

**IN THE COURT OF APPEAL  
ON APPEAL FROM:  
THE HIGH COURT OF JUSTICE  
CHANCERY DIVISION  
COMPANIES COURT  
THE HON. MR JUSTICE HILDYARD**

**Appeal Court Ref 2017/0159**

**No. 7942 of 2008**

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

**AND IN THE MATTER OF THE INSOLVENCY ACT 1986**

**BETWEEN:**

- (1) BURLINGTON LOAN MANAGEMENT LIMITED**
- (2) CVI GVF (LUX) MASTER S.A.R.L.**
- (3) HUTCHINSON INVESTORS LLC**
- (4) YORK GLOBAL FINANCE BDH, LLC**
- (5) GOLDMAN SACHS INTERNATIONAL**

**Appellants**

- and -

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

**Respondents**

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**GOLDMAN SACHS INTERNATIONAL'S  
APPEAL SKELETON ARGUMENT**

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## A. INTRODUCTION

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1. This appeal concerns the meaning of the words “*cost...of funding*” in the definition of “*Default Rate*” in the ISDA Master Agreement. The Default Rate definition requires the non-defaulting party to certify their “*cost...of funding*” the amount due from the defaulting party. This is then used to determine the interest rate to be paid by the defaulting party.
2. Goldman Sachs International (“**GSI**”) appeals against Hildyard J’s finding that these words are, in effect, limited to a “*cost of borrowing*”. GSI contends that the words “*cost...of funding*” include the cost of all types of funding. The definition therefore covers the cost of both borrowing and equity funding, and hybrids of the two.
3. In summary, GSI contends that the definition means what it says: it is the non-defaulting party’s “*cost...of funding*” that is relevant, not its (narrower) cost of borrowing. A cost of equity funding is undoubtedly a cost of funding. The language of the clause therefore supports GSI’s interpretation. This interpretation derives further support from the commercial context in which the definition applies, since ISDA counterparties (including financial institutions such as GSI) actually do respond to losses using equity funding.
4. By contrast, the narrower interpretation favoured by the Judge is at odds with the plain wording of the clause. It is also commercially unrealistic. Finally, it introduces incoherent and unworkable distinctions into the ISDA Master Agreement. In particular, the formal distinction which Hildyard J draws between debt and equity funding fits ill with the types of funding actually used by parties to the ISDA Master Agreement. These types of funding may function economically as borrowing, even if there are equity elements, or may have features characteristic of both debt and equity funding.
5. The Judge accepted that he found this issue to be difficult, stating that the parties’ arguments “*caused [him] to waver considerably, especially on the most acute issue of whether the cost of funding language extends to equity funding.*” (para. 114). GSI submits that, unfortunately, he ultimately came to the wrong result.
6. GSI sets out below a summary of the relevant background and GSI’s position. GSI then develops its submissions.

## **B. RELEVANT BACKGROUND**

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### **B1. ISDA and the ISDA Master Agreement**

7. The ISDA Master Agreement was drafted by the International Swaps and Derivatives Association (“**ISDA**”). ISDA was founded by financial institutions with the aim of standardising derivatives documentation. Financial institutions continue to be among the principal members of ISDA and users of the ISDA Master Agreement.
8. The ISDA Master Agreement is the centrepiece of ISDA’s standard form documentation. It is the dominant standard form used in the ‘Over The Counter’ (“**OTC**”) derivatives market. It governs transactions worth many trillions of dollars.
9. The original ISDA Master Agreement was produced in 1987, with a significantly revised version being issued in 1992. A further revised version was issued in 2002. The 1992 and 2002 versions both use the same definition of “*Default Rate*” and remain in regular use. GSI is party to a 1992 form ISDA Master Agreement with Lehman Brothers International (Europe) (“**LBIE**”), and references below are to the 1992 Form.
10. The ISDA Master Agreement is a pre-printed standard form agreement that sets out the key terms applicable to all derivative transactions between the parties to it. Party-specific terms can be included in the Schedule to the Master Agreement, which applies to all derivative transactions between the parties. Transaction-specific terms are usually included in a confirmation issued for each individual derivative transaction.

### **B2. Types of funding**

11. Companies conclude a broad range of transactions to fund themselves, using a mixture of debt and equity funding. They also use “*hybrid*” funding instruments, which exhibit features of both debt and equity (such as convertible bonds). Even instruments intended to function economically as debt may take a legal form which is not that of a loan (for example repo funding, which “*is structured legally as a sale and repurchase of the securities, [although] it behaves economically as a secured loan, with the securities acting as collateral*”: *Forsta AP-Fonden v Bank of New York Mellon* [2013] EWHC 3127 (Comm) at para. 290).

