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

ISSUES 20 AND 21: 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] and/or the GMA (as defined below) 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 £7.72bn[1]. Rule 2.88(7) requires the surplus to be used, first, to pay statutory interest on dividends for the period between 15 September 2008 and the date of payment of the dividends. Rule 2.88(9) provides that the relevant rate of statutory interest is whichever is the greater of the Judgments Act Rate (i.e. 8% per annum) and "*the rate applicable to the debt apart from the administration*".

2. The claims admitted for dividend in the LBIE estate include 15 claims under the German Master Agreement (the "GMA"). The GMA is a standardised master agreement governed by German law which is utilised for financial derivatives transactions. The GMA can be found at **[Core/9]**.

3. It is understood that the claims under the GMA total approximately £311 million[2]. These claims will receive statutory interest at 8% per annum (i.e. the Judgments Act Rate) save in circumstances where a creditor can establish that its proved debt under the GMA has an applicable interest rate of greater than 8% apart from the administration.

4. The prospect of any creditor discharging this burden would appear to be inherently unlikely in circumstances where interest rates fell sharply shortly after the administration of LBIE in September 2008 and have remained thereafter at an all-time low. By way of example, the main refinancing interest rate of the European Central Bank has, since early 2009, fluctuated between a high of 1.5% and a low of 0.05%.

5. The GMA claims are very different to those made by creditors under the ISDA Master Agreement (the terms of which are to be considered by the Court in the context of Issues 10 to 19) as the GMA does not make provision for any contractual entitlement to interest on the close-out amount which becomes due from LBIE following its termination.

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1 PWC, LBIE: Joint Administrators' Fourteenth Progress Report (March 2015 to 14 September 2015) at Page 9 **[6/13]**.

2 Lomas 13, at paragraph 23 **[2/9]**.

6. The SCG seeks to overcome this difficulty by developing a case based on section 288 of the German Civil Code (the "BGB"), a statutory provision which is only engaged in circumstances where a party is in default of a payment obligation within the meaning of section 286 BGB.

7. Section 288(1) BGB enables a party to claim interest at a rate of 5% above the basic rate of interest applicable during the period of the default. The basic rate of interest, which is addressed at section 247 BGB, has been set at a rate of less than 1% since 1 July 2009. Indeed, the rate has been a negative rate since 1 January 2013. It will be immediately apparent that the rate applicable under section 288(1) BGB would not give rise to a rate in excess of 8% per annum.

8. The SCG seeks to overcome this difficulty by relying on section 288(4) BGB which provides that "*the assertion of further damage is not precluded*". The SCG contends that this constitutes a statutory provision which makes provision for an interest rate applicable to the proved debt under the GMA apart from the administration for the purposes of Rule 2.88(9).

9. These written submissions develop the reasons why the SCG's case should be rejected by the Court. The remainder of these written submission are structured as follows:

   (1) overview of Wentworth's case (pages 4 to 10);

   (2) relevant provisions of the GMA (pages 11 to 13);

   (3) relevant provisions of the BGB (pages 14 to 16);

   (4) expert evidence (pages 17 to 27);

   (5) Issue 20 (pages 28 to 45);

   (6) Issue 21 (pages 46 to 51); and

   (7) conclusion (page 52).

OVERVIEW

ISSUE 20

Issue 20(1)

Whether and in what circumstances, following LBIE's administration, a creditor would be entitled to make a "damages interest claim" within the meaning of section 288(4) of the German Civil Code (BGB) on any sum which is payable pursuant to clauses 7 to 9 of the German Master Agreement?

10. Issue 20(1) is concerned with whether a contractual counterparty to the GMA is entitled to make a claim for *further damage* pursuant to section 288(4) BGB[3].

11. Wentworth contends that a contractual counterparty to the GMA is not entitled, following LBIE's administration, to make a claim for *further damage* under section 288(4) BGB.

12. It is common ground that it is necessary to show a "*default*" within the meaning of section 286 BGB in order to make a claim for *further damage* under section 288(4) BGB. The SCG is unable to establish a default under section 286 BGB. In summary:

    (1) LBIE was not under any payment obligation in respect of the close-out amount under the GMA until the completion of the contractual netting process under clauses 8 and 9 GMA. This process was not complete until after LBIE's administration. Accordingly, there was no defaulted payment obligation, as required by section 286 BGB, prior to LBIE's entry into administration. A default cannot occur following LBIE's entry into administration (see paragraphs 94 to 104).

    (2) Alternatively, even if the close-out amount payable under clauses 8 and 9 GMA can be characterised as being due prior to the administration order, the SCG remains unable to establish a default under section 286 BGB. In summary:

[3] Although the question refers to a "*damages interest claim*" this is not a quote from the BGB or the GMA, but rather the original formulation of Issue 20 in this Application created its own definition of "*Damages Interest Claim*".

(a) There was no default under section 286(1) BGB, the general rule by which a default might be declared by the issue of a warning notice (see paragraphs 106 to 111). In this regard:

(i) no warning notice was served prior to LBIE's entry into administration;

(ii) no legally effective warning notice can be served in accordance with section 286(1) BGB following the entry of LBIE into administration;

(iii) in any event, it is Wentworth's understanding that no warning notices were, in fact, served by the contractual counterparties after the commencement of LBIE's administration; and

(iv) no legally effective warning notices can now be served as the proved debts under the GMA have been paid in full.

(b) No exception to the general rule in section 286(1) (i.e. the requirement to serve a warning notice to trigger a default) is applicable in the present case (see paragraphs 112 to 118). In particular, the SCG is unable to rely upon the exception which applies under section 286(2)(iii) where an obligor "*seriously and definitely refuses performance*". The SCG is wrong to contend that such a state of affairs should be inferred from the fact or grounds of the administration application or administration order.

Issue 20(2)

If the answer to question 20.1 is yes, whether (and if so, in what circumstances) all or part of such "damages interest claim" can constitute part of "the rate applicable to the debt apart from the administration" for the purpose of Rule 2.88(9)?

13. Issue 20(2) is concerned with whether, if the answer to Issue 20(1) is "yes", all or part of a claim for *further damage* under section 288(4) BGB is to be characterised as part

of the "*rate*" applicable to the proved debt "*apart from the administration*" for the purpose of Rule 2.88(9).

14. Wentworth contends that a claim for *further damage* under section 288(4) BGB is not to be so characterised. It relies on three independent reasons, each of which is sufficient to defeat the SCG's case.

15. First, in order for a claim for *further damage* under section 288(4) BGB to be capable of being characterised as a "*rate*" applicable to the debt proved "*apart from the administration*" it is necessary, as held by David Richards J in *Waterfall IIA* [2015] EWHC 2269 (Ch) at [171]-[183], for the SCG to establish that that "*rate*" was applicable to the proved debt at the commencement of the administration by reason of the rights of the creditor at that date.

16. The necessity of a warning notice to trigger a default (and thereby to admit of the possibility of claim to *further damages* under section 288(4) BGB) negates any characterisation of such a claim as the rate applicable to the proved debt "*apart from the administration*" for the purposes of Rule 2.88(9) (see paragraphs 119 to 131).

17. Secondly, even if a default under section 286 BGB was triggered prior to the commencement of LBIE's administration, a claim to *further damage* under section 288(4) BGB is still not a "*rate*" applicable to the proved debt "*apart from the administration*". A claim for *further damage* under section 288(4) BGB is a damages claim for late payment that must be pleaded and proved to the satisfaction of the Court. Accordingly, it is not something (let alone a "*rate*") applicable to the proved debt at the commencement of the administration by reason of the rights of the creditor at that date as required by the judgment in *Waterfall IIA* (see paragraphs 119 to 131).

18. Thirdly, a claim for *further damage*, even if expressed as a rate, is without the necessary properties under German law as would permit its characterisation, as a matter of English insolvency law, as the "*rate*" applicable to the debt proved for the purpose of Rule 2.88(9), as opposed to a rate referable to some other amount (see paragraphs 132 to 133).

19. The practice of the German court is to allow a claimant to elect to have a claim for *further damage* expressed as a rate if, as a result of the delay in payment of the debt due, the claimant has either incurred an interest expense to close the 'funding-gap' as a result of the delay or suffered a loss of interest income by reason of an investment opportunity lost by reason of the 'funding gap'. In such a case, the rate awarded is based upon the sum borrowed or which would have been invested and not the amount owed to the claimant. Accordingly, it is not a rate applicable to the debt proved for the purpose of Rule 2.88(9).

ISSUE 21

If the answer to question 20(2) is that a further claim for damages can be included as part of the "rate applicable to the debt apart from administration" for the purposes of Rule 2.88(9), how in such circumstances is the relevant rate to be determined?

(i) in circumstances where the relevant claim under the German Master Agreement has been transferred (by assignment or otherwise) to a third party, is it the Damages Interest Claim which could be asserted by the assignor or the assignee which is relevant for the purposes of Rule 2.88(9)?

(ii) where the relevant claim under the German Master Agreement has been acquired by a third party, in what circumstances (if any) is such a third party precluded from asserting a Damages Interest Claim under principles of German law?

