Appeal Refs. A3/2017/0153, A3/2017/0153A, A3/2017/159, A3/2017/159A, A3/2017/0294 A3/2017/ 0294A and A3/2017/0302

IN THE COURT OF APPEAL
ON APPEAL FROM THE HIGH COURT
CHANCERY DIVISION
MR JUSTICE HILDYARD
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
(4) GOLDMAN SACHS INTERNATIONAL

Appellants

-and-

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)
(2) WENTWORTH SONS SUB-DEBT S.A.R.L.

Respondents

SKELETON ARGUMENT ON BEHALF OF THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

Introduction

1. This skeleton argument has been prepared on behalf of the joint administrators (the "**Joint Administrators**") of Lehman Brothers International (Europe) (In Administration)

("**LBIE**") for the hearing of appeals by Burlington Loan Management Limited, CVI GVF (Lux) Master S.A.R.L and Hutchinson Investors, LLC (collectively, the "**Senior Creditor Group**" or "**SCG**") and Goldman Sachs International ("**GSI**") (together with the Senior Creditor Group, the "**Appellants**") against certain declarations made by Mr Justice Hildyard (the "**Judge**"), as contained in his Order dated 12 December 2016 (the "**Order**").

Background

2. The Order was made against the background of a series of applications by the Administrators with a view to obtaining the Court's guidance in respect of a variety of issues relating to the proper distribution of the substantial surplus that has arisen in LBIE's administration after all proved debts have been paid or reserved for in full. In summary:

   (1) The first directions application by the Administrators (the "**Waterfall I Application**") sought to resolve issues relating to the ranking of claims in LBIE's estate and the liability of LBIE's members to contribute to the payment of those claims under section 74 of the Insolvency Act 1986 (the "**1986 Act**"). The Waterfall I Application was decided by Mr Justice David Richards at first instance in a judgment handed down on 14 March 2014 ([2014] EWHC 704 (Ch); [2015] Ch 1); by the Court of Appeal in a judgment handed down on 14 May 2015 ([2015] EWCA Civ 485; [2016] Ch 50); and by the Supreme Court in a judgment handed down on 17 May 2017 ([2017] UKSC 38; [2017] 2 WLR 1497).

   (2) The Administrators' second directions application (the "**Waterfall II Application**") sought to resolve issues relating to creditors' rights to statutory interest under Rule 2.88 of the Insolvency Rules 1986 (the "**1986 Rules**"). It was divided into three parts by Mr Justice David Richards at a case management hearing on 21 November 2014: the first part ("**Waterfall II Part A**") covers issues relating to the calculation of statutory interest under Rule 2.88(7); the second part ("**Waterfall II Part B**") deals with the effects of certain post-administration agreements on creditors' rights; and the third part ("**Waterfall II Part C**") is concerned with the construction of the default interest rate provisions of the standard form agreements (the "**Master Agreements**") issued by the International Swaps and Derivatives Association ("**ISDA**") for the purpose of determining the

"*rate applicable to the debt apart from the administration*" within Rule 2.88(9) of the 1986 Rules. Waterfall II Part A was decided by Mr Justice David Richards in a judgment handed down on 31 July 2015 ([2015] EWHC 2269 (Ch); [2016] Bus LR 17); Waterfall II Part B was decided by Mr Justice David Richards in a further judgment handed down on 31 July 2015 ([2015] EWHC 2270 (Ch); [2015] BPIR 1162); and appeals against both of those judgments are currently pending before the Court of Appeal (which has asked for further submissions addressing the impact on those appeals of the Supreme Court's decision in Waterfall I). Waterfall II Part C was decided by the Judge in a judgment handed down on 5 October 2016 ([2016] EWHC 2417 (Ch)) (the "**Judgment**"), which gave rise to the declarations embodied in the Order.

(3) The third application (the "**Waterfall III Application**") was concerned with the rights and obligations of LBIE and its members *inter se*. The first part ("**Waterfall III Part A**"), which involved issues of law, was heard by the Judge, who reserved judgment; and the second part ("**Waterfall III Part B**"), which involved factual disputes, was due to be heard in September 2017, but the parties proposed a settlement, which was approved by the Judge, and the hearing was adjourned.

Waterfall II Part C

3. The central issue in Waterfall II Part C arises from Rule 2.88 of the 1986 Rules:

(1) Rule 2.88(7) of the 1986 Rules provides that "*any surplus remaining after payment of the debts proved shall, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the company entered administration*"; and

(2) Rule 2.88(9) provides that the rate payable under Rule 2.88(7) shall be the greater of (i) the rate in section 17 of the Judgments Act 1838 on the date when the company entered administration (the "**Judgments Rate**") (in the present case, 8% per annum) and (ii) "*the rate applicable to the debt apart from the administration*".

