Waterfall II Application

No 7942 of 2008

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

The Honourable Mr Justice Hildyard

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)

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.À R.L

(3) HUTCHINSON INVESTORS LLC

(4) WENTWORTH SONS SUB-DEBT S.À R.L

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

Respondents

FURTHER WRITTEN SUBMISSIONS ON BEHALF OF THE FOURTH RESPONDENT

Introduction

1. These further submissions address the relevance of a decision of the Bundesgerichtshof handed down on 9 June 2016 (the "2016 BGH Decision") to Issue 20. Wentworth contends that the 2016 BGH Decision supports its position on both Issue 20(1) and Issue 20(2). Wentworth has discussed these further written submissions with Judge Fischer so as to ensure that they accurately reflect the position as a matter of German law.

2. The Court will recall that, as regards Issue 20(1), it is Wentworth's case that there is no claim for *further damage* as a matter of German law as the SCG is unable to establish a "default" within the meaning of s.286 BGB: see Wentworth's Closing Submissions, at [17]-[196]. Wentworth's headline points on the relevance of the 2016 BGH Decision to Issue 20(1) are as follows:

    (1) The 2016 BGH Decision supports Wentworth's case that the single compensation claim under the GMA, which must be calculated in accordance with s.104 of the German Insolvency Code ("InsO"), does not fall due until after LBIE's entry into insolvency proceedings; and

    (2) As a consequence, in the light of the expert evidence as to whether a default can be triggered post-insolvency in relation to an insolvent debtor, no default can arise such that there is no basis for the SCG to claim *further* damage under s.288(4) BGG.

3. The Court will recall that, as regards Issue 20(2), it is Wentworth's case that a claim for *further damage* under s288(4) BGB does not constitute a "*rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9): see Wentworth's Closing Submissions, at [197]-[249]. Wentworth's headline point on the relevance of the 2016 BGH Decision to Issue 20(2) is that it leads one to the conclusion that there was no default within s.286 BGB prior to LBIE's administration and, as a result, a claim for *further damage* does not constitute an rate applicable to the proved debt for the purpose of Rule 2.88(9).

4. Wentworth develops the above points under the following headings:

    (1) S.104 InsO and Wentworth's previous submissions;

(2) 2016 BGH Decision;

(3) Relevance of 2016 BGH Decision to Issue 20;

(4) Expert evidence before the Court on s.104 InsO;

(5) Consequences for Issue 20(1) if the single compensation claim is not due before administration.

(6) Consequences for Issue 20(2) if the single compensation claim is due only after administration.

S.104 InsO and Wentworth's previous submissions

5. Section 104 InsO provides, relevantly, as follows:

> "(1) If the delivery of goods with a market or stock exchange price was agreed to take place exactly on a definitely fixed date or within a definitely fixed period, and if such date or expiry of the period occurs after the insolvency proceedings were opened, performance may not be claimed, but only claims for non-performance.
>
> (2) If financial performance with a market or stock exchange price was agreed to take place at a fixed date or within a fixed period, and if such date or expiry of the period occurs after the insolvency proceedings were opened, performance may not be claimed, but only claims for non-performance. In particular the following shall be regarded as financial performance
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> 1. the delivery of precious metals,
>
> 2. the delivery of securities or comparable rights if it is not intended to obtain a participation in a company in order to establish a long-term association,
>
> 3. performances in specie which have to be effected in foreign currency or in a mathematical unit,
>
> 4. performances in specie the amount of which is indirectly or directly determined by the exchange rate of a foreign currency or mathematical unit, by the interest rate prevailing for claims or by the price of other goods or services,
>
> 5. options and other rights to deliveries or performances in specie in the meaning of nos. 1 to 4.
>
> 6. financial securities within the meaning of section 1 subsection (17) of the Banking Act.

If transactions on financial services are combined in a framework contract for which agreement has been reached that if grounds for insolvency exist it may only be terminated uniformly, the totality of these transactions shall be regarded as a mutual contract in the meaning of sections 103 and 104.

(3) Such claim for non-performance shall cover the difference between the agreed price and the market or stock exchange price prevailing at a point in time agreed by the parties, **at the latest, however, on the fifth working day after the opening of the insolvency proceedings** at the place of performance for a contract with the agreed period of performance. **If the parties do not enter into such an agreement, the second working day after the opening of the insolvency proceedings shall be decisive.** The other party may bring such claim only as an insolvency creditor." (Emphasis added.)