(iii) where does the burden of proof lie in establishing a Damages Interest Claim, and what is required to demonstrate, that a relevant creditor has or has not met such requirement?

20. Issue 21 only arises for determination in the event that (i) a contractual counterparty to the GMA is entitled to make a claim against LBIE for *further damage* pursuant to section 288(4) BGB; and (ii) all or part of such a claim is to be characterised a part of the "*rate*" applicable to the proved debt "*apart from the administration*" for the purpose of Rule 2.88(9).

Issues 21(i) and (ii)

21. Issues 21(i) and (ii) are directed at whether, in circumstances where the close-out amount under the GMA has been assigned, the assignee is able to assert a greater claim to *further damage* than the assignor.

22. Wentworth contends that the assignee of a close-out amount under the GMA can have no greater claim to *further damage* than that which would have been available to the assignor. Wentworth relies upon two independent reasons.

23. First, as explained above in the summary of the answer to Issue 20(2), a claim for *further damage* pursuant to section 288(4) BGB is not a "*rate*" applicable to the debt "*apart from the administration*". Even if that should be wrong as regards the assignor, it is not wrong as regards the assignee (see paragraphs 134 to 136). In summary:

(1) the *Waterfall IIA* judgment establishes that the "*rate*" applicable to the proved debt "*apart from the administration*" is to be determined by reference to the rights of the creditor as at the commencement of the administration;

(2) the assignment of the proved debt has taken place after the commencement of the administration;

(3) the SCG accepts that the assignee can assert a claim for *further damage* only by reference to the period following the assignment; and

(4) accordingly, it is not understood how an assignee's claim for *further damage* can be said to be applicable to the debt proved at the commencement of the administration.

24. Secondly, in any event, German contract law recognises a principle that the debtor should not be prejudiced by the assignment; a principle implicit in the BGB and recognised by the German Federal Court. The effect of the principle is that the assignee is necessarily limited to the *further damage* claim that the assignor could have asserted (see paragraphs 137 to 139).

Issue 21(iii)

25. Issue 21(iii) concerns the burden of proof in establishing a claim for *further damage* under section 288(4) BGB and the boundaries of such a claim.

26. It is common ground that the burden of proof is placed upon the party making the claim.

27. Wentworth contends, in summary, as follows in relation to the boundaries of a claim for *further damage* (see paragraphs 140 to 144):

(1) Section 252 BGB does not allow a claim for loss of profits to be proved merely by the product of an estimate of lost profits. A claimant has to prove, on a balance of probabilities, the facts necessary for estimation (e.g. the kind of

investment that would have been made) and the profit that it would have been earned in the ordinary course of events.

(2) In any event, the rules to be applied by the Court when measuring or quantifying damages are to be found in the English rules of civil procedure ordinarily applicable to a claim for damages for breach of contract as opposed to German principles.

RELEVANT PROVISIONS OF THE GMA

28. The GMA **[Core/9]** is a standardised master agreement governed by German law which is utilised for financial derivatives transactions. The following paragraphs contain a summary of the relevant provisions of the GMA. The key provisions for the purpose of Issues 20 and 21 are clauses 7 to 9 GMA.

29. The GMA treats as a single agreement all derivative transactions (each referred to as a Transaction) entered into pursuant to its terms: see clause 1(2).

30. Payment and performance of obligations falling due under a Transaction before the termination of the GMA are governed by clause 3. In summary:

    (1) payment or performance is to be made on the due dates specified in the Transaction: see clause 3.1;

    (2) all payments are to be made to the payee's account in the specified contractual currency: see clause 3.2;

    (3) there is a netting of simultaneous payment obligations owed by one party to the other: see clause 3.3; and

    (4) there is a provision for interest for late payment which operates prior to the termination of the GMA: see clause 3(4). Clause 3(4) provides as follows:

> "*If a party fails to make a payment in due time, interest shall accrue on the amount outstanding, until such amount is received, at a rate which shall be equal to the interbank interest rate charged by prime banks to each other for call deposits at the place of payment and in the currency of the amount outstanding for each day on which such interest is to be charged, plus the interest surcharge referred to in Clause 12 sub-Clause (3). The right to make further claims for damages is not hereby excluded.*"

31. Clause 7 concerns the termination of the GMA. The relevant provisions are clause 7(2) which makes provision for automatic termination of the GMA and clause 7(3) which addresses the consequences of termination. They provide as follows:

"*(2) The Agreement shall terminate, without notice, in the event of an insolvency. An insolvency shall be given, if an application is filed for the commencement of bankruptcy or other insolvency proceedings against the assets of either party and such party either has filed the application itself or is generally unable to pay its debts as they become due or is in any other situation which justifies the commencement of such proceedings.*

(3) In the event of termination upon notice by either party or upon insolvency (hereinafter called "Termination"), neither party shall be obliged to make any further payment or perform any other obligation under Clause 3 sub-Clause (1) which would have become due on the same day or later; the relevant obligations shall be replaced by compensation claims in accordance with Clauses 8 and 9."

32. Accordingly, the GMA terminated pursuant to clause 7(2) on the making of an administration application in respect of LBIE[4].

33. Clauses 8 and 9 make provision for the calculation and payment of a close-out amount in respect of the damages flowing from the termination of the GMA. Clause 8 requires a calculation by reference to actual or hypothetical replacement transactions. It provides as follows:

"*Claims for Damages and Compensation for Benefits Received*

(1) In the event of Termination, the party giving notice or the solvent party, as the case may be, (hereinafter called "Party Entitled to Damages") shall be entitled to claim damages. Damages shall be determined on the basis of replacement transactions, to be effected without undue delay, which provide the Party Entitled to Damages with all payments and the performance of all other obligations to which it would have been entitled had the Agreement been properly performed. Such party shall be entitled to enter into contracts which, in its opinion, are suitable for this purpose. If it refrains from entering into such substitute transactions, it may base the calculation of damages on that amount which it would have needed to pay for such replacement transactions on the basis of interest rates, forward rates, exchange rates, market prices, indices and any other calculation basis, as well as cost and expenses, at the time of giving notice or upon becoming aware of the insolvency, as the case may be. Damages shall be calculated by taking into account all Transactions; any financial benefit arising from the Termination of Transactions (including those in respect of which the Party Entitled to Damages has already received all payments and performance of all other obligations by the other party) shall be taken into account as a reduction of damages otherwise determined.

[4] The administration order was made on the morning of Monday 15 September 2008 with effect from 07:56am. The recitals to the administration order make clear that the administration application had not been filed prior to the hearing as they contain an undertaking by the directors of LBIE to file the administration application.

> *(2) If the Party Entitled to Damages obtains an overall financial benefit from the Termination of Transactions, it shall owe the other party, subject to Clause 9 sub-Clause (2) and, where agreed, Clause 12 sub-Clause (4), a sum corresponding to the amount of such benefit, but not exceeding the amount of damages incurred by the other party. When calculating such financial benefit, the principles of sub-Clause (1) as to the calculation of damages shall apply mutatis mutandis.*"[5]

34. Clause 9(1) provides for the final payment of single compensation claim to the Party Entitled to Damages. It provides as follows:

> *Unpaid amounts and any other unperformed obligations, and the damages which are payable, shall be combined by the Party Entitled to Damages into a single compensation claim denominated in Euro, for which purpose a money equivalent in Euro shall be determined, in accordance with the principles set forth in Clause 8 sub-Clause (1) sentences 2 to 4, in respect of claims for performance of such other overdue obligations.*

35. Clause 9(2) concerns a single compensation claim *against* the Party Entitled to Damage and the set-off of Counterclaims against that claim.

36. Clause 12 provides an option for the specification of an interest rate under clause 3(4) by the parties. There is however no other provision for interest in the GMA. In particular, there is no contractual provision for interest in respect of the close-out amount payable pursuant to clauses 8 and 9 following the termination of the GMA.

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[5] Clause 8(2) may be varied by certain elections provided for in the standard form GMA in clause 12(4).

RELEVANT PROVISIONS OF THE BGB

37. A translation of the BGB can be found at **[Core/10]**. The provisions of the BGB most relevant to Issues 20 and 21 are set out in the following paragraphs.

38. Section 286 addresses the issue of whether there has been a default in respect of a payment obligation:

> "*(1) If the obligor, following a warning notice from the obligee that is made after performance is due, fails to perform, he is in default as a result of the warning notice. Bringing an action for performance and serving a demand for payment in summary debt proceedings for recovery of debt have the same effect as a warning notice.*
>
> *(2) There is no need for a warning notice if:*
>
> *1. a period of time according to the calendar has been specified,*
>
> *2. performance must be preceded by an event and a reasonable period of time for performance has been specified in such a way that it can be calculated, starting from the event, according to the calendar,*
>
> *3. the obligor seriously and definitively refuses performance,*
>
> *4. for special reasons, weighing the interests of both parties, the immediate commencement of default is justified.*"

39. The provisions of the BGB relevant to the interest payable on a defaulted obligation can be found at sections 288(1), 247 and 248:

(1) Section 288(1) provides that a defaulted money debt bears interest during the period of default at 5% per annum above the basic rate of interest:

> "*Any money debt must bear interest during the time of default. The default rate of interest per year is five percentage points above the basic rate of interest.*"

(2) Section 247 makes provision for the basic rate of interest to which 5% is to be added under section 288(1). The basic rate of interest is presently -0.83%:

"*(1) The basic rate of interest is [-0.83%][6]. It changes on 1 January and 1 July each year by the percentage points by which the reference rate has risen or fallen since the last change in the basic rate of interest. The reference rate is the rate of interest for the most recent main refinancing operation of the European Central Bank before the first calendar day of the relevant six-month period.*

(2) The Deutsche Bundesbank announces the effective basic rate of interest in the Federal Gazette without undue delay after the dates referred to in subsection (1) sentence 2 above."

