular, if that decision relates to an unpaid amount with one counterparty under an ISDA MA.

221. In addition, on the basis of the financial models that GSI has highlighted[50], it appears that an increase in capital would *not* increase *overall* equity funding costs. This is because of the feedback-mechanism between an enhanced capital ‘buffer’ and a consequential lowering of the *unit* cost of equity. To quote from the explanation by PwC relied on by GSI:

> *“[W]e ask what is wrong with the time-honoured notion that the value of a firm has got nothing to do with how it is financed, or the corresponding (and much overlooked) feature of the capital asset pricing model (CAPM) that makes the cost of equity (CoE) sensitive to leverage. Put simply, a strict application of these theories would say that <u>the increase in equity capital levels being mandated</u> will be <u>offset</u> precisely by <u>reductions in the unit cost of equity</u> as calculated in the CAPM.*
>
> …
>
> *To illustrate, let’s say a bank has equity capital of $5bn and a CoE of 15%. Let’s then say that it is required to add <u>a further $1bn of equity capital to satisfy the new regulatory capital ratios</u>. The theory goes that the incremental cost of carrying the extra capital is <u>offset</u> precisely by <u>the reduced cost of equity</u> (to 12.5% in this construction, via the ‘geared’ equity beta in the CAPM), which is applied not just to the new $1bn but to the £5bn that was there already. In notional monetary terms the total cost of equity id $750m both before and after the capital injection.*” (Emphasis added) (Banking Industry Reform, a new equilibrium, Part II, published by PwC, August 2012 at page 13) **[6/11]**

222. As a matter of the economic theory underlying the CAPM model relied on by GSI to measure the effect of an increase in capital, an increase in capital to comply with new capital ratios does *not* increase the overall cost of equity.

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50 See note 1 to GSI’s letter response to the Administrator’s request for further information dated 27 August 2015 **[7/1]**. In that note, GSI refer to the CAPM methodology briefly explained in a paper by PwC. That methodology is said to be derived from the same economic theory – the Modigliani & Miller theorem – which underlies the McKee First Basis and the McKee Second Basis.

223. In this respect, it is moreover important to note that the CAPM model relied on by GSI is not uncontroversial. The CAPM model relied on by GSI is derived from the Modigliani & Miller theorem published in 1958 (**"MM"**) (see paragraphs 170 to 196 above, discussing the McKee First and Second Bases). In its report on banking industry reform following the financial crisis, PwC acknowledged however:

> *"The debate over MM, and whether it applies to banks, has gone on in the background for years. And it is still going on with, to put it crudely, policymakers arguing that banks and investors should be happy to have additional capital (as MM implies), and banks resisting this conclusion on a variety of grounds." Banking Industry Reform, a new equilibrium, Part I, published by PwC, August 2012 at page 9.* **[6/11]**

ISSUE 12

If and to the extent that the cost of funding language included a cost of borrowing:

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

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

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

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

(i) overnight funding; or

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

(iii) funding for some other duration?

224. The answers to Issue 12 flow mostly from the answers already provided in respect of Issue 11. They are therefore taken shortly here.

225. Wentworth's answer to Issue 12 is that, as regards the cost of borrowing the relevant amount:

(1) There should be no assumption that any borrowing is to be based on a limited recourse agreement with the lender having rights of enforcement only against the defaulted claim or other limited recourse basis. Such an assumption imports a constraint which has no basis in the cost of funding language. Further, to assume that limited recourse against the defaulted receivable owed by LBIE is to revive the fallacy that the *"cost"* is of funding a claim against LBIE, which it wrong for the reasons in paragraphs 104 to 107 and 167 to 196 above.

(2) The cost of funding language is inconsistent with a measure of that *"cost"* in terms of an incremental (increase) to an average cost of borrowing or its weighted average cost of borrowing. Neither is implied by the requirements

of an actual or hypothetical transaction to fund the relevant amount. A weighted average cost of borrowing is necessarily compiled from historical transactions, not a new transaction to fund an amount equal to the overdue amount. See in this respect, paragraphs 93 to 107 and 197 to 210 above. Further, an increase to the average cost of borrowing necessarily blends in other borrowings in respect of other amounts and so cannot represent the cost of funding an amount equal to the unpaid amount.

(3) There is no basis for including within that transactional cost the impact on the relevant payee's equity capital, for the reasons explained above at paragraphs 145 to 161 and 211 to 215.

(4) No particular tenor is prescribed for any transaction to borrow the relevant amount. The parameters imposed by the cost of funding language, as explained above in paragraphs 86 to 107 and 157, require the certifying party to state the amount that it was required to pay (or which it considered it would have had to pay) to raise an amount equal to the unpaid amount. The question whether it was appropriate to certify cost of funding based on one tenor or another is determined by application of the test of good faith and rationality.

