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 SUPPLEMENTAL SKELETON ARGUMENT

All references are in the form {Bundle/Tab/Page}

All defined terms bear the meanings set out in Goldman Sachs' trial skeleton argument dated 16 October 2015

I. INTRODUCTION

1. This is the supplemental skeleton argument of Goldman Sachs for the trial of Part C of the Waterfall II Application. It is filed in reply to the skeleton arguments of Wentworth and the Senior Creditor Group dated 16 October 2015 and to the skeleton argument of the Joint Administrators dated 23 October 2015.

2. In this skeleton Goldman Sachs responds to certain arguments raised by Wentworth and the Joint Administrators. It seeks to avoid repetition of arguments already raised by Goldman Sachs or by the Senior Creditor Group in their trial skeleton arguments. To the extent that Goldman Sachs does not reply to any point raised in the other parties' skeleton arguments this should not be taken to imply that they are accepted; the other parties' skeleton arguments are long and for reasons of concision Goldman Sachs has focussed only on the most material points.

II. REPLY TO ARGUMENTS RAISED BY WENTWORTH

3. Goldman Sachs response to Wentworth is structured by reference to four main points:

    (1) Wentworth's interpretation of the Default Rate definition ignores and/or adopts an untenable interpretation of the definition's wording;

    (2) Wentworth's own interpretation of the definition of Default Rate is commercially incoherent and unworkable;

    (3) Wentworth's reliance on other provisions in the 1992 and/or 2002 ISDA Master Agreements is misplaced; and

    (4) Wentworth mischaracterises Goldman Sachs' case on Issue 14.

4. Each point is dealt with in turn.

(1) Wentworth's interpretation of the Default Rate definition ignores and/or adopts an untenable interpretation of the definition's wording

5. A striking feature of Wentworth's skeleton is its disregard of the wording of the Default Rate definition. As Goldman Sachs set out in its trial skeleton, the starting point for any interpretation of the definition must be the words of the definition themselves.[1] However, Wentworth's skeleton either ignores this wording entirely or seeks to rewrite it under the guise of interpretation.

6. The definition refers 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."* This is a single phrase. Yet Wentworth's skeleton fails to offer any adequate explanation for why the phrase "cost…to fund or of funding" should instead be interpreted or re-drafted as "cost…to borrow or of borrowing".

7. First, the critical words "fund" and "funding" are virtually ignored, Wentworth largely concentrating on the word *"cost"* as though it appeared in isolation rather than as part of a compendious phrase. Wentworth offers no answer to the obvious but fundamentally important point that the ISDA Master Agreement would not have said "funding" if it meant "borrowing". In the 95 pages of Wentworth's skeleton this key issue is only touched on once, at para. 114, where it is said that:

   "The use of the cost of funding language in the ISDA MA [Master Agreement] *(as opposed to identifying a benchmark rate, such as LIBOR or an overnight bank rate) is sufficiently explained by the fact that it was felt appropriate to reflect the fact that different counterparties would be likely to have access to borrowing at different rates."*

8. This is obviously an inadequate explanation. The fact that different parties might have had access to *borrowing* at different rates does not mean that the words "of funding" had to be used; the words "of borrowing" would have dealt with this issue just as well.

9. Moreover, the ISDA draftsmen were quite capable of drafting wording that confined the parties to a cost of borrowing (or some other specific type of funding), if that was their intention. They did exactly this in revising the definition of Non-default Rate in the 2002 ISDA Master Agreement, which was amended to refer to a particular deposit

[1] Goldman Sachs' trial skeleton argument, para. 26, citing *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 W.L.R. 2900 and *Arnold v Britton* [2015] UKSC 36.

rate, namely: "*rate offered to the Non-defaulting Party by a major bank in a relevant interbank market for overnight deposits in the applicable currency…*"

10. The inference from their decision not to adopt the same or a similar formulation as regards the definition of "Default Rate" is clear and inescapable: it was intended that this definition would cover *more* than just borrowing.

11. The remainder of Wentworth's skeleton either assumes the very point in issue, which is whether the word "funding" should be read as "borrowing",[2] or relies heavily on supposed differences between debt and equity funding that do not stand up to analysis, and could not therefore provide a workable touchstone for determining what types of funding fell within Wentworth's interpretation of *"cost of funding"* and which did not. For example:

    (1) Equity funding can be raised via a transaction.[3] This is not a point that is unique to debt, as opposed to equity funding.

    (2) Equity funding has a time value, just as borrowing does.[4] There is no special significance in the fact that the time value of borrowing is usually reflected in an interest payment, while the time value of equity funding is frequently reflected in dividends or other costs.[5] In any event the definition of Default Rate does not require a certification of an interest rate. It requires the certification of a cost of funding, from which the payable rate is then derived.

    (3) It is not correct that borrowing necessarily imposes an obligation or contains an option to repay the relevant amount, or that it is only taken out for a particular period.[6] Borrowing may be perpetual, or taken out on a limited recourse basis that makes any repayment contingent on a particular event occurring or asset being available to satisfy the loan. Equally the terms of the borrowing may

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[2] See, for example, paras. 92 (*"The important difference, in the interest rate applicable under the ISDA MA, is that it is permissible, indeed expressly required, to have regard to the rates at which the particular payee party could borrow in the market"*) and 97 *("The first alternative captures the case where the relevant payee actually funds the relevant amount, by transacting to borrow the sum in the market.")*. Either of the arguments being made here by Wentworth, and in many other places, work equally well if the word "borrow" is replaced with the words "raise funding", which uses the word ("funding") actually found in the definition.

