No. 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT
IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)
AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N

ANTHONY VICTOR LOMAS & ORS
(JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

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

Respondents

-and-

GOLDMAN SACHS INTERNATIONAL

Proposed Additional Respondent

JOINT ADMINISTRATORS' SKELETON ARGUMENT

For hearing on 23 June 2015

Time estimate for hearing: 1 hour

Time estimate for reading: 1 hour

Reading list for Judge:

(1) The skeleton arguments;

(2) The draft Order **[A/2/4-6]**; and

(3) The witness statement of Jonathan Patrick Knox Kelly dated 8 May 2015 ("Kelly-1") **[A/5/39-54]**.

Introduction

1. This skeleton argument has been lodged on behalf of the Joint Administrators (the "**Administrators**") of Lehman Brothers International (Europe) (In Administration) ("**LBIE**") for the hearing of the application of Goldman Sachs International ("**GSI**") by Application Notice dated 8 May 2015 (the "**Joinder Application**") for an Order that GSI be joined to the Administrators' application for directions (the "**Waterfall II Application**") for the purposes of Issues 11 to 14 and 27 (the "**Default Rate Issues**").

2. The Administrators consider that the joinder of GSI is appropriate in the circumstances, provided that:

   (1) GSI is limited to those arguments which are not being advanced by the First to Third Respondents (the "**Senior Creditor Group**" or "**SCG**") and there is no duplication of submissions between those advanced by the SCG and GSI;

   (2) the SCG will continue to take the lead on their side of the argument; and

   (3) the further position papers to be filed and served by the parties in accordance with the draft Order are confined to the parties' positions on the additional arguments raised by GSI.

3. The Administrators consider that it would be appropriate for the draft Order at tab 2 of volume A of the hearing bundle to be amended to reflect these points.

Background

The Waterfall II Application

4. As the Court is aware, in the Waterfall II Application, the Administrators seek the Court's directions in respect of certain issues which have a major bearing on the distribution of the surplus in the estate of LBIE.

5. The SCG was joined to represent a group of creditors with ordinary unsecured claims against LBIE. The Fourth Respondent ("**Wentworth**") was joined to reflect the fact that it holds subordinated debt owed by LBIE. The Fifth Respondent ("**York**") was joined to represent the participants in claims held by Bank of America Credit Products Inc with a particular interest in the issue relating to the start date for statutory interest. (In light of its limited role, York did not participate in Tranche B and has indicated that it will not be participating in Tranche C, although it does wish to continue to be informed about the progress of the Waterfall II Application generally.)

6. The Administrators routinely post copies of documents in respect of the Waterfall II Application (such as position papers, witness statements, skeleton arguments and hearing transcripts), together with updates on the progress of the Waterfall II Application, on the dedicated LBIE website. Such updates also invite any creditor which considers that there are relevant positions or arguments not currently before the Court to contact the Administrators.

7. The Administrators' objective is to facilitate resolution of all of the issues in the Waterfall II Application to enable a distribution of the available funds in the Administration to creditors. In the latest progress report, the Administrators estimated that realised surplus funds in the Administration at 14 March 2015 were approximately £4.3 billion; by the end of the year it was expected that this would increase to approximately £4.8 billion; and the projection for the total expected surplus was in the range of £6.0 to £7.6 billion.

8. In relation to claims for interest payable pursuant to IR 2.88(7) ("**Statutory Interest**"), approximately 35% in value of all admitted unsecured claims arise under ISDA Master Agreements. Depending on the outcome of arguments advanced by the SCG, those claims may attract an interest rate in excess of the Judgments Act rate of 8% simple.

<u>The Default Rate Issues</u>

9. The Default Rate Issues relate to the rate of interest payable by LBIE under terminated derivatives transactions governed by the ISDA Master Agreements. As matters stand (and in broad terms):

(1) The SCG are advancing the arguments which seek to ***maximise*** the amount of interest payable by LBIE under the ISDA Master Agreements; and

(2) Wentworth is advancing arguments which seek to ***minimise*** the amount of interest payable by LBIE under the ISDA Master Agreements.

10. At the risk of over-simplification, the SCG is contending that the 'cost of funding' identified in the relevant clause of the ISDA Master Agreements (the "**Default Rate**") should be construed very broadly as properly extending to (i) the cost to fund or of funding a claim against LBIE (the "**First Basis**") or (ii) any and all costs of raising an incremental sum of money, including the cost of equity funding (the "**Second Basis**"); and Wentworth is contending that the Default Rate should be construed as being limited to the lowest available amount that the counterparty would be required to pay if it were to raise funds.

The Joinder Application

11. By way of the Joinder Application, GSI has now applied to be joined to the Waterfall II Application for the stated purpose of making arguments on the Default Rate Issues from the perspective of financial institutions ("**Financial Institutions**") which are creditors of LBIE. GSI has said that it wishes "*to ensure that the interests of Financial Institutions are directly represented and that arguments relevant to them are heard*" (Kelly-1, para 12A). GSI is "*concerned that the position of Financial Institutions may not be adequately addressed and/or protected by the current parties' approach to the issues in dispute*" (Kelly-1, para 11).

12. Another Financial Institution, Deutsche Bank AG, has said 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*" **[B/17/502]**.