12. To a greater or lesser extent, the requirement to use both debt and equity funding applies to all commercial parties. A degree of capital strength is essential if a party is to be perceived as credit-worthy and capable of absorbing losses without defaulting on its obligations.
13. These points apply with particular force to financial institutions. As is well known:
  - (1) Due to the nature of their business, financial institutions are particularly vulnerable if they are perceived no longer to be a credit-worthy counterparty. The financial crisis of 2008-2009 illustrated the fate that can befall financial institutions that lose the confidence of the markets. Even a financial institution which does not have a legal obligation to obtain additional funding through equity capital may come under strong commercial pressure to do so, in order to maintain the confidence of clients, counterparties and regulators.
  - (2) Further, financial institutions are required by law to maintain a certain level of equity capital at all times. These requirements are often referred to as 'capital ratios'. Where a counterparty to a financial institution defaults, the resulting loss will reduce the financial institution's equity capital by a corresponding amount. The financial institution may therefore be *obliged* to respond to this loss by raising further equity capital. This loss cannot be met by raising further borrowing, as the borrowing would raise the institution's liabilities, offsetting any increase in its assets.
14. The need to raise equity capital in response to an ISDA Master Agreement default was seen in practice when LBIE defaulted, in September 2008. At this time a broad range of institutions, including Barclays, Goldman Sachs, Morgan Stanley, JP Morgan, Citigroup and Bank of America, all raised additional equity funding through a variety of different types of instrument. For example, in September 2008, Goldman Sachs announced that it would issue preferred equity and associated warrants to Berkshire Hathaway. This preferred equity required the payment of preferred dividends at a pre-agreed percentage rate, before any dividends could be paid on Goldman Sachs' regular stock.
15. While these points (and especially the applicable regulatory requirements) are particularly acute for financial institutions, it should be noted that the need to raise equity funding in

response to an ISDA Master Agreement default may likewise apply to other users of the ISDA Master Agreements.

### **B3. Key contractual and statutory provisions**

16. The words “*cost...of funding*” arise in the definition of “*Default Rate*” in the ISDA Master Agreement. “*Default Rate*” is defined in Section 14 of the ISDA Master Agreement 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.”

17. The definition of Default Rate is, in turn, used to determine the interest payable on outstanding ISDA claims. Pursuant to Section 6(d)(ii) of the ISDA Master Agreement (1992 Form), the sums owed following termination will be paid “*together with...interest thereon*” at the “*Applicable Rate*”. This is defined in Section 14 as the “*Default Rate*” in cases where the payer is the defaulting party or the payment is otherwise late.
18. Where a party is in administration, interest is paid at the higher of the rate set out in s.17 of the Judgments Act 1838 (8%) and the contractual rate: see Insolvency Rules 1986, Rules 2.88(6), (7) and (9).

## **C. SUMMARY OF GSI’S ARGUMENTS**

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19. GSI submits that the phrase “*cost...of funding*” encompasses the amounts paid pursuant to a transaction to raise equity funding, for the following reasons:
- (1) It follows from the language of the definition, which refers to “*funding*”, not “*borrowing*”;
  - (2) It is supported by the broader commercial context in which the ISDA Master Agreement was drafted and is used, by which entities will in fact raise equity funding in response to a default, and may be obliged to do so;

- (3) The alternative construction adopted by the Judge introduces incoherent and unworkable distinctions, which cannot have been intended by the drafters of the ISDA Master Agreement.
20. On this basis, the definition of Default Rate should encompass an actual or hypothetical transaction to fund the “*relevant amount*” by raising equity funding, as well as an actual or hypothetical transaction to raise borrowing (as per the Judge’s interpretation).
21. Each of these points is developed below.

## **D. GSI’S SUBMISSIONS**

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### **D1. The wording of the definition**

22. GSI’s primary submission is simple: the definition refers to “*funding*”, not “*borrowing*”. “*Funding*” means what it says. Equity funding is (undoubtedly) a widely prevalent type of “*funding*”. It equally undoubtedly carries a cost: this was accepted by the Judge, at least from a “*commercial perspective*” (para. 142).
23. On this basis, a cost of funding based on the cost of a transaction to raise equity funding is within the definition.
24. By contrast, the Judge’s conclusion requires the language of the definition to be ‘read down’, so that “*funding*” actually means only “*borrowing*”. In effect, this requires the conclusion that the drafters of the ISDA Master Agreement, who were (on any view) highly sophisticated parties, inadvertently used the wrong language in the definition of Default Rate.
25. This was the wrong conclusion, and it fails to give adequate weight to the wording of the definition. The correct approach, and the reasons why the Judge was mistaken, are considered below.