(3) Section 248(1) outlaws agreements for the payment of compound interest:

"*An agreement reached in advance that interest due should in turn bear interest is void.*"

40. Section 288(4) provides that a claim for interest pursuant to section 288(1) does not prevent a claim for *further damage* suffered by reason of late payment of the money debt. It provides as follows:

"*(4) The assertion of further damage is not excluded.*"

41. The key provisions relevant to claims for damages are sections 249, 252 and 280

(1) Section 249 provides as follows:

"*(1) A person who is liable in damages must restore the position that would exist if the circumstance obliging him to pay damages had not occurred.*

(2) Where damages are payable for injury to a person or damage to a thing, the obligee may demand the required monetary amount in lieu of restoration. When a thing is damaged, the monetary amount required under sentence 1 only includes value-added tax if and to the extent that it is actually incurred."

(2) Section 252:

"*The damage to be compensated for also comprises the lost profits. Those profits are considered lost that in the normal course of events or in the special circumstances, particularly due to the measures and*

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[6] The zero rate reflects prevailing monetary policy in the Euro-zone, which supports negative interest rates in real terms.

precautions taken, could probably be expected."

(3) Section 280(2) makes clear that a default under section 286 BGB is required in order for the obligee to pursue a claim for *further damage* under section 288(4) BGB:

> "*(2) Damages for delay in performance may be demanded by the obligee only subject to the additional requirement of section 286.*"

EXPERT EVIDENCE

Experts

42. Judge Fischer is a former judge of the German Federal Court of Justice, Germany's highest appellate court. He was appointed in 1990 and was chairman of the ninth senate from 2003. He retired in 2008. The ninth senate specialises in bankruptcy, attorney and tax advisor liability (professional negligence) and the enforceability of foreign decisions.

43. Professor Mülbert is an academic at the University of Mainz. He specialises in aspects of banking law with a focus on credit transactions, guarantees and investor protection.

Reports filed

44. The experts have each filed three reports:

    (1) Judge Fischer and Professor Mülbert each filed their first reports on 16 July 2015. These are referred to as Fischer 1 **[4/8]** and Mülbert 1 **[4/7]**.

    (2) Each filed a reply report on 31 July 2015. These are referred to as Fischer 2 **[4/10]** and Mülbert 2 **[4/9]**.

    (3) Supplemental reports were then filed on 5 October 2015. These are referred to as Fischer 3 **[4/12]** and Mülbert 3 **[4/11]**.

45. Judge Fischer's reports are in German and have been translated to English. Professor Mülbert's reports are in English. It is expected that Judge Fischer will give his evidence in German with the aid of an interpreter and that Professor Mülbert will give his evidence in English.

46. The need for the supplemental reports arose as a result of the recent change of case by the SCG when it abandoned its reliance on clause 3(4) GMA and instead asserted a case based on section 288(4) BGB. The catalyst for this change of case was the expert report of Judge Fischer, filed report on 10 July 2015, in which he explained that clause

3(4) GMA had no relevance to the close-out amount payable by LBIE as clause 3(4) applied only to payments that were due prior to the termination of the GMA **[4/8].**

47. The change of case by the SCG led to a number of further questions of German law being raised for consideration by the experts and these questions are addressed in Fischer 3 and Mülbert 3.

48. Fischer 3 is confined to the areas for further evidence identified by the parties which were not already present in the first and second reports. Professor Mülbert has however filed a consolidated report. In order for the Court to understand how Professor Mülbert's opinion has developed and how his evidence has changed, his earlier reports are retained in the trial bundle alongside his consolidated report.

49. The joint meeting of the German experts took place on 19 October 2015. The Joint Statement was finalised on 22 October 2015. The Joint Statement is in German in accordance with the directions of the Court.

50. The Joint Statement contains the comments discussed by the German experts at the meeting. It does not include the new points that Professor Mülbert sought to add to the Joint Statement at the very last minute. The new points had not been raised by Professor Mülbert at the joint meeting of the German experts or foreshadowed in his expert reports.

51. These new points were provided to Judge Fischer in English despite (i) German being the first language of both Judge Fischer and Professor Mülbert; (ii) the joint meeting of the experts being conducted in German; (iii) the Court ordering that the Joint Statement be filed in German and then translated in English; and (iv) Professor Mülbert being fully aware that Judge Fischer does not prepare written materials in English.

52. One necessary consequence of this state of affairs was that Judge Fischer was unable to consider these new points within the tight timescale set for the preparation of the Joint Statement.

53. The SCG has now indicated that it wishes to serve a supplemental expert report which includes this new evidence. This is a most unsatisfactory way in which to conduct litigation. There is no proper explanation as to why this evidence was not included in the three reports filed to date by Professor Mülbert. Indeed, the new evidence seeks to address matters which were raised in Fischer 1 as long ago as July 2015.

Principal areas of disagreement as regards Issue 20

54. The principal areas of disagreement between Judge Fischer and Professor Mülbert as to the German law relevant to Issue 20 are as follows:

(1) The time at which the close-out amount under clauses 7 to 9 GMA became due for payment ("the Accrual Issue").

(2) The circumstances in which a default can be triggered in response to a delay in the payment of the close-out amount either ("the Default Issue"):

(a) by a warning notice under subsection 286(1) BGB; or

(b) by the inference of a serious and definitive intention not to perform the contract, the proof of which is an exception to the general rule that a warning notice is required under subsection 286(2) BGB.

(3) The circumstances in which can a claim for *further damage* can be expressed as a rate and how and by reference to what principal sum the rate is to be determined ("the Rate Issue").

55. The Court will be hearing oral evidence on this issue of German law and, in these circumstances, these submissions do not contain a detailed treatment of the relevant German legal principles and authorities. The key differences in the approach of the experts is summarised in the following paragraphs.

<u>Accrual Issue</u>

56. Judge Fischer considers that the close-out amount under the clauses 8 and 9 GMA became due only upon calculation of that amount following the termination of the

agreement: Fischer 3/30. Professor Mülbert, by contrast, says that the amount became due immediately upon the termination of the GMA under clause 7(2) upon LBIE's application for administration.

57. The experts agree that section 271(1) BGB is relevant to the resolution of this issue. It provides:

> "*Where no time for performance has been specified or is evident from the circumstances, the obligee may demand performance immediately, and the obligor may effect it immediately.*"

58. Professor Mülbert says that as no time for payment is specified in the GMA it follows from section 271(1) BGB that there is an immediate entitlement to demand payment and, hence, an immediately due obligation: see Mülbert 3/74.

59. Judge Fischer explains that, in absence of a specified time, section 271(1) BGB requires the Court to look what is "*evident from the circumstances*". In this respect, he considers it clear that the obligation to pay the close-out amount cannot be due before that amount is calculated. The calculation requires an election as to which of the specified bases are to apply to calculate that amount and a process of netting to be undertaken also: see Fischer 3/35-36.

60. If Judge Fischer is correct, there will have been no default at the time of LBIE's administration application or administration order. It would follow that:

    (1) There can be no claim for *further damage* as there was no default prior to LBIE's administration; and

    (2) In any event, and irrespective of whether *further damage* under section 288(4) BGB is a "*rate*" within the meaning of Rule 2.88(9), there will have been no entitlement to claim such damages at the commencement of the administration as required by *Waterfall IIA*.

Default Issue

61. Judge Fischer has consistently expressed the view that no default can have occurred under section 286 BGB with respect to the close-out amount under the GMA. He said in his first report that the fact that, following the opening of an insolvency proceeding, a debtor's assets are not his to control and legal process cannot be enforced against him precludes a default arising following the commencement of insolvency proceedings: see Fischer 1/64, 80 and 92; Fischer 3/37-43.

62. Professor Mülbert did not address this issue in his first report, although he agreed that a default was necessary for a claim for *further damage* to arise. He has since taken the position:

    (1) that Judge Fischer's view is based exclusively upon German insolvency law, which he considers to be of no relevance to LBIE's administration, which is governed by English insolvency law: see Mülbert 3/87-92; and

    (2) that, in any event, there is an applicable exception to the requirement for a warning notice to trigger a default under subsection 286(1), namely the inference, under subsection 286(2)(iii)[7], of a serious and definitive intention on the part of LBIE not to perform the GMA: see Mülbert 3/100-124.

