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

CHANCERY DIVISION

COMPANIES COURT

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN:

(1) ANTHONY VICTOR LOMAS

(2) STEVEN ANTHONY PEARSON

(3) PAUL DAVID COPLEY

(4) RUSSELL DOWNS

(5) JULIAN GUY PARR

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

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

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

(3) HUTCHINSON INVESTORS LLC

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

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

Respondents

GOLDMAN SACHS INTERNATIONAL'S SKELETON ARGUMENT

All references are stated in the form [Bundle/Tab/Page Number]

Recommended Pre-Reading (Estimated Time of 1 hour):

The parties' skeleton arguments;

The Witness Statement of Jonathan Kelly (**"Kelly 1"**) [**A/5/39-53**].

I. INTRODUCTION

1. This is the application of Goldman Sachs International (**"Goldman Sachs"**) to join the **Waterfall II Application**. Goldman Sachs' application is listed for 2 hours on 23 June 2015.

2. Goldman Sachs wishes to join the Waterfall II Application in relation to one issue only, namely the proper interpretation of the term "Default Rate" in the ISDA Master Agreement. Goldman Sachs' position is that this definition permits a relevant payee to certify a cost of funding that takes into account all its sources of funding, including (in particular) the cost of equity funding, subject to the certification being provided rationally and in good faith.

3. This issue was formerly covered by Issues 11-14 and 27, as originally formulated. It is anticipated that the arguments Goldman Sachs wishes to make will now be covered by Issues 11 and 12. Based on the information currently available to Goldman Sachs, it is not thought likely that further modification of the reformulated issues will be needed, though Goldman Sachs reserves the right to apply to modify these issues should it be argued that they are too narrow to cover the arguments referred to below.

4. As is explained below, Goldman Sachs is in a position to assist the Court in resolving these issues by ensuring that facts and arguments relevant to the construction of the term, and not currently advanced by any of the existing parties, are fully before the Court. As a party to the Waterfall II Application Goldman Sachs will also be able to ensure that the interests of financial institutions (among the principal users of the ISDA Master Agreement standard form) are properly represented.

5. Goldman Sachs' application is supported by the Applicants in the Waterfall II Application (**"the Joint Administrators")**. It is also supported by the First to Third

Respondents (**“the Senior Creditor Group”**) and not opposed by the Fifth Respondent (**“York”**).

6. Against this background Goldman Sachs had hoped that the application might be dealt with and approved on paper, but unfortunately the Fourth Respondent (**“Wentworth”**) has refused to agree to the application. Wentworth, as the holder of subordinated interests, directly benefits to the extent that it can reduce recoveries for creditors with senior contractual claims.

7. Wentworth’s ostensible reason for its refusal to agree to the application is that Goldman Sachs has not set out a position distinct from that of the Senior Creditor Group. This is incorrect. The arguments that Goldman Sachs wishes to make are distinct. If there was a question of duplication in Goldman Sachs’ arguments then the Joint Administrators could be expected to oppose the application, but they do not. In fact, as will be seen below, the grounds for Goldman Sachs’ application to intervene are perfectly clear and the Joint Administrators have formed the view that Goldman Sachs will be putting forward arguments which are credible and which are not being advanced by any other party.

8. The remainder of this skeleton sets out a brief summary of the relevant factual background, the current position of the parties regarding Goldman Sachs’ application, and Goldman Sachs’ submissions on why it should be added as a party.

II. FACTUAL BACKGROUND

9. A fuller summary of the relevant factual background is set out in the Witness Statement of Jonathan Kelly dated 8 May 2015, filed in support of Goldman Sachs’ application **[A/5/39-53]**. The key points are set out below.

10. Goldman Sachs is a creditor of LBIE. Goldman Sachs originally entered into an ISDA Master Agreement with LBIE in September 1996, and it has claims against LBIE that arise under that agreement.

11. Given the surplus realised in LBIE’s administration, Goldman Sachs stands to be paid interest on these claims pursuant to Clause 6(d)(ii) of the 1992 ISDA Master Agreement (equivalent to Clause 9(h)(ii)(2) of the 2002 ISDA Master Agreement),

should the rate of such contractual interest be higher than that provided for under the Judgments Act 1838 (Insolvency Rules 1986, Rule s2.88(7) and 2.88(9)).

