IN THE HIGH COURT OF JUSTICE **No. 7942 of 2008**

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

(1) ANTHONY VICTOR LOMAS

(2) STEVEN ANTHONY PEARSON

(3) PAUL DAVID COPLEY

(4) RUSSELL DOWNS

(5) JULIAN GUY PARR

(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.A.R.L.

(3) HUTCHINSON INVESTORS LLC

(4) WENTWORTH SONS SUB-DEBT S.A.R.L.

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

Respondents

GOLDMAN SACHS INTERNATIONAL'S

SKELETON ARGUMENT

FOR THE CONSEQUENTIALS HEARING

References to the trial bundles are in the form [Bundle/Tab/Page]. The further Consequentials Hearing bundle is referred to in the form [C/Tab/Page].

I. INTRODUCTION

1. This is the skeleton argument of Goldman Sachs International ("GSI") for the consequentials hearing for Part C of the Waterfall II Application.

2. The parties have agreed a draft order, reflecting the directions made in the Judgment **[C/3/1]**. The outstanding issues for the consequentials hearing are therefore:

   (1) Permission to appeal; and

   (2) Costs.

II. PERMISSION TO APPEAL

3. GSI seeks permission to appeal against aspects of the Judgment, as set out in the attached Grounds of Appeal. In summary:

   (1) GSI seeks permission to challenge the Judge's conclusion on Issue 11,[1] insofar as the Judge concluded that the definition of Default Rate and the words *"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"* were limited to a borrowing transaction. The definition should cover the cost of a transaction to raise equity funding to fund the relevant amount, together with any fees paid or other charges incurred to raise that funding.

   (2) GSI does not seek to challenge, for the purposes of an appeal, the Court's conclusion that the definition of Default Rate requires the certifying party to have regard to an actual or hypothetical transaction to raise the relevant amount. GSI does not contend on appeal that the definition would cover 'model' based measures of cost of funding (such as CAPM) or general measures of cost of capital (such as WACC).

[1] And certain consequential aspects of Issue 12.

(3) GSI supports the Judge's conclusions on Issues 13 and 14. GSI also agrees with the Judge's conclusions on Supplemental Issue 1A. GSI does not advance any position on the other issues in the Judgment, including Issue 10 and the German law issues.

4. On this basis, GSI seeks permission to appeal against paragraphs (ii), (iii), (vi), (viii) and (ix)-(xv) of the draft order.

5. GSI contends that its appeal has a real prospect of success (CPR 52.6(1)(a)). The correct interpretation of the definition of Default Rate is a difficult question, which "*caused [the Judge] to waver considerably, especially on the most acute issue of whether the cost of funding language extends to equity funding"* (Judgment para. 114, **[C/2/36]**). Against this background, there is a real prospect that GSI's arguments will prevail on appeal.

6. GSI does not propose to rehearse all the arguments that it advanced at trial, which will be familiar to the Court. Nonetheless, it would highlight the following specific issues arising from the Judgment, which (it is respectfully submitted) assist in demonstrating that GSI's case has real prospects of success on appeal:

(1) The key to the Judge's reasoning is the proposition that the purpose of the Default Rate definition is to determine a rate of interest, and that *"interest connotes borrowing"* (para. 142 **[C/2/41]**). This is described as the *"key to an understanding of the cost of funding language"* (para. 119 **[C/2/37]**) which *"necessarily…exclude[s]…any method of raising funds where the cost of doing so…is not properly described as interest"* (para. 122 **[C/2/37]**). It is submitted that this approach misconstrues the language and structure of the ISDA Master Agreement. In particular:

(a) The *"governing concept"* of the definition of Default Rate is not the *"concept of interest"* (para. 145 **[C/2/42]**). The word *"interest"* does not even appear in the definition. Rather, the *"governing concept"* is the concept of a *"cost…of funding"*.

(b) It is true that the certified *"cost…of funding"* is ultimately used to *produce* an interest rate: the rate of interest payable by the Defaulting Party on the overdue amount. But this is not the same thing as a requirement to *certify* an interest rate as a party's *"cost…of funding"*. Goldman Sachs respectfully submits that the Judgment conflates these two issues. On the true construction of the ISDA Master Agreement there is no requirement for the certified *"cost of funding"* to itself be an interest rate, provided it can be used to derive an interest rate.