13. In its evidence in support of the Joinder Application, GSI has made clear that it wishes to "*address the specific and limited question of whether the definition of Default Rate encompasses all sources of funding, including equity, rather than being restricted to the cost of borrowing*" (Kelly-1, para 8). It is the Administrators' understanding that GSI wishes to contend for the same outcome as the SCG's Second Basis (i.e. a broad construction of the Default Rate to include the cost of equity) but by taking into account other matters or factors, which derives from facts specific to Financial Institutions, and that they do not wish to supplement the SCG's First Basis arguments in any respect. The Administrators invite GSI to confirm this understanding.

14. In summary, GSI has said that:

    (1) The ISDA Master Agreements are widely used throughout the world and Financial Institutions are among the principal counterparties (Kelly-1, para 12C).

    (2) In the interpretation of the ISDA Master Agreements, the factual matrix should include facts relevant to Financial Institutions (Kelly-1, para 12B).

    (3) The factual matrix which is relevant to the interpretation of the Default Rate provision in the ISDA Master Agreements includes the ways in which Financial Institutions are required to fund themselves (Kelly-1, para 12B).

    (4) Most importantly, when construing the Default Rate provision, the Court should have regard to the fact that Financial Institutions are compelled to fund their assets with a portion of equity (Kelly-1, para 11A). In this regard, GSI have referred to capital adequacy requirements imposed on banks pursuant to international agreements since 1988, when the Basel Committee on Banking Supervision published the first Basel Accord (Kelly-1, para 17) and said that the Default Rate should be construed as permitting a relevant payee to certify a cost of funding that takes into account all of its sources of funding, including the cost of equity (Kelly-1, para 24).

15. The Administrators understand that, if GSI's argument on the point of construction were accepted, GSI would then claim a Default Rate in excess of the Judgments Act

rate of 8% simple (although, in light of Wentworth's recent evidence regarding public information said to demonstrate a cost of funding for The Goldman Sachs Group, Inc., GSI is requested to confirm to the Court that this understanding is correct).

16. As far as the Administrators can tell, the arguments focusing on the position of Financial Institutions, and the way in which they are required to fund themselves, are not presently advanced by the SCG, even though, as holders of claims originally held by Financial Institutions, they are in a commercial position to do so. It is unclear to the Administrators why, in such circumstances, the SCG is not pursuing such arguments. If the SCG had been willing to advance these arguments, the Administrators would have been likely to adopt a difference stance in respect of the joinder of GSI.

17. As to the positions of the existing parties in respect of the Joinder Application:

    (1) The Administrators consider that the joinder of GSI for the purpose of the Default Rate Issues is appropriate in the circumstances provided that:

        (i) GSI is limited to those arguments which are not being advanced by the SCG and there is no duplication of submissions between those advanced by the SCG and GSI;

        (ii) the SCG will continue to take the lead on their side of the argument; and

        (iii) the further position papers to be filed and served by the parties in accordance with the draft Order are confined to the parties' positions on the additional arguments raised by GSI.

    (2) The SCG consents to GSI's application. The SCG considers "*that it is important for the court to hear the perspective of financial institutions*" **[B/17/504]**.

    (3) York has made clear that it has no objection to the joinder of GSI for the purposes of the Default Rate Issues **[B/17/512]**.

(4) Wentworth has not consented to GSI's application. Wentworth's solicitors, Kirkland & Ellis International LLP, have said that they "*do not accept that* [GSI] *is in a position to provide a unique perspective or one relevant to this application*" **[B/17/548]**.

The test for joinder

18. CPR r.19.2(2) (which applies to the Waterfall II Application by virtue of IR r.7.51A(2)) provides:

> "*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*".

19. As Waller LJ stated in *Davies v Department of Trade & Industry* [2006] EWCA Civ 1360, [2007] 1 WLR 3232 at [12], CPR r.19.2 confers "*a very wide power to enable parties who may be affected by a finding in any proceedings to be joined*". The Court should "*read these rules broadly and in order to achieve justice*": *R (Nicklinson) v Ministry of Justice* [2013] EWCA Civ 466 at [12] per Elias LJ.

20. The power in CPR r.19.2(2) "*should of course be exercised in a principled manner, and with the aim of giving effect to the overriding objective of enabling the court to deal with the case justly and at proportionate cost*": *High Commissioner for Pakistan v National Westminster Bank plc* [2015] EWHC 55 (Ch) at [32] per Henderson J.

The present case

21. The Administrators consent to the joinder of GSI on the basis outlined above. They submit that, on that basis, the Court can conclude that the requirements of CPR r.19.2(2) will be satisfied.

22. GSI has confirmed that it is willing and able to comply with the existing pre-trial timetable (Kelly-1, para 14) and the draft Order in respect of the joinder of GSI has been tailored to fit the existing pre-trial timetable.

23. It is not clear whether GSI wishes to file factual evidence to substantiate its arguments in respect of the factual matrix arguments. In the event that GSI wishes to do so, GSI should inform the Administrators immediately, to ensure that, if the need or desirability for such evidence is accepted, directions for such factual evidence can be agreed without imperilling the existing pre-trial timetable.

Conclusion

24. The Administrators are content for the Court to make an Order in the terms of the draft Order at tab 2 of volume A of the hearing bundle, provided that it is amended to reflect the points set out in para 2 of this skeleton argument.

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