4. To determine the "*rate applicable to the debt apart from the administration*" for the purposes of Rule 2.88(9), it is necessary to consider the right (if any) which the creditor has to interest other than that provided for by Rule 2.88(7). In most cases, any such right will be contractual; but it could in theory arise other than from contract (e.g. other statutory rights to interest or rights to interest under a foreign judgment).

5. Waterfall II Part C is concerned primarily with the situation in which (i) the right to interest apart from the administration is a contractual right and (ii) the contract in question was made on ISDA Master Agreement terms.

6. There are two relevant ISDA Master Agreements for these purposes: namely, the "**1992 Master Agreement**" and the "**2002 Master Agreement**".

7. Both of those agreements entitle a party in certain circumstances to claim interest from the other party at "*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*". This rate is defined in the 1992 Master Agreement and the 2002 Master Agreement as the "**Default Rate**".

8. Waterfall II Part C is concerned principally with issues of construction arising from this definition.

9. As to the parties before the Court:

   (1) The creditors interested in ***maximising*** the amount of interest payable under Rule 2.88 include the Appellants, which held substantial claims against LBIE under ISDA Master Agreements and which now seek interest on those claims. The Appellants contend for a construction of the definition of "*Default Rate*" which might provide scope for them to certify a "*rate applicable to the debt apart from the administration*" in excess of the Judgments Rate.

   (2) The creditors interested in ***minimizing*** the amount of interest payable under Rule 2.88 include Wentworth, which, in addition to being the holder of substantial claims against LBIE under ISDA Master Agreements, is also the holder of

subordinated debt claims against LBIE (the "**Sub-Debt**"). The Supreme Court confirmed in Waterfall I that the Sub-Debt ranks for payment after statutory interest (and becomes payable only when statutory interest has been paid in full). To maximise the assets available to pay the Sub-Debt, Wentworth seeks to minimise the prior-ranking statutory interest.

The Issues

10. The divergent interests of the SCG and GSI (on the one hand) and Wentworth (on the other hand) are reflected in the parties' differing approaches to the construction of the definition of "*Default Rate*" in the ISDA Master Agreements. In summary:

    (1) Wentworth contends that the "*cost ... to the relevant payee ... if it were to fund or of funding the relevant amount*" in the definition of "*Default Rate*" is the cost of borrowing the relevant amount, which, in practice, is unlikely to have exceeded the Judgments Rate over the relevant period; whereas

    (2) The SCG and GSI contend that the "*cost ... to the relevant payee ... if it were to fund or of funding the relevant amount*" may include detriments connected with equity funding (including, for example, costs associated with the issuance of shares) and/or funding costs associated with hybrid financial instruments, which may have exceeded the Judgments Rate over the relevant period.

11. The effect of Wentworth's contentions is thus to reduce or eliminate the scope for the amount of statutory interest payable to exceed 8% per annum (being the minimum payable under Rule 2.88(9)), whereas the effect of the contentions advanced by the SCG and GSI is to produce a rate of statutory interest which has more scope to exceed (potentially by a substantial margin) 8% per annum.

12. As a result of these rival contentions, the issues arising in Waterfall II Part C have a very significant effect on the amount of statutory interest payable under Rule 2.88 in LBIE's administration. Substantial sums thus turn on the issues at stake in Waterfall II Part C:

(1) There are 877 creditors with claims under ISDA Master Agreements[1], amounting to approximately £4.5 billion in total[2].

(2) At the Judgments Rate, statutory interest on such claims would amount to approximately £1.8 billion.[3]

(3) By way of illustration, if a contractual rate of 12% per annum were to be applicable across the board (on a compound basis[4]), the amount of statutory interest would rise to approximately £3.8 billion[5].

13. Since the purpose of Waterfall II Part C is (as with the other parts of the Waterfall proceedings) to provide guidance to the Administrators, the issues in Waterfall II Part C extend beyond the central issue of construction to encompass a number of practical issues which are designed to ensure that the Court's decision provides practical assistance to the Administrators to help them in their task of adjudicating on claims to statutory interest.

The Judgment

14. In the Judgment, the Judge identified the relevant background (Judgment, [1]-[21]) before describing the ISDA Master Agreements (Judgment, [22]-[45]) and setting out the applicable English law principles of construction (Judgment, [46]-[49]).

