Appeal Court Ref 2017/0159

IN THE COURT OF APPEAL
ON APPEAL FROM THE HIGH COURT OF JUSTICE
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

ATTENDED
28 JUL 2017
CIVIL APPEALS OFFICE

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

ATTENDED
28 JUL 2017
CIVIL APPEALS OFFICE

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

WENTWORTH'S SKELETON ARGUMENT
IN RESPONSE TO THE APPEALS

Introduction

1. Wentworth opposes the appeals of the SCG and GSI, and contends that the Judge reached the correct conclusion in respect of the meaning of "Default Rate" in the ISDA 1992 and 2002 Master Agreements (the "**ISDA MA**").

2. The SCG's principal argument on this appeal boils down to the contention that the words found in the definition of Default Rate, namely "*cost of funding*", "*costs*" and "*funding*", should be given their "natural and ordinary meaning". In particular, it says these are all broad concepts which, in their natural and ordinary meaning, are capable of covering costs of funding other than merely borrowing, including importantly the cost of equity funding.[1]

3. This argument is flawed for the simple reason that it takes the words "*cost*", "*funding*", and the phrase "*cost of funding*", out of context, and fails to give effect to the rest of the language of the relevant clauses of the ISDA MA in which those words appear.

4. In particular, it ignores two critical features of the definition. First, it ignores the fact that the definition refers to the "*cost of funding the relevant amount*". Second, it ignores the fact that it is obvious from the context in which the phrase "*cost of funding the relevant amount*" appears throughout the ISDA MA, that it is intended to identify the cost of funding the relevant amount *for the period that it is outstanding.*

5. Each of these points, as developed below, indicates that, on the true construction of the definition of Default Rate (and the other interest rates where the same language occurs), cost of funding (or if it were to fund) the relevant amount means the price to be paid, via an actual or hypothetical transaction, for borrowing a sum of money equal to the relevant amount, over the period of time that the relevant amount remains outstanding.

6. In summary (as developed below), this conclusion is supported by:

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[1] SCG Skeleton/paras 10(2), 10(5), 26-32.

(1) The drafting history of the ISDA MA, in particular by reference to the ISDA documentation at the time the "*cost of funding the relevant amount*" language first appeared in 1987; and

(2) The fact that the purpose of "*Default Rate*" (and each other interest rate in the ISDA MA) is to define a rate of interest, that is something which equates to the cost of the time value of money.

7. For these reasons (as developed below) the cost of funding the relevant amount excludes the cost of raising funds in consideration for the issue of equity (see [36-46] below).

The development of the ISDA MA

8. There is powerful textual support for the Judge's conclusion that Default Rate was limited to the cost of borrowing within the terms of the ISDA MA as it developed over time.

9. The previous versions of the MA, and the Users' Guide to the various forms of MA, are relevant aids to construction: *Lomas v JBF Firth Rixson & Ors* [2013] 1 BCLC 27, at [49]-[53], per Longmore LJ; *LBIE v LBF SA* [2013] EWCA Civ 188 at [52]-[60], per Arden LJ.

10. The first forms of ISDA MA appeared in 1987. There were two: (1) the Interest Rate and Currency Exchange Agreement ("**1987 IRCEA**"), intended to be used for transactions in any currency; and (2) the Interest Rate Swap Agreement ("**1987 IRSA**"), referred to as the "*Code-based form*", limited to use for transactions conducted in US$.

11. The 1987 Users' Guide explained (at page 2) that the only differences between the two forms were those necessitated by the multi-currency aspect of the 1987 IRCEA[2]. The 1992 Users' Guide repeated this explanation of the difference between the two forms of 1987 MA [at pages 8-9].

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[2] "*There are no substantive differences in the two forms, other than minor ones necessitated by the multi-currency aspects of the Multi-currency form and the differences in the jurisdiction and governing law sections.*"

12. Both 1987 forms contained a definition of "*Default Rate*" of interest. The 1987 IRCEA definition (Section 14, at page 11) used precisely the same "cost of funding the relevant amount" language that was later used in the 1992 MA and 2002 MA. The 1987 IRSA definition (Section 14, at page 7) however referred only to a borrowing rate: "*a rate per annum determined in accordance with the Federal Funds Floating Rate Option plus the Default Spread*". This was a reference to an interest rate published by the Federal Reserve, plus such uplift to that rate as was specified by the parties in the Schedule to the MA.

13. This specific difference between the two forms was explained in the 1987 Users' Guide (at page 14) as follows:

> *"The Default Rate in the Code-based form is equal to the rate determined in accordance with the Federal Funds Floating Rate Option plus the Default Spread. The Default Spread must be specified in the Schedule. In the Multi-currency form the rate is equal to the payee's cost of funding plus 1%* ***since no published index exists covering all possible currencies****. Under both forms interest is calculated on the basis of daily compounding" (emphasis added)*

14. Accordingly, when the language of "cost of funding the relevant amount" was first introduced by ISDA, it is clear that the draftsman intended to refer to a borrowing cost, and the only reason a borrowing benchmark was not specifically referenced was because the IRCEA could be used for transactions conducted in any currency.

