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

REPLY POSITION PAPER

Introduction

1. This paper summarises the position of Goldman Sachs in response to the position papers filed by Wentworth and the Joint Administrators on 6 August 2015 and 20 August 2015, respectively.

2. This position paper adopts the defined terms used in Goldman Sachs' position paper of 23 July 2015.

3. On 27 August 2015, Goldman Sachs received from the Joint Administrators a request for further information in relation to certain parts of Goldman Sachs' position paper of 23 July 2015. Goldman Sachs will respond to the request for further information separately.

Response to Wentworth's position paper

4. Wentworth's position paper raises only two arguments relevant to the construction of the definition of the "Default Rate", namely:

   (1) That the requirement to certify a "Default Rate" for a particular period implies that the "Default Rate" can only be a cost of borrowing (paragraphs 2-3); and

   (2) That it is difficult to calculate a cost of funding based on a cost of equity funding, implying that the definition of Default Rate can again only be a cost of borrowing (paragraphs 5-7).

5. Both arguments are misconceived, for the reasons set out below.

The requirement to certify a Default Rate for a particular period

6. Wentworth notes that the definition of Default Rate requires the cost of funding the Relevant Amount to be certified "for a period", being the period that the Relevant Amount is outstanding (paragraphs 2-3). This is correct. The period for which the Relevant Amount is outstanding will only be known once the Relevant Amount is paid in full by the Defaulting Party.

7. However, Wentworth then argues that this *"implies that the amount to be funded is required to be repaid at the end of the period, which is an essential feature of borrowing, not of equity"* (paragraph 3).[1]

8. The short answer to this point is that the definition of Default Rate implies no such thing. The Default Rate must necessarily be paid for the period for which the Relevant Amount is outstanding, but this implies nothing about the type of funding that can be used to fund the Relevant Amount for this period. It certainly does not imply that the Relevant Amount may only be funded by term funding of a duration matching this period, or that the non-defaulting party may only certify term funding of a matching duration. This would make no sense, since the non-defaulting party will almost never know how long the Relevant Amount will be outstanding in advance. The Relevant Amount itself may also be uncertain, since it will often not be finalised until the amount due is agreed or otherwise determined or, in the case of an insolvent defaulting party, the non-defaulting party's claim is accepted by the administrator. Thus, in practice, the non-defaulting party will almost never fund the Relevant Amount using term funding of a matching duration and amount, except by coincidence.

9. Accordingly, Wentworth's argument does not hold good even for a cost of funding that *is* based on a cost of borrowing. There is therefore nothing to stop a non-defaulting party raising long-duration or perpetual borrowing (or equity) to fund the Relevant Amount. It would often be appropriate for it do to so, given the likely expectation that the Relevant Amount would not be paid quickly, if at all, by a party that has defaulted on its Master Agreement obligations. In the case of the Lehman default the expectation was that the preponderance of the debt would never be repaid, with the balance repaid in the indefinite future, so it was necessary that they raise long-term funding against this debt. A non-defaulting party that adopts this approach may then apportion the cost of such funding when it comes to certify its cost of funding for the period in which the Relevant Amount was outstanding, once this is finally determined.

10. In any event, it is factually wrong to suggest that a requirement to repay funding on a given date is an *"essential feature of borrowing, not of equity"*. Equity funding can, of course, be raised for a limited period. An obvious example would be preference shares

[1] The Joint Administrators may be taking a similar point, at paragraph 25(2) of their position paper, insofar as they suggest that the definition of Default Rate is concerned with *"funding which gives rise to an obligation to repay the amount borrowed together with interest"* (emphasis added).

which may be redeemed on a certain date. Similarly, borrowing can be raised on an open-ended or perpetual basis, rolling over until a repayment is demanded or made, such as a bank overdraft. A limitation to a particular period is therefore not an inherent characteristic of either borrowing or equity funding: either form of funding can be raised for a limited duration, or without any time-limit.

11. It is therefore wrong for Wentworth to suggest that the Default Rate definition fits more easily with funding raised by way of borrowing rather than with equity funding, on the basis that the cost of the relevant funds has to be certified for a particular period.