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1 Formerly it was considered that there were 854 such creditors (Judgment, [10]). However, since the Twelfth Witness Statement of Anthony Victor Lomas dated 20 August 2015 ("**Lomas-12**"), to which the Judge referred in the Judgment at [10], the number of creditors with claims under ISDA Master Agreements has been revised to 877 following the resolution of certain counterparty queries.

2 Formerly the amount was c. £4.4 billion (Judgment, [10]). However, since Lomas-12, as a result of the revision of the number of creditors to 877, the total value of the claims now stands at c. £4.5 billion.

3 This figure was formerly £1.7 billion (Judgment, [11]). However, since Lomas-12, as a result of the revision of the numbers mentioned above, the up-to-date figures is now £1.8 billion.

4 David Richards J held at first instance in Waterfall II Part A that: (i) a compound rate of interest may be claimed as the "*rate applicable to the debt apart from the administration*" under Rule 2.88(9); and (ii) such compounding ceases upon the payment in full of the proved debt, even if statutory interest remains unpaid. No party has sought to appeal against David Richards J's conclusion on the former point. Whether or not he was correct on the latter point is currently before the Court of Appeal in Waterfall II Part A.

5 This figure was formerly £3.7 billion (Judgment, [11]). However, since Lomas-12, as a result of the revision of the numbers mentioned above, the up-to-date figure in this illustration is now £3.8 billion.

15. The Judge then introduced the central issue of construction (Issue 11), namely as to whether the "*cost ... to the relevant payee ... if it were to fund or of funding the relevant amount*" in the definition of "*Default Rate*" is the cost of borrowing the relevant amount (as Wentworth contends) or may include detriments connected with equity funding or hybrid instruments (as the SCG and GSI contend) (Judgment, [50]-[62]).

16. The Judge set out Wentworth's contentions on this central point (Judgment, [63]-[93]) before describing the contentions of the SCG and GSI (Judgment, [94]-[113]).

17. The Judge then set out his own conclusions on this issue (Judgment, [114]-[147]), holding that the "*cost ... to the relevant payee ... if it were to fund or of funding the relevant amount*" in the definition of "*Default Rate*" is to be certified by reference to the cost which the relevant payee is required to pay under the transaction for borrowing the relevant amount, whether an actual cost (where the relevant payee goes into the market to raise funds) or a hypothetical cost (where it does not do so) (Judgment, [115]).

18. The Judge accepted Wentworth's submission that detriments connected with equity funding (e.g. the issuance of shares) are consequential losses which fall outside the definition of "*Default Rate*" because they are not properly capable of being described as the cost to the relevant payee if it were to fund or of funding the relevant amount (Judgment, [124]-[125]).

19. Having distinguished between debt and equity as legal concepts (Judgment, [136]-[137]), the Judge concluded (Judgment, [139]):

> "*In my view, the focus of the cost of funding language is on identifying what the relevant person would have had to or did pay by way of interest on a daily compounding interest under a transaction giving rise to a debt for the use of the relevant sum over the relevant time. Interest accrues over time on the amounts outstanding until repaid: it is the price over time of having someone else's money; this contrasts with other forms of funding, where the amounts paid are a capped share in participation in profit. The root of a claim for interest is a debt or restitutionary obligation; the root of a claim to dividend is participation in profit. Interest on a debt is to be distinguished from reward for participation or the share in profit which an entity must make available to an investor to persuade that investor to provide the invested funds*".

20. The Judge answered Issue 11 in the following terms (Judgment, [147]):

> "[The] *cost to the relevant payee if it were to fund or of funding the relevant amount is to be certified by reference to* ***the cost which the relevant payee is or would be required to pay in borrowing the relevant amount under a loan transaction, whether an actual cost, where the relevant payee does in fact enter into a loan, or a hypothetical cost, where it does not do so. 'Cost' means the price required to be paid in return for borrowing the funds over the period they are required.*** *Reward for investment by way of a specified (but ultimately discretionary) share in profit is not a relevant 'cost of funding': thus, equity funding is not within the cost of funding language*" (emphasis added).

21. The Judge answered further practical questions in connection with Issue 11 (Judgment, [148]-[164]) as well as additional questions arising from his determination of Issue 11 (Issue 12) (Judgment, [165]-[180]) and various other connected questions (Issues 13 to 18 and 27) (Judgment, [181]-[217], [530]-[531]).