(5) In other words, where (for example) a party actually borrows funds at a particular tenor, the price it was required to pay for borrowing will represent its cost of funding the relevant amount unless it was irrational to borrow for that tenor. This might well be the case if a party locks itself into a long term high rate of interest at a time of high volatility such that any reasonable person would have borrowed at overnight rates so as to take advantage of potential decrease in interest rates. The requirement that pervades both the 1992 and 2002 MA for daily compounding of interest points strongly towards an overnight rate being the appropriate rate in many cases.

226. The only adjustment that is to be made to a certifying party's cost of borrowing is a technical adjustment to strip-out any compounding of interest. This is because the Default Rate is itself to be applied on the basis of daily compounding. It cannot have been the intention of the draftsmen of the ISDA MA to allow a certification at a

compound rate, additionally, and to apply the interest rate produced on a compound basis. Such ‘double-compounding’ has no commercial justification. To require compounding of an existing compound rate would be punitive where the payor is the Defaulting Party and absurd where the certifying party is the payer, as is the case in relation to the Non-Default Rate.

ISSUE 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 or of funding 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.

227. Wentworth's answer to Issue 13 is that the certifying party is bound to certify its cost of funding in an amount equal to the unpaid amount for the period the unpaid amount is outstanding. Certification other than for that period, and without taking account of any fluctuations over time, would not be of its *"cost"* and would not, ultimately, produce a rate intended to reflect the time-value of the unpaid amount for the time it was outstanding.

228. Given these requirements, the practical problem of not knowing for how long the relevant amount will be outstanding, if ever it should be paid, is to be accounted for by a certification at the end of the period which supersedes any prior certificates. Upon certification at the end of the period, any prior certification would have only an evidential role in the event of a challenge to the final certificate. The evidential weight of such certificates would be highly significant, of course, in circumstances (as in the case of many creditors of the LBIE estate, including those within the SCG) where (i) a creditor's certificate, submitted at an early stage, was based on a cost of borrowing (and resulted in a relatively low Default Rate), (ii) interest rates have, since that date, fallen or at least not risen, and (iii) the creditor subsequently certifies a much higher Default Rate at the end of the period.

229. The above solution is practical because in most cases no interest will be paid until the unpaid amount is paid. In the likely minority of cases in which a party might seek to keep down the interest prior to payment of the unpaid amount, an interim certification is possible without being definitive of the *"cost"* for the relevant period.

230. The alternative is a ‘snapshot’ certification based on a guess as to the period of the default. This is favoured by the SCG because of financial turbulence in mid-2008 before the precipitous fall in interests rates in the latter part of that year, which have remained at historic lows ever since.

231. There is no justification for such a ‘snapshot’ certification. The power to certify relates to the *“cost”* of funding an amount equal to the unpaid amount for the period it is outstanding. That *“cost”* can necessarily be certified only at the end of that period. Only at that point will the certifying party be able to state what that *“cost”* was. Prior to that time a any certification is not of that *“cost”* but, necessarily, an incomplete expression of what that *“cost”* is expected to be. Any “snapshot” is only ever likely to be too high or too low relative to the *“cost”* to be certified at the end of the period, and is insensitive to fluctuations in the *“cost”*. This is most clearly seen in the case of a relevant payee who actually funds the relevant amount by rolling over term funding from one year to the next by a fresh form of borrowing (as opposes to transaction for a single loan at a variable rate). Its *“cost”* necessarily varies in a way that would not be reflected were it to certify by reference to its year-one cost only. The *“cost”* has to be an average of the funding cost from year to year until the relevant amount is paid.

232. There is nothing impractical about a final certification:

(1) Interim certificates serve to facilitate the payment of interest by the Defaulting Party, if it should choose to keep down interest on the relevant amount.

(2) The prospect of an underpayment or overpayment of interest under an interim certificate is resolved either by a further payment of interest or a repayment of any overpayment upon a final certification being issued.

ISSUES 14 & 15

ISSUE 14

Whether a relevant payee's certification of its cost of funding for the purposes of applying the "Default Rate" is conclusive and, if not, to what it is subject. In particular whether, in order for a payee's certification to be deemed conclusive, a relevant creditor is under any duty to act:

(i) reasonably

(ii) in good faith and not capriciously or irrationally; or

(iii) otherwise than in its own interests.

ISSUE 15

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 (i) to (iii) set out in that question applies, where does the burden of proof lie in establishing, and what is required to demonstrate, that a relevant payee has or has not met such requirement?