### **The proper approach**

26. The aim of contractual interpretation is to “*identify the intention of the parties by reference to...what a reasonable person having all the background knowledge which*

would have been available to the parties would have understood them to be using the language in the contract to mean”.<sup>1</sup>

27. The language of the clause is central to this exercise. As the Supreme Court has recently confirmed:

“... the reliance placed in some cases on commercial common sense and surrounding circumstances... should not be invoked to undervalue the importance of the language of the provision which is to be construed. The exercise of interpreting a provision involves identifying what the parties meant through the eyes of a reasonable reader, and, save perhaps in a very unusual case, that meaning is most obviously to be gleaned from the language of the provision. Unlike commercial common sense and the surrounding circumstances, the parties have control over the language they use in a contract. And, again save perhaps in a very unusual case, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision.”<sup>2</sup>

28. Further:

(1) It may be appropriate to depart from the natural meaning of the language where it is “less clear” or the drafting of the clause is poor, but “the clearer the natural meaning the more difficult it is to justify departing from it.”<sup>3</sup>

(2) Where the language is unambiguous, the Court must apply it.<sup>4</sup>

(3) The language of the contract will be particularly important where the contract has been carefully drafted by sophisticated parties. As was noted by the Supreme Court in the very recent case of *Wood v. Capita Insurance Services Limited*:

“some agreements may be successfully interpreted principally by textual analysis, for example because of their sophistication and complexity and because they have been negotiated and prepared with the assistance of skilled professionals.”<sup>5</sup>

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<sup>1</sup> *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619 at para. 15 per Lord Neuberger (with whom Lord Sumption and Lord Hughes agreed), citing Lord Hoffman in *Chartbrook Ltd v Persimmon Homes Ltd* [2009] AC 1101.

<sup>2</sup> *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619 at para. 17 per Lord Neuberger.

<sup>3</sup> *Arnold v Britton* [2015] UKSC 36, [2015] AC 1619 at para. 18 per Lord Neuberger.

<sup>4</sup> *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 W.L.R. 2900 at para. 23 per Lord Clarke.

29. The Court should therefore give great weight to the natural and ordinary meaning of the words used in the ISDA Master Agreement. This wording carries particular force where the Court is considering a standard form, prepared with the involvement of leading experts from financial institutions (and their lawyers), such as the ISDA Master Agreement.
30. Finally, where a standard wording is prepared for use by a wide variety of parties and for a wide variety of transactions, the Court should be particularly wary of ‘reading down’ language in that wording. The language used is likely to have been intended to provide for flexibility in its application, allowing it to be used by different types of party and to accommodate changes in market practice and products over time.

### **The correct interpretation**

31. The language used in the “*Default Rate*” definition is clear. The certified rate is defined by reference to the “*cost*” of the non-defaulting party’s “*funding*” the relevant amount, not its cost of borrowing the relevant amount.
32. There can be no serious dispute that equity funding is a type of funding. It also has a clear cost, which may take different forms depending on the type of equity instrument used, but in the most straightforward case includes the amount paid by the company in dividends to its equity funders. The Judge appeared to accept this, as a matter of ordinary language, noting that ““*cost*” bears a broader meaning from a commercial perspective than the meaning I have ascribed to the cost of funding language” (para. 142).
33. Further, if the intention of the ISDA drafters was that the definition should be limited to borrowing, they would simply have provided for the non-defaulting party to certify a “*cost of borrowing*”. The distinction between “*borrowing*” and “*funding*” was clearly grasped by ISDA: the definition of “*Specified Indebtedness*”, for example, refers to “*any obligation in respect of borrowed money*”.
34. However, having acknowledged that the word “*cost*” bore a broad meaning “*from a commercial perspective*”, and that equity funding is a type of funding, the Judge then held

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<sup>5</sup> *Wood v. Capita Insurance Services Limited* [2017] UKSC 24 per Lord Hodge, giving the judgment of the Court.



for various reasons that the definition did not, in fact, cover the cost of equity funding. These reasons do not, with respect, withstand scrutiny.

35. First, it appears that the key premise for the Judge’s reasoning was his view that the “*underlying objective*” of the Default Rate definition was to determine an interest rate, and that “*interest connotes borrowing*”. The Judge described this as the “*key to an understanding of the cost of funding language...*” (para. 119), and it is referred to repeatedly in the Judgment (e.g. at paras. 122, 142 and 145). It was therefore said that the definition excluded forms of funding where the cost “*is not properly described as interest*” (para. 122).
36. However, this premise is flawed:
  - (1) Critically, it conflates (i) the terms of the Default Rate definition with (ii) the fact that the definition is used to generate an interest rate. In particular:
    - (a) The ISDA Master Agreement does not require certification of an interest rate. Rather, under the Default Rate definition the non-defaulting party must certify their “*cost...of funding*”, which is then expressed as a “*rate per annum*”. This rate is then, in turn, used to determine the interest rate applicable to sums due under Section 6(d)(ii).
    - (b) The Judge’s approach therefore confused the requirement to certify a cost of funding that can be used to *produce* an interest rate, with a requirement to *certify* an interest rate. He therefore misunderstood both the language of the relevant clauses and the scheme of the ISDA Master Agreement.
  - (2) Further, the Judge accepted that the certifying party could include, as part of their “*cost...of funding*”, the “*fees paid to a lender as part of the price of borrowing*” (para. 157). He was right to do so: the fees paid to raise funding clearly form part of the “*cost*” of that funding.<sup>6</sup> But, having accepted this submission, it necessarily follows that the “*cost...of funding*” under the definition of Default Rate is not limited to costs taking the form of an interest rate. They do not even need to take the

