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Case No: 7942 of 2008

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE)
AND IN THE MATTER OF THE INSOLVENCY ACT 1986

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 5 October 2016

Before :

THE HONOURABLE MR JUSTICE HILDYARD

Between :

(1) ANTHONY VICTOR LOMAS
(2) STEVEN ANTHONY PEARSON
(3) PAUL DAVID COPLEY
(4) RUSSELL DOWNS
(5) JULIAN GUY PARR
(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION) — **Applicants**

and

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

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David Foxton QC and Craig Morrison (instructed by **Cleary Gottlieb Steen & Hamilton LLP**) for the **Sixth Respondent**

Hearing dates: 9-11 November & 16-25 November 2015
Further submissions received 7, 14 & 21 December 2015
Further hearing 24 June 2016
Supplemental submissions received 21 July 2016

Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

THE HONOURABLE MR JUSTICE HILDYARD

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Mr Justice Hildyard :

INTRODUCTION

1. This is the third tranche of what has become known as the *Waterfall II Application*, which concerns the application of statutory interest pursuant to rule 2.88 of the Insolvency Rules 1986 ("Rule 2.88") on debts proved in the administration of Lehman Brothers International (Europe) ("LBIE").

2. LBIE was the principal trading company for the European operations of the Lehman Brothers group. LBIE entered into administration on 15 September 2008, the same day as the ultimate holding company of the group filed for protection under Chapter 11 of the US Bankruptcy Code. The collapse of the Lehman group shook the financial world.

3. The need for LBIE's Administrators ("the Administrators") to seek directions on the issues in this application, and also on an earlier application *("Waterfall I")*, arises in the context of a substantial surplus in LBIE's administration after paying or providing for the provable debts owed by LBIE in full. The Administrators presently estimate that the surplus is in the region of £7 billion. Such a situation is unusual. The questions raised as to the application of the substantial surplus are both novel and complex.

4. It was held in *Waterfall I*, at first instance (by David Richards J as he then was) and in the Court of Appeal, that the surplus was to be distributed in the order of, first, statutory interest payable under Rule 2.88; secondly, non-provable claims of creditors, including claims to currency exchange losses resulting from a depreciation of sterling against the currency in which creditors' claims were payable between the commencement of the administration and the date on which dividends were paid on such claims; and thirdly, some US$2.27 billion of subordinated debt. (The judgments in *Waterfall I* are reported at [2014] EWHC 704 (Ch), [2015] Ch 1 and at [2015] EWCA Civ 485.) *Waterfall I* is on its way to the Supreme Court; but even if the Supreme Court were to reverse the Court of Appeal's decision, there would still be a surplus after payment in full of the subordinated debt.

5. *Waterfall II* concerns three main issues: (a) the entitlement of creditors to interest on their debts for periods after the commencement of the administration of LBIE; (b) the construction and effect of various agreements made since the commencement of the administration between LBIE acting by the Administrators and very significant numbers of its creditors; and (c) the construction and effect of pre-administration agreements in various standard forms containing (amongst other things) provisions entitling a counterparty of a defaulting party such as LBIE to interest on amounts payable under the relevant agreement(s). To make *Waterfall II* more manageable, David Richards J (as he then was) divided its hearing into three, with a separate hearing for each of the above issues.

6. The first part (*Waterfall IIA*) and the second part (*Waterfall IIB*) have been adjudicated at first instance and are on appeal to the Court of Appeal. It was held in *Waterfall IIA* that statutory interest pursuant to Rule 2.88 accrues on all debts, including contingent and future debts, from the commencement of the administration and ceases to accrue after payment of the final dividend. *Waterfall IIA* is reported at

[2015] EWHC 2269 (Ch). *Waterfall IIB* is not of substantial relevance for the purposes of *Waterfall IIC*; but it is reported at [2015] EWHC 2270 (Ch).

7. The application now before me, *Waterfall IIC*, principally concerns the scope of the entitlements of certain creditors of LBIE to interest in right of proved debts arising under or pursuant to certain standard form master agreements governed variously by English, New York or German law on the terms of which LBIE and its claimant counterparties undertook derivatives transactions before the collapse of LBIE in September 2008.

The ISDA Master Agreements in issue: the 1992 and 2002 Forms

8. The master agreements in issue are (1) the 1992 and 2002 forms of Master Agreement (together "the ISDA Master Agreements", severally "the 1992 Form" and "the 2002 Form") produced by the International Swaps and Derivatives Association, Inc (formerly the International Swap Dealers Association, Inc) ("ISDA") and (2) another form of master agreement for financial derivative transactions governed by German law ("the GMA").

9. Put shortly, the principal question now to be addressed both in the case of the ISDA Master Agreements and in the (analytically quite different) case of the GMA is whether under the relevant master agreement LBIE's counterparty creditor is entitled to interest at a "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9) which exceeds the rate of interest otherwise payable under Rule 2.88(7), which is 8% simple per annum. The latter is the rate specified in section 17 of the Judgments Act 1838 ("the Judgments Act Rate"). Rule 2.88(9) provides for statutory interest under Rule 2.88(7) to be payable at the greater of: (a) the Judgments Act Rate on the date when the company entered administration and (b) the "*rate applicable to the debt apart from the administration*".

The significance of the points in issue

10. The outcome of *Waterfall IIC* will have a significant impact on the amount of the surplus the Administrators will be required to distribute in respect of statutory interest. According to the Administrators' evidence (and in particular, the 12th Witness Statement of one of them, Anthony Victor Lomas ("Mr Lomas") of PricewaterhouseCoopers LLP) there are 854 creditors holding an admitted claim in LBIE's administration, part or all of which arises under an ISDA Master Agreement or associated Long Form Confirmation[1]; and these claims represent approximately £4.4 billion of LBIE's total admitted claims, subject to operation of set-off within a minority of these claims. The Administrators estimate that some 543 of these claims arise under English law; and some 310 under New York law.

11. The Administrators further estimate that at the Judgments Act Rate the statutory interest payable in respect of ISDA claims will be approximately £1.7 billion, accruing from 13 September 2008. By way of illustration, if claims to interest at (say) 8% or 12% compound were admitted, the entitlement would rise to about £2.1 billion

[1] Containing transaction-specific terms agreed between the parties for each individual transaction and supplementing the relevant ISDA Master Agreement: see also para. [30(2)] below.

or £3.7 billion respectively; and at 18% compound the amount would rise to some £6.8 billion.

12. There are fewer claims arising in respect of the GMA, but in aggregate they are still substantial: Mr Lomas, in his 13th Witness Statement, states that, as at 7 October 2014, 15 had been admitted, in an aggregate amount of some £311 million.

The issues for adjudication

13. After certain amendments and deletions to their original Application Notice (issued on 12 June 2014), the issues which the Administrators have submitted for adjudication are set out in Appendix 1 to this judgment.

14. In addition to those issues, a further Supplemental Issue was identified at the commencement of the oral hearing ("Supplemental Issue 1(A)"). Supplemental Issue 1(A) concerns the question whether a rate of interest that arises out of a pre-administration contract but which only begins actually to accrue by reason of action taken by the creditor after the commencement of the administration may be "*the rate applicable to the debt apart from the administration*". That issue too is set out in its agreed form in Appendix 1 to this judgment.

The parties to Waterfall IIC and their roles

15. Although the Administrators are the Applicants, the true contest (at least in the case of the original issues, though the Administrators are more actively contesting Supplemental Issue 1(A)) is between, on the one hand, the first to third Respondents (Burlington Loan Management Limited, CVI GVF (Lux) Master S.A.R.L, and Hutchinson Investors, LLC (collectively, "the SCG")), supported by Goldman Sachs International ("GSI") and, on the other hand, the fourth Respondent, Wentworth Sons Sub-Debt S.A.R.L. ("Wentworth").

16. The members of the SCG through their various affiliates together hold unsecured claims against LBIE in excess of £2.75 billion, of which an aggregate of approximately £1.1 billion are claims (not including interest) under ISDA Master Agreements ("ISDA Claims"). These ISDA Claims were predominantly purchased from third parties.