233. Issues 14 and 15 had been agreed issues as between the Administrators, the SCG and Wentworth, in particular, as to the ability to challenge a certificate for manifest error and for certification of a matter as a *"cost"* if, as matter of construction, that matter was not within the cost of funding language.

234. These aspects of Issues 14 and 15 are disputed by GSI, which outlined its dispute in correspondence prior to the PTR in an email and letter dated respectively 29 September 2015 and 7 October 2015.

235. GSI disputes that a certificate can be challenged for manifest error, if that ground be other than an application of the standard of rationality and good faith. The SCG has changed its position in this respect to agree with GSI.

236. Wentworth and the Administrators are unclear as to whether there is any real dispute in this regard. If a manifest error would justify a challenge on the ground of a lack of

rationality or good faith, then it would assist the Administrators to record that aspect as a separate declaration.

237. There is however a real and substantial dispute in relation to GSI's rejection of a challenge to a certification on the ground that there has been a certification of "*something other than the relevant payee's "cost…if it were to fund or of funding the relevant amount" (as those words may be construed by the Court)*". GSI takes the extreme position that even if a relevant payee should certify something that is not a *"cost"* of funding the relevant amount the certificate is "*conclusive*" provided that the relevant payee believed that had it certified a *"cost"* within the cost of funding language and that it held that belief rationally and in good faith at the time of certification.

238. In this respect, GSI's position is extreme because the standard of rationality and good faith, rather than regulating the exercise of the contractual power to certify, allows the relevant payee to exceed the bounds of the contractual power provided that it does so honestly and in a way that cannot be said to be irrational. As put by the Administrators in explaining their disagreement with GSI's approach, GSI would allow a certificate to stand even if a relevant payee "*certifies the wrong thing*."

239. Wentworth agrees with the Administrators in this respect. As explained in the context of Issue 11 in paragraphs 137 to 144 above, the standard of rationality and good faith regulates the exercise of the contractual power to certify, which power exists only in relation to the certification by a relevant payee of its "*cost… if it were to fund or of funding the relevant amount*". This necessarily means that the relevant payee must apply its mind to certifying its "*cost… if it were to fund or of funding the relevant amount", on the true construction of that phrase. If its certificate can be shown to have aimed at something other than its "cost*" on that true construction, its certificate is not of its "*cost… if it were to fund or of funding the relevant amount*". The fact that the relevant payee is accorded a margin of appreciation by the standard of rationality and good faith does not permit it to ignore the bounds of its contractual power and to certify something else, even if it should act honestly and consider that it has a reason to do so.

240. In concrete terms, if, for example, the court should declare that "*the cost of funding a claim against LBIE*" is not within the meaning of "*cost… if it were to fund or of funding the relevant amoun*t", it cannot be right that a relevant payee's certification on that basis should be *"conclusive" simply because that payee was honest and considered that it had a reason to believe that was its "cost*" when it issued the certificate. The ISDA MA, by its terms, does not permit a certification of an interest rate based upon whatever a rational and honest payee might certify as an interest rate. That is however the result of GSI's argument, which bypasses the words "*cost… if it were to fund or of funding the relevant amount*".

ISSUE 19

Whether the answer 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

241. Neither Wentworth, nor the SCG, suggests that the answer to any of questions 10 to 18 for which they contend as a matter of English law would be any different if decided as a matter of New York law. They disagree, however, as to the correct answer (under either system of law) to certain of those issues, in particular Issues 10-13.

242. Issues 10 to 13 involve matters of construction of the ISDA MA.

243. The principles of New York law as to the construction of contracts are largely matters of common ground between the experts. They are summarised at paragraphs 3-10 of the joint statement of Robert S Smith ("**Judge Smith**", Wentworth's expert)[51] (and Neil B Cohen ("**Professor Cohen**", the SCG's expert))[52] **[4/4]** as follows:

(1) It is the court's task to enforce the parties' agreement, not to reform it.

(2) The words used are considered the best evidence of the parties' intent.

(3) Extrinsic evidence (evidence outside the contract itself) is generally not admissible unless there is found to be an ambiguity. New York law takes a narrow view as to what constitutes an ambiguity.

(4) All contracts contain an implied covenant of good faith and fair dealing. The obligation of good faith and fair dealing includes a promise not to act arbitrarily or irrationally in exercising a discretion contemplated by the contract.

(5) An interpretation that renders the parties' agreement absurd is to be avoided.

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51 Judge Smith is a former Associate Judge of the New York Court of Appeals.

52 Professor Cohen is a professor of law at Brooklyn Law School.

(6) It is a principle of New York law that an interpretation of a contract that places one party at the mercy of another, or permits one party to take unfair advantage of the other, is not favoured (although Professor Cohen believes that the implied covenant of good faith and fair dealing largely prevents situations in which a party would be allowed to take such an unfair advantage).