22. The Judge also considered whether the answers would be the same in the case of Master Agreements governed by New York law (Issue 19) (Judgment, [264]-[282]), holding that the same answers would apply under New York law.

23. In addition, the Judge resolved a number of issues which are not pursued on appeal, including an issue relating to the meaning of the phrase "*relevant payee*" in the definition of "*Default Rate*" (and, more particularly, as to whether it could include an assignee) (Issue 10) (Judgment, [218]-[263]) and issues relating to standard form agreements governed by German law (Issues 20 and 21) (Judgment, [283]-[452] and the Schedule to the Judgment).

24. Finally, the Judge resolved an issue arising from Waterfall II Part A (Supplemental Issue 1A) (Judgment, [453]-[529]), which does not form part of this appeal but was heard by the Court of Appeal as part of the appeals on Waterfall II Part A and Waterfall II Part B.

25. As mentioned above, the Judge's conclusions were encapsulated in the declarations contained in the Order.

The appeals

26. The SCG and GSI appeal against the Judge's conclusions as to the proper construction of the definition of the Default Rate in the Master Agreements and, specifically, as to whether the "*cost ... to the relevant payee ... if it were to fund or of funding the relevant amount*" may include detriments connected with equity funding and hybrid instruments.

27. A table summarising the position in respect of the various appeals is appended hereto. In summary, however, the SCG appeals against declarations (ii), (iii), (iv), (vi), (viii), (ix), (x), (xi), (xii), (xiii), (xiv) and (xxii); whilst GSI appeals against declarations (ii), (iii), (vi), (viii), (ix), (x), (xi), (xii), (xiii), (xiv) and (xv). The difference between them is that:

    (1) the SCG appeals against declaration (iv) (which relates to the financial consequences to the relevant payee of carrying a defaulted LBIE receivable on its balance sheet) and declaration (xxii) (which relates to the position under New York law[6]), whereas GSI does not[7]; whilst

    (2) GSI appeals against declaration (xv) (which relates to the impact on the cost of the relevant payee's equity capital attributable to borrowing a sum equivalent to the relevant amount), whereas the SCG does not.

28. Declarations (i), (v), (vii), (xvi), (xvii), (xviii), (xix), (xx), (xxi), (xxiii), (xiv), (xxv) and (xxvi) are not appealed by any party; and the appeal against declaration (xxvii) (relating to Supplemental Issue 1A) was heard by the Court of Appeal as part of the appeals on Waterfall II Part A and Waterfall II Part B, as mentioned above.

29. Notwithstanding the number of declarations against which the SCG and GSI seek to appeal, the central issue is the question of construction as to whether the "*cost ... to the relevant payee ... if it were to fund or of funding the relevant amount*" in the definition of "*Default*

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6 The SCG's skeleton does not address declaration (xxii) separately. It is therefore assumed that the SCG accepts that declaration (xxii) is correct (i.e. that New York law on these points is the same as English law) and that it is only the Judge's conclusions as to English law which are being challenged by the SCG.

7 GSI was never granted permission to be heard on New York law (Issue 19) (see [19] of the Judgment) and therefore it cannot appeal against declaration (xxii).

Rate" is the cost of borrowing the relevant amount (as Wentworth contends) or may include detriments connected with equity funding and hybrid instruments (as the SCG and GSI contend). The Judge's conclusions on the other points largely flowed from and reflected his conclusion that detriments connected with the issuance of shares fell outside the scope of these words.

30. Accordingly, the arguments advanced by the SCG and GSI in their skeleton arguments in support of their appeals focus on the central question of construction, recognising that the appeals on subsidiary issues will turn on the determination of this central question (see, e.g., GSI's skeleton argument, [56]; and the SCG's skeleton argument, [88]).

The Administrators' position

31. As explained above, the Administrators' purpose in bringing Waterfall II Part C before the Court has been to obtain the guidance which is necessary to enable them to distribute the surplus in LBIE's estate to those entitled to it.

32. Having sought and obtained the Judge's guidance, the Administrators have not sought to appeal against any of the declarations in the Order.

33. As regards the Administrators' position on the appeals:

    (1) Whilst they have not yet seen Wentworth's skeleton argument on the appeals, the Administrators assume that Wentworth intends to resist the appeals and that it will therefore develop fully, both in writing and orally, the substantive submissions in favour of the Judge's conclusions and against the appeals.

    (2) On this assumption, it should not be necessary for the Administrators to advance any substantive submissions on any of the issues in the appeals.