[3] Point (2) of Wentworth's case, at paragraphs 93-103 of its trial skeleton.

[4] Point (1) of Wentworth's case, at paragraphs 85(1), 86-92 of its trial skeleton.

[5] As Wentworth's skeleton wrongly suggests, at paragraph 86.

[6] Wentworth's skeleton, paras. 148, 156.

prohibit early repayment, or include early repayment charges that make any such repayment uneconomic. Alternatively equity funding may include an option for redemption at a particular time (and hybrid instruments usually will), which would mean that it could be "repaid" at that time and is not, therefore, perpetual. None of these points are relevant points of distinction between debt and equity funding.

(4) Nor should it be a material consideration that there is technically a contractual obligation to pay the coupon due on a particular form of funding, as opposed to there being a commercial necessity to make such a payment. The artificiality of such an argument is shown, again, by the contrast between limited recourse debt and preferred equity. Even if there is no formal requirement to pay the coupon due on preferred equity, it will usually be commercially important that it do so if the issuer of such equity is to avoid financial damage (including a higher cost of funding), absent exceptional circumstances. By contrast, there may be a contractual obligation to pay a coupon under limited recourse debt, but a failure to pay such a coupon will (given the limited nature of the recourse available to the borrower) impose much less commercial damage on the issuing party. Again, a formalistic distinction between debt and equity does not, for these purposes as in others, reflect the reality of how parties fund themselves.

12. In any event, even if any of these supposed distinctions existed, it is unclear why any commercial party would consider them a sufficient basis for excluding certain types of funding from the certification process while including others. They are distinctions that are immaterial to the exercise that the Default Rate definition asks the non-defaulting party to perform, which is to certify its "cost…of funding".

13. As noted above, Wentworth's skeleton gives rather more attention to the meaning of the word "cost".[7] However, its arguments on this issue are similarly misconceived.

14. Wentworth first suggests that "cost" means the "price" paid for something:

(1) This argument gets off to an uncertain start, since the definition cited by Wentworth for this proposition (taken from the Shorter Oxford English Dictionary) is itself not limited to the payment of a price but also encompasses

[7] See, in particular, its fourth to sixth arguments at paras. 108-161.

other forms of value that must be given "to effect" something: "*what must be given in order to acquire, produce or effect something; the price (to be) paid for a thing*".[8] In any event, the word "price" does not necessarily bear the narrow meaning (apparently) contended for by Wentworth. "Price" is itself defined in the Concise Oxford English dictionary as *"the amount of money expected, required or given in payment for something; <u>something expended or endured in order to achieve an objective</u>."* The latter meaning would accord with the definition advanced by Goldman Sachs.

(2) Regardless, it is plain that the word "cost" cannot be limited to any narrow meaning of the word "price" in the context of the Default Rate definition. In the first place, the word "cost" does not appear in isolation, but rather in the context of a phrase: "*the cost…to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount"*. The cost to the relevant party of funding an amount may encompass detriments other than the price paid by the funder, without any stretch of the English language. The word "cost" cannot be read in isolation, divorced from the rest of the definition in which it appears. Moreover, the "cost of funding" is a well understood concept[9] which is not limited merely to the price paid for that funding.

(3) Even if Wentworth's argument is correct (which is not accepted) and the word "cost" *was* limited to the price paid, it would still be broad enough to cover many aspects of the cost of equity funding, including (for example) the coupon payable on preference shares. If Wentworth's interpretation on this point was correct it would limit the definition of Default Rate to some extent, but it provides no basis for drawing a relevant distinction between debt and equity funding.

[8] See footnote 24 of Wentworth's skeleton.

[9] See Goldman Sachs' trial skeleton, paras. 32-34.

15. Wentworth also appears to adopt the Joint Administrators' argument that equity may not have a "cost" at all, for the purposes of the definition of Default Rate.[10] For the reasons set out in Goldman Sachs' trial skeleton,[11] this argument has no merit.

16. Finally, Wentworth reiterates its argument that "cost" means "lowest cost", as a matter of the proper interpretation of the definition of Default Rate.[12] Again, this argument does not provide any basis for distinguishing between debt and equity funding. But in any event, as was noted in Goldman Sachs' trial skeleton, this argument is hopeless and reflects Wentworth's attempt to conflate the construction and certification exercises.[13] The question of whether a particular cost of funding is excessive is not a question of the proper interpretation of the definition of Default Rate. Rather, it is a question that goes to whether the certified cost was incurred rationally and in good faith. A cost does not cease to be a cost merely because a party pays more than alternatives which another party later identifies could have been used (perhaps after an extended ex post facto investigation, in circumstances where any alternative is unlikely to be perfectly comparable in any event). The amounts which a party was required to pay in relation to an actual transaction, or which it would have been required to pay in relation to a hypothetical transaction which it rationally and in good faith certifies it would have entered into, are still costs, even if other transactions may have involved different costs.