244. Wentworth contends that, so far as the questions of construction raised by Issues 10-13 are concerned, these principles are materially similar to English principles of construction. It contends that each of the arguments which it advances above as to the true meaning of *"relevant payee"* and "*cost … if it were to fund or of funding the relevant amount*" are equally valid in considering the construction of an ISDA MA which is governed by New York law.

245. Indeed, in relation to a standard form agreement such as the ISDA MA, where the language used is English, and where the language of the relevant provisions is entirely the same whether the contract is governed by English or New York law, it would be surprising if the words carried a materially different meaning under one system of law from the other.[53]

246. So far as Issue 10 is concerned, there is potential disagreement between the experts as to the weight which a New York court would give to certain matters.

247. First, there is a measure of disagreement as to the weight which a New York court would give to the existence of a principle of New York law to the effect that an assignee stands in the shoes of the assignor.

248. Under English law, for the reasons set out at paragraphs 69 to 73 above, the existence of a similar principle of English law is a relevant factor in the construction of the expression *"relevant payee"* in the context of the transfer provisions in Section 7 of the ISDA MA, and tends to suggest that, in the absence of any clear wording, it was not the parties' intention that an assignee could impose on the defaulting party an

53 There is no authority in New York which considers the meaning of the expressions under consideration in Issues 10 to 13.

obligation to pay a greater rate of interest than could have been claimed by the assignor.

249. Judge Smith cites a similar principle of New York law, and suggests that it would be given significant weight by a Court in New York, in deciding whether on the true construction of the ISDA MA an assignee should be entitled to an interest rate higher than the rate the assignor could have recovered.[54]

250. Professor Cohen takes a slightly different view, and suggests that under New York law the court is required to determine the meaning of the ISDA MA as between LBIE and the assignor, and "*does not authorize the application of a presumptive meaning of the agreement derived from the 'stand in the shoes' maxim if the agreement is not explicit as to the meaning of Relevant Payee*".[55]

251. Wentworth does not suggest that the 'stand in the shoes' maxim requires a presumptive meaning to be given to the expression "*relevant payee*". As such, the disagreement would appear to be solely as to the weight to be given to this point in construing the agreement.

252. Second, there is disagreement as to the weight to be given to the rule "*disfavoring an interpretation that places a party at the mercy of another or that permits one to take an unfair advantage of the other*." Judge Smith thinks that this would carry weight in the present context, while Professor Cohen thinks that the obligation of good faith and fair dealing already serves to prevent such unfair advantage.[56]

253. Third, there is disagreement as to the extent to which a New York court could have regard to the predecessor version of the ISDA MA (the 1987 Agreement). As noted in relation to Issue 10 above, the fact that the term "*relevant payee*" was used in the 1987 Agreement, but no assignment of the sum payable on close-out netting was permitted, supports the conclusion that relevant payee is intended to refer to whichever of the original counterparties is owed the relevant amount. Judge Smith

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54 Joint Statement at paragraph 17.

55 Joint Statement at paragraph 17.

56 Joint Statement at paragraph 18.

considers that a New York court could consider the 1987 Agreement in construing relevant payee in the 1992 MA and 2002 MA, and cites a recent decision of the United States Bankruptcy Court for the Southern District of New York (*Lehman Brothers Holding Inc v Intel Corporation*) which supports his view. Professor Cohen agrees that prior dealings between the parties to a contract may be relevant to interpretation of that contract, but notes that the predecessor version of the ISDA MA does not represent a prior dealing between LBIE and the parties here. He seek to distinguish the *Intel Corporation* decision on the basis that it appeared to be a situation where the documentation between the parties (the 1992 MA and its User's Guide) explicitly referred to earlier forms.[57]

254. In fact, the ground given by Professor Cohen for distinguishing *Intel Corporation* is a bad one, since Wentworth's argument (based on the 1987 Agreement) relies on page 30 of the 1992 User's Guide under the heading "Section 7", which explains the reason why the right of transfer under Section 7(b) "was added", which from the context is clearly a reference to its being added to the provisions formerly contained in the 1987 Agreement.

255. In any event, the weight to be given to the various factors relevant to the construction of the expression "*relevant payee*" is a matter for this Court, whose task it is to apply the principles of New York law to the construction of the words used in the agreement.[58] This is essentially the same task that the Court is required to undertake as a matter of English law.