6. At trial, Wentworth relied on s.104 InsO as part of the relevant background in support of its construction of clauses 7 and 8 of the GMA with respect to question of when the single compensation claim became due: see Wentworth's Closing Submissions, at [54]-[57]; Transcript, 24 November, at page 140/line 1 to page 147/line 25. It can be seen that Wentworth highlighted that:

   (1) s.104 InsO was enacted, firstly, to protect master agreements from s.103 InsO, which, if the underlying transactions were treated as separate contracts, would allow an insolvency officeholder to choose which contracts to perform and which to breach (i.e. 'cherry-picking'); and

   (2) s.104 InsO, having been first enacted in a form which inflexibly specified a post-insolvency date by reference to which the claim was computed, was subsequently revised to its modern form and now permits the parties a limited choice as to a settlement date within a 5 working day window and, in the absence of any agreement between the parties, provides for settlement on the second working day, both after the opening of insolvency proceedings.

   (3) In the light of these features of s.104 InsO, which section allowed the provisions of the GMA to have valid effect under German law, Wentworth submitted that s.104 InsO supported its case that the single compensation claim was due only upon its calculation at either the post-insolvency date provided for in s.104 InsO or at the date selected by the parties within the boundaries set by s.104 InsO. The 2016 BGH Decision supports this submission.

2016 BGH Decision

7. On an appeal from the Frankfurt Court of Appeal, the BGH overturned the Frankfurt Court of Appeal's conclusions (1) as to the calculation of the single compensation claim payable to LBIE; and (2) as to LBIE's entitlement to interest on that claim.

8. The facts concerned a series of derivative transactions between LBIE and its counterparty governed by the GMA. LBIE's counterparty had provided collateral to LBIE in the form of stock.

9. As regards the single compensation claim, the BGH held, at paragraph 76(c), that the single compensation claim was to be calculated by reference to settlement prices for the relevant options on the second working day after LBIE's filing for administration, September 17, 2008, and not, as had been held below, September 15, 2008, the date of LBIE's filing for administration.

10. The BGH's reasons for its conclusion are recorded in paragraphs 60 to 74 and 84 of the judgment. It accepted the submission that s.104 InsO was a mandatory provision as regards the computation of the single compensation claim and that clauses 7 and 8 of the GMA were valid only to the extent that they complied with its provisions. S.104 InsO, relevantly, provides that, absent the contractual specification of a settlement date within a window of 5 working days of the opening of insolvency proceedings, the single compensation claim was to be calculated by netting the underlying transactions at prices on the second working day after the opening of insolvency proceedings.

11. The holding of the 2016 BGH Decision is reported as follows:

> "*If the parties to stock option transactions under German law enter into a close-out agreement to apply in the event of insolvency of one party, which contradicts Section 104 Insolvency Code, then [the close-out agreement] is invalid to the extent [of that contradiction] and the provision of Section 104 Insolvency Code is directly applicable.*"

12. The BGH held, paragraph 76c:

> "*Since the compensation claim is determined by Section 104 para. 3 Insolvency Code and not by the invalid Clause 8 para. 1 of the Master Agreement, the Court of Appeals should not have referred to September 15, 2008 for its calculation, but rather, as set*

forth in Section 104 para. 3 sentence 2 Insolvency Code, it should have referred to the second business day after the commencement of the insolvency proceedings, i.e. September 17, 2008. The Parties did not agree on any other point in time after the commencement of the insolvency proceedings, which may at the latest be the fifth business day after the commencement of the insolvency proceedings (Section 104 para. 3 sentence 1 Insolvency Code). For this reason, the claim must be recalculated in such respect."

13. The BGH, therefore, remitted the claim to the Frankfurt Court of Appeals with a direction that the claim be recalculated.

14. As regards interest on that claim, the BGH rejected LBIE's claim for interest. It held that LBIE's counterparty had a claim for the return of its collateral and, pending the resolution of that claim, the counterparty had a right of retention under clause 9.2 of the GMA. The BGH's reasons are recorded at paragraphs 90 to 95 of the judgment. It made no order as regards interest, any such order being consequent on the recalculated amount of the claim, if any.