17. Wentworth has multiple ISDA Claims (aggregating approximately £1.6 billion), also predominantly comprising claims purchased from other parties. In addition, Wentworth owns the shareholders' subordinated debt interest in LBIE and Wentworth's sister company, Wentworth Sons Equity Claims S.à.r.l., owns equity interests in LBIE indirectly.

18. The fifth Respondent, York Global Finance BDH, LLC ("York") is one of five co-participants in unsecured claims against LBIE with an agreed total value of US$676.25 million. York has not advanced any arguments on *Waterfall IIB* or *Waterfall IIC* and was not represented at the trial of the *Waterfall IIC* issues, except as regards Supplemental Issue 1(A), where it was one of the principal contestants.

19. GSI (the sixth Respondent) played no role in *Waterfall IIA* or *Waterfall IIB* but was joined to the *Waterfall II Application* on 23 June 2015 for the purpose of advancing

arguments in respect of *Waterfall IIC* Issues 11 to 14 and 27 in accordance with the order of David Richards J of the same date. GSI's joinder was expressly limited to "*the submission of evidence and the making of arguments which do not duplicate those made by the [SCG]*". GSI has ISDA Claims against LBIE governed by English law.

20. No representation order has been sought whereby to bind formally other creditors. None of the Respondents acts in a representative capacity. Instead, the Administrators have uploaded all the position papers, witness evidence and skeleton arguments served by the Administrators and the Respondents onto the LBIE administration website[2]. Where issues have been agreed between the parties, the Administrators have given notice of the agreed position on the website and invited creditors to contact their team should they have any queries. The same procedure has been adopted in the case of all aspects of the *Waterfall II Application* without objection.

Structure of Judgment

21. This judgment is in three main parts. The first part addresses the ISDA Master Agreements. The second part addresses the GMA. The third part addresses Supplemental Issue 1(A).

PART 1: THE ISDA MASTER AGREEMENTS

22. The issues in relation to the ISDA Master Agreements are not only substantial in terms of monetary value; they raise issues of systemic importance given the widespread use of ISDA Master Agreements, in their various iterations, for over the counter derivative transactions internationally.

23. ISDA Master Agreements are used for a large variety of different types of derivative transaction, and by a broad range of counterparties, from banks and other financial institutions involved in derivatives trading to corporate entities seeking to hedge against interest or currency risks inherent in their business.

24. In *Lomas v JFB Firth Rixson*[3], Briggs J described the ISDA Master Agreement (in its various iterations) as

> "…one of the most widely used forms of agreement in the world. It is probably the most important standard market agreement used in the financial world. English law is one of the two systems of law most commonly chosen for the interpretation of the Master Agreement, the other being New York law."

[2] The Administrators have noted, and I accept, that many of LBIE's creditors are highly sophisticated entities, have been following the Waterfall applications with close attention and are well-equipped to identify whether all arguments which might affect their interests are being advanced.

[3] [2010] EWHC 3372 (Ch), at [53].

25. According to statistics compiled by the Bank of International Settlements, as at the end of December 2014 the total notional amount of over the counter derivatives in existence was US$630 trillion.

26. As may be apparent from the fact that two versions need to be considered in the context of the issues now raised, the ISDA Master Agreements have been revised over the years. Of the standard forms that are still in use and in issue in these proceedings:

    (1) The 1992 Form was the first version that was designed in a form applicable to derivatives other than just swaps, including pure contracts for differences, caps and floors, and to accommodate both financially and physically settled transactions.

    (2) The 2002 Form replicates, for the most part word for word, the provisions of the 1992 Form, albeit with significant changes to provisions concerning the determination of amounts due on early termination, and a different structure in respect of provisions for interest.

27. Both the 1992 and 2002 Forms, which share the same basic architecture, continue to be used, depending on the parties' preference: see *Lomas v JFB Firth Rixson* [2010] EWHC 3372 (Ch) at [8]. The vast majority of the ISDA Master Agreement-governed claims exist under the 1992 Form: but (as elaborated later, and subject to the particular differences noted below) all parties are agreed that the 1992 and 2002 Forms are in relevant part to be construed in the same way.

28. ISDA published *User's Guides* to the 1992 Form and to the 2002 Form. These contain explanations for, and guidance on the operation of, much of the content of the relevant ISDA Master Agreements, and are, in my view, both an admissible and useful tool in the interpretation of the agreements.

29. The architecture of the ISDA Master Agreements is also described in detail in the judgment of Longmore LJ in *Lomas v JFB Firth Rixson* [2012] 2 All ER (Comm) 1076 at [12] and in the first instance judgment of Briggs J in that case (at [9] – [27]).

The basic framework of the ISDA Master Agreements

30. I take the following description of the basic framework from those judgments and from the useful summaries provided in the various Skeleton Arguments filed at the commencement of the hearing of this application:

    (1) The ISDA Master Agreements provide contractually agreed standard terms and conditions which are designed to form part, but not the whole, of the terms of any particular transaction. Their purpose is to set out provisions governing the parties' relationship that are not transaction-specific.

    (2) A particular transaction is generally governed by the terms of a Confirmation, together with the ISDA Master Agreement and any Schedule appended to the ISDA Master Agreement. The ISDA Master Agreement and all Confirmations form a single agreement between the parties, albeit one which governs one or more transactions. Inconsistencies are resolved by

affording priority first to the Confirmation, secondly to the Schedule and lastly to the ISDA Master Agreement itself.

(3) The ISDA Master Agreements envisage that certain provisions will only become operative if the parties make an election in the Schedule and the content of other provisions may depend on what is specified there. The Schedule also gives the parties the opportunity to add to or vary any of the terms contained in the standard form and also to include information (such as addresses for notices) which is specific to the parties.

(4) The Schedule provides for the parties to elect whether the governing law should be English law or the laws of the State of New York.

(5) Every transaction will be subject to a Confirmation. For example, in relation to interest rate swaps, each Confirmation will identify a series of dates upon which the parties are or may be obliged to make payments to each other and will contain the formulae necessary to identify the amounts to be paid. Any fixed rate payable will be specified. Any floating rate will generally be identified by reference to a particular market formula, such as three months sterling LIBOR.

31. The following provisions are common to, or substantially the same in, both the 1992 and 2002 Forms:

(1) Section 1 regulates the relationship and precedence in any particular transaction between the Confirmation, the Schedule and the Master Agreement.

(2) Section 2 contains the general obligations of the parties, including that each will make payment or delivery in accordance with the terms of the "Confirmation". There are detailed netting provisions. Payment obligations are subject to the conditions precedent specified in Section 2(a)(iii), which include that no Event of Default or Potential Event of Default has occurred and is continuing and that no Early Termination Date has occurred or been effectively designated.

(3) Section 3 sets out representations by each party to the other as to their powers and authority, and also as regards the accuracy of specified information and the absence of certain events.

(4) Section 4 stipulates certain continuing obligations of the parties, including the provision of specific information, maintenance of authorisations, and compliance with laws and certain tax obligations.

(5) Section 5 identifies a number of Events of Default or Termination Events. They include a failure to make, when due, any payment required under Section 2(a)(i) (Section 5(a)) and "Bankruptcy Events" (at Section 5(a)(vii)), including where a party seeks or becomes subject to the appointment of an administrator.

(6) Section 6 provides for Early Termination after a continuing Event of Default or a Termination Event. Under Section 6(a) of the ISDA Master Agreements, if an Event of Default with respect to a party (the "Defaulting Party") has occurred and is continuing, the other party (the "Non-defaulting Party") may (but is not required to) designate an "Early Termination Date" in respect of all outstanding transactions. Where "Automatic Early Termination" is specified in a Schedule, an Early Termination Date will occur immediately on the occurrence of certain specified Events of Default. Section 6(e) (headed "Payments on Early Termination") provides for how the sum payable by one party to the other following Early Termination is to be calculated. These provisions constitute contractual methods of calculating close-out positions on the termination of a derivative transaction or series of transactions: Anthracite Rated Investments (Jersey) Ltd v Lehman Brothers Finance SA (in liquidation) [2011] 2 Lloyds Rep 538 at [116] per Briggs J. Where an Early Termination Date occurs, all transactions entered into pursuant to the ISDA Master Agreement are terminated. The Non-defaulting Party is entitled to determine the amount to be paid on Early Termination, in accordance with Sections 6(d) and (e). The broad effect of the provisions is to procure, as far as possible but in an accelerated form, the same economic outcome for the parties as if there had been neither an Event of Default nor an Early Termination: Lomas v JFB Firth Rixson [2010] EWHC 3372 (Ch) at [18]. As such, the amount calculated as due on Early Termination may be payable by either party, dependent on which is "in the money". Section 6(d)(i) requires the calculation of the amount payable under Section 6(e), and service of a notice of such amount on the other party, to take place as soon as practicable after the Early Termination Date. Section 6(d)(ii) provides for interest to be paid on the sum calculated as being due from one party to the other under Section 6(e).