63. Judge Fischer disagrees with the contention that his view of the ability to trigger a default post-insolvency is based upon German insolvency law: see Fischer 3/37-42. He bases his view on the requirements for a default under section 286 BGB which he says are not capable of satisfaction in the light of the legal effects of the opening of an insolvency proceeding. In this respect, in the light of the agreed administration summary provided to the German experts (the "Administration Summary"), he sees no qualitative difference between the effect of a German insolvency proceedings and the effect LBIE's administration. LBIE's administration, governed by English law, is productive of legal effects which mean that, as a matter of German law, there can be no default under section 286 BGB.

[7] Professor Mülbert also relies on subsection 286(2)(iv) in this respect, but he advances no additional argument as to why the requirements of that paragraph are satisfied. Moreover, this provision only applies in exceptional cases: see Fischer 3/53-54.

64. In any event, as regards subsection 286(1):

(1) it is understood that no warning notices have, in fact, been issued since the commencement of LBIE's administration;

(2) the filing of a proof of debt does not constitute a warning notice: see Fischer 1/64 and 80; Fischer 3/41-43; and

(3) the experts agree that a warning notice cannot be issued now as the proved debts have been paid in full: see Mülbert 3/95; Fischer 3/47.

65. Judge Fischer, moreover, disagrees with Professor Mülbert's new argument that a serious and definitive refusal to perform the GMA can be inferred from the fact or grounds of LBIE's administration application or order: see Fischer 3/48-52. Having regards to the Administration Summary, Judge Fischer is of the view that an administration application would not constitute a requisite declaration of intent not to perform (which has to be made to the creditor by the debtor) and, further, that no inference of serious and definitive refusal to perform the GMA is permitted given, in particular:

(1) the fact of insolvency is indicative only of a general inability to pay debts, not a refusal to perform a specific contract or pay a specific debt; and

(2) the fact that an administrator has the option to carry on all or part of a company's business including whether or not to adopt a contract or cause a contract to be performed.

66. For these reasons, Judge Fischer does not agree that a serious and definitive refusal to perform the GMA can be inferred from the fact or grounds of LBIE's administration application or administration order. He is of the view that there was no automatic and immediate default by LBIE at the time of its administration application or order: see Fischer 3/48-52.

67. If Judge Fischer is correct that there is no automatic and immediate default, there will have been no default at the time of LBIE's administration application or administration order. It would follow that:

(1) there can be no claim for *further damage* as there was no default prior to LBIE's administration; and

(2) in any event, and irrespective of whether *further damage* under section 288(4) BGB is a "*rate*" within the meaning of Rule 2.88(9), there will have been no entitlement to claim such damages at the commencement of the administration as required by *Waterfall IIA*.

Rate Issue

68. Professor Mülbert asserts that if the claimant's loss by reason of the delay in payment is "ongoing" in nature, rather than a definite loss suffered for a determined period, the Court will express an award of *further damage* under section 288(4) BGB as a rate, rather than as an amount: see Mülbert 1/34-39.

69. Professor Mülbert also says that any rate awarded may be combined with the minimum rate under section 288(1) BGB, or, alternatively, the creditor might elect to claim its entire loss by way of a claim under section 288(4): see Mülbert 1/ 66-67.

70. Judge Fischer agrees that the German court may express an award of *further damage* under section 288(4) as a rate rather an amount, at the election of the claimant, if either:

(1) *interest expense* is incurred in respect of additional borrowing as a result of the non-payment of the close-out amount; or

(2) *interest income* is lost as a result of a lost invest opportunity by reason of late payment of the close-out amount: see Fischer 1/84-87.

71. In either case, the rate to be awarded as *further damage* under section 288(4) BGB is to be determined by reference to any additional borrowing or the lost investment opportunity. Any additional borrowing or lost investment opportunity may be in *a*

different principal amount or for *a different tenor or investment term* relative to the close-out amount or the period for which it is outstanding. This means that the rate awarded and, for convenience, added to the rate to be paid on the unpaid amount, is determined by reference to a principal sum other than the unpaid debt: see Fischer 1/88-89.

72. If Judge Fischer is correct, any claim for *further damage* under section 288(4) BGB, even if expressed as a rate, cannot, in its nature, be said to be a "*rate*" applicable to the debt proved as required by Rule 2.88(9). It is a rate determined by reference to a different principal amount (as opposed to the debt proved) and only aggregated with the rate applied under subsection 288(1) BGB as a matter of practical convenience.

Principal areas of disagreement as regards Issue 21

73. The principal areas of disagreement between Judge Fischer and Professor Mülbert as to the German law relevant to Issue 21 are as follows:

    (1) whether an assignee of the claim for the close-out amount under clauses 8 and 9 the GMA might claim *further damage* in excess of those that might have been claimed by the assignor ("the Higher Rate Issue"); and

    (2) the particular matters that need to be proved by the creditor (whether the claim has been assigned or not) in order to establish a claim for *further damage* ("the Proof Issue").

Higher Rate Issue

74. The experts agree that a decision of the German Federal Court dated 25 September 1991[8] expressly left open the question of whether an assignee might claim *further damage* in excess of those that might have been claimed by the assignor: see Fischer 1/104; Fischer 2/38; Mülbert 1/69 fn 49, which acknowledges that the BGH was "*not taking a stand*" on whether higher damages could claimed; and Mülbert 3/125 fn 95.

[8] BGH, 25 September 1991 - VIII ZR 264/90, WM 1991, 2036

75. The experts agree that there are a number of views in the German legal literature as to whether and (if so) in what circumstances a higher claim might be made by an assignee relative to any damage suffered or which would have been suffered by the assignor. There are three views summarised at Fischer 1/100-103:

(1) a higher claim may be made by the assignee to recover its total loss;

(2) a higher claim may be made by the assignee, but only from the time that the debtor had knowledge of the assignment of the claim and only to the extent that the loss could have been foreseen by the debtor; and

(3) the assignee cannot recover more than the amount that would have been recoverable by the assignor as the position of the debtor cannot be made worse by the assignment of the claim.

76. Judge Fischer prefers the third view by which a higher claim cannot be made. This view is based on the generally applicable principle that the legal position of the debtor cannot be made worse by an assignment: see Fischer 1/104-106; Fischer 2/48. Thus, the debtor does not have to bear the detriment resulting from a greater loss incurred by the assignee.

77. Professor Mülbert disagrees with Judge Fischer principally on the ground that he considers that German law admits of no such general principle: see Mülbert 3/137-140.

Proof Issue

78. It is common ground that the burden of proof is placed on the party making the claim under the GMA: see Fischer 1/109; Fischer 2/50; Mülbert 3/49; 3/133; 3/146. There is, however, a difference in the views of the experts as to whether the burden of proof is relaxed in relation to certain aspects of the claim.

79. Professor Mülbert says that section 252 BGB is to be read with section 287 of the German Civil Procedure Code to permit a claimant for *further damage* to "estimate" its loss of profit and thereby satisfy the requisite standard of proof: see Mülbert 3/51-52.

80. Professor Mülbert also says that the (older) case law which permitted lending banks to recover as *further damage* the average profit which would have been earned in their ordinary lending business (had the unpaid amount been available to lend) is not confined to banks and would apply to other investors such as a hedge fund: see Mülbert 3/53-56.

81. Judge Fischer agrees that section 252 BGB is a special rule of damages which does permit lost profits to be assessed on the basis of the profit which could probably be expected in the normal course of events. It does not, however, except the need to plead and prove particular matters for *further damage* to be awarded: see Fischer 1/69; Fischer 2/25-26. On this basis, a loss of interest income cannot simply be assumed.

82. Judge Fischer considers that the few special cases in which a lending bank was able to claim lost profit based on what it would have earned in the course of its ordinary lending business are, firstly, confined to banks; and, secondly, reflect a time at which the rates under what are now sections 247 and 288(1) BGB were unusually low (in real terms sub-inflationary) such that a remedy had to be developed under what is not section 288(4) BGB. He doubts that those cases would now even be followed in relation to banks and considers that they would not be extended to other investors: see Fischer 1/70; Fischer 2/27.

83. There is however a threshold question of English law as to whether the disagreement between the experts regarding the Proof Issue is an issue of German law that the Court needs to determine or whether the law of the forum (English law) is the relevant law when considering these aspects of the measurement or quantification of damages.

ISSUE 20

Issue 20(1)

Whether and in what circumstances, following LBIE's administration, a creditor would be entitled to make a "damages interest claim" within the meaning of section 288(4) of the German Civil Code (BGB) on any sum which is payable pursuant to clauses 7 to 9 of the German Master Agreement?

84. As noted above, the SCG had previously contended that clause 3(4) GMA was applicable to any close-out amount payable by LBIE pursuant to clauses 8 and 9 GMA following the termination of the GMA. This case was supported by Professor Mülbert in his report filed on 10 July 2015 **[4/7]**.

85. Judge Fischer filed a report on 10 July 2015 in which he explained that clause 3(4) GMA had no relevance to the close-out amount payable by LBIE as clause 3(4) applied only to payments that were due prior to the termination of the GMA **[4/8]**.