15. The BGH stated, in paragraph 96, as a further reason in support of its conclusion as regards interest that:

"*To the degree Clause 3 para. 4 of the Master Agreement would require interest payments also for the compensation payment already starting at maturity, this rule would be invalid because it deviates from Section 104 para. 2 and 3 Insolvency Code; this regulation does not provide for any interest payment obligation starting already at maturity.*"

16. The BGH also indicated that a delay is required post-computation before default interest might start to run. It said, at paragraph 71(c) and 84:

"*However, in the course of finally concluding the terminated transaction, damages may come to exist as a result of default [Verzug] or other breach of duty.*"

"*As explained, there would be no concerns against damages claims on the basis of an attributable delay in finally concluding the claims under Section 104 Insolvency Code.*"

Relevance of 2016 BGH Decision to Issue 20

17. The following aspects of the BGH decision are strongly supportive of Wentworth's submission that the single compensation claim becomes due only upon the computation of the claim:

(1) The BGH has held that the single compensation claim under the GMA is valid only to the extent of compliance with s.104 InsO.

(2) S.104 InsO is a claim that arises on the opening of insolvency proceedings and requires a post-insolvency calculation. This points to the single compensation claim falling due after the commencement of LBIE's administration (and, indeed, coming into existence only upon the opening of insolvency proceedings).

(3) The BGH has also held that interest cannot, as a matter of contract, run on the single compensation claim from its maturity.

(4) The exclusion of contractual interest would be undermined if, as the SCG contend, there would always be a claim for default interest on the single compensation claim because of an inevitable and automatic default by reason of the debtor's insolvency.

(5) The conclusion that the single compensation claim only becomes due after the opening of LBIE's insolvency proceedings accords with the German expert evidence and authorities as the calculation in accordance with s.104 InsO refers to future prices which are not known (or, indeed, knowable) at the time of termination of the GMA. Potential movements in the market in the post-insolvency period make it impossible to say in advance of computation who will be owed what, or indeed, if there will be any claim at all.

Expert evidence in relation to s.104 InsO

Judge Fischer

18. Judge Fischer gave the following evidence in relation to s.104 InsO:

> "*[T]he amount of [the single compensation claim] must be calculated not according to Cl.8 and 9 GMA, but by the abstract method laid out in [section 104(3) of the German Insolvency Code ("InsO")], which belongs to the substantive terms of German law*": see Fischer 1/paragraph 7.

"*As the single claim for compensation arising under sec. 104(3) InsO only comes into existence as a consequence of the initiation of insolvency proceedings, the claim does not bear interest. A claim for damage due to default is only justified if the debtor was in default before the opening of insolvency proceedings*": see Fischer 1/paragraph 8.

"*If one follows my opinion that the single compensation claim is to be computed not as a compensation claim pursuant to Cl. 8 and 9, but as a claim for non-performance pursuant to sec. 104(3) InsO, the claim only comes into existence as a consequence of the opening of insolvency proceedings, and matures a few days later, after the computation as provided there is complete*": see Fischer 1/paragraph 81.

19. The SCG did not challenge this evidence during the cross-examination of Judge Fischer, notwithstanding that its Leading Counsel chose to cross-examine Judge Fischer in relation to s.104 InsO for other purposes[1].

Professor Mulbert

20. Professor Mulbert's evidence was that s.104 InsO could have no relevance in LBIE's insolvency, which is an English law administration: see Mulbert 2/para 3. Accordingly, Professor Mulbert did not even attempt to address the relevance of s.104 InsO to the construction of the GMA or its mandatory application as a matter of substantive German law.

21. It can be seen from the 2016 BGH Decision that the evidence of Professor Mulbert was wrong.

Expert evidence: conclusion

22. The only expert evidence before the Court as regards s.104 InsO and its relevance to when the single compensation claim becomes due is that of Judge Fischer.

23. The 2016 BGH Decision has confirmed Judge Fischer's evidence on the relevance of s.104(3) to the single compensation claim under the GMA.

24. It is respectfully submitted that the Court should accept the unchallenged evidence of Judge Fischer that s.104 InsO means that the single compensation claim only comes into

[1] See Transcript, 19 November 2015/Page 48/Lines 5-14, in which Judge Fischer mentioned s.104 InsO as relevant to the question of construction and was asked by Mr Dicker QC to "leave aside for the moment rules and principles of German insolvency", a matter to which the SCG did not return.

existence at the commencement of LBIE's administration and does not become due until after the commencement of LBIE's administration[2].

