Appeal Refs: 2017/0153, 2017/0294 and 2017/0302

IN THE COURT OF APPEAL
ON APPEAL FROM THE HIGH COURT
CHANCERY DIVISION
HILDYARD J
No 7942 of 2008

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N

(1) BURLINGTON LOAN MANAGEMENT LIMITED
(2) CVI GVF (LUX) MASTER S.A.R.L.
(3) HUTCHINSON INVESTORS, LLC

Appellants

- and -

(1) ANTONY 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.
(7) YORK GLOBAL FINANCE BDH, LLC
(8) GOLDMAN SACHS INTERNATIONS

Respondents

SENIOR CREDITOR GROUP'S SKELETON ARGUMENT FOR APPEAL

A. INTRODUCTION

1. This appeal concerns the meaning of the definition of Default Rate in the 1992 and 2002 ISDA Master Agreements (the "Master Agreements"). It arises from the judgment and order of Mr Justice Hildyard dated 5 October 2016 and 12 December 2016 respectively.

2. The Default Rate describes the rate of interest payable on certain sums due, but unpaid, under the Master Agreements. It is defined as:

> "*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*".

3. The issue of construction which arises on this appeal concerns the meaning of the phrase "*cost … if it were to fund or of funding the relevant amount*", in particular the meaning of "*fund or … funding*" and the meaning of "*cost*".

4. The definition of the Default Rate is concerned with identifying what it cost or would have cost the payee to obtain replacement funding for the period for which the relevant sum was due but unpaid, and compensating it by entitling it to interest at a certified rate per annum equal to that cost, plus 1%, for the period until the relevant sum is paid (Judgment [60]).

5. The Judge accepted that parties to the Master Agreements fund their activities in various ways, including both debt and equity funding (Judgment [117]).

6. He also proceeded on the basis that: (a) as a matter of ordinary language the phrase "*cost of funding*" is a broad concept which is capable of encompassing forms of funding other than borrowing, including equity funding; and (b) in other contexts the Master Agreements use the phrase "*cost of funding*" in that broad and ordinary sense (Judgment [146]).

7. Despite this, and although saying that he had wavered considerably, the Judge ultimately concluded that a "*more limited construction*" and "*restricted meaning*" should be given to the expression "*cost … if it were to fund or of funding the relevant amount*" in the context of the definition of the Default Rate (Judgment [116], [132]).

8. The Judge read down the ordinary broad meaning of the phrase "*cost of funding*" in the context of the definition of the Default Rate in two ways:

   (1) First, he held that it was limited to "*the cost which the relevant payee is or would be required to pay in borrowing the relevant amount*" (Judgment [147(1)]; and

   (2) Secondly, he held that "*cost*" in this context, was also limited to the "*cost of interest*" which was paid or would have been paid in respect of such borrowing, and did not therefore extend to any other costs of replacement funding (Judgment [123]).

9. The effect of the Judge's conclusions is both surprising and uncommercial. For example:

   (1) A payee who acted reasonably and in good faith in obtaining replacement funding, through a mixture of debt and equity funding or solely through equity funding, and who actually incurred the cost of doing so, is not able to recover such costs in respect of the relevant period by means of the Default Rate.

   (2) Entities which are unable to raise debt but are able to attract equity investment have no cost of funding for the purpose of the Default Rate (such that they would be entitled to a Default Rate of 1% only).

   (3) Further, a payee who obtained replacement funding through borrowing, and who acted reasonably and in good faith in paying additional costs associated with such borrowing, such as facility fees, is not able to recover such costs, as such costs are "*not described as interest*" (Judgment [122]).

10. With the permission of the Judge, the Senior Creditor Group appeals the relevant declarations reflecting the Judge's conclusions (namely declarations (ii), (iii), (vi), (ix), (xi) and (xii)). In summary:

(1) The Master Agreements are carefully drafted documents, developed over many years with the benefit of knowledge of the market. Particular respect needs to be accorded to the words used.

(2) As a matter of ordinary language, and as the Judge himself accepted, "*cost*" is a broad concept and the phrase "*cost of funding*" is capable of encompassing various forms of funding other than solely borrowing. It can include equity funding, funding through hybrid instruments such as convertible debt or preference equity, and any other source or combination of sources of funding, together with the costs of such funding.

(3) As the Judge also concluded, the phrase "*cost of funding*" bears this broad and ordinary meaning elsewhere in the Master Agreements, including in the definition of "*Loss*" in the 1992 Agreement.

(4) The ordinary and broad meaning of "*cost of funding*" ensures that the concepts used in the Master Agreements are sufficiently flexible to operate in a commercially relevant way for the widest range of market participants with a variety of funding structures and requirements, and in various and unpredictable market conditions. This includes participants who, whether for regulatory capital reasons or otherwise, are either unable to fund the relevant amount through borrowing or where it would not be commercially sensible for them to do so.

(5) Nothing in the language of the Default Rate suggests that the definition is to be given a restricted meaning in this context, so as to be limited solely to borrowing and to costs described as interest on such borrowing. In particular, the draftsman has defined the Default Rate by reference to the relevant payee's "*cost of funding*" and not by reference to its "*interest cost of borrowing*".

(6) The reasons given by the Judge for giving the phrase a restricted meaning in the context of the definition of the Default Rate, misunderstand the way in which that definition operates and involve a number of non-sequiturs.