15. The use of precisely the same language in the 1992, and then the 2002, MA (both of which are to be used for transactions in any currency) indicates that there was no intention to alter meaning of "*cost of funding the relevant amount*" from its meaning in the IRCEA.

16. Moreover, the 2002 MA re-introduces an explicit borrowing rate in certain instances (introducing reference to overnight borrowing rates), including an arithmetic mean between an explicit borrowing rate and the rate produced from a party's cost of funding the relevant amount.[3] For example:

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3 See pp.32-36 of the 2002 User's Guide, for a succinct explanation of the different interest rates, and the circumstances in which they are payable under the 2002 ISDA MA.

(1) Interest on amounts owed *by* the Non-defaulting Party, following an Early Termination Date, is payable at the Non-default Rate, defined in terms of "*a rate offered to the Non-defaulting Party by a major bank in a relevant interbank market for overnight deposits*";

(2) Upon the occurrence of an Illegality Termination Event (under Section 5(b)(i)), then amounts which would otherwise be due are postponed until after a Waiting Period of three business days (Section 5(d)), and interest is payable during that period at the "*rate offered to prime banks by a major bank in a relevant interbank market for overnight deposits in the applicable currency*": Section 9(h)(i)(3)(B), and limb (b) of the definition of Applicable Deferral Rate; and

(3) The definition of the Applicable Deferral Rate requires (at paragraph (c)) the determination of the arithmetic mean of an explicit borrowing rate and the cost to the relevant payee of funding the relevant amount.

17. There is no indication in the User's Guide to the 2002 MA that these changes were intended to impose a fundamental change in the way interest could be calculated, e.g. by removing a prior right to calculate interest by reference to a party's cost of equity. That would have been a seismic change in the interest entitlement of the Defaulting Party. The 2002 User's Guide (at p.32) states merely that "*Section 9(h) is a new Section in the 2002 Agreement that consolidates and updates all provisions regarding interest and compensation which were found in Sections 2(e) and 6(d)(ii) of the 1992 Agreement and adds provisions to deal with certain consequences of an Illegality or Force Majeure Event.*"

18. In the absence of any intention to make such a seismic change, the more natural characterisation is that the 2002 MA *retained* the underlying concept that the rates of interest payable under it were to be calculated by reference to the rate at which sums could be borrowed in the market, but merely confined the ambit of such rates to an overnight rate offered by a major bank.

19. Although not conclusive, the fact that in various circumstances the 2002 MA requires the Applicable Rate to be calculated as the arithmetical mean of (a) the cost to one part

if it were to fund or of funding the relevant amount and (b) the overnight rate offered to the other party by a major bank is more consistent with the assumption that the basic parameters of (a) and (b) are the same; i.e. they are both intended to identify the cost, as in transaction price, of borrowing to each of the parties.

Default Rate (and other interest rates under the ISDA MA) intended to arrive at calculation of time-value of the relevant amount for period it is outstanding

Phrase to be construed is "cost of funding the relevant amount"

20. The SCG makes repeated reference to the need to give "cost of funding" its natural and ordinary meaning. In so doing, it ignores vital wording in the definition.

21. Default Rate means "*a rate per annum equal to the cost ... to the relevant payee ... if it were to fund or of funding **the relevant amount** plus 1%*" (emphasis added). By ignoring that the subject of the words "*if it were to fund*" and "*of funding*" is "***the relevant amount***" the SCG fails to give effect to the true meaning of the definition.

22. The SCG points out (correctly) that many entities "*fund themselves*" through a mixture of debt, equity and hybrid instruments (SCG Skeleton/36). GSI says the same (e.g., GSI Skeleton/11, 45(1)). It by no means follows, however, that merely because many entities do so, and because 'cost of funding' in such a context may include the cost of equity funding, that the phrase "*cost of funding the relevant amount*" in the ISDA MA is to be similarly construed.

23. On the contrary, the fact that the object of the funding is "*the relevant amount*" is a critical feature which distinguishes the definition of Default Rate from the cost to an entity of funding itself or its assets more generally.

Context demonstrates that cost of borrowing is intended

24. There are a number of features of the ISDA MA (in addition to the history of the agreement noted above) that indicate that "*cost of funding the relevant amount*" is intended to refer to the price paid for borrowing a sum equal to the relevant amount.