17. Wentworth's approach also generates a particularly unattractive result in the context of the definition of Default Rate. It is common ground (as set out below) that a certification falling outside the scope of the definition of Default Rate will not be valid. It is equally common ground that the only other grounds of challenge are that the certification is not given rationally and/or in good faith; otherwise the certification is final. However, by seeking to qualify the <u>definition</u> of Default Rate by reference to the "lowest cost" principle (rather than merely examining this issue as part of the question of rationality and good faith), Wentworth would allow almost any certification to be challenged on the basis that the certifying party might have paid less for its funding. This would destroy the certainty that the definition of Default Rate was intended to provide, by

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[10] Wentworth's skeleton, paras. 145-161.

[11] Ibid.

[12] Wentworth's skeleton, paras. 137-144.

[13] See Goldman Sachs' trial skeleton at para. 57(1).

which the certification is supposed to be conclusive and subject only to limited grounds of challenge.

18. The scope for such a challenge involved in Wentworth's construction is demonstrated by another aspect of Wentworth's argument:

(1) Wentworth repeatedly asserts that overnight funding will often be an appropriate basis for funding: at various points it is suggested that it would be "most rational"[14] for the non-defaulting party to certify a rate based on the cost of overnight borrowing, or that overnight funding would be "the appropriate rate in many cases".[15]

(2) However, such institutions would very rarely choose to fund a substantial default on an overnight basis for any significant length of time, given that it will only be paid in an uncertain amount at an uncertain future date (if at all). Rather, they would tend to arrange longer-term funding, of a duration and on terms that seemed appropriate to them based on their assessment (acting rationally) of the likelihood of being repaid and the time at which that repayment might be forthcoming. There are inevitable a large number of contingencies in such an assessment, with reasonable parties being able to reach different results as to the appropriate form of funding to use.

(3) Accordingly (and this is equally true if the definition of Default Rate was limited to debt funding), there is inherently scope for dispute about the cost of raising such funding. On Goldman Sachs' approach any uncertainties resulting from this approach are resolved by permitting the non-defaulting party to rely on its own assessment of such a cost, provided it falls within the range of reasonable options and is thus rational. By contrast, Wentworth's approach would render any such certification contestable, by allowing the defaulting party (or indeed other creditors with competing interests, such as, in this case, Wentworth) to assert that lower cost funding could have been available to the certifying party. This is not how the definition of Default Rate is supposed to operate. As Judge

[14] Itself a strange concept, given that the whole purpose of the "rationality" standard is that it encompasses multiple different positions that might be held by reasonable parties.

[15] Wentworth's trial skeleton, paras. 157, 225(5).

Chapman held in the *Intel* case, cited at in Goldman Sachs' trial skeleton,[16] the certainty sought by the drafters of the ISDA Master Agreement was not *"the certainty that the [relevant payment] would be calculated in a particular way"*, but they did seek *"the certainty that the [relevant payment], once determined, would be conclusive and legally enforceable."*[17]

19. For these reasons and those set out in Goldman Sachs' trial skeleton, Wentworth's attempt to impose these artificial and arbitrary restrictions on the definition should be rejected.

(2) Wentworth's own interpretation of the definition of Default Rate is commercially incoherent and unworkable

20. As was noted in Goldman Sachs' trial skeleton (para. 30(4)), a party seeking to cut down the definition of Default Rate to exclude the cost of equity funding can adopt two approaches. They can either argue that the words "cost…of funding" are confined simply to ordinary unsecured borrowing, which would be indefensibly restrictive. Or they can argue that it includes other types of debt as well, which has the merit of being broader (albeit still too narrow) but at the price of being uncertain and commercially nonsensical.

21. Wentworth appears to have adopted the latter approach. It seems to accept that all types of debt, including the "debt" components of hybrid funding instruments (but not the "equity" components) fall within the definition of Default Rate and can be certified as part of a party's cost of funding. Thus, it states that:

(1) At paras. 159-160:

"The fact that some part of a particular instrument has characteristics equivalent to that of borrowing merely demonstrates that in a case where an entity did, or could have, issued hybrid instruments in order to fund the relevant amount, the price paid by that entity in relation to those instruments may in part

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[16] At para. 34(3).

[17] *Lehman Brothers Holdings Inc. and Lehman Brothers OTC Derivatives Inc v. Intel Corporation* (SDNY), 16 September 2015, pages 22-23.

be relevant for determining the cost to it of borrowing the relevant amount. That does not mean that to the extent that the instruments bear characteristics of equity, the price relevant to that part is also relevant to the determination of interest payable under the ISDA MA.

In other words, the fact that some part of a bundle of rights negotiated in relation to an issue of shares might be in the nature of a debt does not mean that any return expected in relation to a share can be described as a "cost"…"

(2) At paras. 213:

"Wentworth's principal response to this is that:

(1) the hybrid nature of an instrument, i.e. one that includes elements of equity and elements of debt, does not undermine the fundamental differences between raising money by issuing equity and borrowing;

(2) nor does it preclude the elements of the price paid by the institution for the instrument that reflect a cost of borrowing, and those that reflect a cost of equity being disentangled."