(7) The Judge's approach is also unsatisfactory in seeking to draw a bright line between funding which constitutes "borrowing" and other forms of funding. The distinction drawn is at best commercially arbitrary and at worst non-existent.

(8) The conclusion reached by the Judge also results in consequences which do not make commercial sense. Rather than operating by reference to the cost of funding which was actually incurred or which would have been incurred by the payee reasonably and in good faith, the Judge's approach provides for the application of an arbitrary and potentially commercially irrelevant default rate.

B. THE MASTER AGREEMENTS

11. The Master Agreement is "*probably the most important standard form agreement in the financial world*"; per Briggs J in *Lomas v JFB Firth Rixson* [2010] EWHC 3372 (Ch) at [53].

12. The forms are used for a huge variety of different types of derivative transactions and by a broad range of counterparties, including banks and other financial institutions, corporate entities and public bodies.

13. According to statistics compiled by the Bank of International Settlements, at the end of June 2016, the total notional amount of over the counter derivatives in existence was $544 trillion.

14. The basic architecture of the Master Agreements is described in the Judgment of Hildyard J below at [30]-[31]. It is also described in the judgment of Longmore LJ in *Lomas v JFB Firth Rixson* [2012] EWCA Civ 419 at [12] and in the judgment of Briggs J in the same case at [9]-[27][1].

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1 Both the 1992 and 2002 versions of the Master Agreements continue to be used, depending on the parties' preferences; *ibid* at [8].

C. INTEREST RATE DERIVED FROM "COST OF FUNDING"

15. Under the Master Agreements, interest is payable from one party to the other in a variety of situations and at a variety of rates.

The 1992 Agreement

16. Under the 1992 Agreement, interest is payable from one party to the other in a variety of situations and at one of three different rates, all of which utilise the concept of the cost to one entity or the other of funding (actually or hypothetically) the relevant amount. The three rates of interest identified in the 1992 Agreement are as follows:

(1) The Default Rate: "*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*".

(2) The Non-default Rate: "*a rate per annum equal to the cost (without proof or evidence of actual cost) to the Non-defaulting Party (as certified by it) if it were to fund the relevant amount*".

(3) The Termination Rate: "*a rate per annum equal to the arithmetic mean of the cost (without proof or evidence of any actual cost) to each party (as certified by such party) if it were to fund or of funding such amounts*".

17. The circumstances in which the 1992 Agreement requires interest to be paid, and the rate applicable in each case, are set out at [37] – [41] of the Judgment.

The 2002 Agreement

18. Section 9(h) of the 2002 Agreement consolidates provisions regarding interest in a way that is not done in the 1992 Agreement. The concept of cost of funding is retained in the majority of the relevant definitions, but in others a new and distinct basis for calculating interest is incorporated, by reference to an overnight deposit rate offered by a major bank.

19. Insofar as the concept of "*cost of funding*" is concerned, the 2002 Agreement retains the 1992 Agreement definitions of the Default Rate and the Termination Rate. In addition, it introduces the concept of the Applicable Deferral Rate which for certain purposes is defined as: "*a rate equal to the arithmetic mean of the* [rate offered to the payor by a major bank for overnight deposits] *and 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*".

20. The circumstances in which the 2002 Agreement requires interest to be paid by reference to a "*cost of funding*" are set out at [44] of the Judgment.

D. THE DRAFTING OF THE MASTER AGREEMENTS

21. A fundamental objective of the draftsman of the Master Agreements was to ensure that their provisions are sufficiently flexible to be capable of being used in a practical and commercially relevant way by the widest range of market participants, for the widest range of products and for market activity in the widest possible range of jurisdictions in an infinitely variable combination of different circumstances: *Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance SA* [2011] 2 Lloyd's Rep 518 at [115]; Judgment [48(4)]; 2002 User's Guide at 5(a).

22. This objective is achieved in large part through the use of general and broad concepts, rather than rigid and narrow ones, in combination with contractual powers of determination and certification which are to be exercised reasonably (i.e. rationally) and in good faith: *Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance SA ibid.* at [115]; Judgment [142].

E. THE APPROACH TO CONSTRUCTION

23. Given their status as one of the most widely used standard form agreements in the world, decisions concerning the interpretation of the Master Agreements have major implications: see *KBF v. UBS* [2014] EWHC 2450 at [120]. The Master Agreements need to be construed having regard to their fundamental objectives and having regard to their

use as standard agreements by a wide variety of parties with different characteristics in a multiplicity of transactions and circumstances: Judgment [48].

24. In addition to the general approach to construction of commercial agreements, as set out in *Rainy Sky SA v. Kookmin Bank* [2011] 1 WLR 2900 at [21][2], the Judge correctly recognised that the following principles are relevant:

(1) "*More than ever, the focus is ultimately on the words used, which should be taken to have been selected after considerable thought and with the benefit of the input and continuing review of users of the standard forms and of knowledge of the market*": Judgment [48(3)].

(2) "*Particular care is necessary not to adopt a restrictive or narrow construction which might make the form inflexible and inappropriate for parties who might commonly be expected to use it*": Judgment [48(4)]; see, too, *The Joint Administrators of Lehman Brothers International (Europe) v. Lehman Brothers Finance SA* [2013] EWCA Civ 188 at [87] – [89].

F. "COST OF FUNDING" – THE SCG'S POSITION

25. The Senior Creditor Group's submissions on the construction of the definition of the Default Rate can be summarised as follows.