12. As a defaulting party, LBIE is obliged to pay this interest at the "Default Rate" (see Clause 14, definition of "Applicable Rate"). "Default Rate" is defined in Clause 14 as follows:

"***"Default Rate"*** *means a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum.*"

13. A number of the issues before the Court on the Waterfall II Application concern the proper interpretation of this definition. The key issue on which Goldman Sachs wishes to address the Court is whether this definition encompasses all sources of funding, including equity, rather than being restricted to the cost of borrowing (i.e. debt).

14. This is a particularly important issue for financial institutions, including Goldman Sachs. As is set out at paras. 15-21 of Kelly 1 **[A/5/44-46]**, the fact that financial institutions rely on funding from multiple sources is part of the factual matrix against which the ISDA Master Agreements must be construed. The factual matrix includes that financial institutions are subject to regulatory rules and market requirements that require them to maintain a certain level of equity capital. This means that such institutions may respond to a default under an ISDA Master Agreement by raising new equity, rather than relying (or exclusively relying) on further borrowing.

15. This occurred in the aftermath of Lehman Brothers' default in September 2008, with both the size of the default and the resulting market conditions prompting many financial institutions to raise significant equity from investors.

16. Goldman Sachs' position is that, in order to ensure that financial institutions are properly compensated for the delay to payment of sums due from LBIE upon its default, it is necessary that the Default Rate payable by LBIE may reflect all the sources of funding on which the payee may draw, including equity funding. Goldman Sachs' legal case on the proper interpretation of the term will be developed in more detail in its position paper in due course.

17. However, it came to Goldman Sachs' attention during its monitoring of the progress of the Waterfall II Application that:

(1) None of the existing parties had advanced evidence or arguments relevant to the funding requirements of financial institutions. This no doubt reflected the fact that none of the existing respondents were financial institutions.

(2) In particular, none of the existing parties had made any arguments based on the regulatory and other capital requirements applicable to financial institutions and how those would bear on the proper construction of the clause. This point was expressly made at footnote 1 to the Exhibit to the Third Witness Statement of Patrick McKee, for the Senior Creditor Group, where it was noted as a specific example of a basis for funding that was *not* argued by those parties **[B/12/373]**.

(3) Worryingly, Wentworth did see fit to advance an argument that Financial Institutions should be subject to special restrictions on the type of funding which they could use to certify their Default Rate, *limiting* such institutions to certifying their average borrowing and expressly restricting them from relying on their cost of equity funding (Wentworth's Position Paper, para. 71 **[A/8/147-148]**).

18. Against this background, Goldman Sachs considered that it was necessary for it to apply to become a party to the Waterfall II Application, so as to ensure that the arguments which it would wish to advance were put before the Court and the interests of financial institutions were properly represented.

19. Separately, and in order to understand the recent developments in the Waterfall II Application in more detail Goldman Sachs has also sought various documents from the Joint Administrators, requesting (in particular) copies of documents in relation to the changes to the parties' cases and to the reformulation of the issues to be decided by the Court. However, the Joint Administrators initially refused to give Goldman Sachs sight of the correspondence passing between the parties, on the basis that it must first apply to join the application (Kelly 1, paras. 29-44 [**A/5/48-52**]). Only a limited amount of such material has been provided since Goldman Sachs' application to intervene was issued.

20. Goldman Sachs has therefore (to date) only been able to follow certain developments in the case from either summaries provided by the Joint Administrators, or from the publication of documents on the Joint Administrators' website. Part of the Order sought by Goldman Sachs in this application would require Goldman Sachs to be provided with all the material that has passed between the parties and which is relevant to the Default Rate issues. Assuming it is joined, Goldman Sachs will wish to consider and take appropriate account of this material in formulating its position paper.

III. THE CURRENT POSITION OF THE PARTIES

21. Goldman Sachs issued the current application on 8 May 2015. Since then:

(1) The Joint Administrators have confirmed that they support Goldman Sachs' application, on the basis that they accept that Goldman Sachs' position is distinct from that of the Senior Creditor Group (letter of 4 June 2015, **[B/17/527-528]**) and that Goldman Sachs' arguments are ones they "believe to be credible" (letter of 8 June 2015 to Clifford Chance on behalf of Deutsche Bank, [**B/17/532-533]**). The Joint Administrators also agreed with Goldman Sachs' suggestion that, in order to save time and costs, the application could be dealt with on the papers, assuming the other respondents agreed.