25. **First**, in every circumstance in which the language "*cost of funding the relevant amount*" appears in the ISDA MA, its purpose is to identify the cost of providing a replacement for a sum of money which is due, but unpaid, under the ISDA MA, *for the period such sum is outstanding*. The various uses of "*cost of funding the relevant amount*" in the context of overdue amounts from one party to the other under the ISDA MA are summarised in the Judgment at [34]-[45], and Appendix 2 to the Judgment. As there noted, there are numerous circumstances in which one party may owe to the other interest on a single overdue amount at the Default Rate (i.e. based on its cost of funding the relevant amount) for part of the period the amount is outstanding but at the Non-default Rate (i.e. based on the cost of the *other* party's cost of funding the relevant amount) or the Termination Rate (i.e. based on the arithmetic mean of each party's cost of funding the relevant amount) for a different part of the period the same amount is outstanding.

26. The very fact that each of the defined terms (Default Rate, Non-default Rate and Termination Rate) identifies a rate of *interest* is important, since interest is fundamentally concerned with the cost of the use of money over time, i.e. the time value of money: Mann, Legal Aspects of Money, 7th ed., 3.07 ("*Interest has been defined as payment by time for the use of money*"); Blackstone, Commentaries, Book II, Ch.30, p.45 ("*an increase by way of compensation for the use of money*"). Contrary to the complaints made by SCG/GSI of the Judge (SCG skeleton/[60]-[61], and GSI skeleton/[36]) this is not to conflate the terms of the Default Rate definition with the fact that the definition is used to generate an interest rate. It is proper to have regard to the purpose for which the defined term is used in the ISDA MA to understand its scope.

27. Accordingly, wherever it appears in the ISDA MA "*cost of funding the relevant amount*" is intended to identify the cost of obtaining a replacement sum *over time*. This necessarily narrows the concept of "*cost of funding*" to the cost incurred in consideration for the acquisition of a sum of money over a period of time. This is another way of saying that it is the cost of borrowing a sum of money, since it is in borrowing money that the cost is linked to the time for which the money is acquired.

28. This accords with, and reflects, the general law which regards interest as (1) part of an attempt to provide *restitutio in integrum* (as opposed to compensating for loss generally

including a loss of profits or other consequential losses) and (2) intended to reflect the rate at which the party who is owed money "*would have had to borrow money to supply the place of that which was withheld*": *Tate v Lyle Food and Distribution Limited v Greater London Council* [1982] 1 WLR 149, per Forbes J at pp.154-155.[4]

29. This necessarily excludes costs incurred in obtaining a sum of money for any other purpose, such as to obtain additional capital, consequential losses and costs incurred otherwise than as the consideration for the provision of the money over time, such as costs paid to third parties for a service provided in connection with raising money (e.g. fees for legal services in connection with raising the money). In particular, it excludes cost incurred in obtaining a sum of money as a permanent accretion to an entity's assets – such as a contribution of capital. There being no obligation to return that sum of money, the cost of acquiring it cannot possibly be a proxy for the time value of money.

30. **Second**, the definition requires the calculation to be based on a transaction – either an actual transaction (the cost "*of funding*") or a hypothetical one (cost "*if it were to fund*"). In either case, the transaction must be one to raise a sum equal to the "*relevant amount*". It is important to note that, apart from the fact that in one case the transaction is actual and, in the other case, it is hypothetical, the nature of the transaction in both cases is precisely the same. That is, it is a transaction to acquire a sum equal to the relevant amount for the period it is outstanding.

31. This outlaws, for example, a transaction whereby the relevant payee raised a sum of money for a different purpose, or in a different sum. That is not to say, however, that a transaction to raise a different sum might not provide evidence from which the cost of raising the relevant sum might be inferred. It also outlaws reliance on the relevant payee's cost of funding itself or its assets more generally. Before the Judge, the SCG contended that an entity was entitled to have regard to what it referred to as an entity's 'cost of funding' – i.e. the weighted cost of all sources of funding its entire asset base.

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4 See also *Sempra Metals* [2008] AC 561, at [103], per Lord Nicholls. It remains the approach in commercial cases to calculate interest by reference to the short-term cost of unsecured borrowing for the relevant class of litigant: see *Department of Energy and Climate Change v Jones* [2014] EWCA Civ 363, per Sharp LJ at [18].

This point does not appear to be pursued in its skeleton in the same way as it was below[5]. It is right not to pursue it, since such cost is clearly not the cost of *transacting* at all, let alone a transaction in order to acquire an amount *equal to the relevant amount*.

32. **Third**, it follows that the cost of funding is to be equated with the *transaction cost*, that is, the price to be paid in return for acquiring a sum equal to the relevant amount for the period it is outstanding. This necessarily excludes costs payable to anyone other than the person providing the funding, because such costs would by definition not be in return for the provision of the funding. GSI (skeleton/51(1)) contends that it is artificial to restrict "cost" to sums that are paid to the funder, and that any sums (e.g. legal fees or underwriting fees) payable to third parties should also be included. The restriction is far from artificial. It is mandated by the words, and the purpose, of the definition as described above. Legal fees payable to a third party are payable in return for legal services provided by that third party. Similarly underwriting fees are payable to others in return for the provision of underwriting. Such services reflect a distinct benefit that is received and which has a price reflective of that benefit. To treat them as part of the funding cost merely because there is a causal link is as flawed as treating a bus fare to the shop as part of the price of the groceries purchased.