(1) The definition should be given its ordinary and natural meaning

26. The Default Rate is concerned with the determination of a rate of interest payable to a relevant payee in respect of certain sums due, but unpaid, under the Master Agreements[3].

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2 The guidance set out in *Rainy Sky SA v. Kookmin Bank* is unaltered by the decision of the Supreme Court in *Arnold v Britton* [2015] AC 1619: see *Wood v. Sureterm Direct Ltd* [2017] UKSC 24 *per* Lord Hodge at [8] – [15].

3 The most significant application of the Default Rate in the context of LBIE's administration is to sums calculated as due on Early Termination: see Section 6(e)(ii) and the definition of "Applicable Rate" in the 1992 Agreement and see Section 9(h)(ii)(2) and the definition of "Applicable Close Out Rate" in the 2002 Agreement.

27. The Default Rate is defined by reference to the payee's actual ("*cost … of funding*") or hypothetical ("*cost … if it were to fund*") cost of funding. Neither "*funding*" nor "*cost*" is defined by the draftsman.

28. The language used should be given its ordinary and natural meaning. The phrase "*cost of funding*" together with its constituent parts, "*funding*" and "*costs*", are broad concepts which reflect the fact that the Master Agreements are intended to operate among a range of users, with differing funding structures and requirements, and in a wide variety of circumstances.

29. In their natural and ordinary meaning[4], such concepts are capable of covering the cost of forms of funding other than merely borrowing, including the cost of equity funding, funding through hybrid instruments such as convertible debt and preference equity, and any other source of funding or combination of sources of funding used by market participants.

30. The Judge himself acknowledged that, as a matter of ordinary language, "*cost of funding*" is a broad concept, which is capable of encompassing forms of funding other than borrowing (Judgment [146]).

31. There is nothing in the definition to indicate that the definition of Default Rate should be given a more restricted or limited meaning. The drafting of the definition ('*a rate per annum equal to …*') makes clear that it is designed to enable an input (a cost of funding) to be turned into an output (an interest rate). There is nothing that suggests that the input must be limited solely to a particular form of funding or to a particular type of cost. In particular, the definition uses the word "*funding*" and not the word "*borrowing*", and the word "*cost*" rather than "*interest rate*".

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4 The Oxford English Dictionary (online) defines funding as "*money provided for a particular purpose*" and cost as "*an amount which has to be paid or spent to buy or obtain something*". However, the draftsman has not defined "*funding*" or "*cost of funding*" in any particular way, and the court should be slow to do so. Whether any given state of affairs falls within the language of the provision is, in large part, a question of fact which will usually best be determined on a case by case basis.

32. This applies equally to all the contexts in which the "*cost of funding*" language is used in the Master Agreements[5].

(2) The ordinary meaning produces commercially appropriate results

33. As the Judge acknowledged (Judgment [60]), the Default Rate definition is aimed at identifying the cost of replacement funding for the period of delay in payment of certain amounts due under the Master Agreements, and compensating the relevant payee by providing for the payment of interest at a certified "*rate per annum*" equal to that cost for the period until it is paid.

34. The rationale for providing this manner of compensation is that:

(1) The primary loss suffered by a relevant payee as a result of late payment is the benefit forgone by not being able to use such funds from the time at which they were meant to be paid.

(2) The relevant payee could seek to mitigate that loss by raising an amount equal to the sums owed to it, putting itself into the position it would have been in if it had been paid promptly.

35. The Default Rate therefore provides compensation by reference to the cost which was or would have been incurred by the relevant payee as a consequence of raising a sum of money equal to the amount owed but unpaid.

36. This rationale holds true across the range of potential users and circumstances if the expression "*cost…of funding*" is given its ordinary and natural meaning, and is capable of including debt funding, equity funding, funding through hybrid instruments, or any other source or combination of sources of funding by which market participants commonly fund themselves. It reflects the fact that corporate entities employ a range and mix of funding sources, each of which has its own cost.

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5 i.e. the definitions of the Default Rate, Non-default Rate and Termination Rate and definition of Loss in the 1992 Form Master Agreement and the definitions of Default Rate, Termination Rate, part of the Applicable Deferral Rate and Close-out Amount in the 2002 Form Master Agreement. The circumstances in which these rates of interest are payable under the Master Agreements are set out at [37] – [44] of the Judgment.

(3) All sources of funding involve a cost

37. The ordinary and natural meaning of the expression "*cost…of funding*" reflects the fact that all sources or combinations of sources of funding (whether debt, equity or a hybrid source) involve a cost for the party obtaining funding.

38. A variety of established methods exist to measure such costs.

39. The cost of debt funding through borrowing involves a calculation of the return to be provided to the entity's lenders on their debt investments, which represents the compensation that the market demands in exchange for providing debt funding to the relevant entity. This commonly includes an interest rate so that the interest payable will form part of the "*cost of funding*".

40. Similarly, the cost of equity funding reflects a calculation of the return to be provided to the entity's shareholders on their equity investments, which represents the compensation that the market demands in exchange for providing equity funding to the relevant entity. Cost of equity is frequently measured using a number of different methods. The most commonly used model for assessing the cost of equity funding remains the capital asset pricing model ("CAPM").

    (1) Using historical and market inputs, CAPM provides a calculation of the cost of equity by reference to the anticipated rate of return per annum on shareholders' investment.