The alleged difficulties with certifying a cost of equity funding

12. Most of Wentworth's position paper is devoted to setting out the supposed details of Goldman Sachs' particular funding position (as to which, see below), notwithstanding that Goldman Sachs has not yet certified its Default Rate. It is asserted that these details suggest that it is difficult to establish a *"sufficient link in practice between an entity's cost of raising funds for its assets/losses generally and funding the relevant amount for the period it is outstanding"* on the basis that this requires *"consideration of the motivation for raising funds in one way or another."* (paragraph 7).

13. This argument is flawed on a number of grounds:

    (1) The first point is that the particular circumstances of Goldman Sachs' cost of funding are not relevant to the definition of "Default Rate". The question for the Court is what types of funding are *capable* of being certified as a Default Rate. This is a question of contractual construction that does not turn on the circumstances of any individual party, and it would be wrong to decide this issue by reference to the circumstances of a particular institution. The points raised by Wentworth in relation to Goldman Sachs' particular position may have some relevance to the precise Default Rate certified in due course by Goldman Sachs, but that is not the issue before the Court on this Application.

    (2) In any event, the premise of Wentworth's argument is that the non-defaulting party is required to establish a link between the *"cost of raising funding for its assets/losses generally"* and funding the Relevant Amount, based on the

"motivation" for raising those funds. This premise is obviously wrong on the wording of the definition of "Default Rate". This definition requires only that the non-defaulting party certify the cost *"of funding"* or *"if it were to fund"* the Relevant Amount. Far from needing to establish that it was "motivated" to raise particular funds to fund the Relevant Amount, there is therefore no requirement on the non-defaulting party to raise funding in the amount of the Relevant Amount or even any funding at all.[2] The non-defaulting party is entitled to certify (*"without proof or evidence of any actual cost"*) a cost of funding based on the cost that it would have experienced if it had raised the equity funding (or any other type of funding) to fund the Relevant Amount. No question of "motivation" therefore arises.

(3) Further, Wentworth offers no basis for generalising from the supposed (though overstated) difficulties in establishing a particular party's cost of funding to its further assertion that it is difficult to certify a cost of funding generally. There is no proper basis for such a generalisation, for at least two reasons. First, equity funding is not automatically more complex than debt funding. A given non-defaulting party may have used or had access to more or less complicated equity funding arrangements. But the same is true of any given party's borrowing arrangements, which may be very simple or very complex. Second, the mere fact that it is possible to identify a particular party with complex funding arrangements (and it is not accepted that Goldman Sachs is such a party) can provide no basis for excluding that type of funding from being certified altogether by *any* party. The ISDA Master Agreement is a standard form contract used by many different Financial Institutions, such that the particular funding arrangements of one individual institution will not dictate the meaning of this standard form.[3]

(4) In any case, Wentworth's assertions regarding Goldman Sachs' funding position are inaccurate in many respects. By way of example:

[2] As an example, in *Lehman Brothers Finance SA v SAL Oppenheim Jr. & CIE. KGAA* [2014] EWHC 2627 (Comm), the claimant's Default Rate for a €2.96m claim was 12%, based on an 11% cost of borrowing incurred by its parent entity under a US$450m credit facility.

[3] See, for example, Lord Millett at para. 7 of *AIB Group (UK) Ltd v. Martin* [2001] UKHL 63, [2002] 1 WLR 94.

(a) At paragraph 5(1), Wentworth attempts to draw a distinction between Goldman Sachs' cost of issuing equity and the cost of equity of the broader Goldman Sachs group, including the holding company The Goldman Sachs Group, Inc. (**"GSGI"**). This misunderstands the manner in which the Goldman Sachs group (including GSGI, Goldman Sachs and other subsidiaries) raises capital. GSGI raises capital and does so on a consolidated basis for the needs of the group as a whole. Capital is then allocated to subsidiaries within the group (including Goldman Sachs) as required. To the extent required, given this background, Goldman Sachs avers that the cost of equity funding of Goldman Sachs will be the same as that of GSGI. In *Lehman Brothers Finance SA v SAL Oppenheim Jr. & CIE. KGAA*, the credit facility on which the 12% Default Rate was based was between the claimant's parent, Lehman Brothers Holdings Inc, and third party lenders, and it was not disputed between the parties that the funding rate of 11% available to the parent was appropriate for its subsidiary, the claimant.[4]