86. The reply expert reports were filed on 31 July 2015. Professor Mülbert's report agreed that there was force in Judge Fischer's opinion on the inapplicability of clause 3(4) GMA to a close-out amount payable pursuant to clauses 8 and 9 GMA, but suggested that there may be a contrary argument **[4/9]**.

87. Following the service of the reply expert reports, the SCG decided to abandon its case based on clause 3(4) GMA (a case that it had advanced from the outset of the Waterfall II Application in 2014). The parties are now agreed that the GMA does not contain any contractual provision for the payment of interest on the close-out amount which becomes due from LBIE following the termination of the GMA. The SCG now advances a new case based on section 288(4) BGB.

88. It is common ground that, in order to make a claim for *further damage* under section 288(4) BGB, it is necessary to show a "*default*" in respect of the obligation to pay the close-out amount within the meaning of section 286 BGB.

89. The Court will be receiving expert evidence from Judge Fischer and Professor Mülbert relevant to the issue of whether there has been a default in respect of the obligation to pay the close-out amount within the meaning of section 286 BGB.

90. Wentworth contends that there are two independent reasons why the SCG is unable to establish a default under section 286 BGB. The first is based on the requirement in section 286 BGB that the payment obligation has fallen due; the second is based on the requirement in section 286 to satisfy the additional steps that must be taken to trigger a default.

91. First, a default is not capable of arising under section 286 BGB unless the payment obligation falls due prior to the commencement of insolvency proceedings. The effect of the GMA is that LBIE did not come under any payment obligation in respect of the close-out amount until the completion of the contractual netting process under clauses 8 and 9 GMA. This process was not complete until after the commencement of LBIE's administration. Accordingly, there was no defaulted payment obligation, as required by section 286 BGB, prior to LBIE's entry into administration.

92. Secondly, even if the close-out amount payable under clauses 8 and 9 GMA is found to have fallen due prior to LBIE's entry into administration, the SCG remains unable to establish the further matters required for a default under section 286 BGB. In summary:

    (1) there was no default by the service of a warning notice under section 286(1) BGB, the general rule by which a default might be declared; and

    (2) no exception to the general rule in section 286(1) (i.e. the requirement to serve a warning notice) is applicable in the present case.

93. The above points are developed in turn in the following paragraphs.

Default is not capable of arising under section 286 BGB unless the payment obligation falls due prior to the commencement of insolvency proceedings

94. There are three separate aspects to Wentworth's case on this issue:

(1) a default under section 286 BGB requires the payment obligation to be due;

(2) the close-out amount payable by LBIE under clauses 8 and 9 GMA did not become due prior to the commencement of LBIE's administration; and

(3) a default cannot be triggered following the commencement of LBIE's administration.

Default under section 286 BGB requires the payment obligation to be due

95. Section 280(2) BGB makes clear that a default under section 286 BGB is required in order for the obligee to pursue a claim for *further damage* under section 288(4) BGB. Accordingly, the SCG must establish a default within the meaning of section 286 BGB.

96. Section 286(1) BGB provides, in clear terms, that the requirement that the payment obligation has fallen due is a necessary gateway to a default:

> *If the obligor, following a warning notice from the obligee that is made after performance is due, fails to perform, he is in default as a result of the warning notice. Bringing an action for performance and serving a demand for payment in summary debt proceedings for recovery of debt have the same effect as a warning notice.* (emphasis added)

97. Judge Fischer and Professor Mülbert agree that a payment obligation must be due in order for a default to be capable of arising under section 286 BGB: Fischer 1/63-64; Mülbert 3/29, 32, 36 and 102.

Close-out amount did not become due prior to the commencement of LBIE's administration

98. The GMA is governed by German law and is to be interpreted according to the German principles of construction. The relevant principles of construction, which are not disputed, may be summarised as follows:

(1) Under German law contractual interpretation is to be guided by sections 133 and 157 BGB. These are set out at Fischer 1/29. The objective is to "*ascertain the true intention rather than adhering to the literal meaning*".

(2) The starting point for interpretation is the wording of the contract. Contracts must be interpreted in good faith, taking account of customary practice, the purpose of the contract, and the circumstances under which contract came into being.

(3) The terms of a contract are normally to be interpreted in accordance with their objective meaning.

99. When the above principles are applied to the GMA, it is clear (as supported by the expert reports of Judge Fischer) that the close-out amount payable under clauses 8 and 9 did not become due prior to the commencement of LBIE's administration. In particular:

(1) The party to be paid will not be known until after the termination of the GMA. This is because – notwithstanding that the label "Party Entitled to Damages" is applied to the "solvent party" – the calculation of damages may result in an amount owed to the "insolvent party" by the "solvent party". It is a 'two-way' damages calculation.

(2) The Party Entitled to Damages has to elect whether to use actual replacement transactions in the market or to apply its mind to the price of hypothetical replacement transactions under clause 8(1).

(3) The Party Entitled to Damages has to account for any financial benefit to it arising from the termination as a reduction of any damages entitlement under clause 8(1).

(4) The Party Entitled to Damages has to combine any amount due with other amounts to produce the entitlement to a single compensation claim under clause 9(1).

(5) The above exercise may result in a compensation claim owed to the Party Entitled to Damage, a nil balance either way, or to a compensation claim payable to the insolvent party, if the Party Entitled to Damages has received an overall financial

benefit, e.g. by release from the future performance of out-of-the-money derivative positions.

(6) There is no stipulation in the GMA which seeks to deem the close-out amount as being due with effect from the date of the termination of the GMA.

100. Accordingly, the natural construction of the GMA is that the close-out amount becomes due only upon its calculation, which is the earliest time at which an amount owed might have been identified and demanded. It cannot have been the parties' intention to constitute a default before the earliest time it could have been known what (if any) amount was to be paid.

101. Professor Mülbert's reliance upon section 271(1) BGB is misplaced: see Mülbert 3/74. Section 271(1) BGB simply requires the Court, in the absence of a stipulation as to time for payment in an agreement, to consider the circumstances when deciding when payment is due: Fischer 3/35-36. For the reasons given above, it clear that the obligation to pay the close-out amount cannot be due before that amount is calculated. The calculation requires an election as to which of the specified bases are to apply to calculate that amount and a process of netting to be undertaken.

102. Accordingly, there was no defaulted payment obligation, as required by section 286 BGB, prior to LBIE's entry into administration.

Default cannot be triggered following the commencement of LBIE's administration

103. Wentworth contends that a default within the meaning of section 286 is not capable of arising unless the payment obligation became due prior to the commencement of insolvency proceedings.

104. As explained in the following section of these written submissions, a default cannot be triggered following the commencement of LBIE's administration.

No default under section 286 BGB even if the close-out amount was due prior to LBIE's entry into administration

105. There are two separate aspects to Wentworth's case on this issue:

    (1) The inability to constitute a default under section 286(1) BGB by the legal effective service of a warning notice after the commencement of LBIE's administration; and

    (2) The lack of any applicable exception to the general rule in section 286(1) (i.e. the requirement to serve a warning notice) in the present case.

<u>No default by a warning notice served after the commencement of LBIE's administration</u>

106. Wentworth contends that it is not possible for a default to be triggered after the commencement of LBIE's administration.

107. One aspect of Wentworth's case is that a warning notice served after the commencement of LBIE's administration is not capable of triggering a default under section 286(1): see Fischer 1/64 and 80; Fischer 3/37-40.

108. It is common ground that a warning notice requires the obligee to make a clear and definite demand for payment of an amount that is due: see JS/22.

109. Judge Fischer and Professor Mülbert agree that an effective warning notice cannot be served following the commencement of German insolvency proceedings: see Fischer 3/38 and Mülbert 3/88. Judge Fischer and Professor Mülbert disagree on whether an effective warning notice can be served following the commencement of LBIE's administration. The Court will be hearing oral evidence on this issue of German law and, in these circumstances, these submissions do not contain a detailed treatment of the relevant German legal principles and authorities. In summary:

(1) Wentworth's position is supported by the 1928 decision of the then German Supreme Court (*Reichsgericht*) and by a number of distinguished commentators. The following passage is taken from the judgment of the Supreme Court[9]:

> "*The supreme court appeal, finally, seeks a review of whether the plaintiff went into default because the defendant filed its claim in the bankruptcy proceedings against the plaintiff's assets; this question must be answered in the negative. By opening the bankruptcy proceedings under KO [Konkursordnung, the predecessor of present German Insolvency Code (InsO)] sec. 6, the plaintiff forfeited the power to dispose of its assets belonging to the bankruptcy estate. Therefore the filing of the bankruptcy claim to be entered in the schedule of claims entails no demand made to the debtor for payment; after all, such a demand could not have been satisfied. It also has not attained that significance subsequently after the suspension of proceedings for lack of sufficient assets, especially because the defendant has not contended that it initiated anything else for the collection of its claim after that claim had been disputed by the bankruptcy administrator during the audit meeting.*"

(2) The reason for the inability to trigger a default following the commencement of German insolvency proceedings arises from the fact that, following the commencement of the insolvency proceedings, the debtor's assets are no longer in its control and there is a moratorium on legal process against the debtor. Claims must instead be established by way of proof in the insolvency, and claims are to be discharged by the payment of dividends in the insolvency.