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<sup>6</sup> Though the Judge arbitrarily limited such fees to the sums paid to the lender, rather than other fees incurred in raising the funding. This point is returned to below, regarding the inconsistencies in the Judge’s approach.

form of a rate per annum, provided that they can be expressed as a rate per annum. The Judge's reasoning is therefore internally inconsistent. It must follow from his conclusion on the 'fees' issue that the definition is not limited to costs taking the form of an interest rate.

- (3) In any event, in most cases the cost of a transaction to raise equity funding can easily be (and very often are) expressed as a "*rate per annum*". For example: the preference shares issued by Goldman Sachs to Berkshire Hathaway required the payment of a cumulative preferential dividend of 10% per year; as did the preferred shares issued by Morgan Stanley to Mitsubishi in October 2008. Those are rates expressed in the transaction documents rather than one derived by calculation. It is no more difficult to certify such rates as a "*cost...of funding*" than it would be to certify an interest rate on borrowing. Indeed this feature of preference shares reflects the fact that those providing the funding seek a particular return on that funding measured over time – a feature which is functionally indistinguishable from the role of an interest rate in debt transactions.

37. Second, the Judge was persuaded by a submission that the only "*cost*" that counted under the definition of Default Rate was a cost resulting from an "*obligation to pay*", which he appeared to consider required a formal contractual obligation to pay a specific amount (paras. 134-140 and 150-152). This appears to include an obligation to pay a specific amount even if the obligation does not have to be performed at a specific time, because there is a right to roll-up interest. So-called "*discretionary*" payments (i.e. payments where there was no contractual obligation to pay) were therefore excluded from the definition. This conclusion was, again, incorrect:

- (1) It takes an excessively formalistic approach to the concept of "*cost*". The Judge had noted that the word "*cost*" had a "*broader meaning from a commercial perspective*" than the meaning he ascribed to the definition of Default Rate. The reason for this broader "*commercial*" view is that the payment of dividends on equity is, for practical purposes, a commercial obligation. Without the payment of such dividends, investors will not provide equity funding. These dividends are the price they expect to be paid for funding the company.

- (2) The position is particularly clear for cumulative preference shares, where (in summary) the obligation to pay the preferred dividends so as to generate the required percentage rate of return accumulates each year until the full amount due is paid, and *no* dividends can be paid to any other shareholder until the preferred shareholder is paid in full. Even though the payment of the preferred equity dividends may be formally discretionary, it is no less ‘obligatory’ in practice than the payment of interest on borrowing, and the decision not to pay but “roll up” the payment carries significant commercial detriment for the party who has obtained the funding. If the dividends were *never* paid then the company would never be able to make any distributions to its shareholders, and it would swiftly lose all access to equity funding. These payments are therefore not “*discretionary*”, in any meaningful sense of the term.
- (3) Moreover, to the extent there was any concern that parties might needlessly pay sums to equity funders, and then seek to pass on that cost to the defaulting party, the appropriate solution is to be found in the fact that any “*cost...of funding*” must be certified in good faith and rationally.<sup>7</sup> If a defaulting party considers that the non-defaulting party is unnecessarily making gratuitous or over-generous payments to its equity funders, it can therefore challenge the certification of that payment as not reflecting the non-defaulting party’s actual “*cost...of funding*”. In practice this concern must be more theoretical than real, as a company will not pay dividends to its shareholders unless it perceives that it is proper to do so, but this provides a safeguard against that unlikely eventuality. The same safeguard protects against a concern that borrowing may be undertaken on unrealistic terms.

38. Third, the Judge said that this restrictive interpretation was necessary to “*keep within sensible boundaries the matters subject only to the control of good faith and rationality*” (para. 116). As to this:

- (1) This concern may have had some force as regards the broadest possible measure of a non-defaulting party’s ‘cost of equity’, including purely model-based costs such as “*Weighted Average Cost of Capital*” and “*CapM*” (mentioned at paras. 117 and

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<sup>7</sup> All parties accepted that the certification in the definition of Default Rate was subject to such a limitation, and this was approved by the Judge: paras. 193-194, the Judge’s declaration (xviii).