33. On the other hand, where the *funder* imposes a facility fee, then it is legitimate to view such fee as part of the price of the funding, and the Judge was correct to recognise this at [157]. It makes no difference if that fee is built into the interest rate charged, or payable as a lump sum. There is no difficulty – if the latter – in converting it into a cost per annum over the lifetime of the loan.

34. **Fourth**, it also follows that the "cost of funding the relevant amount" is such cost as the relevant party was (or would have been) required to pay – that is, the cost that was imposed on that party as an obligation, as opposed to something which it had a discretion whether to pay, or a discretion as to the amount to be paid.

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5 See paragraph 87 of the SCG's written submissions which appear to treat the cost of carrying a defaulted receivable owed by LBIE as *a factor* that may be taken into account by the relevant payee.

35. The SCG in fact accepts that the purpose of the cost of funding language is to produce an interest rate to compensate the relevant payee for the time value of the unpaid relevant amount: see paragraphs 33-35 of its written submissions. Its error however is to treat the loss of the relevant amount for the time it is outstanding as merely the "*primary loss*" suffered by a relevant payee as a result of late payment. In addition to this "*primary loss*", the SCG asserted in its grounds of appeal (although it does not develop these points in its skeleton) that the cost of funding language permits and requires[6] certification of (1) any cost to the relevant payee of an increase in its capital; and (2) any cost or financial consequence to the relevant payee "*of carrying a defaulted LBIE receivable on its balance sheet*"[7]. In its skeleton it continues to maintain that the language permits the cost of any legal or other services causally related to raising the relevant amount, actually or hypothetically.

36. Such an expansive treatment is illogical and unprincipled. The logic of the cost of funding language, and of providing *restitutio in integrum*, for the time value of the unpaid relevant amount, is to enable the relevant payee to fund a substitute amount, actually or hypothetically. It is in this way that the relevant payee is made whole. To award a cost of capital – which reflects an expected profit on the relevant payee's enterprise – is to over-compensate the relevant payee: first, by providing a measure of profit which should logically *exceed* the time value of money[8]; and, secondly, by doing so on *a risk-free basis*, i.e. the expected return is to be paid by the relevant payor irrespective of the success or failure of the relevant payee's enterprise.

37. The same is true of any impact on the relevant payee's weighted average cost of capital (WACC) "*of carrying a defaulted LBIE receivable on its balance sheet*". Any cost or financial consequence is a result of LBIE's default and has nothing whatsoever to do

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6 See paragraphs 58 and 59 below, which address the use of the cost of funding language where the payor is required to certify its cost of funding to produce a rate of interest to be paid to the payee. The SCG and GSI approach the cost of funding language in terms of that which is permitted to be included and ignore the multiple uses of the cost of funding language within the ISDA MA.

7 See paragraph 5 of the SCG's Amended Grounds of Appeal, which explains that the SCG's appeal against declaration (v) is intended to enable the relevant payee to certify an increase in its "*cost of borrowing or cost of shareholder funding... as a consequence of having an LBIE receivable on its balance sheet.*"

8 A commercially rational actor would only pursue a venture if it expected to earn more than the time value of money, which it would otherwise earn as interest.

with the time value of the unpaid relevant amount. It is moreover a cost or financial consequence that is not based upon a transaction to fund the relevant amount, actual or hypothetical. It too is a consequence of LBIE's default[9].

38. Likewise, the cost of any legal or other services causally related to raising the relevant amount, actually or hypothetically, represents the price of a service and does not reflect in any way the time value of the unpaid relevant amount.

The definition excludes cost of equity

39. The main commercial purpose of the SCG's and GSI's opposition to the Judgment is that they would wish to include the (likely higher[10]) cost of raising equity within the definition of the Default Rate. In GSI's case, this would involve (as the Judge noted at [128]) certifying a "*cost of funding the relevant amount*" in excess of 8% in circumstances where it in fact borrowed many billions of dollars from federal funds, shortly after LBIE's collapse, at rates between 0.01% and 1.10% pa.

40. Before the Judge, the SCG's argument focused on an entity being able to rely upon its general 'cost of funding' (i.e. its cost of funding all of its assets) with a mixture of debt and equity. Its appeal skeleton appears to limit its argument to an entity being able to rely upon the cost of a transaction whereby it raised a sum equal to the relevant amount through the issue of equity. It is worth noting that this is unlikely ever to occur – and for this reason alone was unlikely to have been in the contemplation of the drafter of the ISDA MA. The Default Rate applies to any overdue amount under the ISDA MA, including overdue Unpaid Amounts. An equity issue in respect of such amounts is most unlikely. It is also unlikely in the case of an unpaid close-out amount because of the

9 The SCG's appeal against declaration (v) is in this respect inconsistent with its acceptance of declaration (vii), which excludes from the scope of certification loss of profits or consequential losses "*arising from the non-payment of the relevant amount*". This inconsistency is not avoided by the attempt to downplay the appeal against declaration (v) in paragraph 87 of the SCG's written submissions. Any loss felt by reason of the consequences of LBIE's default is not part of the cost of funding "*the relevant amount*". It cannot be included under the label of a mere factor to be taken into account.