(7) Section 7 contains a general prohibition on transfer of any interest or obligation under the relevant agreement, with certain exceptions described more fully below.

(8) Section 8 sets out rules for payment in the selected contractual currency and the conversion of judgment debts into that currency.

(9) Section 9(a) to (g) provides for miscellaneous matters, including (for example) an entire agreement clause, the required process for modifications or amendments, and no waiver of rights upon delay or a failure to exercise them. Section 9(h) is contained only in the 2002 version and relates to interest: see below.

(10) Sections 10, 11 and 12 contain various provisions for transactions to be treated as entered through the party's head or home office (section 10), for indemnification of expenses (section 11) and for the service of notices (section 12). Section 13 is a governing law and jurisdiction clause.

(11) Section 14 is a definitions section: for convenience a copy is attached.

Specific provisions relating to interest under the ISDA Master Agreements

32. The 1992 and 2002 Forms differ in two main areas. One area is that section 6 of the 2002 Form contains only one method for calculating the amount payable following Early Termination, namely the calculation of an Early Termination Amount, which may, but is not necessarily required to, be based on quotations for replacement transactions. There is no "one-way" termination option under the 2002 Form. The *User's Guide* to the 2002 Form explains at paragraph 5(a) that the drafting changes to the early termination provisions in the 2002 Form were introduced in order to bring greater flexibility.

33. The second area of difference of most particular relevance to the questions raised in *Waterfall IIC* is the provisions in the ISDA Master Agreements relating to the payment of interest, to which I turn next.

Provisions of the 1992 Form relating to interest

34. Under the 1992 Form, interest is payable from one party to the other in a variety of situations and at a variety of different rates, all of which utilise the concept of the cost to one party or the other of funding the relevant amount.

35. Although the question at issue in this application is the meaning of *"Default Rate"*, the draftsman has used the same underlying concept of the cost to one or other entity of funding the relevant amount within the definition of *Default Rate* as within the definition of all other rates applicable under the agreement.

36. The three different rates of interest identified in the 1992 Form are as follows:

    (1) *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) *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"; and

    (3) *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".

37. The circumstances in which the 1992 Form requires interest to be paid, and the rates applicable in each case, are as follows:

    (1) Prior to the occurrence of an Early Termination Date in respect of a relevant Transaction, a party that defaults in the performance of any obligation is required to pay interest on the overdue amount, for the period from the due date of payment until the date of actual payment: see and compare section

2(e) in the 1992 Form and section 9(h)(i) of the 2002 Form. Such interest is payable at the Default Rate[4].

(2) Following the occurrence of an Early Termination Date, the party which is obliged to pay to the other such amount as is calculated as being due in respect of any Early Termination Date is required to pay interest on that amount from the Early Termination Date until the date on which it is paid at the Applicable Rate: Section 6(d)(ii)[5]. The rate may be different as between (a) the period between the Early Termination Date and the date on which the relevant amount becomes payable[6], and (b) the period between the date on which the amount becomes payable and the date on which it is in fact paid. In particular:

(a) for the period between the Early Termination Date and the date upon which the amount becomes payable, interest is calculated:

i) where the amount is due from a Non-defaulting Party, at the Non-default Rate;7

ii) where the amount is due from a Defaulting Party, at the Default Rate;8 and

iii) where the amount is due following occurrence of a Termination Event (and not an Event of Default), at the Termination Rate;[9]

(b) for the period after the date on which such amount becomes payable, interest is calculated in all cases at the Default Rate.[10]

(3) Following the occurrence of an Early Termination Date, one of the component elements in the calculation of what is due between the parties is "Unpaid Amounts". "Unpaid Amounts" comprise sums due under section 2(a)(i), or which would have been due but for the suspension of a payment obligation under section 2(a)(iii). Interest on Unpaid Amounts is payable from the date on which the obligation accrued due (or would have accrued due) and the Early Termination Date, at the Applicable Rate. Thus:

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[4] This is subject to the proviso in the 1992 version that on the occurrence of an Early Termination Date no further amounts under Section 2(e) shall be required to be paid: Section 6(c).

[5] "Applicable Rate" is defined in Section 14.

[6] The amount becomes payable on the date on which the notice given to the other party of such amount became effective: Section 6(d). The date upon which a notice becomes effective depends upon the manner in which the notice was given: Section 12(a).

[7] Under item (c) of the definition of Applicable Rate in Section 14, as an obligation "payable or deliverable … by a Non-defaulting Party".

[8] Under item (a) of the definition of Applicable Rate in Section 14, as an obligation "payable or deliverable … by a Defaulting Party".

[9] Under item (d) of the definition of Applicable Rate in Section 14, on the basis that it is an amount owing by neither a Defaulting nor a Non-defaulting Party, and thus falls within "all other cases".

[10] Under item (b) under the definition of Applicable Rate.

(a) if the Unpaid Amount is due from a Defaulting Party, interest is payable at the Default Rate;

(b) if the Unpaid Amount is due from a Non-defaulting Party, interest is payable at the Non-default Rate;

(c) if the Unpaid Amount is due from either party in circumstances where the Early Termination Date was consequent upon a Termination Event, interest is payable at the Termination Rate.

38. It follows that there are numerous permutations as to which party will be required to pay interest, and at what rate, on the amount or amounts owing under Section 6(e). Appendix 2 of this Judgment (which is derived from Wentworth's written submissions) provides an illustrative worked example of some of the possible permutations. As demonstrated by Appendix 2, in many circumstances a single amount comprising the sum due under Section 6(e) is likely to attract (for the different periods of time the amount is outstanding or for the different components within the amount) interest calculated by reference to the cost of funding of one or other of the parties, or a combination of the parties.

39. A simple and common example will be where Party A suffers an Event of Default, the parties have opted for Second Method and Loss, and an amount, say £100m, is calculated as owing pursuant to section 6(e) of the 1992 Form from Party B (the Non-defaulting Party) to Party A (the Defaulting Party). There will inevitably be a delay between the occurrence of the Event of Default and Party B serving its calculation notice, at which point the amount becomes payable. In this case:

(1) for the period between the Early Termination Date and the date on which the amount of £100m became payable, interest on £100m will be calculated at the Non-default Rate (i.e. the cost to Party B, the paying party, if it were to fund £100m, as certified by it); and

(2) for the remainder of the period until payment, interest is payable at the Default Rate (i.e. the cost to Party A, the payee party, if it were to fund, or of funding, £100m, as certified by it, plus 1%).

40. Another example is where Party A suffers a Termination Event and £100m is found due to Party B. In this case, interest on £100m would be calculated as follows:

(1) for the period between the Early Termination Date and the date on which the Section 6(e) amount became payable, interest is calculated as the arithmetic mean of the cost to Party A if it were to fund or of funding £100m and the cost to Party B if it were to fund or of funding £100m (i.e. at the Termination Rate); and

(2) for the period from the date on which the Section 6(e) amount became payable and the date it was paid, interest is calculated as the cost to Party B if it were to fund or of funding £100m plus 1% (i.e. at the Default Rate).

41. An important (the SCG would say crucial) feature of the definitions of Default Rate, Non-default Rate and Termination Rate is that in each case the "relevant payee", the

"Non-defaulting Party" or the relevant party (as the case may be) is required to certify the cost to it, in each case "without proof or evidence of any actual cost". The SCG contend that this provision for certification is the contractually agreed control mechanism which has the triple function of (a) reserving to the relevant payee (as regards the Default Rate), the Non-defaulting Party (as regards the Non-default Rate) or the relevant party (as regards the Termination Rate) a right to determine for itself the relevant cost, (b) with the control mechanism being simply that such determination must be made in good faith and not irrationally, thereby (c) excluding the ability of the other party to second-guess or litigate the costs so certified except on grounds of bad faith or irrationality.