(c) The Judge's own reasoning accepts this proposition at least to some extent, in concluding that the fees paid to a lender in exchange for borrowing (which are not an interest rate) can be taken into account as part of the certified cost of funding (Judgment, para 157 **[C/2/45]**). It would seem to follow that these costs are used when deriving *"a rate per annum"* for the purposes of determining the Default Rate, Non-default Rate and Termination Rate in the 1992 ISDA Form.

(2) The Judge's interpretation produces outcomes that are commercially unrealistic, and unlikely to represent the proper construction of the ISDA Master Agreement. As to this:

(a) Commercial parties raise funding via a variety of methods, including equity and debt funding. Each of these types of funding has a *"cost" "from a commercial perspective"*, as the Judgment acknowledges (para. 142 **[C/2/41]**).

(b) The Judge also acknowledged that *"particular care is necessary not to adopt a restrictive or narrow construction which might make the form inflexible and inappropriate for parties who might commonly be expected to use it."* (Judgment, para. 48(4) **[C/2/17]**).

(c) However, the Judge's interpretation requires the parties to disregard the range of funding options that they actually use, and instead assume that they will respond to an ISDA default by raising borrowing. This does not reflect the way that commercial parties actually fund themselves. In the absence of clear language requiring this result (which could easily have been included in the Master Agreement), there is no proper basis for reading down the broad words *"cost…of funding"* in this way.

(d) This is a particularly acute issue for financial institutions, which may be required to raise equity funding to fund the relevant amount (e.g. as a result of market pressures or to meet regulatory requirements). The Judge's interpretation may require them to disregard the way in which they are obliged to fund themselves. Financial institutions are the largest users of the ISDA Master Agreement (certainly by value) and these requirements would have been generally known in the market when the ISDA Master Agreement was drafted (and subsequently) and to the draftsman of the ISDA Master Agreement. The restrictions applicable to financial institutions should therefore be taken into account in interpreting the ISDA Master Agreement.

(3) The Judge's approach may also lead to arbitrary results, where forms of funding with commercially equivalent results but which adopt legally different forms would fall to be treated very differently. The Judgment acknowledges that equity funding may *"mimic"* an entitlement to interest, but suggests that it is *"not the same"* as borrowing and so is not within the definition (para. 138 **[C/2/40]**). However, a mere difference between two legal forms of funding cannot be sufficient: the key question is whether the difference is one that actually *matters* from the perspective of commercial parties, such that equity funding should not give rise to a relevant *"cost…of funding"* for the purposes of the Default Rate definition. If the two types of funding are so similar in their commercial effects that one *"mimics"* the other, then this is a powerful reason why both should be within the definition.

(4) The Judge's approach may also produce commercially nonsensical outcomes, whereby 'debt' components of hybrid instruments may be certified but 'equity' components may not be. There is no reason why commercial parties would have contemplated this result.

(5) To the extent that the Judgment relies upon a difference between a formal legal obligation to pay interest under borrowing, and a *"discretionary"* obligation to pay dividends on equity funding, this distinction elevates form over substance. In practice it is a commercial requirement of equity funding that the funders are paid for their contribution: a party that fails to do so will

soon be out of business. This is particularly so for financial institutions, which must maintain the confidence of the financial markets if they are to retain the access to funding (of any type) that they need to continue to operate. Further, this is not a pure "discretion" in that the failure to exercise it carries both a legal, and commercial detriment for the company. In addition, if legal form is to be the hallmark of whether a transaction can constitute a cost of funding, then this would suggest that repo funding could not fall within the Default Rate definition given that *"a repo is structured legally as a sale and repurchase of the securities,* [although] *it behaves economically as a secured loan, with the securities acting as collateral"*: *Forsta AP-Fonden v Bank of New York Mellon* [2013] EWHC 3127 (Comm) at [290].