Consequences for Issue 20(1) if the single compensation claim is not due at or before administration

25. As the Court will recall, Wentworth contends that it is not possible to declare a default under s.286 BGB against an insolvent obligee following the commencement of insolvency proceedings in respect of that oblige: see Wentworth's Closing Submissions, at [5], [21]-[25] and [88]-[98].

26. In circumstances where the single compensation claim under the GMA (as interpreted by the 2016 BGH Decision) was not due until after the opening of insolvency proceedings (and, indeed, did not exist until their opening), there can be no post-insolvency default now and so no claim for *further damage*. In this regard:

    (1) Judge Fischer and Professor Mulbert agree that a default cannot be established against the obligee's insolvent estate following the commencement of German insolvency proceedings in respect of the obligee so as to entitle the creditor to bring a claim for interest in the insolvency: see paragraph 21 of the Joint Statement at [4/13].

    (2) Judge Fischer was of the opinion that s.286 BGG – as a matter of the construction of that provision – did not permit a default by an insolvent obligee following the commencement of English administration proceedings: see Fischer 1/64 and Fischer 3/37-40.

    (3) The high point of Professor Mulbert's responsive evidence was that the position "*may*" be different in an English administration: see paragraph 21 of the Joint Statement at [4/13]. Professor Mulbert was unable, however, to give any reasons of substance as to why a different position should follow.

[2] Whether a claim exists ("*Enstehung*") is distinct, both in the German language and in logic, from when a claim is due ("*Falligkeit*"). Whether the single compensation exists at or before or after the opening of insolvency proceedings, Wentworth submits that it is due only after is computation post-insolvency, as already outlined in its submissions.

Consequence for Issue 20(2) if the single compensation claim is not due until after administration

27. Wentworth contends that the reasoning of the 2016 BGH Decision supports its submission that a claim for *further damage* is not an applicable rate within the meaning of Rule 2.88(9).

28. This requires an assessment of the SCG's primary and alternative cases at trial, first, to make clear that the SCG's new case following the 2016 BGH Decision is a departure from those previously run and, secondly, that it is one which encounters substantial difficulties in relation to Rule 2.88(9).

SCG's primary case at trial

29. The SCG's primary case at trial focused on establishing *the coincidence* of (1) the accrual of the single compensation claim under the GMA and (2) the default on that claim by LBIE, under s.286 BGB, upon LBIE's application for administration on 15 September 2008 (i.e. a matter of minutes before the administration order was made): see, in this respect, paragraphs 8 to 105 of the SCG's written closing submissions and, in particular, paragraphs 8(1) to 8(4), 21, 45, 48(4), 70, 72 and 105.

30. The reasons why the SCG's primary case at trial should be rejected are set out in Wentworth's Closing Submissions, at [117]-[192]. Those submissions are repeated and now supplemented by the above submissions as to when the single compensation claim comes into existence and becomes due.

31. If correct, the SCG's primary case would have allowed it to say that it had a right to *further damage* before LBIE's administration, having identified a due and defaulted claim prior to the administration.

SCG's alternative case at trial

32. The SCG's alternative case at trial, at paragraphs 8(5) and 106 to 112 of its written closing submissions, was that a default under s.286 BGB could nonetheless be triggered after LBIE's administration by the filing of a proof of debt. This case was clearly flawed,

amongst other reasons, because a proof is a claim to participate in an insolvency proceeding, not a demand capable of triggering a default: see Wentworth's Closing Submissions, at [99] to [116]. Moreover, the SCG's case was not supported by the expert evidence.

SCG's response to the 2016 BGH Decision

33. The SCG has, in correspondence following the 2016 BGH Decision[3], recognised the difficulties caused by the 2016 BGH Decision and has sought to develop a further alternative case:

> "*The [SCG's] position at the November hearing was that a default is capable of occurring after the commencement of English insolvency proceedings. Hence even if the debt falls due after the date of administration, a default may still occur, and a claim for further damages may still arise, after the date of administration (see [110]-[111] of the [SCG's] written closing submissions).*" (Emphasis added.)

34. As such, the SCG's contends that the falling due of the single compensation claim after LBIE's administration is nothing to the point because *the circumstances* of a default can occur prior to the maturity of the claim. It, therefore, contends that it is irrelevant to debate when exactly the single compensation claim becomes due.