256. Materially the same points arise in construing the words as a matter of English law, and they lead to the conclusion that "*relevant payee*", for the reasons set out under Issue 10 above, is limited to an original contracting party and does not extend to an assignee. The points made by Judge Smith echo to a great extent the arguments advanced by Wentworth under Issue 10. They are persuasive reasons for interpreting "*relevant payee*" as excluding an assignee of the amount payable under Section 6(e). There is no principle of New York law which should lead the Court to arrive at a

57 See the Joint Statement at paragraph 19.

58 It is to be noted, in any event, that each of the points where the experts differ as to weight, is a secondary or supportive point in Wentworth's argument.

different conclusion on this question from that which it reaches as a matter of English law.

257. So far as Issue 14 is concerned, the parties are in agreement that as a matter of English law a party's certificate as to its Default Rate is conclusive unless the certificate is made otherwise than in good faith and rationally (Wentworth and the Administrators also agree the certificate may be challenged on the basis of manifest error[59]).

258. The experts agree that under New York law where a contract give a party a discretion, then such discretion must not be exercised arbitrarily or irrationally.[60] Professor Cohen appears to suggest that there is no discretion in certifying a Default Rate.[61] This is wrong: where the certifying party has the option to determine (for example) which lender or lenders it will look to in order to arrive at the cost to it if it did borrow, or could have borrowed, there is no escape from the conclusion that the certifying party has a discretion in exercising that choice.[62] Professor Cohen agrees that if the agreement gives the enforcing party the right to choose among several methods of funding in determining its funding cost, that right would constitute a discretion so as to engage the rationality principle.[63]

259. There is only one US authority which has considered this point – namely *Finance One Public Co Ltd v Lehman Bros Special Financing Inc* (cited at paragraph 37 of Judge Smith's report).

260. Both experts are agreed that the *Finance One* case is not binding on a New York court, but is of persuasive authority. They disagree as to the weight which a New York court would give to the decision. Judge Smith explains (at paragraphs 37-40 of his report) why the decision would have little persuasive authority in New York, in particular that it failed to have regard the principles of fair dealing, and failed to have

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59 As yet the SCG and GSI do not agree to challenge on this basis, as explained above at paragraphs 233 to 236.

60 Joint Statement at paragraph 20.

61 Professor Cohen's report, at paragraph 65. **[4/2]**

62 Judge Smith's reply report, at paragraph 13. **[4/1]**

63 Joint Statement, at paragraph 21.

regard to the obligation not to act irrationally or arbitrarily. Professor Cohen's disagreement is largely based on the principles of precedent (see paragraph 62 and footnote 1 of his report). Given his acceptance of the obligation not to act irrationally or arbitrarily, and the fact that the ISDA MA clearly provides leeway to the certifying party as to the precise basis of its certification of the Default Rate, Judge Smith's reasoning as to the persuasive force of the *Finance One* case is to be preferred.

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ANNEX 1

SELECTED PERMUTATIONS FOR CALCULATION OF INTEREST UNDER SECTION 6(E) OF THE 1992 MA

1. The following permutations are based on the following example:

(1) Either (i) an Event of Default ("**EoD**"), or (ii) a Termination Event, occurs with respect to Party A on 15 September. 18 September is designated by Party B as the Early Termination Date.

(2) Party B, having calculated the amount due under Section 6(e) (the "**Termination Amount**") provides notice of such amount, which notice becomes effective on 10 October.

2. First possibility:

(1) Party A suffers an EoD. The parties have opted for Second Method and Loss and the Termination Amount is owed *by* Party A.

(2) Interest for the period from 18 September until the Termination Amount is paid is calculated at the Default Rate (i.e. the cost of funding of **Party B**).

3. Second possibility:

(1) Party A suffers an EoD. The parties have opted for Second Method and Loss and the Termination Amount is owed *to* Party A.

(2) Interest is calculated for the period from 18 September to 10 October at the Non-default Rate (i.e. by reference to the cost of funding of **Party B**).

(3) Interest is calculated for the period from 10 October until the Termination Amount is paid at the Default Rate (i.e. by reference to the cost of funding of **Party A**).

4. Third possibility:

   (1) Party A suffers a Termination Event. The parties have opted for Second Method and Loss, and the Termination Amount is owed *by* Party A.

   (2) Interest is calculated for the period from 18 September to 10 October at the Termination Rate (i.e. by reference to the cost of funding of **Party A** *and* **Party B**).

   (3) Interest is calculated for the period from 10 October until the Termination Amount is paid at the Default Rate (i.e. the cost of funding of **Party B**).

5. Fourth possibility:

   (1) Party A suffers a Termination Event. The parties have opted for Second Method and Market Quotation, and the component parts of the Termination Amount (payable *to* Party A) include: (a) the Termination Currency Equivalent of the Market Quotations, (b) Unpaid Amounts owing to Party A, and (c) Unpaid Amounts owing to Party B.