10 It is an obvious point that equity investors generally expect a higher return than that payable on debt because equity is a riskier form of investment.

viability of borrowing for users of the ISDA MA[11]. In any event, the features of the ISDA MA already referred to demonstrate that the cost of equity funding is excluded from the definition. In summary:

(1) Equity is fundamentally different to debt. It is a permanent accretion to the capital of the company, not the provision of money for a limited period of time.[12]

(2) Equity has three essential characteristics:

(a) It is a measure of the liability of the contributory;

(b) It is an interest in the company subject to the contract between the company and its members *inter se*;

(c) The right to money is only "*to a sum of money of a more or less amount*", recognising the uncertain nature of a shareholder's entitlement to income or a return of capital in a winding-up.[13]

(3) In respect of the most basic and common form of a share – the ordinary share in a limited company – from the perspective of the shareholder, any particular return on equity is merely in the nature of an expectation. There is no *right* to any amount that might be enforced as something the company has to pay. Without any breach of any obligation a company might refuse to pay a dividend either because it has no cash, no sufficient reserves or a reason not to declare a dividend. For this reason, Farwell J did not express any definite monetary entitlement in his classic definition. As the High Court of Australia explained

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11 In a similar vein, if the SCG/GSI arguments are correct, the experience of claims for interest asserted in the Lehman insolvency to date would be highly surprising. A number of claims for interest under the ISDA MA have been asserted in the bankruptcy of LBHI in the US. Of those, the vast majority are at rate (well below 8%) that are consistent with *borrowing* rates during the relevant period: see 11th witness statement of Anthony Lomas, at [80] to [92]. This is confirmed by the witness statement of Robert Bingham, at [12] to [20].

12 As to preference shares, see below at Paragraphs 42 to 48.

13 *Borland's Trustee v Steel* [1901] 1 Ch 279, at p.288 per Farwell J. This passage has been repeatedly approved at the highest level: see e.g., *Re Paulin* [1935] 1 KB 26, at pp.50 and 56 (CA); *Grays Timber Products Ltd v Revenue and Customs Commissioners* [2010] 1 WLR 497, at [27] per Lord Walker (HL).

in *Pilmer v Duke*[14]: "*Once issued, a share comprises 'a collection of rights and obligations relating to an interest in a company of an economic and proprietary character, but not constituting a debt'.*"

(4) The anticipated return that a shareholder might expect (but has no legal right to) is thus particularly inapposite as a foundation for identifying the time value of money: there is no *obligation* to return to the shareholder the equity it invested; and dividends paid on it – even if they mimic to some extent interest, being paid as a percentage of the capital invested – are referable not to the time-value of money, but to the profits made by the company. In this respect see Farwell J in *Bond v Barrow Haematite Steet Co*:[15] "*Interest is not an apt word to express the return to which a shareholder is entitled in respect of shares paid up in due course and not by way of advance. Interest is compensation for delay in payment and is not accurately applied to the share of profits of trading, although it may be used as an inaccurate mode of expressing the measure of the share of those profits.*"

(5) Further features of share capital undermine the suggestion that the expected return on equity might be considered a "*cost*":

(a) Equity capital can be redeemed. Redemption at par does not compensate the investor for the time-value of the money. It involves simply giving back a sum equivalent to the money invested.

(b) Equity capital can also be written off in the light of losses incurred. A capital reduction means that the company will have had the use of the money invested, for which it may never have paid any dividend or other return.

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[14] (2001) 180 ALR 249 at 255

[15] [1902] Ch 353, 363.

(6) There is also a further – and more subtle – difference between debt and equity which suggests that the draftsmen of the ISDA MA cannot have intended a return on equity to be "*cost*":

(a) A debt can be repaid at any time by an unconditional tender of the amount owed (including any pre-payment costs and other charges for early payment).

(b) A debt incurred to fund the relevant amount can, therefore, be repaid at the point the unpaid amount ceases to be outstanding.

(c) By contrast, equity cannot usually be redeemed at the will of the company. An ordinary share is usually conceived of as an interest in the company and a permanent increase in its capital.

(d) Any return on capital will in most cases continue to be enjoyed even *after* the relevant amount ceases to be outstanding.

(e) The fact that in relation to the most common form of equity – an ordinary share – a return on capital might be paid after the unpaid amount ceases to be outstanding is a further indication that the draftsmen of the ISDA MA cannot have intended a certification based upon an expected return on equity.