    (2) The prevalence and widespread use of CAPM as a method for calculating the cost of equity has been recognised by the courts. For example, in *Multi Veste 226 B.V. v. NI Summer Row Unitholder* [2011] EWHC 2026 (Ch) Lewison J noted at [261] that "*the experts agreed that the capital asset pricing model ("CAPM") is an accepted method used to estimate a cost of equity based on market data*". In *Gul Bottlers (PVT) Limited v. Nichols plc* [2014] EWHC 2173 (Comm) at [145] Cooke J described CAPM as constituting "*The most widely utilised method for estimating the cost of equity*".

41. The particular mix of funding that is most appropriate for a given entity will depend on all the circumstances, including the availability of different sources and their relative cost. Corporate entities measure the average cost of those sources, by way of a weighted average cost of capital calculation ("WACC").

(1) WACC is at the foundation of modern corporate finance and constitutes a well-established framework for calculating the average cost of all of an entity's different sources of funding (whether debt, equity or hybrid) in the form of a rate per annum. WACC is computed by calculating an average of each of these costs, weighting each component according to the portion of the total funding represented by that particular type of funding.

(2) The prevalence of WACC as a calculation method has long been recognised by the courts. For example, WACC is commonly used in a compensatory context where it is necessary to assess the present value of future losses to a particular entity. Specifically, WACC is used as the appropriate discount rate per annum for accelerated payment, reflecting expert opinion that the time value of money to an entity should be calculated with reference to the average cost of all of its funding rather than a discrete component of that cost (such as its cost of debt); see, for example *Multi Veste 226 B.V. v. NI Summer Row Unitholder* ibid at [255] – [266]; and *Gul Bottlers (PVT) Limited v. Nichols plc* ibid at [109], [144]–[146] and [152].

(4) A restricted meaning would not be commercially sensible

42. It follows that restricting the phrase "*cost of funding*" to a particular source of funding, such as borrowing, and to the interest rate on such borrowing would not be consistent with the purpose of the Default Rate. It would result in compensation being calculated by reference to the cost of a form of funding that did not take place or would not have done, rather than by reference to one which did or would have done.

43. If a creditor uses equity funding, there is no sensible commercial rationale for the Default Rate to require compensation to be assessed by reference to the cost of borrowing, which cost the relevant payee did not incur, or could or would not have incurred, as opposed to a cost which rationally and in good faith it actually incurred or

would have incurred. For example, it would be nonsensical to require a relevant payee that cannot borrow at all (whether for reasons of creditworthiness, capital adequacy ratios or loan covenant restrictions or any other reason) to certify the cost that it would have incurred had it borrowed the relevant amount. Not only might that exercise be impossible, but the compensation it identifies does not reflect the cost that the relevant payee incurred or would have incurred in putting itself in the position it would have been in, had it been paid promptly. In the circumstances, such a certification would neither be rational or in good faith. It would be of a fictional cost for a form of funding that would never have taken place and, rather than compensating the creditor at the appropriate rate, would result in an award of interest at an arbitrary rate on an arbitrary basis.

44. Any interpretation of the definition that is limited to a particular source of funding or type of cost would also be unsatisfactory in practice. There is not always a strict division between debt and other types of funding. For example, parties to the Master Agreements may issue hybrid instruments or preference equity to fund the relevant amount, which may contain elements characteristic of both debt and equity funding. A lender may charge a fee for a loan (which will increase the overall cost of that funding to the borrower) or may agree to add an equity feature (such as convertibility) to a debt issuance (which will likewise increase the cost of that funding to the borrower). It follows that a narrow construction of the meaning of "*cost of funding*" is likely to give rise to definitional issues and uncertainty, contrary to the regime of flexibility and finality envisaged by the Master Agreements.

(5) The role of rational and good faith certification

45. The Default Rate provision entitles and requires the relevant payee to certify the "*cost…if it were to fund or of funding the relevant amount*". The certification requirement means that, in practice, the Default Rate is determined by reference to the relevant payee's rational and good faith assessment of the cost that it did incur or would have incurred as a consequence of funding the relevant amount.

46. Deference to the rational and good faith determination of the relevant payee is consistent with, and a means of achieving, the draftsman's objective of mitigating the risk of fact-specific disputes and the attendant risk of protracted litigation: *Lehman*

Brothers Holding Inc. v. Intel Corporation S.D.N.Y. Sep 16 2015 at p.22; Judgment [48(5)]. By allowing the relevant payee to make a rational and good faith determination of how it did or would have funded the relevant amount, and the cost of doing so, the certification process enables the general concepts used in the Master Agreements to operate with flexibility and finality across a range of contexts and among a range of parties, and to bind the parties without the need to have recourse to a third party arbiter. It is also entirely consistent with the wide latitude conferred on the determining party in other contexts within the Master Agreements, such as in relation to "*Loss*" in the 1992 Master Agreement and "*Close-out Amount*" in the 2002 Master Agreement, subject only to the control of good faith and rationality.

47. The certification process does not, however, give the relevant payee *carte blanche* when determining the relevant Default Rate. The relevant payee, when making its certification, is constrained by the requirements of the Default Rate provision. Accordingly, when certifying its cost of funding, the relevant payee is required rationally and in good faith to determine in all the circumstances: (a) what it did or would have done in order to raise a sum equal to the relevant amount at the time when the funding need arose; and (b) how much it cost or would have cost to do so for the period that the Early Termination Amount is outstanding.