(3) At para. 215:

"…None of these examples undermines the key distinction between borrowing and equity. Some part of a given bundle of rights might properly be a "cost"; however, that does not mean that other parts of that bundle are also a "cost"…"

22. The concession that the "debt" elements of complex instruments fall within the definition of Default Rate no doubt reflects Wentworth's recognition that any narrower interpretation would be indefensible, in light of the definition's wording or context. An interpretation of the definition that confined it to "ordinary unsecured borrowing" alone would deprive the words "cost…of funding" of most of their content.

23. However, Wentworth's approach creates its own insurmountable problems, which demonstrate that it cannot be the correct interpretation of the definition of Default Rate:

(1) First, it relies on a distinction between "debt" and "equity" that is completely unworkable as a matter of both law and fact. As to this:

(a) If this approach was to work then it would have to be based on a clear-cut definition of "debt" as opposed to "equity", which would allow the bounds of the definition of Default Rate to be crisply identified. These are not concepts that are defined or otherwise used in the ISDA Master Agreement. Notably, Wentworth offers no such definition. This is unsurprising, because no such definition exists. In practice funding arrangements exist on a spectrum, with hybrid instruments using (as Wentworth acknowledges) elements of both debt and equity funding, and the ingenuity of those in financial markets allows transactions structured in the form of sale or purchase (or other notionally "non-debt" transactions) to achieve the same economic effects as debt. Contrary to Wentworth's suggestion,[18] its interpretation would therefore result in great uncertainty.

(b) In any event, even if a reasonably clear distinction between "debt" and "equity" could be formulated, the idea that it is possible to "disentangle" those elements of a hybrid funding instrument that are "debt" and "equity" related, and only certify the former, is naïve. In many cases it will be highly disputable as to whether a particular feature falls into either category. It would also be unclear how (if at all) the broader terms relating to such funding (such as terms relating to financial covenants, provision of information, security, warranties etc) would be taken into account in such a process. Similarly, it is not clear how the costs of the instrument would be apportioned between the debt and equity components of the relevant instrument once the "disentangling" had taken place. All this would severely undermine the certainty that the ISDA Master Agreement was intended to promote.

(2) Second, quite apart from any question of whether this approach could be applied in practice, it is obvious that to do so would be artificial and uncommercial:

(a) Funding packages come in a multitude of different forms, with complex terms that are often carefully negotiated between the parties and "give and take" across different elements as part of that process of negotiation.

[18] Wentworth's trial skeleton, paras. 84, 110, 115-122.

There is no reason why the parties to the ISDA Master Agreement would have intended that some of those terms (deemed by Wentworth to constitute terms relating to "debt") could be covered by the definition of Default Rate, but not others (those relating to "equity"). This would result in the certification of a cost of funding that will, at most, only reflect part of the funding arrangement that was actually agreed.

(b) Even in the case of non-hybrid instruments Wentworth's approach would introduce, at the boundary between "debt" and "equity" instruments, highly artificial distinctions between various forms of funding which are used for exactly the same economic purpose. The point can be simply illustrated. On Wentworth's case, if the funding party raises heavily subordinated perpetual borrowing or limited recourse borrowing to fund the Relevant Amount, it will be able to certify the cost of that borrowing. That is so notwithstanding that the amount of any return and the prospect of any repayment of the principal are uncertain in both cases. But if the non-defaulting party raises preferred equity to fund the Relevant Amount, it will not be able to certify its cost. This is so notwithstanding that the coupon payable on that equity may be exactly the same rate as that arising under the subordinated borrowing. This result is commercially absurd.

(3) Much like its interpretation of "cost" as meaning "lowest" cost, Wentworth's approach would also create the scope for wide-ranging challenges to the certified cost of funding. Goldman Sachs argues that the Default Rate definition should be broadly construed to permit any type of funding to be certified, subject to the limits of rationality and good faith. On this approach there is therefore likely to be little, if any, dispute about whether the certified cost of funding falls within the scope of the definition. There might be a dispute about whether it is rational and/or in good faith, but the high threshold for such a challenge (the certification usually being conclusive) lends a significant amount of certainty to the process. By contrast, Wentworth's approach introduces significant uncertainty at both the definitional and certification stages of the process. It is likely to generate disputes about whether the "disentangling" process has been conducted correctly, and whether the certified cost of funding

therefore falls within the scope of the definition at all. It is then likely to generate a dispute about whether the certified cost of funding is a rational and good faith reflection of the certifying party's cost (the non-debt elements of the funding instrument having been somehow stripped out). How this could be assessed, in circumstances where the certified cost must ignore the "equity" components of any funding package and thus be inherently artificial, is wholly unclear.

24. None of these difficulties arise if the words *"cost…of funding"* are given their natural meaning, so as to allow the parties to certify the cost of any type of funding that they actually used or would have used (subject to rationality or good faith). By contrast, they are inevitable in any attempt to read down the definition in the manner suggested by Wentworth. In the circumstances it is obvious that Wentworth's approach cannot reflect the proper construction of the definition of Default Rate.