   (2) Interest on Unpaid Amounts is calculated on Unpaid Amounts owing both *to* and *by* Part A, and also on the Termination Amount from 18 September to 10 October, at the Termination Rate (i.e. calculated by reference to the cost of funding **Part A** and **Party B**).

   (3) Interest is calculated on the Termination Rate from 10 October until payment at the Default Rate (i.e. calculated by reference to the cost of funding of **Party A**).

User's Guide to the ISDA 2002 Master Agreement

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INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

5. ***Counterparts and Confirmations.*** Section 9(e)(i) recognises that the parties may execute and deliver the 2002 Agreement and any amendment or modification thereof in counterparts, including by facsimile and by electronic messaging system (which does not include e-mail). The ability to execute and deliver by electronic messaging system is new in the 2002 Agreement.

Section 9(e)(ii) acknowledges that parties often first agree to the terms of a Transaction orally and provides that the parties intend to be legally bound from the moment they agree on the terms of a Transaction. It provides that a Confirmation will be entered into as soon as practicable and may be executed and delivered in counterparts, including by facsimile transmission, exchange of telexes, exchange of electronic messages or by an exchange of e-mails. The 2002 Agreement adds e-mail as an acceptable form of communication for the exchange of Confirmations. Parties relying on this provision should consider the relevance of any applicable statute of frauds or other similar laws as this provision does not supersede the requirements of any such statute or law.

6. ***No Waiver of Rights.*** Section 9(f) provides that any failure or delay of a party to exercise a right in respect of the 2002 Agreement will not be presumed to operate as a waiver of such right, nor will a partial exercise of any right be presumed to preclude any subsequent or further exercise of that right. Section 9(f) has not been amended in the 2002 Agreement.

7. ***Headings.*** Section 9(g) states that headings of Sections in the 2002 Agreement are for convenience of reference only and are not to affect the interpretation of such Sections. Section 9(g) has not been amended in the 2002 Agreement.

8. ***Interest and Compensation.*** Section 9(h) is a new Section in the 2002 Agreement that consolidates and updates all provisions regarding interest and compensation which were found in Sections 2(e) and 6(d)(ii) of the 1992 Agreement and adds provisions to deal with certain consequences of an Illegality or a Force Majeure Event. All interest pursuant to Section 9(h) is calculated on the basis of daily compounding and the actual number of days elapsed.

Section 9(h) includes provisions relevant prior to the occurrence or effective designation of an Early Termination Date as well as provisions relevant following the occurrence or effective designation of an Early Termination Date.

a. ***Prior to Early Termination.***

i. ***Interest on Defaulted Payments.*** Section 9(h)(i)(1) provides that a party that defaults on any payment obligation will on demand pay interest on the overdue amount for the period from (and including) the original due date for that payment to (but excluding) the date of actual payment. The interest is assessed at the Default Rate. This provision was contained in Section 2(e) of the 1992 Agreement. Default

Rate is defined in Section 14 of the 2002 Agreement as the payee's cost of funding plus one percent per annum and has not been amended from the 1992 Agreement.

ii. ***Compensation for Defaulted Deliveries.*** Section 9(h)(i)(2) states that a party that defaults in making a required delivery will on demand (i) compensate the other party to the extent provided for in the relevant Confirmation or elsewhere in the 2002 Agreement and (ii) unless otherwise provided in the relevant Confirmation or elsewhere in the 2002 Agreement, pay interest on the fair market value of the asset which was to be delivered. The interest will be paid for the period from (and including) the originally scheduled delivery date to (but excluding) the date of actual delivery (and excluding any period in respect of which interest or compensation is due as described in Section II.J.8.a.iv. below). The interest is assessed at the Default Rate. The fair market value of an asset will be determined as of the originally scheduled date for delivery, in good faith and using commercially reasonable procedures, by the party entitled to take delivery.

Section 2(e) of the 1992 Agreement provided that compensation for defaulted deliveries had to be made to the extent provided for in the relevant Confirmation or elsewhere in the 1992 Agreement. The 2002 Agreement goes further by providing that where no provision is made in the relevant Confirmation or elsewhere in the 2002 Agreement, the Defaulting Party must pay interest on the fair market value of the relevant asset at the Default Rate. Where relevant, parties are, however, encouraged to address this issue in their Confirmation.

iii. ***Interest on Deferred Payments.*** Section 9(h)(i)(3) addresses payments that are deferred under the 2002 Agreement for one of three reasons. First, payments may be deferred because a Section 2(a)(iii) condition precedent has not been met. Second, payments may be deferred during an Illegality or a Force Majeure Event Waiting Period. Third, payments may be deferred because of the occurrence of an Illegality or a Force Majeure Event, the expiration of the applicable Waiting Period and the continuance of such Illegality or Force Majeure Event at the end of the Waiting Period. Section 9(h)(i)(3) provides that, in each situation, interest be paid at the Applicable Deferral Rate, a new term defined in Section 14. Applicable Deferral Rate is divided into three sub-clauses to address each of the three deferral situations discussed in the preceding sentences.