41. So far as this last point is concerned, Wentworth does not suggest that the tenor of any funding must 'match' the period for which the relevant amount is outstanding. That is likely to be impossible due to the uncertainty of the period for which the debt will be outstanding. The point is that shares are ordinarily conceived of as an interest in the company and a permanent increase in its capital. That is a world away from a transaction aimed at producing compensation for being kept out of money over time.

Preference shares

42. While a preferred share differs from an ordinary share insofar as it carries an entitlement to be paid a fixed dividend (fixed at a rate relative to the par value) in priority to any dividend to be paid to ordinary shares, it retains the essential characteristics of equity which render payments made by the company in respect of it inapposite as a proxy for the time-value of money, and thus outside the ambit of the "*cost of funding the relevant amount*" language.

    (1) Whatever the precise bundle of rights, on day 1 after issue, a preferred shareholder cannot say he has any *right* to be paid a return any more than an ordinary shareholder can. He can only say that he expects a certain level of profit and that, if achieved, he can claim priority relative to an ordinary shareholder.

    (2) Expressed in other words, the 'preferred' bit of preferred stock is a relatively better entitlement to income as compared to an ordinary share, not an "*absolute*" one. Palmer's Company Law describes preference shares as follows, at 6.101[16]:

    > *"As their name implies, preference shares usually carry some preferential rights in relation to other classes of shares, particularly in relation to ordinary shares. There are no rigid rules but the preferential rights usually relate to the payment of dividends and/or priority as to repayment of capital on a winding up."*

    (3) Relative to a debt, the return on a preferred share is as much in the nature of an expectation as the return on an ordinary share. The right to dividend is described in Palmer's Company Law at 6.110 under the heading "*No absolute right to dividend*":

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16 See also *Prudential Assurance Co Ltd v Chatterley-Whitfield Collieries Ltd* [1949] AC 512, 520-521 in which Viscount Maugham, in the context of capital reduction described the preferred shareholders' rights as "*rights of priority*" as compared to ordinary shareholders and in terms of their "*relative expectations of income yield*"; *Beck v Weinstock* (2013) 297 ALR 21, in which the High Court of Australia held that a preference share was a share with some entitlement in priority to another class of share, whether or not that other class was issued or simply defined in the company's articles.

"Preference shares almost always carry a preferential right to a fixed dividend. This is expressed as a percentage of the nominal value of the share. Thus, e.g. there can be 6 per cent preference shares.

But like all dividends this right only applies if there are distributable profits lawfully available to the company. The right is not to a dividend but to preferential treatment if and when one is distributed. That in turn depends upon the terms of the articles as to whether this right only arises when a dividend is declared."[17]

(4) Even if preference shares have a right to participate in surplus profits, i.e. in addition to a fixed priority as to dividend, it is accepted that preference shares may be repaid by means of a capital reduction, allowing companies to *frustrate* any expected return on preferred shares in response to changes in fiscal or financial regimes.[18] Palmer's Company Law summarises the position as follows at 6.122:

"Changes in the fiscal and financial regimes may prompt companies to repay their preference shares by means of a reduction of capital. It is now well established that such a risk is an integral part of the preferred share's rights."

(5) The suggestion that preferred shareholders might in any way be considered debenture-holders was rejected as long ago as 1889. In *Birch v Cropper* (1889) 14 App Cas 525, Lord Macnaghten declined to hold that preferred shareholders were entitled to either "*a return of their capital, with 5 per cent. interest up to the day of payment*" or "*the capital value of a perpetual annuity of 5 per cent*". He said, at 546:

"The ordinary shareholders say that the preference shareholders are entitled to a return of their capital, with 5 per cent. interest up to the day of payment, and to nothing more. That is treating them as if they were debenture-holders, liable to be paid off at a moment's notice. Then they say that at the utmost the preference shareholders are only entitled to the capital value of a perpetual annuity of 5 per cent. upon the amounts paid up by them. That is treating them

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17 See also Gore-Browne on Companies, Vol. 1 at [5]. The entitlement to dividend on a preferred share, like an ordinary share, is ordinarily made subject to the discretion of the board of directors or the company in general meeting: *Bond v Barrow Haematite Steel Co* [1902] 1 Ch 353, 362 per Farwell J. See also *Re Buenos Ayres Great Southern Railway Co Ltd* [1947] 1 All ER 729, 741 per Romer J.

18 See *House of Fraser v AGCE Investments Ltd* [1987] AC 387, HL *per* Lord Keith approving *Re Saltdean Estate Co* [1968] 1 WLR 1844 *per* Buckley J.

as if they were holders of irredeemable debentures. But they are not debenture-holders at all."

43. It is no answer to the above points to identify instruments which do not share all the characteristics of ordinary shares (such as preferred shares, or hybrid instruments such as convertible notes).