(3) Wentworth's reliance on other provisions in the 1992 and/or 2002 ISDA Master Agreements is misplaced

25. Wentworth also relies on:

(1) The definition of "Non-default Rate" and "Termination Rate" in the 1992 ISDA Master Agreement, which use the same form of words as the definition of Default Rate; and

(2) The reformulated definition of Non-default Rate in the 2002 ISDA Master Agreement, which allows the non-defaulting party to certify a *"rate offered to the Non-defaulting Party by a major bank in a relevant interbank market for overnight deposits in the applicable currency, such bank to be selected in good faith by the Non-defaulting Party for the purpose of obtaining a representative rate that will reasonable reflect conditions prevailing at the time in the relevant market."* [19]

26. Goldman Sachs submits that neither point takes Wentworth any further.

[19] A similar change is made to the new definition of "Non-Accrual rate" and the interest payable in the event of an Illegality Termination Event.

27. Looking first at the definition of Non-default Rate and Termination Rate in the 1992 ISDA Master Agreement:

(1) Goldman Sachs accepts that the same meaning must apply to the words that appear in the definition of Default Rate and the definition of Non-default Rate and Termination Rate, to the extent the same words are used. These words are therefore broad enough, in principle, to accommodate any type of funding, while recognising that the different circumstances in which they operate may well involve different considerations of what can be certified in good faith and rationally.

(2) However, the context in which the definitions of Non-default Rate and Termination Rate apply is very different to that of the Default Rate:

(a) The Default Rate definition applies where a party is owed money, but has not been paid the sum it is owed by a Defaulting Party, or by a Non-defaulting Party that has paid late (i.e. after the notice of the amount payable under Section 6(d) has become effective). It will therefore often be the case that the relevant payee will need to raise equity funding to plug the hole created by the failure to pay.

(b) By contrast, where the same wording applies to the *paying* party (as in the definition of Non-default Rate and the first part of the definition of Termination Rate) different considerations apply. The paying party does not have to deal with consequences of not being paid, but instead is required to pay a sum to the *other* party, as and when the time for payment falls due. It accordingly has the benefit of the Relevant Amount in the intervening period, and these definitions require it to account for that benefit. Moreover, since it holds the Relevant Amount prior to payment, there is no need for it to fund a shortfall in its capital as a result of a default. It is therefore much less likely that it would have chosen to fund the Relevant Amount by raising equity funding, since there is no question of it having to deal with any reduction in its equity capital.

(3) This difference between the two situations is reflected at the stage of certification, when the certification must be given rationally and in good faith.

Given that it is materially more likely that a reasonable *paying* party would certify a cost of funding based on its cost of borrowing, it might be irrational (depending on the circumstances) for it to certify cost of funding based on the cost of equity funding where there is no possibility of it suffering a depletion of its equity capital. Certainly, it is less likely that it would do so than the party that stands to be *paid* the Relevant Amount (and is thus, until payment is made, forced to deal with the consequences of a reduction to its equity capital).

28. It is also notable that Wentworth's approach (where all the relevant definitions are narrowly construed as being limited to a cost of debt) would produce potentially perverse consequences. As Goldman Sachs noted in its trial skeleton, when this approach is applied to the definition of Default Rate it would mean that the Non-defaulting Party would only be paid a rate of 1% (the minimum possible) if it could not access borrowing, potentially due to the effects of the very default that has triggered the requirement to pay the Default Rate. Exactly the same vice applies to a narrow interpretation of the other definitions. It would have the bizarre consequence that the recipient of the payment due from the Non-defaulting Party would be paid no interest at all if the Non-defaulting Party would have been unable to raise debt funding, notwithstanding that it is in precisely those circumstances that the funds held by the Non-defaulting Party (but owed to the other party) would likely to be of most value to the Non-defaulting Party.

29. The changes to the 2002 ISDA Master Agreement also do not assist Wentworth. On the contrary, they help support Goldman Sachs' case. As to these:

    (1) It is clear that this is a significant change as compared with the previous wording. Whereas before the Non-defaulting Party could certify for the purposes of the Non-default Rate a cost of funding based on any source of funding (on Goldman Sachs' case) or any cost of debt funding (on Wentworth's case) it is now limited to the interest that would be paid on a particular form of deposit, namely the "*rate offered to the Non-defaulting Party by a major bank in a relevant interbank market for overnight deposits in the applicable currency…*". In the circumstances, no sensible inference can be drawn either way from the lack of any explanation for the change in the accompanying User Guide.

(2) However, it is possible to draw two inferences from this change that support the broad interpretation of Default Rate advanced by Goldman Sachs:

(a) First, it would have been easy for the ISDA drafting team to have changed both the definition of Default Rate *and* the definition of Non-default Rate to be limited to a particular form of funding. They did not do so. The clear implication is that the definition of Default Rate was intended to (and is still intended to) cover a broader range of funding options.

(b) Second, the drafting change provides a practical demonstration of the ease with which the draftsmen of the ISDA Master Agreement could have limited the definition of Default Rate at the outset, so as to only cover borrowing or a specific type of funding, if that was their intention. Again, the implications of their not doing so are obvious.