(6) Other associated costs

48. All costs associated with the relevant form of funding should be capable of forming part of the "*cost of funding*" provided that they are certified by the relevant payee rationally and in good faith.

49. In particular, the natural meaning of the word "*cost*" in the context of the Default Rate definition includes all costs actually borne or which would have been borne by the relevant payee as a consequence of raising a sum in the relevant amount. Those costs are capable of including any fees paid, or charges incurred as a necessary requirement to obtain funding to fund the relevant amount, subject to the relevant payee's obligation to certify its cost of funding rationally and in good faith.

G. "COST OF FUNDING" – THE JUDGE'S APPROACH

50. In construing the Default Rate definition, the Judge accepted that:

(1) The Default Rate definition is aimed at identifying the cost of replacement funding for the period of delay in payment of certain amounts due under the Master Agreements, and compensating the relevant payee by providing for the payment of interest at a certified "*rate per annum*" equal to that cost for the period until it is paid: Judgment [60].

(2) Institutions utilise many and various means to fund their business activities, including equity funding and routinely attribute a cost to all their funding operations: Judgment [117].

(3) As a matter of ordinary language "*cost…of funding*" is a broad concept, capable of encompassing forms of funding other than borrowing, including equity funding: Judgment [146]. The Judge accepted that the Master Agreements use the expression "*cost of funding*" in its ordinary and natural sense as encompassing the cost of forms of funding other than borrowing, (including equity funding) in the context of the definition of "Loss" in the 1992 Agreement; see also the definition of "Close-out Amount" in the 2002 Agreement.

(4) From a commercial perspective, "*cost*" also bears a broad meaning (Judgment [142]) and the cost of equity funding "*may be assessed by techniques such as a CAPM*": Judgment [138].

51. Notwithstanding this, the Judge nevertheless held the expression "*cost…if it were to fund or of funding the relevant amount*" should be given a "*more limited construction*" in the context of the Default Rate definition (Judgment [116]) and ought to be construed as meaning "*the cost which the relevant payee is or would be required to pay in borrowing the relevant amount*" (Judgment [147(1)]). Further, according to the Judge, those costs are limited to the interest charged to the relevant payee in return for the relevant borrowing.

52. As a consequence, the effect of the Judge's approach was to disregard the words used by the draftsman and to construe the phrase "*cost to the relevant payee…of funding the relevant*

amount" as if it said "*the interest charged to the relevant payee if it were to borrow or by borrowing the relevant amount*".

53. The Judge's analysis is at [114] – [146]. As summarised at [116], he gave four reasons for giving the words used a more restricted and limited meaning than they ordinarily have. None of the reasons given by the Judge provides any justification for departing from the ordinary and natural meaning of the words selected by the draftsman. They reflect a combination of *non-sequiturs* and misunderstandings as to the operation of the Default Rate definition.

54. It is also notable that, in reaching the conclusion he did, the Judge gave no consideration to the commercial rationale for the Default Rate definition and provided no justification for the commercial consequences of his limited construction. For example, the Judge recognised that one consequence of his approach is that, where a relevant payee funds the relevant amount by means of hybrid instruments, it may be entitled to include part of the cost of such funding when determining the Default Rate 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*" (Judgment [141]). However, the Judge made no attempt to explain why, whether as a matter of language or commercial sense, the Default Rate definition should require a relevant payee who has funded the relevant amount through the use of (for example) hybrid instruments to ignore part of the costs associated with doing so when certifying its cost of funding.

H. THE JUDGE'S FIRST REASON

55. The first reason given by the Judge for departing from the ordinary and natural meaning of the phrase "*cost…of funding*" was that a restrictive construction is necessary "*to remain consistent with the underlying objective of providing for a certified rate per annum of interest*" (Judgment [116(a)]).

56. This is incorrect. The underlying objective of the Default Rate provision is just as capable of being achieved where the phrase "*cost…of funding*" is given its ordinary and natural meaning.

57. The Default Rate definition operates by deriving a per annum rate from the cost incurred by the relevant payee in raising an amount equal to (i.e. "funding") the relevant amount. In this regard, the determination of the Default Rate involves two principal steps:

(1) First, it involves the relevant payee identifying and certifying the "*cost to* [it]…*if it were to fund or of funding the relevant amount*"; and

(2) Second, it involves the relevant payee identifying a "*rate per annum equal to*" whatever that certified cost may be.

58. A rate per annum is capable of being derived from a cost irrespective of whether that cost is already expressed as a rate per annum and irrespective of whether the cost is itself in the nature of interest. The Judge was plainly wrong to hold otherwise.

59. The first reason given by the Judge for adopting a restrictive construction to the language of the Default Rate definition appears to have stemmed from at least two fundamental and connected errors in his approach and analysis.

60. First, he approached the construction of the Default Rate provision on the assumption that, since it was ultimately concerned with providing a rate of interest, it must necessarily do so by reference to a funding cost which is itself in the nature of interest. Thus he held that:

(1) "*The key to an understanding of the cost of funding language in all the contexts in which it is used…is its express use of and focus on "interest" and its deployment of terms that confirm that "interest" in its usual sense is the proxy for whatever might be the cost of funding*": Judgment [119].