The provisions of the 2002 Form relating to interest

42. Section 9(h) of the 2002 Form is a new section which consolidates and updates all provisions regarding interest and compensation, which were found in Sections 2(e) and 6(d)(ii) in the 1992 Form. The concept of cost of funding to either party is retained in some cases; but in other cases there is added a new basis for calculating interest, by reference to the overnight rate offered by major banks.

43. Those rates of interest, as defined in the 2002 Form, which continue to be based on the cost of funding a particular amount by one or other party are:

    (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) *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 it) if it were to fund or of funding such amounts"*; and

    (3) *Applicable Deferral Rate, which for certain purposes is defined as "a rate equal to the arithmetic mean of the rate determined pursuant to clause (a) above* [being 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"*. (This is referred to below as the "Cost of Funding Applicable Deferral Rate", to distinguish it from the definitions of Applicable Deferral Rate which refer to the overnight rates offered by banks.)

44. The principal circumstances in which the above definitions (and thus the calculation of interest by reference to cost of funding to one or other party) apply are as follows:

    (1) If an Early Termination Amount is payable by a Defaulting Party, then interest is payable on the Early Termination Amount for the period from the Early Termination Date until payment at the Default Rate.

    (2) If an Early Termination Amount is payable *to* a Defaulting Party, then interest is payable on the Early Termination Amount (a) from the Early Termination Date until the Section 6(e) amount becomes payable at the Non-

default Rate, and (b) from the date on which the Section 6(e) amount becomes payable at the Default Rate.

(3) If an Early Termination Amount is payable consequent upon a Termination Event (as opposed to an Event of Default), then interest is payable on that amount:

(a) from the Early Termination Date until the date the Early Termination Amount is payable, at the Cost of Funding Applicable Deferral Rate; and

(b) from the date on which the Early Termination Amount is payable, until actual payment, at the Termination Rate.

45. As in the 1992 Form, under the 2002 Form a single amount payable under Section 6(e) may well attract interest rates which are calculated by reference to the cost of funding of both parties, in respect of different periods for which the amount is outstanding. The *User's Guide* published by ISDA for the 2002 Form (as to which see further below) explains in comprehensive detail the various circumstances in which interest is payable under that agreement, and the rates applicable in each case.

Applicable principles of construction: English law

46. After that overview of the relevant provisions of the ISDA Master Agreements in both relevant versions, and before turning to the particular issues on the construction of such agreements that the Administrators have requested should be adjudicated, I should summarise shortly the principles of construction which fall to be applied. I can do so briefly, since the general principles are by now well established and neither these nor more particular aspects relevant to interpretation of agreements of the character of the ISDA Master Agreements were substantially in dispute.

47. The general legal principles for the purposes of English law are encapsulated in the judgment in the Supreme Court of Lord Clarke JSC (with whom the other judges agreed) in *Rainy Sky SA v Kookmin Bank* [2011] 1 WLR 2900, in particular at [21]:

> "The language used by the parties will often have more than one potential meaning. I would accept the submission made on behalf of the appellants that the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other."

48. In the context of the ISDA Master Agreements, and having regard to their intended and actual use as standard agreements by parties with such different characteristics in

a multiplicity of transactions in a plethora of circumstances, the following principles are also relevant:

(1) It is "*axiomatic*" that the ISDA Master Agreements should, "as far as possible be interpreted in a way that achieves the objectives of clarity, certainty and predictability, so that the very large number of parties using it know where they stand": *Lomas v JFB Firth Rixson ibid.* at [53] *per* Briggs J.

(2) Although the relevant background, so far as common to transactions of such a varied nature and reasonably expected to be common knowledge amongst those using the ISDA Master Agreements, is to be taken into account, a standard form is not context-specific and evidence of the particular factual background or matrix has a much more limited, if any, part to play: see *AIB Group (UK) Ltd v Martin* [2002] 1 WLR 94.

(3) 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: see *The Joint Administrators of Lehman Brothers International (Europe) v Lehman Brothers Finance* [2013] EWCA Civ 188 at [53] and [88].

(4) The drafting of the ISDA Master Agreements is aimed at ensuring, among other things, that they are sufficiently flexible to operate among a range of users in an infinitely variable combination of different circumstances: *Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance S.A ibid. per* Briggs J (at [115]): 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.

(5) That drafting is also aimed, to adopt what was said in an expert report submitted in a recent case (*Lehman Brothers Holdings Inc v Intel Corporation* S.D.N.Y. Sep 16, 2015, "the *Intel* case") in the United States Bankruptcy Court for the Southern District of New York by one of the principal draftsmen of the 1992 ISDA Master Agreement (Professor Jeffrey Bruce Golden), at "mitigating the risk of fact-specific disputes and the attendant risk of protracted litigation" by providing for the parties to have considerable latitude in the exercise of contractual rights subject to "general terms of reasonableness and good faith".

49. I turn to the particular issues raised, deferring consideration (as did all the parties in their oral submissions) of Issue 10 (relating to the assignment of rights under the ISDA Master Agreements) until after considering the issues raised (by Issue 11 to 13) as to the extent of such rights in relation to claims for interest at the Default Rate.

Issue 11

50. Issue 11 asks, with reference to the definition of "*Default Rate*" in the ISDA Master Agreements (being the same in both versions):

> "*Is the meaning that should be given to the expression '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' capable of including:*
>
> *(1) The actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount; and/or*
>
> *(2) The actual or asserted average cost to the relevant payee of raising money to fund or of funding all its assets by whatever means, including any cost of raising shareholder funding; and/or*
>
> *(3) The actual or asserted cost to the relevant payee to fund or of funding and/or carrying on its balance sheet an asset and/or of any profits and/or losses incurred in relation to the value of the asset, including any impact on the cost of its borrowings and/or its equity capital in light of the nature and riskiness of that assets; and/or*
>
> *(4) The actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE.*"

51. The essence of the questions posed by Issue 11 is a request for the Court to identify the essential characteristics of the contractual term "*cost ... if it were to fund or of funding the relevant amount*". Issue 11 presents a series of different possibilities and asks whether, on the proper construction of the contractual words, the definition of "*Default Rate*" is capable of including one or more of them.

52. Issue 11 is a key one for the Administrators: its determination is necessary to enable creditors to formulate and certify their claims for interest at the Default Rate and to enable the Administrators to assess whether such claims are properly payable or not. Its division into four sub-questions is designed to provide the most comprehensive guidance to creditors and Administrators in respect of a wide variety of claims. The Administrators further invited the Court to address specifically, in determining these sub-questions, a number of points likely to assist in achieving a full determination and in enabling them to deal with the variety of claims likely to be submitted.

53. The sharpest division between the parties relates to Issue 11(2), and whether the "cost of funding" language permits only the cost of borrowing the relevant amount, but not the cost of issuing equity.

Points relevant to construction and not contentious

54. Some general points that are broadly accepted by all the parties may be of assistance in putting their otherwise competing submissions in context.

55. The first and most obvious point to note is that there is no express definition in the ISDA Master Agreements of the expressions "funding" and "cost of funding"; nor are those words terms of art with a settled meaning[11]. These expressions are not terms of art with a settled or invariable meaning, and must take their colour and meaning from the context. However, the SCG and GSI naturally stress that it is those words that must be given meaning according to the context, and that their selection, rather than the words "borrowing" and "costs of borrowing", suggests that they bear a different or broader meaning, or at least are capable of doing so.

56. Secondly, the cost of funding language has remained the same in each iteration of the ISDA Master Agreements, from the first (relating only to swaps) in 1987.

57. Thirdly, the parties agree that the ISDA Master Agreements are carefully drafted documents, developed over many years with the benefit of the knowledge of the market, were and are intended to be and are used by a wide variety of parties in a wide variety of circumstances, and are commercial agreements intended to provide commercially sensible results.