<u>(4) Wentworth mischaracterises Goldman Sachs' case on Issue 14</u>

30. Wentworth takes two points on Issue 14,[20] namely that the certification should be challengeable on the grounds (a) of manifest error, and (b) that it *"is something other than the relevant payee's "cost ... if it were to fund or of funding the relevant amount" (as those words may be construed by the Court).*[21]

31. On the first point, Goldman Sachs opposes any inclusion of a separate ground of challenge based on manifest error. On this:

(1) Wentworth's position appears to be that this heading adds nothing to the requirements of rationality and good faith. As the SCG has noted in its trial skeleton, if this is right then it is, at best, unnecessary.[22] As Goldman Sachs understands Wentworth's position, an "error" in a certification would be sufficiently "manifest" when it is irrational (i.e. no reasonable party would have certified its cost of funding on the stated basis), but not otherwise. In these

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[20] And the equivalent provisions of Issue 15.

[21] Wentworth's trial skeleton, paras. 233-240.

[22] SCG's trial skeleton, paras. 128-130.

circumstances adding a reference to "manifest error" to the response to Issue 14 would simply serve to cause confusion without benefit.

(2) Alternatively, if it is suggested that the test of "manifest error" adds anything to the test of rationality and good faith then Goldman Sachs opposes such an addition. In general a clause permitting a challenge to a determination on the basis of manifest error must be expressly included in a contract; it will not be implied.[23] No basis has been offered for such an implication here, which would depart from the usual position. Moreover, while a test based on rationality is easily stated and (at least as a matter of law) easy to apply, a test based on manifest error is not. There is limitless scope for argument about whether a given point is a relevant "error" and whether it is "manifest", and the addition of such a test would badly undermine the certainty that the certification process aims to offer.

32. Separately, Wentworth suggests that Goldman Sachs argues that it is sufficient that a party rationally believes its certification to fall within the definition of Default Rate, even if it does not in fact (according to the Court's interpretation) do so.[24]

33. This is not correct. Goldman Sachs accepts that a certification must fall within the definition of "Default Rate", as properly interpreted by the Court. It is not sufficient that the certifying party *believes* that its certified cost of funding falls within the definition, if (applying the Court's proper construction of the definition) it does not actually do so.

34. However, it is Goldman Sachs' position that no challenge should be possible to a certification that *does* fall within the definition of Default Rate (as determined by the Court), provided it is rationally and honestly made.

35. It is on this basis that Goldman Sachs resists the formulation proposed by Wentworth for Issue 14, which would permit a challenge where the certification is *"is something other than the relevant payee's "cost ... if it were to fund or of funding the relevant*

[23] For example, in an expert determination clause a right to challenge the determination for manifest error will not be implied: Kendall on Expert Determination (5th Ed), 14.11-1.

[24] The Joint Administrators take the same point, suggesting that this is argued in Goldman Sachs' trial skeleton (Joint Administrators' skeleton, para. 143). This is incorrect; Goldman Sachs' trial skeleton does not argue this point.

amount" (as those words may be construed by the Court)". Goldman Sachs is concerned that this wording, as presently drafted, goes well beyond a ground of challenge on the basis that the certification is outside the scope of the definition of Default Rate. By appearing to permit a challenge where the certified cost of funding is "*something other than the relevant payee's "cost…of funding""*, it risks opening the door to a factual challenge to the certification, on the basis that the certified cost was not the "relevant payee's cost" but rather was something else. This is precisely the kind of factual challenge that the definition of Default Rate was intended to preclude.[25] Provided the certification is given rationally and in good faith, within the definition as interpreted by the Court, it should be conclusive.

36. To the extent it is felt necessary to refer to a ground of challenge based on the scope of the definition (and Goldman Sachs does not consider it necessary to do so), Goldman Sachs suggests that this should be limited to permitting a challenge where the certification *"does not fall within the scope of the expression "cost … if it were to fund or of funding the relevant amount", as those words may be construed by the Court."*

III. REPLY TO ARGUMENTS RAISED BY THE JOINT ADMINISTRATORS

37. Goldman Sachs puts forward arguments below in response to a limited number of points raised by the Joint Administrators and which are not otherwise dealt with elsewhere, as follows:

    (1) The regulatory regime applicable to financial institutions is relevant to the interpretation of the ISDA Master Agreement;

    (2) The wording of the definition of Default Rate should not be 'read down' i.e. interpreted narrowly;

    (3) The Relevant Payee need not assume that they raised funding in precisely the size of the Relevant Amount;

[25] As set out above, it is also precisely the kind of challenge that Wentworth, by construing the word "cost" as "lowest possible cost", seems anxious to permit.

(4) It may be rational to certify a cost of funding based on term funding for the duration of the period for which the Relevant Amount is outstanding.

38. Goldman Sachs also notes the following general points:

(1) At various points in their skeleton the Joint Administrators note their desire to ensure an expeditious distribution of the surplus of the LBIE administration.[26] This is unobjectionable as far as it goes, but the convenience of the Joint Administrators is not, of course, a touchstone for interpreting the ISDA Master Agreement. The Court's decision on the correct interpretation of that agreement will be applied well beyond the bounds of the LBIE administration, and the agreement must be construed on its merits.