(2) His construction is "*intended to reflect that, in this particular aspect, the governing objective is the determination of a rate of interest; and interest means borrowing*": Judgment [142].

61. This analysis is fundamentally flawed:

(1) Contrary to the Judge's conclusion at [119], none of the Default Rate, Non-Default Rate, Termination Rate or Applicable Deferral Rate definitions uses the word "*interest*". Instead, they each utilise the concept of a "*cost of funding*" and operate by deriving a rate per annum from that cost.

(2) A rate of interest can be derived from a cost irrespective of whether the cost is itself in the nature of interest. It is obvious, for example, that an effective rate of interest can be derived from the discounted issuance amount of a zero coupon bond, or from an upfront underwriter's fee, each of which can be notionally spread over the relevant term; in consumer finance, for example, ancillary costs are regularly incorporated into an overall annual percentage rate (APR)[6]. It is even more self-evident that a rate can be derived from a cost that is itself expressed as a rate, whether that be a cost of debt or equity expressed (as is typical) as a rate per annum or some combination of the two (such as a WACC).

(3) The Judge's approach at [119] turns the Default Rate provision on its head by treating "*interest*" as acting as a "*proxy for*" the relevant payee's "*cost of funding*". In fact, under the Default Rate provision it is the cost incurred by the relevant payee if it were to fund or of funding the relevant amount that provides the basis for determining the applicable rate of interest, not vice-versa. The Judge's approach simply conflates the input with the output.

(4) The Judge was correct to conclude (at [142]) that the governing objective of the Default Rate is the determination of a rate of interest. But that says nothing about the nature of the costs used to determine that rate of interest, and the Judge was wrong to consider otherwise. There is no reason, either as a matter of construction or as a matter of commercial sense, to read the Default Rate provision as though it only encompasses "*costs*" which are already in the nature of interest.

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6 See, for example, the definitions in Directive 2008/48/EC of APR ("the total cost of the credit to the consumer, expressed as an annual percentage of the total amount of credit" - Article 3(i)), and "total cost of the credit to the consumer" ("all the costs, including interest, commissions, taxes and any other kind of fees which the consumer is required to pay in connection with the creditor agreement and which are known to the creditor, except for notarial costs…" – Article 3(g)).

62. The Judge said that "*My decision is not intended to entail or signify any more general substitution of legalistic or restrictive interpretation in place of the commercial expectation of flexibility with the control of rational and good faith certification which the ISDA Master Agreements no doubt generally reflect*" (Judgment [142]).

63. However, the effect of his approach was to give the phrase "*cost of funding*" a more restricted meaning than its ordinary and natural meaning and, in effect, to substitute the word "*interest*" for the broader concept of "*cost*" which the draftsman had chosen to use and, moreover, to do so in contrast to the Judge's interpretation of the same phrase in the context of the definition of "Loss" under the 1992 Agreement.

64. The second connected error made by the Judge concerns his analysis of the effect of the daily compounding provisions under section 6(d)(ii) of the 1992 Agreement and section 9(h)(iii) of the 2002 Agreement.

65. The Judge construed the daily compounding provisions as if they also required the "*cost*" of the relevant payee's funding, as opposed to the rate of interest derived from it, to be a cost that was itself subject to daily compounding. For example:

(1) At paragraph [120]: "*The question is not whether a cost is capable of being attributed to a particular means of raising funds; it is what daily compounding rate was or would have been paid by the payee by way of interest to fund the relevant amount over the period of it being outstanding.*"

(2) At paragraph [121]: "*Put another way, such rate of interest on the basis of compounding daily over the actual days elapsed between the relevant amount becoming payable and actual payment as the payee certifies it did, or would have had to, pay is the measure of its cost of funding for the purposes of the relevant rate.*"

(3) At paragraph [122]: "*The adoption of a rate of interest compounded daily as the measure of the cost of funding seems to me necessarily to exclude from the ambit of the cost of funding language any method of raising funds where the cost of doing so over the relevant period in respect of the relevant amount is not described as interest. This conclusion has an obvious impact on the issue whether (a) equity funding and (b) hybrid instruments fall within the cost of funding language*" (emphasis added).

66. As a consequence of that analysis, the Judge concluded that the daily compounding provisions supported a conclusion that *"cost...of funding"* means *"interest payable on borrowing"*.

67. This analysis is also fundamentally flawed. The Default Rate definition provides that the rate of interest payable is *"equal to"* the relevant payee's cost of funding plus 1%. Pursuant to section 6(d)(ii) of the 1992 Agreement and section 9(h)(iii) of the 2002 Agreement, the amount of interest payable at that rate is *"calculated on the basis of daily compounding and the actual number of days elapsed"*. In other words, it is the rate of interest derived from the relevant payee's cost of funding, and not the *"cost of funding"* itself, that has to be the subject of daily compounding.

68. The Judge's analysis of the operation of the daily compounding provisions was therefore back-to-front, so that he was wrong to conclude that those provisions supported, let alone required, a construction which departed from the ordinary and natural meaning of the language used in the Default Rate definition.

I. THE JUDGE'S SECOND REASON

69. The second reason given by the Judge for departing from the ordinary and natural meaning of the phrase *"cost...of funding"* was *"to ensure consistent construction of the cost of funding language in each of the contexts in which it appears in the ISDA Master Agreements, and whether the relevant cost is a cost to the relevant payee or to the relevant payor"* (Judgment [116(b)]).