58. Fourthly, as may already be apparent, the essential difference in approach between the Respondents is whether in such circumstances a definitive meaning is to be ascribed to the expressions concerned, as Wentworth contends; or whether (as the SCG and GSI contend) there is no need to fix on a definitive meaning: rather, the question is whether, on a "case by case basis", a particular way of raising funds and its associated "cost" is capable of falling within the description in any of the infinitely variable combinations of different circumstances in which the ISDA Master Agreements may have been adopted and apply.

59. Fifthly, the cost of funding language (a) is deployed in the context of each of the different interest rates applied in the 1992 Form (and in the case of Default Rate and Termination Rate in the 2002 Form); (b) applies in the case of both the cost "of funding" and also the cost "if it were to fund"; and (c) is applicable, depending on the context in which the particular rate is to be applied under the relevant ISDA Master Agreement, to determine the cost to the relevant payee *and/or* the relevant payor.

60. Sixthly, in each case, the cost of funding language is aimed at identifying the cost of replacement funding for the period of delay in payment of the amounts due, and compensating the payee by providing for the payment of "interest" (see sections 2(e) and 6(d)(ii) of the 1992 Form and section 9(h) of the 2002 Form) at a certified "rate per annum" equal to that cost for the period until it is paid.

61. Seventhly, although (as I will come on to explain more fully in the part of this judgment which deals particularly with the position under New York law) there are differences between the two jurisdictions in their respective approaches to issues of contractual construction, none of the parties contends for any different result according to the choice of English or New York law. Indeed, it seems likely (as the SCG submitted without demur) that the draftsmen of the ISDA Master Agreements

[11] Originally, Wentworth advanced an argument that the expression *"cost…if it were to fund…the relevant amount"* had a "generally understood meaning in the banking derivatives market"; but it abandoned this argument well before the hearing.

anticipated that they would produce the same result whichever of the two laws was adopted.

62. I turn to elaborate the competing arguments of the SCG, GSI and Wentworth. As Wentworth's arguments rely on a restrictive interpretation it is convenient to deal with those first, and then to discuss the SCG's (and GSI's) more general approach and their suggested responses to Wentworth's more detailed points.

Wentworth's submissions on Issue 11

63. The twin central pillars of Wentworth's case on Issue 11 are that in the context (a) "funding" means borrowing the relevant amount and (b) "cost" means the price required to be paid in transacting to borrow the relevant amount for the period it is required. 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 required to pay in 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. On this basis, it is Wentworth's case that only the price paid for money borrowed, and neither other ways of funding nor any other costs, fall within the definition.

64. Mr Zacaroli QC distilled Wentworth's case into seven points, summarised as follows (and which were then elaborated upon, as I explain later):

(1) The *purpose* of the cost of funding language is to define a rate of interest, and interest is fundamentally concerned with the cost of the use of money over time, i.e. the time value of money.

(2) The contractual remedy provided to achieve that purpose is based upon *a transaction* to fund the relevant amount. The *"cost"* which is to form the basis of the rate of interest is the *"cost"* of *that* transaction. The transaction is either actual or hypothetical – the two being mutually exclusive.

(3) The transaction is one to fund an incremental sum of money *equal to* the unpaid amount. In the case of the Default Rate, "*the relevant amount*" is an amount equal to whatever amount is owed by the payor, whether an amount under Section 2(a) or Section 6(e).

(4) "*Cost*" is the *price* to be paid (or which would be paid) to fund the relevant amount, not simply any financial benefit provided or detriment incurred as a result of the transaction to fund the relevant amount. In particular, any financial detriment measured in terms of change in the anticipated return for investors is irrelevant: the cost of funding language is aimed at identifying the cost of replacement funding for the period of delay in payment of the principal; the relevant payee could use such replacement funding to invest and thus make the anticipated return to its equity investors. Further, it is the cost of that transaction which is in issue and not other costs.

(5) "*Cost*" also connotes the amount or rate which the relevant payee is (or would be) *required* to pay to fund the relevant amount, as opposed to an amount or rate (if different) which the relevant payee could *choose* to pay. Wherever the relevant payee has more than one alternative funding

transaction, at different prices, then it can only be said to be *required* to pay that which (taking into account all relevant considerations) is the lowest of the alternatives.

(6) The cost of funding language permits only the cost of *borrowing* the relevant amount, as opposed in particular to the (necessarily estimated) cost of issuing equity. The ISDA Master Agreement provides for interest on the principal sum outstanding until the principal sum is repaid. The cost of funding language is directed at identifying the cost of a replacement for that unpaid debt for the period until it is paid. The cost of issuing equity is neither a true "cost", because the return on equity is a mere expectation and imposes no obligation on the company to pay any certain sum, nor relative to any period, because an increase in equity is a permanent increase in capital, the return on which is not measured by reference to time outstanding.

(7) The cost of funding language excludes losses arising from LBIE's default.

65. Mr Zacaroli elaborated each of these seven points as follows.

66. First, he submitted that the cost to one or other party under the ISDA Master Agreement of funding, or if it were to fund, a particular sum is the basic concept employed in the ISDA Master Agreement in order to calculate the rate of what is expressly defined as *"interest*" payable on overdue amounts. Taking the 1992 version, Mr Zacaroli referred by way of example to section 2(e), which specifically refers to the obligation to pay "*interest*" on the overdue amount, and to section 6(d)(ii), which specifically refers to "*interest*" being paid on the amount calculated as being due following an Early Termination Date.

67. He further submitted in this context that it is self-evident that the cost to the relevant payee if it were to fund, or of funding, the relevant amount is to be calculated by reference to the period of time during which the relevant amount is unpaid. Hence, each of the ISDA Master Agreements expressly refers in a number of places to "*interest*" being calculated on the basis of (a) "*daily compounding*" and (b) "*the actual number of days elapsed*": see, for example, Sections 2(e) and 6(d)(ii) in the 1992 Form.

68. Especially in combination, he submitted that the reference to interest and the prescribed method of its calculation make clear that what the draftsmen had in mind as the proper measure for the time value of money was the cost of borrowing it for the stipulated period. That was consistent, he added, with the ordinary measurement in English law, as explained by Lord Nicholls in *Sempra Metals Ltd (formerly Metallgesellschaft Ltd) v IRC and another* [2008] 1 AC 561 at [103]:

> "In the ordinary course the value of having the use of money, sometimes called the "use value" or "time value" of money, is best measured in this restitutionary context by the reasonable cost the defendant would have incurred in borrowing the amount in question for the relevant period. That is the market value of the benefit the defendant acquired by having the use of the money."

69. Mr Zacaroli also referred me to *Tate and Lyle Food and Distribution Limited v Greater London Council* [1982] 1 WLR 149. There, Forbes J, in awarding interest on damages at 1% over base rate, said (at pages 154 to 155):

> "I do not think the modern law is that interest is awarded against the defendant as a punitive measure for having kept the plaintiff out of his money. I think the principle now recognised is that it is all part of the attempt to achieve *restitutio in integrum*. One looks, therefore, not at the profit which the defendant wrongly made out of the money he withheld — this would indeed involve a scrutiny of the defendant's financial position — but at the cost to the plaintiff of being deprived of the money which he should have had. I feel satisfied that in commercial cases the interest is intended to reflect the rate at which the plaintiff would have had to borrow money to supply the place of that which was withheld."