(6) The arbitrariness of the distinctions promoted by Wentworth (and accepted by the Judge) can also be seen in the fact that it accepts fees payable to a lender for borrowing are included within the definition, but seeks to exclude fees incurred in raising the funding where they are paid to other parties (such as legal or underwriting fees). This is justified on the basis that these are *"engagements separate or distinct from the transaction of borrowing"* (Judgment, para. 123 **[C/2/37-38]**). But this is correct only at the most formalistic level. These fees are clearly paid to raise the funding in question, rather than for any separate purpose. Further, whether the fees are paid to the lender or a third party might depend on the happenstance of how the lender's business is structured. These fees should also be included within the definition as a cost of that funding, and Wentworth's attempt to exclude them demonstrates that its approach is not grounded in commercial reality.

(7) It is suggested at para. 116 of the Judgment that this approach ensures that the meaning of *"cost…of funding"* is consistent throughout the ISDA Master Agreement. However, this disregards the fact that the *"cost of funding"* language is also used in the definition of *"Loss"* and the Judgment accepts that this language can (in that context) include broader measures of funding (such as equity funding), following *Lehman Brothers Holdings Inc v Intel Corporation* S.D.N.Y. Sep 16, 2015 (para. 146 **[C/2/42]**). Consistency with the approach adopted in *Intel* should have required a similar approach in the Default Rate definition.

(8) Likewise, the possibility that GSI's approach could create complexity in marginal cases is, at most, a neutral factor. There is undoubtedly the potential for difficult cases to arise at the extremities on *both* approaches. For example, the Judgment itself contemplates that there may be a need to *"disentangle"* complex hybrid instruments on Wentworth's interpretation (para. 141 **[C/2/41]**). This is no easy task and one that the parties to the ISDA Master Agreement are not likely to have thought appropriate. The Judgment also appears to acknowledge that Wentworth's approach breaks down where the relevant payee cannot borrow, but can raise equity funding (para. 163 **[C/2/46]**). Contrary to the suggestion in the Judgment, this is not an implausible scenario: it in fact occurred, for certain institutions, in the financial crisis of 2008, where certain major financial institutions (such as RBS and Lloyds) were unable to borrow further sums and had to be recapitalised by raising equity capital. Wentworth's interpretation, by arbitrarily restricting the definition of "Default Rate" to a cost of borrowing, cannot properly accommodate this situation.

(9) Finally, the Judge did not adequately explain why the requirement that the relevant payee's *"cost…of funding"* be certified rationally and in good faith offers inadequate protection against the abuse of a broader definition of *"Default Rate"*. A similar restraint on certification was accepted as adequate in the *Intel* case, the reasoning in which (as noted above) was accepted by the Judge.

7. The difficulties which arise from the outcome of the case can be illustrated by the example of cumulative preference shares carrying a fixed dividend. The primary cost of such funding (the fixed percentage dividend due on the shares) is easily identifiable and can be converted into an interest rate without difficulty. The requirement to pay the fixed dividend is not *"discretionary"* in any commercially meaningful sense: if a party refused or failed to pay the fixed dividend, as opposed to merely postponing the payment (with the divided being "rolled up" in the meantime) they would suffer the legal detriment of being unable to pay dividends to any shareholder again, something which is commercially impossible (and in any event indistinguishable from a power on a borrower's part to "roll up" interest obligations). The requirement to pay such dividends is therefore a real *"cost…of funding"*, which will be functionally identical

to many forms of borrowing. Nonetheless, on the Judge's interpretation, such funding would be excluded from certification under the Default Rate provisions of the ISDA Master Agreement.

8. GSI submits that this cannot be the right result. There is certainly a real prospect of arguing that such funding falls within the definition of *"Default Rate"*.

9. To the extent required, GSI also submits that there is some other compelling reason for the appeal to be heard (CPR 52.6(1)(b)). Quite apart from the very large amount at issue in the LBIE administration, the ISDA Master Agreement is the dominant standard form in a market worth many trillions of dollars. It is very likely that the judgments in these proceedings will the final word on the points they decide, certainly as a matter of English law. Against this background, it is appropriate that the issue of the correct construction of the ISDA Master Agreement receive consideration from the Court of Appeal.