(b) At paragraph 5(2) Wentworth observe that GSGI issued US$15.8 billion of preferred or ordinary stock in September 2008 and April 2009. While this is correct, it should be noted that it does not provide a complete picture of the capital position of GSGI or the Goldman Sachs group at that point in time. It is then suggested by Wentworth that this funding was not used to fund the cost of an unpaid amount of US$86m, being the sum due from LBIE to Goldman Sachs. The basis for this suggestion is apparently that a larger sum was raised by GSGI than was owed by LBIE. This is a non-sequitur. The fact that US$15.8 billion was raised in no way prevented *part* of that sum from being raised or used to fund the Relevant Amount, even if the balance of the sum raised would be used for other purposes. The point is again demonstrated by *Lehman Brothers Finance SA v SAL Oppenheim Jr.*

[4] [2014] EWHC 2627 at para. 51.

& CIE. KGAA, where the Claimant relied on the cost of a US$450 million credit facility when certifying a Relevant Amount of €2.96 million.[5]

(c) For the same reason, the relevance of Wentworth's assertion that this sum was used to fund GSGI's "*business generally and by reason of manifold business needs and ambitions*" (paragraph 5(7)) is not understood. One of these "needs" was, of course, funding the Relevant Amount.

(d) At paragraphs 5(3)-(6) it is stated that GSGI's capital ratios were in excess of the minimum ratios then in force and applicable to GSGI, so that there was no connection between the funding raised and Lehman's default. But the fact that GSGI was not obliged by the regulatory capital ratios in force in 2008 to raise equity immediately did not mean that it did not do so or that it could not have done so. GSGI could justifiably have had regard to the fact that:

(i) New, more restrictive capital ratios were likely to be introduced by regulators in the near future (as did in fact occur). At the relevant time, it was in fact clear that the "direction of travel" by regulators was firmly towards Financial Institutions being required to hold greater capital;

(ii) Other market counterparties expected a level of capital strength in excess of that required by regulators (as explained in Goldman Sachs' position paper at paragraph 9(1)(d) and Appendix paragraphs 12-13), requiring capital to be raised to meet losses in order to maintain market confidence; or

(iii) Further defaults from other counterparties might erode the buffer in the financial institution's capital ratios, meaning that more funding might have to be raised in the near future at a less advantageous time (again as explained in Goldman Sachs' position paper at paragraph 9(1)(d)).

[5] [2014] EWHC 2627 at para. 51. The amount of the facility referred to in this paragraph of Burton J's judgment (US$450 million) is confirmed in the SEC filings relating to Barclays' purchase of certain Lehman Brothers' assets: http://www.sec.gov/Archives/edgar/data/806085/000110465908059841/a08-22764_58k.htm.

In any case, it is the fact that a financial institution might be required by regulatory rules or market expectations to raise equity, as would have been foreseen at the time the ISDA Master Agreement was drafted, that is relevant to the question of the correct interpretation of the definition of "Default Rate", not Goldman Sachs' particular position in 2008.

(e) At paragraph 5(6) Wentworth again relies on the filings made by Goldman Sachs in the bankruptcy of other Lehman Brothers entities. This argument was first raised on the eve of the hearing of Goldman Sachs' joinder application. Goldman Sachs responded to this argument in the Second Witness Statement of Jonathan Kelly. Wentworth's reliance on these filings remains misconceived for the reasons given by Mr Kelly.

(f) Paragraph 6 can be shortly dealt with: all these figures are costs of *borrowing*, not costs of equity. As has been set out in detail in Goldman Sachs' position paper, losses to equity could not be replaced by borrowing.

(g) It is also noted the Federal Reserve funding identified at paragraph 6(2) could only be raised against a pledge of assets by the relevant Financial Institution, and that a defaulted receivable due from LBIE would not have been considered an acceptable asset for these purposes.

14. Wentworth's argument on this issue is, accordingly, also misconceived.

Other points raised by Wentworth

15. Wentworth raises two other points in its Position Paper, in addition to the arguments set out above.

16. First, Wentworth suggest that there is an inconsistency in Goldman Sachs' position paper regarding whether the non-defaulting party may certify a cost of funding that they "could" or "would" have used (footnote 1).