(2) The Senior Creditor Group has confirmed that it also supports Goldman Sachs' application, on the basis that it "*is important for the court to hear the perspective of financial institutions in Waterfall II (Part C)*" (letter of 14 May 2015, **[B/17/504-505]**).

(3) York has similarly confirmed that it does not object to Goldman Sachs being joined to the application (letter dated 19 May 2015 **[B/17/512]**).

(4) The only party that has not agreed to Goldman Sachs' application is Wentworth, whose solicitors stated by a letter dated 27 May 2015 that it could not confirm whether it consented to the application on the grounds that it did not understand the basis on which Goldman Sachs was advancing a position distinct from that of the Senior Creditor Group (**[B/17/518-19]**). Wentworth

has maintained this position in its most recent letters, dated 8 June 2015 and 16 June 2015 (**[B/17/529-531; B/17/548-550]**).

(5) For completeness, it should also be noted that Deutsche Bank (another financial institution with claims in LBIE's insolvency) has also supported Goldman Sachs' application. Deutsche Bank has confirmed that *"it shares Goldman Sachs' view that, unless one or more financial institutions is joined as a party to the Waterfall II Application, all the issues necessary to enable the court to make a determination that will allow the Administrators to pay interest to LBIE's creditors will not be properly argued and, indeed, some issues may not be argued at all."* (letter of 13 May 2015 from Clifford Chance on behalf of Deutsche Bank, **[B/17/502]**). Deutsche Bank has stated that its current intention is not to apply to join the proceedings itself in order to save time and costs and avoid duplication, since there is a commonality of approach between its position and that of Goldman Sachs.

IV. GOLDMAN SACHS' SUBMISSIONS

The relevant law

22. The power to add a party to proceedings is set out in CPR 19.2(2), which reads:

"The court may order a person to be added as a new party if-

(a) it is desirable to add the new party so that the court can resolve all the matters in dispute in the proceedings; or

(b) there is an issue involving the new party and an existing party which is connected to the matters in dispute in the proceedings, and it is desirable to add the new party so that the court can resolve that issue."

23. In applying this rule, the Court will also need to have regard to the overriding objective, including any cost or delay to the proceedings that may be associated with the addition of a new party (see White Book commentary at 19.5.11, relating to CPR 19.5 but equally applicable to CPR 19.2).

Why it would be desirable for Goldman Sachs to join the Waterfall II Application

24. There are a number of straightforward reasons why it would be desirable for Goldman Sachs to be added as a party to the Waterfall II Application:

    (1) Goldman Sachs will be able to assist the Court by advancing arguments regarding the funding requirements (and in particular the equity funding requirements) applicable to financial institutions. These include arguments as to why it would have been (objectively) intended by the parties to the ISDA Master Agreement that the parties and (in particular) financial institutions would be able to certify their cost of equity as a recoverable cost of funding under that agreement. None of the current parties is subject to these funding requirements, and none has sought to put forward arguments based upon them. However, they form an essential part of the factual matrix against which the definition of "Default Rate" must be construed, in circumstances where financial institutions are among the principal users of the ISDA Master Agreement.

    (2) Goldman Sachs will also be able to assist the Court in relation to the relevant commercial background more broadly, including in relation to how the ISDA Master Agreement was operated in practice by financial institutions and other classes of counterparty. This is potentially an important area, in circumstances where at least one argument has already been made based on the alleged market usage of a particular class of counterparty (see 24(4) below).