III. COSTS

10. GSI submits that its costs of the Waterfall IIC Application (and those of the other parties) should be paid as an expense of the LBIE estate. In particular:

(1) GSI has acted as (in effect) a representative party, providing submissions to assist the Court and Administrators with the distribution of the LBIE estate.[2] In particular, it has acted to represent the interests of financial institutions and to advance arguments relevant to the particular circumstances of financial institutions. This was particularly important in the context of the ISDA Master Agreement issues raised in Waterfall IIC, since financial institutions are the principal users of the ISDA Master Agreement form. As the Judgment notes:

(a) *"Mr David Foxton QC advanced submissions from the particular perspective of financial institutions (by whom ISDA was originally founded and which are (by value at least) the principal users of the ISDA Master Agreements)."* (para. 104 **[C/2/33]**).

[2] Though it was not a formal representative party.

(b) The perspective of *"prominent (and by value almost certainly predominant) users of the ISDA Master Agreements, [w]as (in effect) represented by GSI."* (para. 142 **[C/2/41]**).

(2) Financial institutions form a significant class of claimant in the LBIE administration, and it was therefore appropriate that arguments relevant to their interests were before the Court. Moreover:

(a) The Judge held on Issue 10 that the *original* ISDA counterparty's circumstances must be considered in certifying a *"cost…of funding"*, rather than the circumstances of any assignee. Many of the original counterparties in the LBIE administration would have been financial institutions, even if they later assigned their claims. Accordingly, the funding requirements applicable to financial institutions may apply to parties claiming in the LBIE administration that are not themselves financial institutions, and it is important that the relevance (or otherwise) of financial institutions' approach to funding has been determined as part of the application.

(b) In any event, the arguments relating to the position of financial institutions are relevant more broadly to the proper construction of the ISDA Master Agreement, given that financial institutions are the key drafters and users of the ISDA form and that funding requirements applicable to such institutions are therefore (at least arguably) a relevant consideration in interpreting the definition of Default Rate.

(3) In a directions application in insolvency proceedings, where parties act (in effect) in a representative capacity, it is appropriate to pay those parties' costs from the estate. The point is illustrated by David Richards J's decision in Waterfall IIA and B, where effectively identical issues arose. In the consequentials hearing following those proceedings the SCG sought their costs from the LBIE estate on the basis that it represented the position of other LBIE creditors in a similar position. Wentworth, by contrast, argued that the proceedings were effectively a hostile dispute between Wentworth and the SCG, and that the winning party should have their costs from the losing party to the extent that they were successful. Since Waterfall IIA and B was, in

effect, a draw (Waterfall IIA generally being won by Wentworth but Waterfall IIB being won by the SCG), Wentworth proposed that there be no order as to costs overall. David Richards J accepted the SCG's arguments, rejecting those of Wentworth. He held that:

(a) The essential question is whether the *"correct characterisation of the trial"* is *"hostile litigation between interested parties or…the Joint Administrators seeking directions with a view to the proper administration of the estate."* (page 94, lines 6-12 **[8/3A/24]**)

(b) David Richards J held that the Waterfall IIA and B hearing fell into the latter category (page 94, line 22 – page 95, line 2 **[8/3A/24]**). He relied, in particular, on the fact that:

"[T]here were certain issues raised none of them frivolous all of them requiring determination… [Wentworth and the SCG] were not formally representatives, but if they had not been willing to argue the points the administrators would I think have needed to seek the appointment of representative creditors to argue these points." (page 95, lines 9-21 **[8/3A/24]**)

Further:

"I do not think in the circumstances of this case it would necessarily have been satisfactory for the Joint Administrators themselves to have argued all the points on behalf of the general body of unsecured creditors." (page 95, line 22 – page 96, line 1 **[8/3A/24]**)

(c) David Richards J specifically noted that the fact that certain parties were advancing arguments in their own interest "*would be likely to occur in any administration"* and that this was *"inevitably the case"* (page 95, lines 2-8 **[8/3A/24]**), but this did not prevent those parties from having their costs paid from the LBIE estate.

(d) Accordingly, David Richards J concluded that:

"I…am clearly and firmly of the view that the correct characterisation of this litigation so far brings this into the category of case where, as a

general proposition, the costs of the respondents should be paid as expenses of the administration." (page 96, lines 2-8 **[8/3A/24]**).

It is right to record that David Richards J noted that he was not pre-deciding the costs position in Waterfall IIC (page 96, lines 9-15 **[8/3A/24]**). Nonetheless, his reasoning applies with equally force to Waterfall IIC, which forms part of the same overall application. There is no relevant distinction between the two phases of the application on the costs issues that now have to be decided.