70. Forbes J went on to point out that, while it was not permissible to look at the particular attributes of the claimant, it was right to look at the nature or class of the claimant and enquire at what rates someone in that class could borrow at:

> "I am also satisfied that one should not look at any special position in which the plaintiff may have been; one should disregard, for instance, the fact that a particular plaintiff, because of his personal situation, could only borrow at a very high rate, or on the other hand, was able to borrow at specially favourable rates. The correct thing to do is to take the rate at which plaintiffs in general could borrow money. This does not, however, to my mind, mean that you exclude entirely, all the attributes of the plaintiff, other than that he is a plaintiff … I think it would always be right to look at the rate at which plaintiffs, with the general attributes of the actual plaintiff in the case (though not, of course, with any special particular attribute), could borrow money as a guide to the appropriate interest rate … in commercial cases it seems to me that the rate at which a commercial borrower can borrow money would be the safest guide."[12]

71. Mr Zacaroli acknowledged that there was this important difference: in the interest rate applicable under the ISDA Master Agreement it *is* permissible, indeed expressly required, to have regard to the rates at which the particular payee party could borrow in the market. However, he submitted that, that difference aside, the fact that the general law regards the calculation of the time value of money as based on the rate at which the payee who has been kept out of his money could borrow in the market to

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[12] This remains the approach in commercial cases: see *Secretary of State for the Department of Energy and Climate Change v Jones* [2014] EWCA Civ 363, *per* Sharp LJ at [18]: "In commercial cases the rate of interest is usually set by reference to the short-term cost of unsecured borrowing for the relevant class of litigant, though it is always possible for a party to displace a "rule of thumb" by adducing evidence, and the rate charged to a recipient who has actually borrowed money may be relevant but is not determinative".

replace the relevant amount, is an important starting point in construing what the draftsman of the ISDA Master Agreement should be taken to have had in mind in respect of provisions the purpose of which was to arrive at an appropriate interest rate.

72. In the second of his seven principal points, Mr Zacaroli focused on the use of the cost of funding language to define the contractual remedy for the late payment of an amount. He submitted that the words "cost of funding" pertain to an actual transaction. In contrast, the words *"if it were to fund"* import a counterfactual to an actual funding transaction. The first alternative captures the case where the relevant payee actually funds the relevant amount, by transacting to borrow the sum in the market. The second captures the case where the relevant payee does not actually transact, but enables it to rely on the cost it would have incurred had it done so. But in either case the calculation is to be referable to a transaction. The fact that one transaction is actual and the other hypothetical is the only difference between the two alternatives.

73. Mr Zacaroli submitted that there is nothing in the language ("*of funding*"; "*if it were to fund*") which suggests that any different concept is to be included in the hypothetical alternative that is not already within the actual alternative. The transaction posited, whether actual or hypothetical, must be one between the party who is to certify and another person (or persons) to raise a sum of money in the relevant amount. The mere allocation of cash raised otherwise than in a transaction of such a kind is not such a transaction: the only recoverable cost is that referable to the actual or hypothetical transaction to raise the relevant amount.

74. The third point as elaborated by Mr Zacaroli is that the transaction thus contemplated is to fund a sum of money *equal to* the amount owed under the ISDA Master Agreement, whether (i) a payment obligation under Section 2(a)(i), (ii) an "*Unpaid Amount*" following an Early Termination Event, or (iii) the obligation under Section 6(d) to pay the amount calculated in accordance with Section 6(e). The calculation thus pays no regard to the circumstances of the default nor, in particular, to the fact that the relevant amount is owed by an insolvent company.

75. As a corollary, cost of funding the relevant amount precludes the certifying party from basing its calculation on the riskiness, and thus value, of either the *asset* represented by the defaulted claim against LBIE, or the riskiness or value of its assets generally.

76. Also, and as a corollary of the point that the focus is on the cost of the transaction of funding the relevant amount, Mr Zacaroli submits that the focus is not on determining what income return an investor would have to be offered for the risk of an investment, which will inevitably be based on that investor's appreciation of the nature of the venture and of its assets, their associated risks, and the prospect of other (such as capital) return. Put another way, the focus is on a borrowing issue (the cost of a borrowing transaction), not a corporate finance concept (the cost of capital); the funding cost must relate to the transaction required to fund the relevant amount, not the cost of funding the assets and/or enterprise of the relevant payee.

77. Wentworth's fourth principal point focuses on the word "*cost*" and is directed to limiting the cost of funding to the price paid for the borrowing, and excluding other incidental costs or detriment. The argument is in part semantic (that the word "*cost*" is generally equated with the *price* to be paid for something, and means the price which

the certifying party either actually pays to the counterparty from whom it raises the relevant amount, or the price it would have paid to a counterparty had it entered into such a transaction) and in part practical (to the effect that the broad construction favoured by the SCG and GSI would introduce complexity and uncertainty at odds with the efficient working of the mechanism of the ISDA Master Agreement).

78. The semantic part of the argument needs no elaboration. As to the undesirable effects that it is said would flow from any broader construction, Mr Zacaroli stressed especially five sub-points as follows:

(1) Notwithstanding the widespread use of the ISDA Master Agreement over the past 30 years, there is no reference to such a broad interpretation of the cost of funding language in ISDA materials, any case or any text book dealing with the subject. Further, it has never been the case under the general law that the calculation of interest should include any, let alone all, other financial benefits/detriments, or financial outlay to third parties, in some way caused by or connected with such borrowing in the market.

(2) The breadth of the interpretation proposed would, Mr Zacaroli submitted, introduce complexity and uncertainty which is at odds with the efficient working of the mechanism of the ISDA Master Agreements. In the first place the parameters of the range of potential financial detriments said to arise from additional funding are difficult to define. Moreover, it introduces potentially difficult questions of causation. Mr Zacaroli posited as an example: if an entity (with a capitalisation of many billions of dollars) has an unpaid amount owing by LBIE, as a result of LBIE's default, of $100m, the task of identifying whether any of (a) an increase in its overall cost of borrowing, (b) the return its investors require on their capital, or (c) an increase in the rate which one or other new borrower demands for further lending as a consequence of the additional borrowing is far from straightforward – if, indeed, it is possible to undertake at all. The task of disentangling what additional costs may be laid at the door of the additional borrowing is likely to be impossible. The difficulties are great enough when an entity actually does go into the market to borrow. If it does not do so, but is left to calculate the possible additional financial detriments of a hypothetical borrowing transaction, then they are greater still. The difficulties would yet further be compounded because in order for a comprehensive calculation of the financial consequences of the additional borrowing to be made, any *benefits* received (with all of the attendant difficulties of identification and causation) must logically be taken into account as well.

(3) Mr Zacaroli identified a further complication in light of the fact that the cost of funding language applies to certification both by the payee and the payor. For example, if Party A suffered an Event of Default 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). He submitted that the obvious purpose of this is that although Party B owes the £100m from the Early Termination Date, it cannot possibly pay it prior to the

calculation notice being served, so for the period up to that date it would be unfair if the interest rate should be based on the potentially higher cost which Party A (the Defaulting Party) would face in borrowing that sum. In contrast, once it has received the calculation statement, any delay in payment of £100m is its fault, and it is fair that Party A is compensated for that delay by reference to the cost to it of borrowing an equivalent sum in the market. 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 any and all 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. 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. Mr Zacaroli submitted that this is an especially unrealistic exercise for Party B, as the Non-defaulting Party, to undertake. It is by definition hypothetical, since Party B is the paying party. It requires a counter-intuitive, if not perverse, incentive: namely to explore all the ramifications of borrowing £100m and include all financial detriments to which that gives rise, for the purpose of *increasing* the amount of interest Party B would need to pay.

(4) Mr Zacaroli submitted further that the alternative interest rates provided for in the 2002 Form (introducing, alongside the cost of funding language, rates of interest defined by reference to overnight deposit rates[13]) are also inconsistent with the SCG's broader construction. As to this, in the case of the Non-default Rate, it was changed from the rate (without restriction) at which the Non-defaulting Party could borrow, to the overnight rate at which it could deposit to/with a major bank in the relevant market, whilst in the case of the Applicable Deferral Rate, the change was from the rate at which *the party* could borrow (without restriction) to an objective deposit rate available in the market with a prime bank. If the broader construction is correct, that was a seismic change, since any prior right to calculate the cost of funding the relevant amount on the basis of a broad range of financial benefits and detriments consequent upon the funding transaction was being removed. The 2002 *User's Guide*, however, 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*". In the absence of any intention to make such a seismic change, the more natural characterisation is that the 2002 Form *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 deposited in the market, but merely confined the ambit of such rates to an overnight deposit rate offered by a major bank.

[13] The 2002 *User's Guide* contains (at section J(8)) a succinct explanation of the different interest rates, and the circumstances in which they are payable under the 2002 Form.

(5) Mr Zacaroli further submitted that this conclusion is supported by the fact that in various circumstances the 2002 Form requires the Applicable Rate to be calculated as the arithmetical mean of (a) the cost to one party 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. Although not conclusive, this is more consistent with the assumption that the basic parameters of (a) and (b) are the same; that is, they are both intended to identify the cost, as in transaction price, of borrowing to each of the parties.