35. The SCG's new alternative case is not only a departure from its primary case; it is a departure which runs into difficulty as regards Rule 2.88(9) of the Rules. It necessarily accepts that there is neither a default nor damage until the claim in question matures post-insolvency. The creditor has no right to *further damage* as at the date of LBIE's administration and so no basis on which to assert a rate "applicable" to the single compensation claim as at the date of administration within the meaning of Rule 2.88(9) of the Rules.

36. To expand upon the above point, although *the circumstances* from which a serious and definitive refusal might be inferred can exist before a claim matures, the default is *effective* only from the maturity of the claim: see the SCG's writing closing submissions at paragraph 82(5), citing Mulbert 3/paragraphs 102 and 122-124 and *Lowisch and Feldman*

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[3] See Freshfields' letter dated 13 July 2016, paragraphs 4 to 7.

in Staudinger Rn 88 at tab 59A: "*if…the refusal to perform took place prior to the maturity of the claim, default still does not take effect until the due date.*"

37. Accordingly, even if one assumes in favour of the SCG[4] that LBIE's administration application was a serious and definitive refusal by LBIE to pay the single compensation claim:

    (1) If the creditors' single compensation claim matured (and, indeed, came into existence) after LBIE's application for administration only, there can have been no default as at the commencement of the administration.

    (2) The consequence is that the creditor had no right to *further damage* under s.288(4) BGB as at that commencement of the administration date. This is because the constitutive elements of a right to *further damage* simply do not exist at the relevant time.

    (3) There is, therefore, no right to that might constitute a rate "applicable" apart from the administration under Rule 2.88(9) of the Rules.

Inter-relationship with supplemental Issue 1(a)

38. In this last respect, it is relevant to remind the Court of Supplemental Issue 1(a) and to explain the difference between the rights under the ISDA Master Agreement the subject matter of that issue and the German law statutory provisions the subject matter of Issue 20.

39. In the context of the debate as to whether a Default Rate under an ISDA Master Agreement could be said to be "applicable" to a close-out amount which would arise post-administration only upon notice and certification, the SCG submitted as follows (at paragraph 12 of its submissions):

    "*Put another way, what matters is whether the claim to interest is pursuant to rights which the creditor had at the date of commencement, regardless of whether those*

[4] This assumption is made contrary to Wentworth's case at trial, and the powerful expert evidence of Judge Fischer (formerly the presiding Judge of the BGH responsible for insolvency matters), that there is no proper basis for concluding that LBIE's administration application was a serious and definitive refusal by LBIE to pay the single compensation claim: see Wentworth's Closing Submissions, at [164] and [179] to [184].

rights were present, future or contingent, and not whether the relevant rate of interest had itself vested or was accruing as at that date." (Emphasis added.)

40. On this basis, the SCG argued against York's submissions that the contingency of the close-out amount precluded the characterisation of the Default Rate as "applicable" for the purpose of Rule 2.88(9). In essence, the SCG said that the close-amount, although contingent, and the right to interest upon it on it were rights which the creditor *had* under its contract with LBIE as at LBIE's administration.

41. Whatever the decision reached on Supplemental Issue 1(a) as regards the Default Rate under the ISDA, it is clear the right to *further damage* under s.288(4) BGB is distinct in content from a contractual right to interest that is integrally linked under the same contract to the close-out amount. Absent a default and damage, there is no right to *further damage*, as Professor Mulbert has made clear in stating the requirements for that right "*to be established*": see Mulbert 3/paragraphs 29, 33 and 36

42. Absent an effective default and damage by reason of delay which a particular creditor can assert against LBIE, s.288(4) BGH is only a provision of the BGB which potentially might apply, much in the same way a provision of a foreign Judgment Act rate might apply in the event of a successful suit on a claim in a foreign court (and which does not give rise to a rate "applicable" apart from the administration for the purpose of Rule 2.88(9).

43. The SCG cannot overcome this difficulty by the further suggestion that a creditor who, at some point, might have a claim for *further damage* in fact already has a right under s.288(4) BGB, albeit a right that is not "vested". As regards a damages claim, of which default and damage are constitutive matters, the creditor has no right unless and until those matters are made out. At the time of LBIE's administration, the creditor can only point to an abstract provision of the BGB which he cannot assert.

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21 JULY 2016