- 138). The Judge was clearly concerned that the definition of Default Rate might be unduly broad if such models were included within it, requiring some limit to be imposed on the requirement to certify a “*cost...of funding*”.
- (2) However, these “*boundaries*” are provided by limiting the “*cost...of funding*” to an “*actual or hypothetical transaction*”, by which the relevant funding is raised (noted, for example, at paras. 115 and 124). This is consistent with the wording of the definition, which refers to “*funding...the relevant amount*”. The focus of the definition is therefore on the cost to raise the funding required to meet the shortfall caused by the defaulting party’s failure to pay (i.e. the “*relevant amount*”). The very fact that cost is determined by actual or hypothetical transactions will itself provide meaningful limits on the amounts which can be certified.
  - (3) There is no need to go further, and restrict the relevant transaction to the cost of raising borrowing. This limitation is arbitrary, and entails the rewriting of the definition rather than its interpretation.
39. Fourth, the Judge suggested that his interpretation was “*necessary in order to...ensure consistent construction of the cost of funding language in each of the contexts in which it appears*” (para. 116). This comment appears to be based on his view that the words “*cost of funding*”, as they appear in the definitions of Non-default Rate and Termination Rate (which, at least in the 1992 ISDA form, use similar language to the definition of Default Rate), were also directed at the determination of a rate of interest. But this is simply a restatement of his first point, and it is therefore circular. If the words “*cost...of funding*” are not centred on the “*concept of interest*”, as the Judge found, then there is no reason why any of these definitions should be interpreted in this way.
40. Moreover, the Judge’s conclusion actually introduces an arbitrary distinction between the meaning of the words “*cost of funding*” in the definition of “*Loss*”, and the meaning of the same words in the definition of “*Default Rate*”. In particular:
- (1) “*Loss*” is defined by the ISDA Master Agreement to mean “*an amount that [a] party reasonably determines in good faith to be its total losses and costs...in connection with this Agreement*” including (amongst various other matters) “*any...cost of funding*”.

- (2) The Judge noted the New York decision of *Lehman Brothers Holdings Inc. and Lehman Brothers OTC Derivatives Inc v. Intel Corporation*,<sup>8</sup> in which the US Federal District Court rejected an attempt to interpret this provision restrictively. In brief summary:
- (a) Intel alleged that it had sustained a loss as a result of the non-delivery by Lehman Brothers of certain Intel shares. Lehman argued that the only method by which the non-defaulting party could calculate its “Loss” was to use the “*fair market value*” of the undelivered shares, rather than any broader basis.
  - (b) Judge Chapman rejected Lehman’s argument. She noted that there was nothing in the text of the definition of Loss that “*explicitly mandates any particular calculation method or otherwise modifies the plain meaning of that first sentence of the definition*”. Intel was accordingly entitled to select any methodology for calculating its loss that it wished, subject to the requirement to do so reasonably and in good faith.<sup>9</sup>
  - (c) Adopting this approach, it must have followed that that the meaning of the words “*cost of funding*” in the definition of “Loss” would be interpreted as being broad enough to cover equity funding. By parity of reasoning, there is nothing in the definition to require any particular form of funding to be used.
- (3) The Judge agreed with both the “*result and rationale*” of the *Intel* case: para. 143. However, he held that the “*governing concept*” for the definition of “Loss” is “*the concept of loss*”, whereas for the definition of “Default Rate” the “*governing concept*” was the “*concept of interest*”, so a similarly broad approach should not apply to the definition of Default Rate (para. 145). This again mistakenly conflates the terms of the Default Rate definition with the fact that the definition is used to generate an interest rate.

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<sup>8</sup> Southern District of New York, 16 September 2015, 1:13-ap-01340.

<sup>9</sup> Ibid at page 20. Note that the definition of “Loss” expressly requires the non-defaulting party to act “*reasonably*” and in good faith, whereas the implicit limitation in the definition of “Default Rate” is to act “*rationally*” and in good faith.

- (4) In any event, there is no way to reconcile the two approaches, which would lead to the words “*cost of funding*” being given different interpretations in different parts of the ISDA Master Agreement.
  - (5) The *Intel* decision rightly holds that, where the ISDA Master Agreement used general words to describe a head of recovery, the Court should not ‘read down’ those words to prescribe a narrower meaning. The same approach should be followed as regards the definition of Default Rate. The words “*cost of funding*” should be broad enough to cover equity funding in each case.
41. It follows that the Judge’s reasons for displacing the clear wording of the definition were wrong. This is determinative of the appeal.