(6) Mr Zacaroli suggested that a further reason for excluding much of the wider "financial detriments" of raising funding which the SCG/GSI would include is that it falls outside the definition of "*cost*" because it is paid as the price for a wholly separate service. The services received reflect a distinct benefit that is consumed and which has a price reflective of that benefit. The expense is the value of legal, advisory or other services such as underwriting, not the price of a sum of money equal to the unpaid amount.

79. On this basis, Mr Zacaroli submitted that losses and costs extraneous to the actual or hypothetical borrowing transaction were not within the phrases, either in the actual or in the hypothetical context. He further submitted that the exclusion of consequential losses was inherent in the fact that the definition of Default Rate does not use the concept of loss but rather the concept of the cost of a replacement and the costs payable other than to the counterparty to the borrowing transaction are excluded because they are not a cost of that transaction at all (being referable to some separate transaction or separately provided service).

80. Put another way, Mr Zacaroli submitted, it is only the cost of the transaction for funding the relevant amount, and not the consequential cost to the Non-defaulting Party of the default, which is to be measured and certified.

81. Mr Zacaroli made the additional point that if the broader construction urged were correct, it is difficult, perhaps impossible, to justify the additional one per cent provided for in the Default Rate.

82. Turning to the fifth of his principal points on behalf of Wentworth, Mr Zacaroli submitted that the use of the word "*cost*" implies something which the relevant payee is *required* to pay, as opposed merely to something it *could* have paid or chose to pay, and that if the relevant payee certified an amount (as the cost to it of funding the amount) which was higher than that which it was required to pay, that would not (to the extent of the excess) represent a "*cost*". Accepting it was an extreme one, Mr Zacaroli put forward as an example that if the relevant payee could have borrowed the relevant amount (thereby actually obtaining a substitute for the defaulted debt) at a rate of 0.01%, but could also have raised the sum by way of some other form of funding (assuming it is within the meaning of the cost of funding language) at a rate of 10%: he submitted that it is only the former which represents the "*cost*" of funding. I suppose less extreme examples might be where the relevant payee has the option of lower rates of interest in return for a shorter loan period, more extensive security, or enhanced priority.

83. Mr Zacaroli submitted that the certification requirement was not a sufficient control, or a substitute for linguistic rigour; the concepts of good faith and rationality had to be anchored in some objective and properly defined concept.

84. Wentworth's sixth principal point is perhaps the most crucial and contentious (although to no little extent its previous points lead up to and support it): this is that (a) the cost of funding language equates "*cost*" to the price which has to be paid to fund an amount equal to the unpaid amount for the period it is outstanding and (b) costs associated with the issue of equity do not satisfy this requirement.

85. Mr Zacaroli encapsulated this sixth point as follows:

(1) Each of (i) the Default Rate, (ii) the Non-default Rate and (iii) the Termination Rate is a calculation designed to identify an appropriate interest rate to be imposed on one or other party under the ISDA Master Agreements;

(2) Interest is compensation for the time value of money, that is for one party being kept out of its money for the period between default and payment; and

(3) It is an essential feature of cost of funding language that:

(a) "*cost*" is what has to be paid to fund the amount; and

(b) "*cost*" relates to the period for which the unpaid amount, for example "*the relevant amount*", is outstanding.

(4) These essential features mean that only the price of borrowing can be considered a "*cost*". Only borrowing imposes an obligation to repay, or to pay interest, and it is only in respect of borrowing that the cost relates to the use of the money for a period of time.

86. Mr Zacaroli contrasted this with the nature of a share and the bundle of rights it comprises, which he submitted were of a fundamentally different nature from a debt. In this regard he cited the classic explanations of the nature and characteristics of a share in a company in Farwell J's judgments in (a) *Borland's Trustee v Steel* [1901] 1 Ch 279 at 288 (which has repeatedly been approved at the highest level) and (b) *Bond v Barrow Haematite Steel Co* [1902] Ch 353 at 363 (which has not been doubted). On the basis of *Borland's Trustee v Steel* he drew attention especially to three particular aspects or characteristics of a share that differentiate it from a debt:

(1) It is a measure of the *liability* of the contributory (the latter word, of statutory origin, being also significant of the legal relationship).

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

(3) 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 on a winding up.

87. Mr Zacaroli also quoted the following passage from Farwell J's judgment in *Bond v Barrow Haematite* at 363:

> "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."

88. Further, although recognising that preference shares typically carry an entitlement to an apparently fixed dividend expressed in percentage terms relative to par value, Mr Zacaroli submitted that this difference from ordinary shares did not, on proper analysis, fundamentally alter their characteristics as a measure of participation in the company rather than a debt owed by the company. In particular, as its appellation signifies, a preference share differs from an ordinary share in prescribing, as the *quid pro quo* for priority, a limited right, expressed as a percentage of nominal value, to share in any dividend declared by a company out of its distributable profits, with any right to any further participation in surplus on a winding up usually being, again as a *quid pro quo* for priority, confined (if not altogether excluded). Cumulative preference shares confer the additional entitlement to the carrying over of any deficit in the satisfaction of the dividend right from accounting period to accounting period until discharged. Also as a price of priority, it is now well established that preference shares may be redeemed or repaid by means of a reduction of capital, and any preference rights thus extinguished.

89. Mr Zacaroli noted that 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 as if they were holders of irredeemable debentures. But they are not debenture-holders at all."[14]

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[14] By his observation in *Re Isle of Thanet Electric Co* [1950] Ch 161 that, over the passage of time the position of preference shareholders has "*become somewhat more approximated to…that of debenture holders*" Lord Evershed MR did not in any way erode the distinction between debt and equity. The readiness of the court to accede to a reduction of capital of preferred stock (such that it might be "repaid") does not alter the fundamentally uncertain nature of the return on the equity investment.

90. In short, Mr Zacaroli submitted, in issuing shares a company is selling a right to participate in whatever profits of a company can be and are lawfully distributed; the "sale" proceeds are an accretion to its funds, and the sale may have been prompted by the need for such funds; but the "sale" is not a cost to the company, and strikes up no debt owed by the company such as to attract interest or paying a price measured by time for the use of money.

91. As to hybrid instruments, entitling their holders to a mixture of rights, some characteristic of shares and others characteristic of borrowing (such as a convertible bond for which a coupon is payable until the bond is converted into equity), Mr Zacaroli submitted that the same distinction between a right to participate (the equity element) and the entitlement to interest for the period the debt remained outstanding (the debt element) remained.

92. Mr Zacaroli's seventh and last principal point was that in any event consequential losses (such as what Mr Foxton described in his oral submissions as the "knock-on effects" on the cost of funding generally caused by the cost of funding the relevant amount) cannot have been intended to be within the cost of funding language.

93. As Mr Zacaroli put it, aside from the fact that such consequential losses would be excluded for similar reasons to the exclusion of further financial detriment caused by the raising of additional funding, any detriment caused by the counterparty's default would have no connection to the cost of raising a sum of money as substitution for the amount owed by the defaulting party.

The SCG's approach

94. The SCG rejected Wentworth's analysis and each of its constituent elements. They portrayed their case as straightforward: the phrase "*cost of funding*" should be given its broad and natural meaning and should not be read down or restricted to exclude recovery of loss occasioned by or incidental to perfectly legitimate and commonly used methods adopted by many users of the ISDA Master Agreements to fund their businesses. Further, the recoverable costs should include any costs incurred in connection with the funding operation, subject only to the constraints of good faith and rationality imposed by the certification process.

95. Mr Robin Dicker QC's overarching submission on behalf of the SCG is that there is simply no good commercial reason for restricting the costs of funding language to borrowing, nor for excluding other costs or detriment incidental to any rationally selected method of funding; and further, if the draftsmen had intended to restrict recovery to the cost of borrowing, they would have said so, and would certainly not have eschewed the word "borrowing" in this context as they appear to have done.

96. At the commencement of his oral submissions on behalf of the SCG, Mr Dicker characterised the issue for the Court as being essentially:

> "…can you be sure, regardless of the breadth of the parties and circumstances, that any particular approach to cost of funding is not capable of being a legitimate approach?"