44. The fact that *part* of an instrument has characteristics equivalent to that of borrowing merely demonstrates that in a case where an entity did, or would have, issued hybrid instruments in order to fund the relevant amount, the price paid by that entity in relation to those instruments may *in part* be relevant for determining the cost to it of borrowing the relevant amount. That does not mean that to the extent that the instruments bear characteristics of equity, the price relevant to that part is also relevant.

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

46. The Judge is criticised by the SCG and GSI for not giving precise guidance as to how such instruments are to be treated. The criticism is misplaced because no instruments were before him, and the SCG and GSI each accepted the clear distinction in principle between debt and equity. The fact that the Judge declined to write an essay classifying particular instruments not before him is neither a matter that can fairly be criticised nor one which highlights a defect in his conclusions.

47. Even at a high level, and without access to any particular terms, it is readily apparent that the example of hybrid instruments focused upon by the SCG and GSI is unlikely to present particular problems in practice. A convertible bond, for example, involves a cost, in the sense of a requirement to pay for the purpose of acquiring the face amount of the bond for the period which it is outstanding, up to the point in time at which it is converted and is thus, during that period, a proxy for the cost of funding the relevant amount. Thereafter, however, there is no *obligation* on the company to pay (see above) and any payment received by the holder is not referable to the cost of providing funding

for a period of time, and it thus ceases to be a proxy for the cost of funding the relevant amount.

48. Indeed, the convertible bond demonstrates that there is indeed a bright-line distinction between debt and equity: the first being relevant to the definition of Default Rate, the second not.

<u>Response to other points made by SCG/GSI</u>

49. Most of the points advanced in the SCG and GSI skeletons are met, directly or indirectly, by the submissions made above. The failure to deal with any point expressly is not to be taken as acceptance of it. A few specific points are addressed further in the following paragraphs.

Other sources of funding involve a "cost"

50. The SCG says that equity funding also involves a "*cost*", being the compensation that the market demands in exchange for providing equity funding (SCG skeleton, [37] – [41]). This argument suffers from the same flaw as SCG's principal argument, namely that it takes the word "*cost*" out of its context within the definition of Default Rate.

51. Whether or not the return expected by investors may be described for some purposes as a "*cost*" from the perspective of the company does not mean that it is an appropriate proxy for the cost of *funding the relevant amount for the period it is outstanding*. As noted above, even where the shareholder's funds are in fact returned to it, any additional payments, e.g. by way of dividend, are not merely the price paid for having use of the shareholder's money for a period. In the first place, such payments can only be made out of profits. Secondly, and consequently, the right to participate in profits beyond a rate of return that a company has an obligation to pay (as is the case with interest on a debt) represents reward for the risk that the company will not make profits and so pay any return at all.

52. It is equally irrelevant that WACC constitutes a well-established framework for calculating the average cost of all of an entity's different sources of funding (SCG

Skeleton, [41(1)]). Such a calculation is wholly divorced from what it would cost an entity to raise, by a transaction, a sum equal to the relevant amount during the period of default. GSI recognises this distinction, in accepting (GSI skeleton/38(1)) the force of the Judge's conclusion that to allow cost of funding the relevant amount to include model-based costs such as CAPM and WACC would lead to an overly broad definition of Default Rate[19]. GSI goes on to state (correctly) that the fact that the "*cost is to be determined by actual or hypothetical transactions will itself provide meaningful limits on the amounts which can be certified*". (GSI then contends – wrongly – that this means that there is no need to go further and limit the definition to the cost of borrowing. The reasons for excluding the cost of a transaction by which equity is raised are not, however, based on the contention that the definition would be inherently too broad, but on the fact that payments in respect of equity cannot qualify as a proxy for the timevalue of money for the reasons set out above.)

Commercial context: entities may need to raise capital

53. GSI places particular reliance on the fact that financial institutions are required to maintain a certain level of equity capital, and that many financial institutions needed (either because of regulatory requirements, or to maintain market confidence) to raise further equity as a consequence of LBIE's default: see GSI Skeleton at [11-13].

54. This is flawed for the reasons already referred to. Raising capital in order to meet regulatory requirements involves (a) a permanent accretion to capital; and (b) payment to the provider of the capital as reward for the particular risks incurred in providing equity. It has nothing to do with the cost of providing funding to compensate for the default in payment of a receivable, for the period such default lasts.

55. The fact that an entity needs to raise capital as a result of LBIE's default is irrelevant. It is unlikely that costs associated with such capital raising would be recoverable as

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[19] Likewise, an "investment" based approach to the calculation of an interest rate on a running account, which utilised WACC and CAPM, was rejected by Gloster J in *Masri v Consolidated Contractors International UK Ltd* [2007] EWHC 468 (Comm) at [32]: "[T]*he CAPM approach involves so many variables and unknowns that no useful assumption could be made of its likely movements over a long period, I find it unreal to suppose that it would have been an objectively reasonable interest rate to apply to the running account.*"

consequential losses resulting from a breach of contract, or would otherwise be included within the definition of Loss or Close-out Amount under the 1992 or 2002 ISDA MA. Whether or not they are so recoverable, however, they could not possibly be recovered through the back door as part of the cost of funding the amount of the defaulted receivable, for the period that it was outstandaing.