### **Conclusion on language**

42. On this basis, GSI submits that the Judge should not have overridden the clear language of the definition, so as to find that the words “*cost...of funding*” meant “*cost of borrowing*”. He thereby rewrote the definition, without any valid basis for doing so. He should have found that the cost of a transaction to raise equity funding was clearly within the language “*cost...of funding*”.

### **D2. The commercial context**

43. As is set out above, the language of the definition is clear. But the conclusion that the definition of “*Default Rate*” should cover equity funding derives further support from the commercial context in which it was agreed.
44. As regards the relevant principles:
- (1) The commercial context is important in construing the definition within its ‘factual matrix’. “*Commercial common sense*” remains a “*very important factor to take into account when interpreting a contract*”.<sup>10</sup>

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<sup>10</sup> *Arnold v. Britton* [2015] UKSC 36, [2015] AC 1619 at para. 20 per Lord Neuberger.

- (2) As Lord Clarke held in *Rainy Sky*, “ *where a term of a contract is open to more than one interpretation, it is generally appropriate to adopt the interpretation which is most consistent with business common sense.*”<sup>11</sup>
  - (3) What matters are the facts that would reasonably have been known to the parties at the time of contracting.<sup>12</sup> Where the contract is a standard form, this will tend to limit the role for factual background.<sup>13</sup> However, knowledge that would reasonably be known to the class of parties using the standard form will remain relevant.<sup>14</sup>
  - (4) Thus, if the commercial context for a standard form is generally known to users of that agreement (or reasonably should be known to them), then it remains relevant for the purposes of interpreting the meaning of the contract.
45. In this case the following factors, which would have been well known to all reasonable users of the ISDA Master Agreement at all material times, are relevant:
- (1) Companies fund themselves using both debt and equity funding. They may need to raise equity funding in response to a default, since this will erode their equity capital base. Such funding may be necessary to maintain the confidence of counterparties (and the market more generally) in the ability of the non-defaulting party to meet its obligations. Alternatively, such funding may be necessary if lenders are not willing to advance borrowing on competitive terms, or at all, due to the circumstances of the non-defaulting party.
  - (2) This is particularly the case for financial institutions. These institutions are the main users of the ISDA Master Agreement (certainly by value), as the Judge acknowledged (paras. 104 and 142). The need to maintain a solid capital base,

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<sup>11</sup> *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50; [2011] 1 W.L.R. 2900 at para. 30 per Lord Clarke. See also para. 30, to similar effect: “*If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other.*”

<sup>12</sup> *Arnold v. Britton* [2015] UKSC 36, [2015] AC 1619 at para. 21.

<sup>13</sup> See for example, *AIB Group (UK) Plc v. Martin* [2002] 1 WLR 94 per Lord Millett at para. 7 (dissenting on the outcome) and the authorities cited in Lewison on the Interpretation of Contracts (6<sup>th</sup> Ed) at 3.18.

<sup>14</sup> *Dairy Containers Ltd v. Tasman Orient CV (The Tasman Discoverer)* [2004] UKPC 22; [2005] 1 WLR 215 at para. 12 per Lord Bingham: while “*no inference may be drawn as to the knowledge or intention of any particular party*”, “*The contract should be given the meaning it would convey to a reasonable person having all the background knowledge which is reasonably available to the person or class of persons to whom the document is addressed.*” . *The Tasman Discoverer* was a case about a negotiable bill of lading, but a similar approach should apply to standard forms.

founded on equity funding, is essential for such institutions. This is both due to both the commercial requirements of their business, and the regulatory requirements imposed upon them. Though the latter requirements are specific to financial institutions, they are well known in the market generally: any party sophisticated enough to use the ISDA Master Agreement (or, at least, any reasonable party) would certainly be aware that financial institutions are regulated for capital adequacy.<sup>15</sup>

46. Against this background, it is very likely that any reference to “*funding*” would have been intended to encompass equity funding. If there were any doubts as to the meaning of the words “*cost...of funding*” (which, as per the submissions above, there is not) then this commercial context would resolve them.
47. By contrast, the Judge’s interpretation requires the definition to be interpreted as if it solely referred to ‘borrowing’, and requires a cost of funding to be certified on that basis, notwithstanding that both the drafters of the definition and users of the ISDA Master Agreement would have known that the loss caused by the default would often be met by raising equity funding. This is commercially unrealistic, and another reason why the Judge’s interpretation should be rejected.