(3) The English administration regime shares these features. In particular: (i) a statutory moratorium on legal proceedings is imposed on the making of an administration application and continued from the commencement of administration; (ii) from the time of the administration order the company's assets are to be dealt with in accordance with the statutory scheme of administration: see *Re Polly Peck International plc (No.4)* [1998] 2 BCLC 185; *Re Lehman Brothers International Europe (in administration)* [2010] 2 BCLC 301[10]; and (iii) further,

[9] RG, 06 June 1928 - I 328/27, RGZ 121, 207, 211

[10] In *Re Polly Peck International plc (No 4)*, Mummery LJ stated as follows (at pp201-202):

> "*The provisions of that code apply both to the case of an insolvent company which has gone into formal liquidation and to one in respect of which an administration order has been made. The essential characteristic of the statutory scheme is that the liquidator or administrator is bound to deal with the assets of the company as directed by statute for the benefit of all creditors who come in to prove a valid claim. There is a statutory obligation on the administrators of PPI to treat the general creditors in a particular way.*"

from the time of the giving of notice of an intention to distribute the assets are held on a statutory trust for the purpose of distribution to meet the claims of creditors who have proved their claims in the administration[11].

110. Accordingly, the SCG is unable to rely on section 286(1) to trigger a default in the present case as no warning notices were served prior to LBIE's entry into administration.

111. In any event, the SCG cannot, even on its own case, gain any assistance from section 286(1) as:

(1) No warning notices were, in fact, served by the contractual counterparties to the GMA after the commencement of LBIE's administration. The filing of a proof of debt in LBIE's administration does not constitute the service of a warning notice. This conclusion follows from German authority that the filing of a proof of debt in a German insolvency proceeding does not constitute the service of a warning notice: see Fischer 3/37-40; JS/23; and

(2) Judge Fischer and Professor Mülbert agree that no warning notice can now be served as the proved debts under the GMA have been paid in full: see Mülbert 3/95 and JS/25.

In *Re Lehman Brothers International Europe (in administration)*, Briggs J approved and applied this statement of principle in respect of LBIE under the post-Enterprise Act administration regime (at [204]):

> "*The insolvency code which has that principle at its heart applies just as much to a company in administration as it does to a company in liquidation, and takes effect from the date of the administration order.*"

See also the observations of the Court of Appeal in *Bloom v Harms Offshore* [2010] Ch 186-187 at [22]-[24]:

> "*I do not accept that the protection of the assets of a company in administration is to be regarded by the court as differing in substance from the protection of the assets of a company in compulsory liquidation. In both cases, the assets of the company are dealt with by an officer appointed by the court in accordance with statutory duties…[T]he creditors of a company in administration are entitled to have the company and its assets dealt with in accordance with the statutory scheme applicable to such companies*."

[11] *Revenue and Customs Commissioners v Football League Ltd* [2013] 1 BCLC 285, 310-311 at [100]-[104] *per* David Richards J, applying *Ayerst (Inspector of Taxes) v C & K (Construction) Ltd* [1976] AC 167.

No exception to section 286(1) BGB which is applicable in the present case

112. The inability of the SCG to rely on section 286(1) means that it has therefore to establish an automatic and immediate default prior to the making of the administration order in respect of LBIE. It is for this reason that the SCG contends that the fact of an administration application constitutes an automatic and immediate default under section 286(2)(iii) BGB. As set out above, section 286(2)(iii) BGB requires the creditor to discharge the very high burden of establishing that the obligor "*seriously and definitively refuses performance*".

113. It is established by a decision of the Munich Court of Appeal that the exception would not apply in circumstances where a party entered into a German insolvency proceeding: see Mülbert 3/104. Judge Fischer's evidence is that the same conclusion follows in relation to an application for an English administration order by reason of the common features shared between an administration and a German insolvency proceeding: see Fischer 3/37-40 and 47-50; whereas Professor Mülbert seeks to argue that an administration application would trigger the exception: see Mülbert 3/83 and 96-124. The Court will be hearing oral evidence relevant to this issue of German law and, in these circumstances, these submissions do not contain a detailed treatment of the relevant German legal principles and authorities.

114. The resolution of this issue will also require the Court to consider the nature of administration so as to determine whether the SCG is able to establish that the administration application in respect of LBIE constituted a serious and definitive refusal by LBIE to perform its obligations under the GMA giving rise to an automatic and immediate default under section 286(2)(iii) BGB.

115. Wentworth draws attention to the following matters in support of its case that the administration application did not constitute an automatic and immediate default under section 286(2)(iii) BGB.

    (1) Section 286(2)(iii) BGB is an exception to the general rule that a warning notice is required and is to be construed narrowly in accordance with "strict requirements": see Fischer 3/37 and 48.

(2) Section 286(2)(iii) BGB requires any declaration of an intent not to perform to be addressed by the debtor to the creditor. By contrast, an administration application is addressed to the Court, not any creditor: see Fischer 3/37 and 48.

(3) Administration is a non-terminal insolvency proceeding which does not automatically terminate contracts or trigger a default under a contract. An administrator has the power to cause the company to carry on all or part of its business or to perform any executory contract to achieve one or more purposes of administration. In the absence of an express provision in a contract, administration does not, as a matter of English law, automatically terminate a contract or trigger a default under a contract. A serious and definitive intention not to perform cannot, therefore, be inferred under section 286(2)(iii) BGB from making of an administration application.

(4) In *Re MTI Trading Systems Ltd* [1998] BCC 400, 402-03, Saville LJ said of the pre-Enterprise Act administration regime:

> "*It seems to me that there is a sharp distinction to be made between winding-up and administration orders. The former bring the life of the company to an end; the latter are designed to revive, and to seek to ensure the continued life of the company if at all possible.*"

(5) This observation has been affirmed and applied post-Enterprise Act in *Hammonds (a firm) v Pro-Fit USA Ltd* [2008] 2 BCLC 159 at [41]-[52] *per* Warren J.

(6) In *Re MF Global UK Ltd (in special administration)* [2013] 1 WLR 3874 the Court considered whether the appointment of special administrators was analogous to a winding-up such that it could be said to have triggered an automatic termination under a Global Master Repurchase Agreement ("GMRA"). David Richards J found that the special administration had not triggered automatic termination of the GMRA. The Judge explained the essential differences between winding-up and administration as follows (at [52]):

> "*In my judgment, Mr Zacaroli is correct in his submission that the essential characteristic of a liquidation and the appointment of a liquidator, which distinguishes them from other insolvency proceedings and the appointment of other officers, is that the sole purpose of a liquidation is the realisation of*

assets and the distribution of assets amongst creditors. Save in limited circumstances and then only for a limited time, the business of the company will cease upon the appointment of a liquidator. This distinguishes liquidation from the numerous other insolvency proceedings listed in the definition of act of insolvency in the GMRA, including in particular administration. An administration and other insolvency proceedings may result in the realisation of a company's assets and a distribution of the proceeds among creditors, but the alternative of a rescue of the company as a going concern is at least one of the purposes or objectives of those proceedings. In those cases it is understandable that the non-defaulting party under the GMRA would wish to have an opportunity to wait and see how the proceedings develop before deciding whether to exercise its right to serve a notice declaring an event of default and thereby close out all outstanding transactions under the GMRA, particularly where the protection provided by paragraph 6(j) has been incorporated into the agreement."

(7) There is nothing in the administration application filed in respect of LBIE that impacts on the above conclusion. The fact that the administration application required LBIE to establish that it was or was likely to become unable to pay its debts is a factor common to all administration applications and does not permit a necessary inference that LBIE's obligations under the GMA would not be performed.

116. The SCG's failure to satisfy the test under section 286(2)(iii) on the basis of LBIE's administration application should be unsurprising because the test of an objective inference of a serious and definitive refusal to perform under German law is very similar to the test of an objective inference of a repudiation or inevitable breach under English law.