    (3) Provided that the Court of Appeal has the benefit of adversarial argument from parties with divergent economic interests in the outcome of the appeals, the Administrators will adopt a neutral role and will not participate in adversarial argument.

(4) The Administrators will continue to be represented on the appeals to assist the Court in relation to any issues that may arise during the hearing of the appeals; to update the Court on the progress of LBIE's administration (including the extent of the surplus and any distributions of the surplus to creditors); to assist the Administrators in following the arguments advanced and the Court's decisions in respect of the appeals; and to ensure that the Administrators are in a position to address the Court on any consequential matters which may arise in light of the Court's determination of the appeals.

Conclusion

34. For the reasons set out above, the Administrators intend to take a neutral stance in relation to the substantive issues to be determined in the appeals. The Administrators will abide by, and seek to apply to LBIE's administration, the Court's determination of the appeals.

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28 July 2017

Waterfall II Part C – Schedule of issues being appealed by the SCG and GSI

Issue	Declaration	Senior Creditor Group ("SCG"):			Expressly addressed in the SCG skeleton	GSI A/N[1]	Expressly addressed in the GSI skeleton
		CVI A/N	Burlington A/N	Hutchinson A/N			
10	(i)	~~Appealing~~[2]	~~Appealing~~	~~Appealing~~		Not joined on this issue	
11	(ii)	*Appealing*	*Appealing*	*Appealing*	Addressed generally in [10]-[83]	Appealing	Addressed in [19] and throughout [22] to [53]
	(iii)	*Appealing*	*Appealing*	*Appealing*	Addressed generally in [10]-[83]	Appealing	Addressed in [19] and throughout [22] to [53], esp. at [31] to [36]
	(iv)	Appealing	Appealing	Appealing	[87]	Not appealing	
	(v)	Not appealing	Not appealing	Not appealing		Not appealing	
	(vi)	*Appealing*	*Appealing*	*Appealing*	Addressed generally in [10]-[83]	Appealing	[50(1)(b)] to [(d)]
	(vii)	Not appealing	Not appealing	Not appealing		Not appealing	
	(viii)	Appealing	Appealing	Appealing	Addressed generally in [10]-[83]; specifically at [88]	Appealing	[37]
	(ix)	*Appealing*	*Appealing*	*Appealing*	Addressed generally in [10]-[83]	Appealing	[37]
	(x)	Appealing	Appealing	Appealing	[86]	Appealing	[51(2)]
	(xi)	*Appealing*	*Appealing*	*Appealing*	Addressed generally in [10]-[83]; specifically at [85]	Appealing	[51(1)]
	(xii)	*Appealing*	*Appealing*	*Appealing*	Addressed generally in [10]-[83]; [85]	Appealing	Not expressly addressed
12	(xiii)	Appealing	Appealing	Appealing	Addressed generally in [10]-[83]; [88]	Appealing	Not expressly addressed

[1] GSI were only given permission to appear in respect of Issues 11-14 and 27.

[2] Strikethrough denotes the withdrawal of the SCG's appeal on certain issues, as reflected in amended appellant's notices of 18-20 May 2017.

Issue	Declaration	Senior Creditor Group ("SCG"):			Expressly addressed in the SCG skeleton	GSI A/N[1]	Expressly addressed in the GSI skeleton
		CVI A/N	Burlington A/N	Hutchinson A/N			
	(xiv)	Appealing	Appealing	Appealing	Addressed generally in [10]-[83]; specifically at [41], [48] and [88]	Appealing	[38]
	(xv)	Not appealing	Not appealing	Not appealing		Appealing	[38]
	(xvi)	Not appealing	Not appealing	Not appealing		Not appealing	
13	(xvii)	Not appealing	Not appealing	Not appealing		Not appealing	
14	(xviii)	Not appealing	Not appealing	Not appealing		Not appealing	
15	(xix)	Not appealing	Not appealing	Not appealing		Not joined on these issues	
16	(xx)	Not appealing	Not appealing	Not appealing			
18	(xxi)	Not appealing	Not appealing	Not appealing			
19[3]	(xxii)	Appealing	Appealing	Appealing	Addressed at [10] of the SCG's amended grounds of appeal		
20[4]	(xxiii)	Not appealing	~~Appealing~~	~~Appealing~~			
	(xxiv)	Not appealing	~~Appealing~~	~~Appealing~~			
21	(xxv)	Not appealing	~~Appealing~~	~~Appealing~~			
27	(xxvi)	Not appealing	Not appealing	Not appealing		Not appealing	

[3] New York law.

[4] German law.