**D3. Limiting the definition to “borrowing” would result in inconsistent and incoherent outcomes**

48. The wording and commercial context of the definition of Default Rate therefore point strongly in favour of GSI’s interpretation, which would permit the certification of a cost of funding based on a transaction to raise equity funding.
49. If there was any remaining doubt on this interpretation, it is dispelled by considering the many inconsistencies and anomalies that are produced by the Judge’s interpretation. These are the inevitable consequence of trying artificially to restrict the types of “*cost...of*

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<sup>15</sup> This is therefore a very different case to *Lehman Brothers Special Financing Inc v. Carlton Communications Ltd* [2011] EWHC 718 (Ch), where it was argued that the ISDA Master Agreement should be interpreted in light of a detailed and esoteric requirement of the regulations applicable to banks (at paras. 24-28). As Briggs J noted, this came close to an argument the subjective intentions of bank counterparties should govern the interpretation of the agreement (para. 28), since such matters would not be known to non-bank counterparties. By contrast, the need for financial institutions to maintain a level of equity funding would be known to all but the most myopic users of the ISDA Master Agreement.



*funding*” which may be certified, without regard to the ways in which they actually raise funding.

50. GSI relies, in particular, on two points which show that equity funding should not be excluded from the definition:

(1) Most importantly, the Judge’s interpretation relies on a sharp distinction between ‘debt’ and ‘equity’ funding that simply does not exist in the commercial world:

(a) Many “*hybrid*” instruments straddle the divide between these two types of funding. Convertible bonds are an obvious example. These could be debt instruments which can be converted into equity, or preference shares which provide for mandatory conversion to debt. On the Judge’s approach, these transactions either would instantaneously cease to be a cost of funding within the definition of “*Default Rate*” at the moment of conversion from debt into equity, or conversely would become a cost of funding when converted from equity into debt, producing a commercially unworkable result. These are but one example - there are myriad different types of funding, and new forms of instrument are continuously being invented.

(b) Moreover, instruments that are formally ‘equity’ funding may very well, in practice, impose legal and commercial obligations that are more compelling than the formal legal obligations imposed by ‘borrowing’. A bank that failed to pay the dividend due on cumulative preference shares might be subject to a legal restriction in terms of its ability to pay dividends on common stock, be legally required to permit the preference shareholder to appoint directors to its board, and, commercially, be at grave financial risk. By contrast, long-term subordinated debt will often permit the payment of interest to be ‘rolled-up’ and deferred (or even for the bondholders to be ‘bailed in’, to become shareholders), an option that may well be taken up if the company is under financial strain. Similarly, debt funding may be very long term or even perpetual, while equity funding might have a redemption option that allows it to be repaid.

- (c) The distinction between ‘debt’ and ‘equity’ therefore breaks down in practice. The Judge’s attempt to draw a firm distinction between ‘borrowing’ and ‘non-borrowing’ does not reflect commercial reality.
- (d) The Judge acknowledged this point, but had no convincing answer to it. At para. 141 he sought to deal with “*hybrid*” funding instruments, saying that “*part of the cost of a hybrid instrument could theoretically be within the cost of borrowing language, but only if it is possible to disentangle the interest rate element payable in respect of making available to the payee the relevant amount over the relevant period from other costs (in particular, any equity element cost, or some cost not referable to the relevant period during which the relevant amount is outstanding)*”. However:
  - (i) This is a convoluted solution to an unnecessary problem. As the language used by the Judge (“*disentangle*”) suggests, this exercise would entail dividing up a single instrument into its ‘debt’ and ‘equity’ components. But the difficulty only arises if an unduly narrow interpretation of the definition is adopted, which ignores the fact that both components will often be found in a single instrument.
  - (ii) Further, by only permitting part of the cost of a hybrid funding instrument to be certified, this approach would artificially limit the certifiable “*cost...of funding*”, ignoring the real cost. The Judge actually noted that this approach would understate the true cost of the funding, stating that the debt element would “*in economic terms be only part of the cost*” (para. 141). But this merely illustrates how commercially unrealistic this interpretation is: it requires the severing of different parts of a single transaction, forcing the non-defaulting party to ignore the true “*economic*” cost of their funding. Economically, these elements come as a package and it is not meaningful to consider them in isolation

The Judge’s interpretation therefore produces an arbitrary and unworkable result that would need to be determined on a case-by-case basis, potentially through unnecessary satellite litigation about how to treat different elements of a single

financial instrument. The overall effect is that forms of funding with commercially equivalent results will end up being treated very differently. This cannot have been what the drafters of the ISDA Master Agreement intended.

- (2) The Judge refused to decide the question of how his definition of Default Rate could apply if the relevant payee could not borrow at any price. He said that the “*circumstance of a party not being able to borrow at all, whilst yet able to equity fund, as being remote; and it may be that it was not within the contemplation of the draftsmen. I think the matter should be left unless and until the unusual case arises*” (para. 163). With respect, this was far too sanguine. The situation where institutions could not raise further borrowing (but could raise equity funding) actually did arise during the 2008 financial crisis. In any case it would certainly have been foreseeable when the ISDA Master Agreement was drafted that a non-defaulting ISDA party, faced with a major default, might struggle to raise further funding through borrowing but could raise that funding through equity to recapitalise itself on the grounds that it otherwise remains a viable and attractive business. Any interpretation that cannot accommodate this situation is likely to be wrong.