(A) ***Section 2(a)(iii).*** In the case of payments deferred because a Section 2(a)(iii) condition precedent has not been met, the deferring party must, subject to the other provisions of Section 9(h)(i)(3), pay interest from (and including) the date that the payment would, but for Section 2(a)(iii), have been payable to (but excluding) the date of actual payment, at the Applicable Deferral Rate. Clause (a) of the definition of Applicable Deferral Rate indicates that interest will be assessed at a rate equal to the rate offered to the payer by a major bank in the interbank market for overnight deposits in the applicable currency.

(B) ***Section 5(d).*** In the case of payments deferred during a Waiting Period associated with an Illegality or a Force Majeure Event, the deferring party must, for so long as no Event of Default or Potential Event of Default with respect to that party has occurred and is continuing, pay interest for the period from (and including) the date the amount would, but for Section 5(d), have been payable to (but excluding) the earlier of (i) the date the payment is no longer deferred pursuant to Section 5(d) and (ii) the date during the deferral period upon which an Event of Default or Potential Event of Default with respect to that party occurs, at the Applicable Default Rate. Clause (b) of the definition of Applicable Deferral Rate indicates that interest will be assessed at a rate equal to the rate offered to prime banks by a major bank in a relevant interbank market for overnight deposits in the applicable currency.

(C) ***Continuing Illegality or Force Majeure Event.*** In the case of payments deferred because an Illegality or a Force Majeure Event has continued to exist after any applicable Waiting Period has ended, the deferring party must, for so long as the event or circumstance giving rise to the Illegality or Force Majeure Event continues and no Event of Default or Potential Event of Default with respect to that party has occurred and is continuing, pay interest on the overdue amount for the period from (and including) the date the party fails to make the payment due to the occurrence of the relevant Illegality or Force Majeure Event (or, if later, the date the payment is no longer deferred pursuant to Section 5(d)) to (but excluding) the earlier of (i) the date the Illegality or Force Majeure Event ceases to exist and (ii) the date during the period on which an Event of Default or Potential Event of Default with respect to that party occurs (and excluding any period in respect of which interest is due as described in Section II.J.8.a.iii.B. above), at the Applicable Deferral Rate. Clause (c) of the definition of Applicable Deferral Rate indicates that interest is assessed at a rate equal to the arithmetic mean of (i) the rate offered to the payer by a major bank in a relevant interbank market for overnight deposits in the applicable currency and (ii) a rate per annum equal to the cost to the payee if it were to fund or of funding the relevant amount.

iv. ***Compensation for Deferred Deliveries.*** Section 9(h)(i)(4) provides that if a delivery has been deferred because (i) a Section 2(a)(iii) condition precedent has not been satisfied; (ii) a Waiting Period for an Illegality or a Force Majeure Event exists; or (iii) an Illegality or a Force Majeure Event continues to exist after the applicable Waiting Period has elapsed, the party required (or that would otherwise have been required) to make the delivery will compensate and pay interest to the other party if and to the extent provided for in the relevant Confirmation or elsewhere in the 2002 Agreement.

b. ***Early Termination.*** Section 9(h)(ii) addresses (i) how interest is taken into account in the determination of an Unpaid Amount and (ii) how interest is calculated for Early Termination Amounts, in each case following the occurrence or effective designation of an Early Termination Date.

i. ***Unpaid Amounts.*** Section 9(h)(ii)(1) provides that for purposes of determining an "Unpaid Amount" interest will accrue on the amount of any payment obligation or the amount equal to the fair market value of any obligation required to be settled by delivery for the period from (and including) the date the relevant obligation was (or would have been but for Section 2(a)(iii) or Section 5(d)) required to have been performed to (but excluding) the relevant Early Termination Date. Interest is assessed at the Applicable Close-out Rate. Applicable Close-out Rate is a new definition in Section 14 of the 2002 Agreement, but part of the definition is modeled on the definition of Applicable Rate in the 1992 Agreement. Broadly, the Applicable Close-out Rate for Unpaid Amounts is determined based on whether there is a Defaulting Party or a Non-defaulting Party or one of more Affected Parties at the time of the early termination. In other words, what generally matters is how the non-paying or non-delivering party is characterised at the time of the termination only, subject to clause (a)(iii) of the definition discussed below.