117. An administration order (let alone an administration application) does not, as a matter of English law, permit the inference that a company intends to repudiate a contract, let alone import the automatic acceptance of a repudiation. The prospect that a business might be carried on in whole or in part, even for the limited purpose of a beneficial winding up, is reflected in the approach of English contract law to the question of whether a repudiation or anticipatory breach might be inferred, without more, from the opening of insolvency proceedings. In this regard:

(1) The Court of Appeal has recently re-stated the test for repudiation in *Eminence Property Developments Ltd v Kevin Christopher Heaney* [2011] 2 All ER (Comm) 223, where Etherton LJ said at [61]:

> "*[T]he legal test is simply stated, or, as Lord Wilberforce put it, "perspicuous". It is whether, looking at all the circumstances objectively, that is from the perspective of a reasonable person in the position of the innocent party, the contract breaker has clearly shown an intention to abandon and altogether refuse to perform the contact."*

(2) In relation to bankruptcy it was held as long ago as 1874 that the fact of bankruptcy, without more, was not sufficient to permit the inference of an intention to repudiate or an inevitable non-performance by the debtor or his representatives. In *Morgan v Bain* (1874-75) LR 10 CP 15, Brett J explained at 26:

> "*In this case the plaintiffs petitioned the Court of Bankruptcy, and so gave notice to all their creditors that they were insolvent. Now, whatever may have been thought at one time on this subject, it appears to be the law that mere insolvency does not per se put an end to the contract. But the plaintiffs had become insolvent, and had informed the defendants of the fact. I think the effect of the judgment of Mellish, L.J., in the case of Ex parte Chalmers 13, is not that insolvency puts an end to the contract, or alters it, but that when one contracting party gives notice to the other that he is insolvent, and does nothing more, the other party has a right to assume that he intends to abandon the contract. The Lord Justice says, "If an insolvent has any such beneficial contracts, it is his duty to inform his creditors or the court of bankruptcy, if the case be within its jurisdiction, of the fact, and he can then apply to have a sufficient part of his assets applied for the completion of the contracts; and if the contracts were beneficial, this would no doubt be allowed by his creditors or by the Court. If this were done, and due notice were given to the creditor, I entertain no doubt he would be bound to complete the contract on his part, and would not be allowed to take advantage of the insolvency of the other party to put an end to the contract. But when the insolvent or his trustee does nothing of the kind, he practically gives notice to his creditors and to those with whom he has contracted that he does not mean to pay any of his debts or perform any of his contracts." The meaning of this seems to be that when the fact of insolvency is communicated to the vendor, a duty arises on the part of the insolvent to negative the presumption, that the vendor would be otherwise entitled to draw, that the insolvent intends to abandon the contract.*"

(3) Accordingly, even a bankruptcy – a proceeding designed solely to release a debtor's person from his liability and to distribute his bankruptcy estate in satisfaction of those liabilities – does not entitle a counterparty to assume an

inevitable non-performance by the debtor's representatives. The onus is upon the debtor's representatives (under the modern legislation, his trustee in bankruptcy) to affirm or disclaim the contract and time is allowed for that.

(4) Perhaps unsurprisingly, the authorities also support the fact that the commencement of an administration does not permit the inference of an intention to repudiate or an inevitable non-performance by the debtor or his representatives: see *Astor Chemicals Ltd v Synthetic Technology Ltd* [1990] BCC 97; *Re P&C v R&T (Stockport) Ltd* [1991] BCC 98; *Re Olympia and York Canary Wharf Ltd (No 2)* [1993] BCC 159; *Re Joint Administrators of Rangers Football Club plc* [2012] SLT 599, at [52]; Fletcher, Higham and Trower (2nd ed.), at p153.

(5) The making of an administration application, including the jurisdictional condition of the company's inability or likely inability to pay its debts, does not therefore permit the inference of inevitable non-performance or of an objective intention not to perform, applying the tests for repudiation and anticipatory breach under English law. This is expressly acknowledged in the Administration Summary, at paragraph 1.10.

118. Accordingly, it is difficult to see how an administration application can be treated as establishing a serious and definitive refusal by LBIE to perform its obligations under the GMA so as to give rise to an automatic and immediate default under section 286(2)(iii) BGB.

Issue 20(2)

If the answer to question 20.1 is yes, whether (and if so, in what circumstances) all or part of such "damages interest claim" can constitute part of "the rate applicable to the debt apart from the administration" for the purpose of Rule 2.88(9)

119. Wentworth contends that a claim for *further damage* under section 288(4) BGB does not constitute part of the "*rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9). It relies on three independent reasons, each of which is sufficient to defeat the SCG's case.

120. First, the necessity of a warning notice to trigger a default (and thereby to admit of the possibility of claim to *further damages* under section 288(4) BGB) negates any characterisation of such a claim as the rate applicable to the proved debt "*apart from the administration*" for the purposes of Rule 2.88(9).

121. Secondly, even if a default under section 286 BGB was triggered prior to the commencement of LBIE's administration, a claim to *further damage* under section 288(4) BGB is still not a "*rate*" applicable to the proved debt "*apart from the administration*". A claim for *further damage* under section 288(4) BGB must be pleaded and proved to the satisfaction of the Court. Accordingly, it is not appropriate to characterise it as a "*rate*" applicable to the proved debt at the commencement of the administration "*apart from the administration*" for the purposes of Rule 2.88(9).

122. These above two reasons are conveniently taken together, before the third reason, as they flow directly from the conclusions reached by David Richards J in the *Waterfall IIA*, at [171]-[182].

123. The issues before the Court in *Waterfall IIA* included the question of whether "*the rate applicable to the debt apart from the administration*" in Rule 2.88(9) are apt to include (and, if so, in what circumstances) a foreign judgment rate of interest or other statutory interest rate.

124. It should be noted that the SCG did not seek to contend, at the *Waterfall IIA* trial, that section 288(4) BGB was a statutory rate of interest which satisfied the requirement of being a "*rate applicable to the debt apart from the administration*". No doubt this was

because the hearing took place prior to the SCG's abandonment of its case founded on clause 3(4) GMA.

125. The SCG did contend, however, that a creditor entitled under the terms of its contract to bring proceedings in New York should be entitled to statutory interest at the rate of 9% (as opposed to the Judgments Act Rate of 8%) on the basis that this rate would be applicable to a New York judgment. The submission of the SCG is recorded at [173]:

> "*…the SCG and York submit that the words "the rate applicable to the debt apart from the administration" are apt to include not only a rate which is in fact applicable to the debt but also a rate which <u>would</u> be applicable to the debt if the creditor obtained judgment for it.*" (emphasis added)

126. David Richards J rejected the submission of the SCG. The learned Judge held that the "*rate applicable to the debt apart from the administration*" was to be determined solely by reference to the rights of the creditor at the commencement of the administration. He found that it was not permissible for a creditor to rely on a rate which would be applicable to a debt if a creditor took certain steps after the commencement of the administration. The key passages of the judgment, which are directly applicable to the arguments pursued by the SCG in support of its new case based on section 288(4) BGB, can be found at *Waterfall IIA*, [177]-[183].

127. The SCG's case on section 288(4) is analytically no different from its case in relation to the New York Judgment Act which was rejected by the Court in *Waterfall IIA*.

128. As to the first reason relied upon by Wentworth, the requirement to take the further step of serving a warning notice to trigger a default (and thereby to admit of the possibility of claim to *further damages* under section 288(4) BGB) means that the reasoning in *Waterfall IIA* is directly applicable to the attempt of the SCG to rely on section 288(4) BGB. It does not constitute a "*rate applicable to the debt apart from the administration*" by reason of the rights held by the creditor at the commencement of the administration.

129. As to the second reason relied upon by Wentworth, the requirement for *further damage* under section 288(4) BGB to be pleaded and proved to the satisfaction of the Court based on the actual damage suffered by the creditor means that the reasoning in

Waterfall IIA is directly applicable to the attempt of the SCG to rely on section 288(4) BGB. It does not constitute a "*rate applicable to the debt apart from the administration*" by reason of the rights held by the creditor at the commencement of the administration.

130. The SCG is unable to distinguish the present situation from *Waterfall IIA* on the footing that a right to claim *further damage* is analogous to a tortious claim in respect of which damage has occurred as at the administration date and, from that perspective, is distinct from a suit not yet commenced in a foreign jurisdiction. The construction of Rule 2.88(9) is, as the Judge made clear in *Waterfall IIA*, at [182], not to be conflated with the concept of provability under Rule 13.12:

> *"The determination of the existence of debts and liabilities for the purposes of proof, governed by Rule 13.12, is irrelevant to the meaning of the phrase "the rate applicable to the debt apart from the administration" in rule 2.88(9)"*

131. The contingencies which might result in an award of *further damage* are analytically no different from those in relation to a foreign judgment act rate. Indeed, a claim for further damages under section 288(4) BGB is in fact more remote. This is because an award of damages and how that is expressed are ultimately matters for the Court, whereas an award of post-judgment interest is at a prescribed rate.

132. The third reason relied upon by Wentworth is that, a claim for *further damage*, even if expressed as a rate, is without the necessary properties under German law as would permit its characterisation, as matter of English insolvency law, as the "*rate*" applicable to the debt proved for the purpose of Rule 2.88(9), as opposed to a rate referable to some *other* amount.

133. The Court will be hearing oral evidence relevant to necessary properties under German law of a claim for *further damage* and, in these circumstances, these submissions do not contain a detailed treatment of the relevant German legal principles and authorities. In summary:

(1) The practice of the German court is to allow a claimant to elect to have a claim for *further damage* expressed as a rate if, as a result of the delay in payment of

the debt due, the claimant has either incurred an interest expense to close the 'funding-gap' as a result of the delay or suffered a loss of interest income by reason of an investment opportunity lost by reason of the 'funding gap'. In such a case, the rate awarded is based upon the sum borrowed or which would have been invested and not the amount owed to the claimant.

(2) The significance of the need for an election by the claimant and the ultimate control of the remedy by the Court is that it cannot be said that there is any necessary connection in terms of a "*rate*" between *further damage* and the unpaid amount. If awarded at all, it can only be said that such *further damage* might be expressed as a rate.