51. The Judge’s narrow interpretation introduced two further arbitrary distinctions, which are also indefensible (whether or not the definition was restricted to equity or debt funding):

- (1) As has already been noted, the Judge agreed that the cost of fees paid to a lender could be included in the non-defaulting party’s certification of their default rate (para. 157). However, he expressly excluded other fees that would have to be paid to raise funding, such as legal and underwriting fees (*ibid*), notwithstanding that these are necessary costs to raise funding. There is no coherent basis for this distinction. The definition of “*cost...of funding*” is not limited to sums paid to the funder, but rather covers the costs of funding the relevant amount. These costs are undoubtedly real and would have to be paid to raise funding (of any type). There is no reason to artificially restrict the definition to exclude such costs.
- (2) The Judge appeared to conclude that a non-defaulting party must certify a cost of funding based on a transaction *solely* for the relevant amount, taking place in isolation. Accordingly, it could not certify the pro-rata cost of raising a larger

amount, of which part (but not all) would be allocated to fund the relevant amount (paras. 153-154). If this was the Judge’s conclusion, then it (again) demonstrates that his analysis failed to engage with the commercial realities of raising funds in the circumstances of an ISDA default. Fund-raising does not take place in a vacuum. It is very unlikely that any party would undertake a fund-raising transaction – whether debt, equity or hybrid – solely to meet a particular default. Rather, parties will tend to raise funds as part of a larger transaction, part of which will be used to meet the loss of the “*relevant amount*”. It is overwhelmingly likely that the ISDA drafters would have intended for the defaulting party to be allowed to certify this cost on a pro-rata basis, as the cost of funding the relevant amount.

52. These difficulties further illustrate the danger of adopting an excessively narrow interpretation of the definition.
53. Finally, it is noted that, by contrast with the points set out above, the Judge seemed to attach some weight to the fact that certifying a cost of equity funding could (in the circumstances of this case) result in a higher rate than if the definition was limited to a ‘cost of borrowing’ (paras. 128-129).
54. To the extent that this difference in outcomes was relied upon, in interpreting the definition of “*Default Rate*”, the Judge’s approach was misguided in both fact and law:
  - (1) First, the certified rate turns on the particular circumstances of the non-defaulting party and the circumstances of the default. In the unusual circumstances of the markets following the 2008 financial crisis there may well have been an unusually wide difference in the cost of borrowing and equity funding, at least for some institutions. But this is not a basis on which to interpret the definition, which has been included in the 1992 ISDA Master Agreement for 25 years and which must apply at all times and in all markets.<sup>16</sup>
  - (2) Second, it ignores the fact that a cost of equity may still reflect some or all the *real* cost of a party’s funding, depending on the circumstances of the default, if for legal

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<sup>16</sup> A “*cost of borrowing*” will not necessarily produce a low rate. The recent New York decision of *Good Hill Master Fund L.P. v. Deutsche Bank AG* 2017 NY Slip Op 00428 provides an example where a party’s cost of funding was certified at 21%, on the basis that this was their cost of borrowing pursuant to “*the interest rate on loans from third-party investors*”. The Court upheld this rate as being validly certified.

or commercial reasons they would respond to the default by raising equity funding. In these circumstances it is irrelevant that borrowing may be cheaper than equity funding, since borrowing would not meet the needs imposed by LBIE's default.

(3) Third, as a matter of law, it is strictly irrelevant that the particular circumstances in which a contract applies end up producing unpredictably costly results for one party. This was recently reaffirmed by the Supreme Court in *Arnold v. Britton*,<sup>17</sup> where a management charge 'ratchet' clause proved to be (relatively) expensive in the (unforeseen) low inflation economy of 2015. However, this did not mean that the clear language of the clause should be distorted.

(4) Fourth, the Court will no doubt be careful to prevent abuse, ensuring that the certified costs are not overstated. This is achieved by the requirement that the "*cost...of funding*" be certified rationally and in good faith.

55. Accordingly, while it is true that that a Default Rate including equity funding could, in the particular circumstances of this case, produce a higher Default Rate than if the definition was limited to borrowing, this is irrelevant to the correct interpretation of the definition.

## **E. CONCLUSION**

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56. For the reasons set out above, the appeal should be allowed. GSI has prepared an alternative set of declarations, to replace those made by the Judge, which are attached to its Appellant's Notice. Those declarations follow from the arguments set out above, but further submissions on them can be made as required.

**DAVID FOXTON QC**

**CRAIG MORRISON**

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<sup>17</sup> [2015] UKSC 36, [2015] AC 1619.