(2) Joint Administrators cite the witness statements of Mr Lomas on several occasions.[27] It should be noted that Mr Lomas's evidence, to the extent it is considered by the Court, is not expert evidence; he is a witness like any other.

<u>(1) The regulatory regime applicable to financial institutions is relevant to the interpretation of the ISDA Master Agreement</u>

39. Goldman Sachs notes that the Joint Administrators refer to the decision of Briggs J in *Lehman Brothers Special Financing Inc v. Carlton Communications Ltd* [2011] EWHC 718 (Ch), in connection with Goldman Sachs' argument that the regulatory regime applicable to financial institutions forms part of the factual matrix against which the ISDA Master Agreement should be construed (Joint Administrators' skeleton, paras. 58-59).

40. *LBSF v. Carlton Communications* concerned the correct interpretation of Section 2(a)(iii) of the 1992 ISDA Master Agreement, pursuant to which payment obligations of the parties are subject to certain conditions precedent. LBSF argued that this clause should not be interpreted as a "walk-away clause", discharging the non-defaulting party from any obligation to make payment. One reason for this, it was argued, was that the regulatory *"capital adequacy requirements of most bank participants in ISDA*

[26] See, for example, Joint Administrators' skeleton argument at paras. 11, 27, 46-48, 60 and 62.

[27] See, for example, Joint Administrators' skeleton argument at fn 5 (para. 27), paras. 108.

agreements was such as to prohibit the inclusion of walk-away clauses" and that this was a background fact that should be taken into account in interpreting the relevant clause (para. 17). Briggs J rejected this argument.

41. Goldman Sachs submits that this decision has no application to the arguments advanced in the Waterfall II Application. In particular:

(1) In *LBSF v. Carlton Communications* it was argued that a very specific and recondite aspect of the detailed regulatory regime applicable to banks should be taken into account in interpreting the ISDA Master Agreement. As is summarised at para. 20 of the Judgment, expert evidence was led that, inter alia, (a) banks generally entered into netting arrangements with their counterparties, in order to net losses arising under certain transactions against gains under others, (b) regulators assessing a bank's credit risk exposures under the Basle regime would recognise netting arrangements as reducing such risk, and apply regulatory capital adequacy requirements accordingly, (c) a walk-away clause would prevent such a netting arrangement from working and (d) bank users of the ISDA Master Agreement reported their exposures on the basis that the ISDA Master Agreement gave rise to an effective netting arrangements and therefore they must have assumed that the ISDA Master Agreement did not include a walk-away clause. It was argued that Section 2(a)(iii) of the ISDA Master Agreement should be interpreted in LSBF's favour in light of these points.

(2) Given that this argument descended to a level of detail that would not generally have been known by non-bank counterparties using the ISDA Master Agreement, Briggs J unsurprisingly rejected it. It is clear from his reasoning that it was the particular implication of the regulatory capital regime that he was considering, not the existence of that regime generally, that formed the basis for his decision. Thus:

(a) Briggs J stated that the relevant knowledge related to the *"the regulatory and capital adequacy underlay for the proposition that a regulated bank would be unlikely to intend to contract under the Master Agreement on the basis that Section 2(a)(iii) was a walk-away clause."* (para. 24).

(b) Similarly, Briggs J held that *"the regulatory capital implications of [the] sale by regulated banks" of derivatives and "banks' regulatory capital concerns"* would not have been contemplated by other non-bank parties (paras. 25 and 26).

(3) Moreover, as Briggs J stated at para. 28, the particular argument advanced by LSBF *"came unacceptably close"* to an argument that the subjective interpretation/intentions of a particular party in relation to the ISDA Master Agreement should determine the interpretation of the agreement. This was not a question of background fact at all, but rather a matter of what banks (wrongly, so he held) had understood the ISDA Master Agreement to mean.

(4) None of these points apply to Goldman Sachs' argument in the present case. Goldman Sachs relies on the simple fact that banks are subject to regulations which require them to hold equity capital and that losses will reduce that capital. This is a fact that both the draftsman of the ISDA Master Agreement and all classes of users of that agreement (whether or not banks themselves) would be aware of. Putting the point another way, it is hard to imagine any reasonably well informed party, entering into the ISDA Master Agreement, would have been ignorant of the fact that banks are required to hold equity capital and can be required to raise further equity capital in the event they sustain losses.

42. Accordingly, Goldman Sachs submits that the decision in *Carlton Communications* turned on its facts, and does not lay down any broader principle that the existence of the capital regulatory regime applicable to financial institutions is not relevant to the interpretation of the ISDA Master Agreement.

43. In any event, it is noted that *Carlton Communications* only deals with the regulatory regime applicable to financial institutions, which is only one aspect of the factual matrix relied upon by Goldman Sachs. As is set out in Goldman Sachs' trial skeleton (paras. 46-47), Goldman Sachs also relies on the *market* pressures which may cause parties to the ISDA Master Agreement to need to raise equity capital in response to a default. These may be particularly acute for banks but they apply to all counterparties. These pressures would, accordingly, be known to all parties dealing with the ISDA Master Agreement (or operating in commerce generally). The Joint Administrators do not appear to suggest otherwise, citing *Carlton Communications* only in relation *to "the*

argument by GSI that the regulatory capital requirements of regulated financial institutions are part of the factual matrix against which the ISDA Master Agreements should be construed" (Joint Administrators' skeleton, para. 58).