(3) This basic distinction is reflected in the language of the BGB:

(a) A right to claim *further damage* under section 288(4) BGB is distinct from the right to default interest under section 288(1) BGB. The distinction is emphasised by the distinct expressions for each concept in the German language:

(i) "Basiszinssatz" (basic rate of interest);

(ii) "Verzugszinssatz" (default rate of interest); and

(iii) "Geltendmachung weiteren Schadens" (assertion of further damage).

(b) The German terms for interest rate, whether basic or default, imply a right to interest expressed as a rate to be applied to a principal sum. The German term for damages does not imply this; rather, it implies a claim to damages to be proven on the facts in the light of the loss suffered.

(4) Accordingly, a claim for *further damage* is not to be characterised as a "*rate*" applicable to the debt proved as at the commencement of the administration. It

cannot therefore be "*the rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9).

ISSUE 21

Issue 21(i)

If the answer to question 20(2) is that a further claim for damages can be included as part of the "rate applicable to the debt apart from the administration" for the purposes of Rule 2.88(9), how in such circumstances is the relevant rate to be determined?

(i) in circumstances where the relevant claim under the German Master Agreement has been transferred (by assignment or otherwise) to a third party, is it the Damages Interest Claim which could be asserted by the assignor or the assignee which is relevant for the purposes of Rule 2.88(9)?

134. Issue 21 does not arise for determination in circumstances where the answer to Issue 20 is that a claim for *further damage* under section 288(4) cannot be included as part of the "*rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9).

135. Wentworth contends, in the event that the Court wishes to determine Issue 21, that the *further damage* which could be asserted by the assignee under section 288(4) following the assignment of the claim is not relevant for the purposes of Rule 2.88(9).

136. The short point is that the reasoning of the *Waterfall IIA* judgment means that the *further damage* of the assignee cannot be relevant. Wentworth relies upon the following:

    (1) the *Waterfall IIA* judgment establishes that the "*rate*" applicable to the proved debt "*apart from the administration*" is to be determined by reference to the rights of the creditor as at the commencement of the administration: see *Waterfall IIA*, at [177]-[183];

    (2) the "*rate*" applicable to the proved debt (assuming for present purposes that a claim for *further damage* is a "*rate*" in the relevant sense) at the commencement of the administration is determined by reference to the damages incurred by the assignor;

(3) the assignment of the proved debt has taken place after the commencement of the administration;

(4) the SCG accepts that the assignee can assert a claim for *further damage* only by reference to the period following the assignment; and

(5) accordingly, it is not understood how an assignee's claim for *further damage* under section 288(4) can be said to be applicable to the debt proved at the commencement of the administration as required by *Waterfall IIA*. The assignee's claim necessary post-dates the commencement of the administration.

Issue 21(ii)

If the answer to question 20.2 is that a further claim for damages can be included as part of the "rate applicable to the debt apart from the administration" for the purposes of Rule 2.88(9), how in such circumstances is the relevant rate to be determined?

(ii) where the relevant claim under the German Master Agreement has been acquired by a third party, in what circumstances (if any) is such a third party precluded from asserting a Damages Interest Claim under principles of German law?

137. Wentworth contends (as supported by the expert reports of Judge Fischer) that German contract law recognises a principle that the debtor should not be prejudiced by an assignment of a claim.

138. The principle is implicit in the BGB and recognised by the German Federal Court. The effect of the principle is that the assignee is necessarily limited to the *further damage* claim that the assignor could have asserted.

139. The Court will be hearing oral evidence relevant to this issue of German law and, in these circumstances, these submissions do not contain a detailed treatment of the relevant German legal principles and authorities. Wentworth contends, in summary, as follows:

    (1) The German Federal Court, in a decision dated 25 September 1991[12], expressly left open the question of whether an assignee might claim *further damage* in excess of those that might have been claimed by the assignor: see Fischer 1/104.

    (2) It is implicit in the BGB, in particular by reason of section 404 BGB, the legal position of the debtor cannot be made worse by an assignment. Section 404 BGB provides as follows:

        "*The obligor may raise against the new obligee the objections that he was entitled to raise against the previous obligee at the time of assignment.*"

    (3) The German Federal Court has, in a number of decisions, taken a broad view of the effect of section 404 BGB and the principle which it reflects. These decisions

[12] BGH, 25 September 1991 - VIII ZR 264/90, WM 1991, 2036

have interpreted section 404 BGB as requiring that the legal position of the debtor should not be made worse by an assignment of the claim to the new creditor: see Fischer 1/104-105.

(4) There is a further general principle of German law that a contract should not impose obligations on a third party. One consequence is that a contract of assignment cannot by its terms make worse the position of the debtor. This principle informs whether an assignment should, by the effect of the transfer, enable the debtor to be placed in a worse position. Accordingly, the debtor does not have to bear the detriment resulting from a greater loss incurred by the assignee: see Fischer 1/105

(5) There are strong policy reasons why an assignee should not be able to recover a greater loss than the assignor as such a conclusion would encourage 'debt-trafficking' to the detriment of the debtor: for example, an assignment on the footing that some part of the higher damages are rebated back to the assignor: see Fischer 1/106.

(6) Moreover, the assignees are very likely to have purchased the claims under the GMA at a discount to their face value. It would represent an unfair windfall to the creditor and an unjustifiable detriment to LBIE if, in these circumstances, the creditor could assert a higher claim for *further damage* than that which could have been asserted by the assignor.

Issue 21(iii)

If the answer to question 20.2 is that a further claim for damages can be included as part of the "rate applicable to the debt apart from the administration" for the purposes of Rule 2.88(9), how in such circumstances is the relevant rate to be determined?

(iii) where does the burden of proof lie in establishing a Damages Interest Claim, and what is required to demonstrate, that a relevant creditor has or has not met such requirement?

140. It can be seen that Issue 21(iii) concerns the burden of proof in establishing a claim for *further damage* and the boundaries that are placed on such a claim.

141. It is common ground that the creditor asserting the claim bears the burden of proof in establishing a claim for *further damage*.

142. There are then a number of points in relation to the boundaries that are placed on a claim for *further damage*.

143. The most significant issue on which the experts disagree are:

    (1) Whether claimants apart from banks can rely on a simplified method of calculating losses: see Mülbert 3/56; Fischer 1/69-70 and Fischer 2/27.

    (2) Whether a claimant for *further damage* under section 288(4) is able to rely upon section 287 of the German Civil Procedure Code which permits an estimate to be made for loss of profits (recoverable as damages under section 252 BGB) in circumstances where the actual loss of return is not clear: see Mülbert 3/51-55; Fischer 2/22-26.

144. The Court will be hearing oral evidence relevant to this issue of German law and, in these circumstances, these submissions do not contain a detailed treatment of the relevant German legal principles and authorities. Wentworth contends, in summary, as follows:

(1) It is only banks that benefit from the simplified method of calculating losses. This position is supported by a Judge of Germany's highest court: see Mülbert 3/56.

(2) A claim for loss of profits requires the creditor to prove, on a balance of probabilities, all of the facts on which the Court is to conduct an estimate of damage. For example, the creditor will be required to prove the kind of investment that would have been made if the debt had been paid and the likely profit that investment would have ordinarily made. Accordingly, a loss of profits cannot be assumed.

(3) In any event, there is a threshold problem that the SCG's case on loss of profits is founded squarely on section 287 of the German Civil Procedure Code. It is a provision of civil procedure which is inapplicable in the English court (as the forum in which any disputes in relation to the GMA claims would be resolved), which will apply only foreign substantive law:

    (a) The distinction between foreign substantive law and foreign procedural rules is clear from *Harding v Wealands* [2007] 2 AC 1. The House of Lords affirmed the long standing rule of the common law that questions of procedure – including measuring or quantifying damages – are governed by the law of the forum.

    (b) The distinction between substance and procedure is observed by Article 12(1)(c) of the Rome I Regulation (No. 593/2008) (on the law applicable to contractual obligations): see Dicey, Morris & Collins, The Conflict of Laws 15th Ed at 32-154; *Stylianou v Toyoshima* [2013] EWHC 2188 (QB), at [92].

    (c) Accordingly, section 287 of the German Civil Procedure Code is irrelevant to a claim made in England against LBIE.

CONCLUSION

145. The Court is therefore invited to answer Issues 20 and 21 as follows:

(1) Issue 20(1): a creditor is not entitled, following LBIE's administration, to make a claim for *further damage* under section 288(4) BGB on any sum which is due under clauses 8 and 9 GMA.

(2) Issue 20(2): a claim for *further damage* under section 288(4) BGB does not constitute all or part of the rate applicable to the debt apart from the administration for the purpose of Rule 2.88(9).

(3) Issue 21(i): a claim by an assignee of a close-out amount under the GMA for its *further damage* under section 288(4) BGB does not constitute a rate applicable to the debt apart from the administration for the purpose of Rule 2.88(9).

(4) Issue 21(ii): the assignee of a close-out amount under the GMA can have no greater claim to *further damage* than that which would have been available to the assignor.

(5) Issue 21(iii): the creditor bears the burden of proof in establishing a claim for *further damage* on a balance of probabilities.

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