    (3) Goldman Sachs will also be able to represent the interests of financial institutions in the Waterfall II Application more generally, ensuring arguments relevant to their position are heard. The existing respondents are all hedge funds who have acquired their claims in the secondary market as assignees, and whose interests on this issue are not necessarily aligned (and in the case of Wentworth, are clearly not aligned) with those of financial institutions. Financial institutions are a major class of LBIE creditor, and the decision in the Waterfall II Application will have significant consequences for the claims of these creditors in the administration of LBIE. The Court's decision on the proper interpretation of "Default Rate" will also have significant consequences for all users of the ISDA Master Agreement in the market, since it will likely

determine the meaning of that term for all future disputes as to the position following a default. This is not an area where the courts have had much cause or opportunity to consider the issues. If Goldman Sachs is not joined as a party there is a risk that it and other financial institutions will be effectively bound by the outcome of the Waterfall II Application, without any opportunity to participate in it and to ensure that their arguments are heard.

(4) In particular, Goldman Sachs will be able to ensure that arguments from other parties that are prejudicial to the interests of financial institutions are properly answered. In these proceedings there has already been an attempt by Wentworth to put forward an interpretation of "Default Rate" that would have severely restricted the basis on which financial institutions (but not other types of parties) could certify their Default Rate, based on a trade usage argument applicable only to financial institutions. This argument was misconceived, including in its attempt to single out one class of participants in the market for special (and restrictive) treatment in terms of trade usage and now appears to have been abandoned **[A/6/62-63]**; [**B/13/394-400**]. There nonetheless remains the possibility of other arguments prejudicial to the position of financial institutions being raised in the future, and this episode illustrates the potential danger if financial institutions are not represented in the Waterfall II proceedings.

(5) These concerns have not been assuaged by Wentworth's most recent position paper ([**B/13/394-400]**), which is couched in very general terms. It would certainly give Wentworth the flexibility to make arguments prejudicial to financial institutions (including that they should not be entitled to certify their cost of equity funding) in due course. Nonetheless, it is already apparent that Wentworth are intending to run arguments to which Goldman Sachs would wish to object (and it is noted that no other parties have yet responded to these arguments). For example, at paragraphs 2 and 3 of its most recent position paper Wentworth appears to argue that the definition of "Default Rate" should not take into account the cost of shareholder or equity funding, which is an argument that Goldman Sachs does not accept and which (if it was accepted) would cause serious prejudice to financial institutions that may choose to or be required to rely on such funding.

(6) Goldman Sachs further notes that no delay would result from its addition to the proceedings. The final hearing to determine the relevant issues in the Waterfall II Application is listed for 7-10 days commencing 9 November 2015. The existing trial date provides ample time for Goldman Sachs to set out its position and for the other parties to set out their positions in response. The current hearing dates will also provide time for Goldman Sachs to make such oral submissions as are required. The Joint Administrators have also agreed a revised timetable for the provision of documents to Goldman Sachs and for the filing of further position papers (see correspondence at **[B/17/510-511, 515-517, 534-535, 540-543]**), which is reflected in the draft order attached to this skeleton argument. The overriding objective thus militates in favour of Goldman Sachs being added to the proceedings.

25. Goldman Sachs therefore submits that there are clear reasons why it would be desirable for it to be made a party to the existing proceedings, so that all the matters in dispute can be resolved, pursuant to CPR 19.2(2)(a). To the extent that any party may oppose Goldman Sachs' position that the definition of "Default Rate" may include the cost of equity funding, it would also be desirable for Goldman Sachs to be added as a party so as to resolve any dispute that may arise with that party (CPR 19.2(2)(b)).

26. Against this background, Wentworth's suggestion that Goldman Sachs' arguments would not add anything to those of existing parties is plainly wrong. As is set out above it is a matter of record that the Senior Creditor Group has *not* put forward arguments relevant to the regulatory capital requirements applicable to financial institutions (footnote 1 to the Exhibit to the Third Witness Statement of Patrick McKee **[B/12/373]**). These are important factors for the Court to have regard to when construing Default Rate. Wentworth's own past arguments also demonstrate why it is necessary that financial institutions are represented in the application. There is nothing in the correspondence to suggest that Wentworth will not (if it thinks it appropriate) continue to advance, or even seek to resurrect, arguments that may prejudice financial institutions.

V. CONCLUSION

27. For the reasons set out above, Goldman Sachs therefore requests that it be added as a respondent to the Waterfall II Application, and that the Court make an order in the form attached to this skeleton argument.

MARK HOWARD QC

CRAIG MORRISON

18 June 2015

Brick Court Chambers

7-8 Essex Street

WC2R 3LD