70. This reason is, with respect, simply wrong. The Judge's approach does not ensure consistent construction of the *"cost of funding"* language in each of the contexts in which it appears in the ISDA Master Agreements.

71. Indeed, rather than ensuring consistency, it results in the phrase *"cost of funding"* being given different meanings in different parts of the Master Agreements, as the Judge himself acknowledged (Judgment [146]):

> *"...my conclusion as to the meaning to be attached to the cost of funding language does not imply or connote that in all contexts in which the phrase "cost of funding" is deployed, any means of funding other than borrowing is excluded. Thus, for example, the fact that in the definition of "Loss" in the 1992 Form "cost of funding" is specifically mentioned does not, in my view, either preclude recovery of the cost of equity funding, just as it does not, also in my view, influence the meaning of the phrase in the context of the Default Rate, the Non-default Rate and the Termination Rate, which I have been addressing".*

72. Thus, on the Judge's approach:

(1) If any claim is covered by the definition of "Loss" in the 1992 Agreement, the relevant party is entitled, as part of the calculation of its total losses and costs (or gain), to include its "cost of funding" on the basis that this may include cost of equity or other funding (and the same conclusion must follow with respect to the use of the term "costs of funding" in the definition of "Close-out Amount" in the 2002 Agreement).

(2) If, however, the claim is covered by, for example, the Default Rate, the relevant party's "*cost of funding*" is construed more restrictively, so as to be limited to the interest rate on any borrowing.

73. It is unreal to suppose that a draftsman seeking to achieve "*the objectives of clarity, certainty and predictability*" (*Lomas v JFB Firth Rixson* ibid. per Briggs J at [53]) would have intended the phrase "*cost of funding*" to have different meanings in different parts of the same document.

74. Furthermore, whilst the Judge correctly recognised that there are circumstances in which the Non-Default Rate and Termination Rate in the 1992 Agreement and the Termination Rate in the 2002 Agreement may require the payor (rather than the payee) to certify its "*cost of funding*", this does not justify or support a restricted construction of the phrase "*cost of funding*".

75. The ordinary and natural meaning of the expression, as including a range of means of funding, operates in the same way regardless of whether it is concerned with the payor's or the payee's cost of funding. In either case, the certifying party is required rationally

and in good faith to determine: (a) what it did or would have done in order to raise a sum equal to the relevant amount at the relevant time; and (b) how much it cost or would have cost it to do so for the relevant period.

J. THE JUDGE'S THIRD REASON

76. The third reason given by the Judge for departing from the ordinary and natural meaning of the phrase *"cost…of funding"* was *"to reflect accurately what I consider to be the actual or hypothetical transaction posited by the cost of funding language, which is one of a loan between the ISDA party concerned and another at a rate of interest chargeable by reference to the amount of such loan as is outstanding over the period in question"* (Judgment [116(c)]).

77. This reasoning is entirely circular. It assumes what the Judge was seeking to establish. It starts from the premise that the cost of funding language refers to interest charged on a loan transaction and then uses that premise to construe the cost of funding language as referring solely to interest charged on a loan transaction.

78. The Judge also emphasized the juridical distinction between a right to interest and a right to dividend (Judgment at [136]-[138]). But this distinction is irrelevant for the purpose of identifying what is a "*cost of funding*": the different legal features of funding sources are not of themselves determinative of whether such sources have a real and measurable economic cost. The distinction drawn by the Judge is premised on the same (erroneous) starting assumption that the cost of funding language refers to interest charged on a loan transaction.

79. The Judge went on to remark in relation to cost of equity that "*the cost is not actual: it is simulated or synthetic and developed in accordance with the technique or model adopted*" (Judgment [138]).

80. That is also wrong:

(1) Where an entity funds through equity a required sum which it has not received, it incurs an actual cost. That cost is the return to be provided to the entity's shareholders on their equity investments, in turn representing the compensation

that the market demands in exchange for providing equity funding to the relevant entity.

(2) Equity funding necessarily has a cost, otherwise no corporate entity would choose to borrow. The cost of equity funding is, moreover, a measurable cost, recognised as such and used as an important parameter by financial institutions, corporations and investment funds, all of which commonly are parties to ISDA Master Agreements. That cost is no less real if funded through equity rather than debt, even if the method of quantifying that cost is different. Models for assessing the cost of equity are well established and regularly applied (including in expert evidence for the purposes of assessing discount rates to be applied in present-valuing damages).

(3) The Judge's rejection of such costs on the basis that "*the cost is not actual*" therefore involves giving the concept of "*cost*" a restricted or limited meaning in the definition of Default Rate which is divorced from commercial reality (see the Judge's comment at [142] to the effect that "*cost bears a broader meaning from a commercial perspective from the meaning I have ascribed to the cost of funding language*").

K. THE JUDGE'S FOURTH REASON

81. The fourth and final reason given by the Judge for departing from the ordinary and natural meaning of the phrase *"cost…of funding"* was *"to keep within sensible boundaries the matters to be subject only to the control of good faith and rationality"* (Judgment [116(d)]).

82. However, this reasoning is also fundamentally flawed:

(1) In the context of the Judge's conclusion that "*funding*" means "*borrowing*", it will still be necessary to determine whether, for example, the relevant borrowing transaction should be based on term funding to match the duration of the claim to be funded, overnight funding or funding for some other duration and whether the interest charged should be assumed to be on a fixed or floating basis.