Consistency in the ISDA MA

56. The SCG criticise the Judge for having failed to give the phrase "*cost of funding*" a consistent meaning throughout the ISDA MA (SCG skeleton/[10(3)] and [69]-[73]). GSI makes a similar point at GSI skeleton/[40]. In particular, it is suggested that on the Judge's approach "*cost of funding*" has a different meaning in the Default Rate definition to its meaning in the definition of Loss.

57. This is, again, flawed because it takes the phrase "*cost of funding*" out of its context. In fact, it is not that "*cost of funding*" means different things in the different parts of the agreement, but that in the context of the definition of the Default Rate, the relevant phrase is "*cost of funding the relevant amount*" (for the period it is outstanding) whereas in the definition of Loss, the phrase is just "*cost of funding*". Whatever may be the true meaning of that phrase in the context of the Loss definition has no bearing on the correct interpretation of the phrase "*cost of funding the relevant amount*" in the context of the Default Rate definition.

58. The more important point is that the phrase "*cost of funding the relevant amount*" must have the same meaning wherever it occurs – in the context of defining one of the various rates of interest (Default, Non-default and Termination) in the ISDA MA. This is important in demonstrating that certain of the arguments advanced by the SCG and GSI below cannot be right. Under the terms of the ISDA MA, the cost of funding language applies either to the payor or payee and in some cases to both of them. For example, where Party A suffered an EoD and a Termination Amount of £100m is due *to* Party A, then interest is payable by Party B, for the first period (up to the date of the calculation notice) at the Non-default Rate (based on the cost *to Party B* of funding £100m) and thereafter at the Default Rate (based on the cost *to Party A* of funding £100m). Where Party B (who *owes* £100m) is certifying the cost *to it* of funding £100m, if, as the SCG

and GSI contend, the cost of funding language encompasses a range of ancillary costs and financial detriments that would be suffered by Party B if it were to raise £100m, then Party B would be failing to comply with the contractual requirements unless it sought, in good faith and on a rational basis, to include every such detriment (and, logically, any offsetting benefits). If it did not do so, it would (on the SCG's and GSI's case) wrongly *reduce* the interest rate it was required to pay to Party A for the relevant period.

59. Even if the hypothetical exercise required to certify such costs were possible, it is so burdensome a task that it cannot have been contemplated by the draftsmen of the ISDA MA in order to produce a rate of interest, which is intended to compensate for the time-value of money. Indeed, the range of detriments which the SCG and GSI would include are a long way from the concept of a payment in return for a sum of money for a period, which is the essential element in computing the time value of money.

60. As noted above, losses or costs incurred by a Non-defaulting Party as a consequence of the default itself may or may not be recoverable as part of the calculation of Loss or Close-out Amount under the ISDA MA (and that depends on the nature of the loss or cost and the breadth of the definitions of Loss and Close-out Amount), but that in no way informs the meaning of "*cost of funding the relevant amount*" for the period it remains unpaid.

An entity that is unable to borrow

61. Both the SCG and GSI suggest that the Judge's conclusion cannot be right, since it does not cater for the entity that cannot borrow at all. They are wrong to do so.

62. First, insofar as they rely on an entity which has rendered itself unable to borrow, whether by reason of covenant restrictions or because of its inability to comply with regulatory capital requirements, the argument fails to take account of the fact that Default Rate includes the alternative, hypothetical, basis – i.e. the cost to the relevant payee if it were to fund the relevant amount, without actually having to enter into a transaction that would have put it in breach of covenant or regulation.

63. Second, insofar as they rely on an entity to whom no-one will lend, the suggestion that this leads to the conclusion that it is necessary to include the cost of equity is misconceived. The possibility that no-one will *lend* to an entity, but would be willing instead to invest by way of equity (thus taking a higher risk than lending) is (as the Judge noted at [163]) so remote as to be excluded from the circumstances within the reasonable contemplation of the draftsman of the ISDA MA. In the extreme event that no-one will lend to an entity, then it is far more likely that no-one would invest equity – in other words, the entity simply has no ability to fund the relevant amount at all. The SCG's suggested solution to the problem – that equity funding should be included –is thus no solution at all. In such circumstances, then either the Administrators' suggestion[20] that zero, plus 1%, is the appropriate Default Rate is to be adopted, or it is necessary to fall-back on the hypothetical limb of the definition (along the lines suggested by Forbes J in *Tate & Lyle* (above) in the context of arriving at a commercial rate of interest), namely that it is the cost of a person in the position of the relevant payee, shorn of the characteristic that prevents it from borrowing.

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28 July 2017

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20 Joint Administrators' skeleton argument dated 23 October 2015, paragraph 52.