(4) The Administrators supported GSI's joinder application, as recorded in paragraph 2 of their skeleton argument for the joinder application: "*The Administrators consider that the joinder of GSI is appropriate in the circumstances*" **[6/8/2]**. The Administrators also made clear that GSI was advancing arguments that other parties were not advancing, in particular in relation to the way in which financial institutions are required to fund themselves (see paragraph 14 of the Administrators' skeleton argument for the joinder application **[6/8/5]**). It is clear that if GSI had not been there to advance those arguments, but had simply notified the arguments to the Administrators, the Administrators would have had to advance the arguments themselves. Where a group of creditors have a distinct perspective on an issue which needs to be resolved in an administration, it is plainly better for arguments arising from that perspective to be put to the Court by a party who is able to represent that interest, rather than by the Administrators. The Court's costs order should reflect this position.

(5) In case an argument is made that GSI and the SCG's submissions were somehow duplicative, GSI notes the following points:

(a) GSI's interests are not identical with the SCG's. It made submissions from the particular position of financial institutions, as noted in the passages from the Judgment set out above. This reflected the basis on which permission was granted for GSI to join the proceedings.[3] If GSI

[3] This was the basis on which GSI was joined to the application. In correspondence Wentworth has cited highly selective excerpts from the joinder hearing transcript to suggest that GSI joined solely for its own purposes. This is misleading: GSI's joinder application repeatedly referred to the importance of ensuring that financial

had not joined, these submissions would not have been made. This point was also recognised by the Administrators as described above. It is submitted that it was important for the Court to take GSI's arguments into account before reaching any decision on the correct construction of the ISDA Master Agreement, and GSI's submissions were described during the trial as *"very helpful"* (Day 2, page 138, line 25 **[8/5/35]**).

(b) Furthermore, GSI was successful on a number of issues on which it made distinct arguments, with the Judge accepting its submissions in preference to those of Wentworth. Examples include the dispute under Issue 14 regarding the permissible bases of challenges to certification (paras. 195-208 of the Judgment **[C/2/52-54]**), on which GSI was the *"principal opponent"* of Wentworth (para. 199 **[C/2/52]**), and the matters that can be taken into account in assessing the default rate, where the Judgment *"endorse[d] the position adumbrated on behalf of GSI"* (paras. 183-189 **[C/2/50-51]**).

(c) In any event, GSI and the SCG actively sought to avoid duplication in their submissions. For example, at trial the SCG took the lead in opening oral submissions, while GSI did so in the reply submissions. Where appropriate, GSI deferred to the SCG in areas where they would otherwise have made the same submissions (such as on Supplemental Issue 1A, where GSI made no substantive submissions after ascertaining that the SCG was advancing the position that GSI would have taken).

There was therefore no real issue of duplication.

11. For these reasons, GSI submits that its costs should be paid from the LBIE estate.

12. Wentworth has argued that GSI and the SCG should pay its costs, and not receive their own, on the basis that the Waterfall IIC dispute should be treated as *"hostile"*

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institutions were represented in the application, and that GSI was seeking to join to make submissions relevant to their interests. GSI can provide references for this material, if required, should Wentworth persist in suggesting otherwise.

litigation rather than an application for directions and it was the successful party in the litigation. However, this is an attempt to re-run the arguments that were rightly rejected by David Richards J in Waterfall IIA and B. They should be rejected in Waterfall IIC as well, for the same reasons.

13. To the extent relevant, GSI also notes that it succeeded on certain issues, including the disputed parts of Issue 14 (paras. 195-208 **[C/2/52-54**) and aspects of Issues 11 (rejecting Wentworth's argument that the relevant *"cost"* must be the lowest available: para. 133 **[C/2/39]**) and Issue 13 (rejecting Wentworth's *"one size fits all"* approach to the matters that may be taken into account in calculating the Default Rate (paras. 183-190 **[C/2/50-51]**). If costs were simply to follow the event, it would therefore be appropriate to make a split order as to costs to reflect those issues on which GSI was successful and on which Wentworth lost. But, for the reasons given above, GSI's primary position is that all costs should be paid from the LBIE estate, such that this point need not arise.

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