(2) The wording of the definition should not be 'read down'

44. Separately, the Joint Administrators suggest that Goldman Sachs has argued that *"the Court should not 'read down' the contractual words by defining them or spelling out what they mean"*.[28] Paras. 21 and 59 of Goldman Sachs' trial skeleton are cited in this regard.

45. Goldman Sachs believes that the Joint Administrators have misread Goldman Sachs' submissions on this point. Goldman Sachs agrees that the Court should give its interpretation of the definition of Default Rate and the words "*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"*. Goldman Sachs argues that the definition should be interpreted broadly, in accordance with the natural meaning of the words used, so as to include any source or type of funding without restriction merely to a cost of borrowing. The Court should therefore reject an interpretation that would 'read down' these words as being limited to borrowing, rather than other types of funding. This is the point being taken at para. 21 of Goldman Sachs' trial skeleton. It is unclear why the Joint Administrators also refer to para. 59, which does not appear to relate to this point.

(3) A transaction by which the Relevant Amount is raised need not be for precisely the size of the Relevant Amount

46. At paras. 91-94 of their skeleton the Joint Administrators raise a new issue, regarding whether "*the cost must be the cost of funding the relevant amount to address the cash shortfall caused by the non-payment, or whether it can be the cost of funding some other amount for other purposes"*. They give the example of a Relevant Payee that could have raised the precise sum required to fund the Relevant Amount at a cost of funding of 5%, but who has raised or could raise a larger sum at a rate of 10%. They

[28] Joint Administrators' skeleton argument, para. 62.

ask which the cost of the larger sum can be certified as the Relevant Payee's cost of funding, or only the smaller sum.

47. The answer, Goldman Sachs submits, will turn on the particular facts in which the Relevant Payee did or would have raised the relevant funding and whether it was or would have been rational and/or in good faith to raise the larger sum and fund the Relevant Amount out of this sum. Assuming that the Relevant Payee did or would have raised the larger sum, in good faith and rationally, it would be entitled to fund or assume it would have funded the Relevant Amount out of that larger sum and calculate the "cost of funding" accordingly. The Relevant Payee is not required to assume it would only have raised the marginal amount required to fund the Relevant Amount, but no other sums. This will often be unrealistic, given the many funding commitments that the Relevant Payee may well have to meet.

48. Practical examples illustrates the point:

    (1) Take a given Relevant Payee that was the non-defaulting party in relation to two simultaneous ISDA Master Agreement defaults, each with different parties. Both defaults resulted in a Relevant Amount becoming due to the Relevant Payee of £50 million. The relevant cost of funding these Relevant Amounts would be (at least) the pro rata cost of raising £100 million, not £50 million. It cannot be the case that the cost of funding both Relevant Amounts must be assumed to only be the marginal cost of raising £50 million, as this would necessarily understate the real costs to which the Relevant Payee was exposed as a result of the defaults and the non-payment of the Relevant Amounts.

    (2) If this is right, then the same result should follow where the second £50 million is needed to serve funding requirements of the Relevant Payee other than funding a Relevant Amount due under an ISDA Master Agreement. It would be rational and in good faith for the Relevant Payee to certify the cost of the £50 million based on a pro rata share of the larger funding package.

(4) The rationality of certifying a cost of funding based on term funding for the duration of the period for which the Relevant Amount is outstanding.

49. Finally, the Joint Administrators suggest that it will never be rational to certify a cost of term funding for the period for which the Relevant Amount was outstanding (Joint Administrators' skeleton, para. 121). Goldman Sachs agrees (as it stated in its trial skeleton: para. 58(3)(c)) that it is improbable such funding would have actually been used in the context of the LBIE default, given the uncertainty as to whether the Relevant Amount would actually be repaid (and if so when). But, as a matter of construction of the ISDA Master Agreement and its general application, the possibility of this being a rational basis to assess "cost of funding" cannot be ruled out.

50. It is important to emphasise that the Court is being asked to interpret the definition of Default Rate, not apply that interpretation to any particular facts or any particular certification. The Joint Administrators state as much, at para. 62 of their skeleton.[29] However, the Joint Administrators appear to be asking the Court to pre-judge the certification question on this particular issue. This is dangerous. If, for example, the Relevant Amount was funded by long-duration funding with an early repayment option, it may well be appropriate to assume that the term of that funding would ultimately be identical to the period for which the Relevant Amount is outstanding. The Court should accordingly be cautious, at the stage of interpreting the definition of Relevant Amount (which is the only question before the Court), to assume that it will *never* be rational to certify a particular duration of funding. On appropriate facts it may be.

[29] Where the Joint Administrators state that *"The parties have always proceeded on the basis that the issues in Tranche C, including Issue 11, raise questions of construction, which are properly capable of being decided without reference to the facts of any particular case."*

IV. CONCLUSION

51. For the reasons given above and in Goldman Sachs' trial skeleton argument, it is respectfully submitted that the Court should answer Issues 11-14 and 27 in the form set out in the appendix to Goldman Sachs' trial skeleton.

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