(2) The Judge accepted that the relevant payee's rational and good faith assessment of what it did or would have done is used to determine the period of the borrowing, the amount of interest charged on that borrowing and whether such interest is fixed or floating (Judgment [176] – [177]; [188] – [190]). As the Judge put it at [190] (adopting the SCG's submission on this point) it is necessary to review each certificate on its merits and to ask in respect of such certificate "*Let's see what you say you did, or let's see what you say you would have done, and let's assess that*".

(3) Exactly the same approach is required where "*cost of funding*" is given its ordinary and natural meaning, and the relevant payee is required to certify a cost by reference to the type of funding that it did use or considers it would have used. The draftsman decided, in the interests of flexibility and finality, that the mechanism of rational and good faith certification should be used by the relevant payee to determine the Default Rate. The task is not qualitatively different or necessarily more complicated than if "*cost of borrowing*" is used.

(4) The Judge was not entitled to conclude that the control of good faith and rational determination is somehow within "*sensible boundaries*" when it relates to funding by borrowing but outside such boundaries when it relates to any other form of funding. Indeed, in some cases, identifying a hypothetical borrowing rate may be far more complicated than the actual cost incurred by an entity using equity funding, particularly where, for regulatory or other reasons, the payee is not permitted to or was not able to borrow.

83. More broadly, it was not open to the Judge to depart from the ordinary and natural meaning of the words used by the draftsman on the basis that he considered (wrongly) that the matters which the draftsman has made subject to the determination of the relevant payee are too broad. It was not open to the Judge to reject as inadequate the control mechanism that the draftsman had adopted, namely rational and good faith certification, as a justification for giving the definition a restricted or limited meaning, contrary to the ordinary and natural meaning of the words that the draftsman had chosen to adopt. Such an approach to the construction of the Master Agreements is wholly unjustified.

L. OTHER ERRORS IN THE JUDGE'S APPROACH AS TO "COST"

84. As well as giving a restricted meaning to the word "funding", the Judge also erred in four further specific respects when construing the scope of the "*cost...of funding*" language in the Default Rate.

85. First, the Judge wrongly held that the word "cost" referred only to the "*cost of interest (actual or hypothetical) in respect of the relevant amount over the relevant period*" and does not include "*payments to third parties which...arise in connection with or in consequence of the* [funding]" (Judgment [123]). This is wrong for the reasons given above: see **. The Judge held that this conclusion followed from his conclusion that only the cost of interest (actual or hypothetical) falls within the definition of cost of funding. If he is wrong in this respect (which the SCG respectfully contends he is for the reasons given), this conclusion must also fall away.

86. Second, at [154] the Judge appeared to reject the submission that a party that funds the relevant amount, or would have funded the relevant amount, from the proceeds of a larger fund-raising transaction is entitled to certify the cost of that funding on a pro-rata basis, for the purposes of establishing its "*cost...of funding*" under the definition of Default Rate. However, there is no reason, whether as a matter of construction or as a matter of commercial sense, to read the Default Rate provision as precluding a relevant payee, subject to its obligation to act rationally and in good faith, from using the costs incurred by it in the context of a larger (or, indeed, smaller) fund-raising transaction as a reference point for its assessment of the cost to it of funding the relevant amount. The Judge erred to the extent that he held otherwise at [154] of the Judgment and, as a consequence, declaration (x) is wrong to the extent that it reflects that error.

87. Third, the Judge held at [147] that the "*cost of funding language does not encompass costs or financial consequences to the relevant payee of carrying a defaulted LBIE receivable on its balance sheet*". This is also wrong when stated in such absolute terms. The relevant payee is required to determine the cost to it of funding the relevant amount for the period for which it remains unpaid. The fact that the Early Termination Amount remains unpaid may impact on that cost since a putative funding counterparty may assess the funding transaction to be more or less risky as a result (just as any other impairment of the relevant payee's assets might be relevant in such an assessment). In this sense, it is plainly

the case that the financial consequences to the relevant payee of carrying a defaulted receivable on its balance sheet can be taken into account, along with other relevant factors, as part of a rational and good faith determination of its cost of funding. The Judge erred to the extent that he held otherwise at [147] of the Judgment and, as a consequence, declaration (iv) is wrong to the extent that it reflects that error.

88. Fourth, by declarations (xiii) and (xiv) the Judge further defined the meaning of the expression "*cost…to the relevant payee…if it were to fund or of funding the relevant amount*" on the assumption that the phrase only refers to the cost which the relevant payee is or would be required to pay in borrowing the relevant amount under a loan transaction. Those declarations are wrong to the extent that they hold that the meaning that can be given to the "*cost…of funding*" language is confined to the narrow meaning preferred by the Judge, as opposed to that contended for by the Senior Creditor Group.

M. CONCLUSIONS

89. The Appeal in respect of the Judge's order should be allowed. The phrase "*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*" is to be given its ordinary and natural meaning. As such, it is wide enough to cover all forms of funding, including equity funding, and all costs incurred in respect of such funding, as determined by the rational and good faith certification of the relevant party.

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12 May 2017

South Square, Gray's Inn

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IN THE COURT OF APPEAL

ON APPEAL FROM THE HIGH COURT

CHANCERY DIVISION

HILDYARD J

No 7942 of 2008

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

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

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