17. There is no such inconsistency. As Goldman Sachs explains in its position paper, the non-defaulting party may certify any basis of funding that they could have used (paragraphs 12(4), 13-15). But, given the requirement to do so in good faith and

rationally (paragraphs 13-14), the non-defaulting party cannot certify a basis of funding that they might never have actually used, and to that extent must certify a cost that they "would" have used (paragraphs 8(3) and 8(4), where the requirement to certify in good faith and rationally is expressly identified).

18. Second, it is noted that Wentworth's position paper asserts that the *"cost of funding assets, or of funding losses, is unrelated to the cost of funding the Relevant Amount for the period it is outstanding"* (paragraph 4). It does not put forward any arguments in support of this position, and it is unclear whether this is intended to be a freestanding point or simply an introduction to paragraphs 5-7.

19. To the extent it is a freestanding point, it should be rejected:

    (1) First, it assumes the very point in issue, i.e. whether the cost of funding the "Relevant Amount" can take into account these costs of funding, particularly in circumstances where the status of the non-defaulting party as a financial institution means that it is required (by regulatory or accounting requirements) to respond to the default by funding "assets" or "losses" based on the amount owed by the defaulting party.

    (2) In any event, for the reasons already given by Goldman Sachs, the wording of the Default Rate definition supports their case that the non-defaulting party is permitted to take into account such costs in certifying its cost of funding the Relevant Amount. The key word is "relevant" – as is noted in Goldman Sachs' position paper (paragraph 7(2)), it is not an abstract sum of money that is being funded, but the "Relevant Amount" owed by the defaulting party. Consistent with the court's consideration of Loss, this permits the particular consequences of the default (including the manner in which the non-defaulting party is required to deal with the consequences of the default) to be taken into account in determining the cost of funding that Relevant Amount. Wentworth puts forward no arguments in response to this position.

Response to the Joint Administrators' position paper

20. It is noted that the Joint Administrators' position paper sets out arguments relating to all the issues in relation to which (in the Joint Administrators' view) there is an arguable case that has yet to be stated by any other party. These arguments are not, in most cases, a response to the points raised in Goldman Sachs' position paper. Most do not go to issues of construction but rather to certification issues. Goldman Sachs does not respond to these further arguments in this reply position paper, but will do so to the extent required in its skeleton argument in due course.

21. The exception is the argument raised by the Joint Administrators at paragraph 25(3) of its position paper, which does respond directly to Goldman Sachs' position paper. In this paragraph it is suggested that:

    (1) The requirement on Financial Institutions to maintain a certain level of capital has no bearing on the cost to them of funding the Relevant Amount, *"which is a cash-flow issue rather than a capital requirement"*; and

    (2) The Master Agreement should not be interpreted in light of the *"regulatory requirements applicable to a particular class of counterparty."*

22. Goldman Sachs refutes both arguments.

23. First, the Joint Administrators' suggestion that the cost to fund or of funding the Relevant Amount is a "cash-flow" issue misunderstands the point being made by Goldman Sachs. As set out in Goldman Sachs' position paper, regulatory and market requirements to hold capital determine the type of funding that may be raised to fund the "Relevant Amount", in response to a default under the ISDA Master Agreement. Thus the applicable regulatory rules and market demands (or other matters set out in Goldman Sachs' position paper) may require that a non-defaulting party respond to the default by funding the Relevant Amount with equity, which may result in the non-defaulting party incurring a higher cost than if it had funded the Relevant Amount with borrowing. The relevant rules will therefore affect the cost of the funds that Financial Institutions can raise to fund the Relevant Amount.

24. Second, Financial Institutions are not merely "a particular class of counterparty". As is set out in detail in Goldman Sachs' position paper, they have always been among

the principal classes of counterparty using the Master Agreement, and they were instrumental in the process by which the 1992 form and the 2002 form were drafted. It is therefore clear that the drafters of the Master Agreement would have had regard to the regulatory and market environment in which Financial Institutions operated, and would have intended the Master Agreement to be interpreted in light of these facts. The definition of Default Rate would certainly not have been intended to prejudice parties that were subject to capital requirements, by requiring those parties to disregard the effect of those requirements on their cost of funding.

MARK HOWARD QC

CRAIG MORRISON

4 September 2015

Waterfall II Application

No. 7942 of 2008

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Respondents

GOLDMAN SACHS INTERNATIONAL'S REPLY POSITION PAPER

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