Clause (a)(i) of the definition of Applicable Close-out Rate indicates that, in respect of obligations payable or deliverable by a Defaulting Party, the rate of interest is the Default Rate. Clause (a)(ii) states that, in respect of obligations payable or deliverable by a Non-defaulting Party, the rate of interest is the Non-default Rate. The definition of "Non-default Rate" has been amended in the 2002 Agreement to be the rate offered to the Non-defaulting Party by a major bank in the interbank market for overnight deposits in the applicable currency. Clause (a)(iii) provides that, in respect of obligations deferred pursuant to Section 5(d), if there is no Defaulting Party and for so long as the deferral period continues, then the rate of interest is the Applicable Deferral Rate (*i.e.*, a rate equal to the rate offered to prime banks by a major bank in a relevant interbank market for overnight deposits in the applicable currency). Lastly, clause (a)(iv) states that in all other cases following the occurrence of a Termination Event, the rate of interest is the Applicable Deferral Rate (*i.e.*, a rate equal to the arithmetic mean of (i) the rate offered to the payer by a major bank in a relevant interbank market for overnight deposits in the applicable currency and (ii) a rate per annum equal to the cost to the payee if it were to fund or of funding the relevant amount).

ii. ***Early Termination Amounts.*** Section 9(h)(ii)(2), formerly Section 6(d)(ii) in the 1992 Agreement, provides that interest will be paid on an Early Termination Amount for the period from (and including) the Early Termination Date to (but excluding) the date the amount is paid, at the Applicable Close-out Rate. Clause (b) of the definition of Applicable Close-out Rate provides for two possible timeframes. The first timeframe is from (and including) the Early Termination Date to (but excluding) the date on which the Early Termination Amount is payable. If a Defaulting

Party owes the Early Termination Amount, the interest rate is the Default Rate. If a Non-defaulting Party owes the Early Termination Amount, the interest rate is the Non-default Rate. If an Affected Party or a Non-affected Party owes the Early Termination Amount, the interest rate is the Applicable Deferral Rate (*i.e.*, a rate equal to the arithmetic mean of (i) the rate offered to the payer by a major bank in a relevant interbank market for overnight deposits in the applicable currency and (ii) a rate per annum equal to the cost to the payee if it were to fund or of funding the relevant amount). The second timeframe is from (and including) the date on which the Early Termination Amount is payable to (but excluding) the date of actual payment. If the Early Termination Amount is not paid because an event or circumstance in the nature of an Illegality or a Force Majeure Event exists on the payment date, then for so long as the Early Termination Amount remains unpaid due to the continuing existence of such event or circumstance, interest is assessed at the Applicable Deferral Rate (*i.e.*, a rate equal to the arithmetic mean of (i) the rate offered to the payer by a major bank in a relevant interbank market for overnight deposits in the applicable currency and (ii) a rate per annum equal to the cost to the payee if it were to fund or of funding the relevant amount). If the Early Termination Amount is owed by a Defaulting Party, the Default Rate applies and if the Early Termination Amount is owed by a Non-defaulting Party, the Non-default Rate applies, but, in either case, excluding any period where the Applicable Deferral Rate applies. In all other cases, the interest rate is the Termination Rate (*i.e.*, a rate equal to the arithmetic mean of the cost to each party if it were to fund or of funding the relevant amount).

K. Section 10—Offices; Multibranch Parties

An optional representation and agreement is included in Section 10(a) of the 2002 Agreement that provides that a party entering into a Transaction through an Office other than its head or home office is obligated in terms of recourse against it to the same extent as if it had entered into the Transaction through its head or home office. However, a party will not have recourse to the head or home office of the other party if a Waiting Period under Section 5(d) is in effect. This exception for a Waiting Period was not included in the 1992 Agreement, since the 1992 Agreement did not include a concept of a Waiting Period. In order for Section 10(a) to have effect, it must be specified in Part 4(c) of the Schedule as applicable. The representation and agreement in Section 10(a) is separate from the representation concerning Multibranch Parties in Section 10(b).

Section 10(b) states that if a party is specified as a Multibranch Party in Part 4(d) of the Schedule, that party may enter into, book and make and receive payments and deliveries with respect to, a Transaction through any Office listed for that party in Part 4(d). Section 10(b) is the equivalent of Section 10(c) in the 1992 Agreement.

Section 10(c) is the equivalent of Section 10(b) in the 1992 Agreement, but the clause has been amended to provide for more detailed treatment of branches. Section 10(c) provides that the Office through which a party enters into a Transaction will be the