97. To quote the SCG's skeleton argument at paragraph 46, Mr Dicker submitted that "The only interpretation of the Default Rate which gives effect to its purpose is one which permits the relevant payee to certify, subject to a duty to act rationally and in good faith, a cost of funding which takes into account any type of funding used or which could have been used to fund the relevant amount."

98. Accordingly, the SCG submit that:

(1) "Funding" includes any source or sources of funding (i.e. of raising money). It is capable of including debt funding, equity funding, funding through hybrid instruments (such as convertible debt or preference equity), repo funding or any other source or combination of sources of funding.

(2) The "cost" of that funding includes all costs borne, or which would have been borne, by the relevant payee as a consequence of funding the relevant amount.

99. In particular, the SCG contend that the cost of funding language encompasses:

(1) all and any financial outlay incurred in raising a sum of money equivalent to the relevant amount by issuing equity, e.g. legal or other professional fees for an IPO;

(2) the relevant payee's overall cost of funding (whether by debt or equity) calculated by reference to the risks associated with the business and the return required by its funders – including shareholders – in light of those risks;

(3) any changes to the relevant payee's overall cost of funding all of its assets as a consequence of raising money to fund or of funding the relevant amount;

(4) the consequences to the relevant payee of carrying a defaulted receivable on its balance sheet; and

(5) the actual or asserted cost to the relevant payee of funding a claim against LBIE.

100. In every case, in the SCG's submission, the control mechanism is not a semantic restriction but the requirement that the cost claimed must be certified by the claimant rationally and in good faith. As it was put in the SCG's skeleton argument at paragraph 38:

> "The certification process is an integral part of the regime. It ensures that, notwithstanding the broad concepts used in the Default Rate clause, and which are necessary for it to apply across a wide range of potential users and circumstances, determinations can be made with relative ease and certainty, without second-guessing and litigation, and will be binding so long as they have been made rationally and in good faith."

101. In further elaboration of the SCG's submission as to the breadth of the cost of funding language, Mr Dicker pointed out that:

(1) Any construction must take into account the case where in actual fact the payee has, upon default and non-payment, either been required (by commercial necessity or regulatory requirement or otherwise) or chosen to fund what Mr Dicker termed "the gap" by issuing shares/equity: if that is in fact what the relevant payee did in good faith it would be extraordinary, and cannot have been intended, to deny it recovery of the cost actually incurred.

(2) It is nonsensical to suggest (and Wentworth did not suggest) that the issue of shares/equity does not have a cost, and equally nonsensical to suggest that, if an entity chooses actually to fund the non-receipt of funds by way of raising equity rather than borrowing, it has not incurred any cost of funding in the relevant sense.

(3) Indeed (as Mr Dicker stated in opening) "from the perspective of a commercial party, cost of equity is a very familiar metric", and the courts have accepted that there are accepted methods of quantifying that cost, such as the Capital Asset Pricing Model ("CAPM"), which Lewison J (as he then was) in *Multi Veste 226 B.V. v NI Summer Row Unitholder* [2011] EWHC 2026 (Ch) at [261] took to be "*an accepted method used to estimate a cost of equity based on market data*", and which in *Gul Bottlers (PVT) Limited v Nichols plc* [2014] EWHC 2173 (Comm) at [145] Cooke J described as constituting "*the most widely utilised method for estimating the cost of equity*".

(4) There is no sensible reason for excluding from the phrase a measurable cost of an accepted means of funding, especially where that method of funding has actually been adopted or is the only real expedient left; and to do so would be inconsistent with the purpose of the provision ("to compensate a relevant payee for the cost of funding the gap left by non-payment").

(5) Further, any attempt so to limit the application of the phrase would be unworkable in practice, since there is no strict division between debt and other types of funding, there being many hybrid instruments which may contain characteristics of both.

102. Mr Dicker also submitted, by reference more particularly to Wentworth's contentions, that:

(1) It is unduly restrictive, and mistaken, to regard the cost of equity as not measured by time. On the contrary, he submitted, equity bears an expected cost which is directly proportional to the period over which it is outstanding, being the rate of return expected by an investor for the period during which his money is tied up. The distinction Wentworth seeks to draw between the respective durations of equity and debt funding is simplistic and inaccurate. Equity funding can be raised for a limited period, as in the case of preference shares which need to be redeemed on a certain date, or any shares which are subsequently redeemed or repurchased. Conversely, borrowing can be raised on different bases, with more or less open-ended terms for repayment, such as bonds with no maturity date (so-called perpetual debt).

(2) Mr Dicker rejected Wentworth's suggestion that the disputed phrase contemplates, not equity funding for the purposes of the enterprise as a whole, but only a transaction to raise a sum of money in the relevant amount, as an unsupported assertion. Again, the application of the phrase should not be so limited as to exclude perfectly ordinary means of plugging a capital gap opened up by a default. Further, there is no basis for any assertion or underlying presumption that companies borrow to cover particular exposures, whereas they issue equity only to fund the enterprise as a whole: indeed, businesses seldom match funds, and most, if not all, funding is enterprise funding. In such circumstances, the draftsmen should not be thought to have had the intention of excluding the most natural means of funding or (in the case of hypothetical funding) stipulating an unusual form of transaction; much more likely is that in the context of enterprise funding their intention was to permit recovery of the appropriate portion of the costs certified rationally and in good faith to be referable to the relevant amount.

(3) Even if it is accepted (as indeed the SCG did accept) that the Default Rate must be paid for the period for which the relevant amount is outstanding, Mr Dicker submitted that it in no way follows that the relevant amount can only be funded by term funding of a matching duration: it makes no sense to construe the Default Rate in that way in circumstances where the relevant payee will almost never know for how long the relevant amount will be outstanding. Further, where it appears that the relevant amount could be outstanding for an indefinite period (as was initially thought to be the likely position in relation to LBIE), or would only be paid at some indeterminate point in the future, one rational and good faith response would be for the relevant payee to fill the funding gap on a permanent basis and do so through the use of equity funding.

(4) Mr Dicker dismissed also the suggestion (Wentworth's fourth point) that "*cost*" denotes the price to be paid, as distinct from benefit provided or detriment incurred, as a result of the transaction to fund the relevant amount. "*Cost*" is capable of encompassing the provision of benefit or the incurring of detriment, and would ordinarily be treated as doing so.

(5) Mr Dicker submitted that Wentworth's submission that "*cost*" connotes the cost necessarily required to be paid, and thus the lowest in cost terms of any alternative means of funding, is an impermissible gloss, and would lead to consequences that the draftsmen cannot sensibly have intended (such as limiting the cost to that for secured lending or opening up an inquiry as to whether a lower cost might have been obtained).

(6) Also unsupported, Mr Dicker submitted, is Wentworth's contention that there is such difficulty or abstraction in the calculation of the cost of equity as to suggest that equity funding costs cannot have been intended to fall within the meaning of "costs of funding". Such a conclusion could only be based on expert evidence; and there had been none on that point. Such evidence as there is supports the availability and sufficiency of a CAPM for assessing such costs. A CAPM is designed to calculate the cost of equity by predicting the future returns required by investors through analysis of historic returns. CAPM is routinely deployed for such assessments by

investment analysts, utility regulators, corporate planners, companies and government officials; and its prevalence as a method of 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) at [261] Lewison J (as he then was) noted 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".

(7) Furthermore, the assessment of costs in respect of hypothetical borrowings is not as straightforward as Wentworth assumed and submitted. It would depend on assessments capable of considerable variation. Mr Dicker drew attention in this context to the examples given in evidence filed by the Administrators of different methodologies which might be adopted, and the varying scenarios and costs according to the term and conditions of the borrowing and the financial standing of the borrower.

(8) As to the seventh strand of Wentworth's argument (to the effect in summary that losses consequential upon default are outside the costs of funding language), Mr Dicker again relied on the basic objective of compensation to justify including such losses if necessary properly to reflect the consequences of having to fund the gap caused by default (subject always, of course, to the control mechanism of good faith and rational certification).

103. Mr Dicker concluded by once more exhorting the benefit and likely intention of broad construction, enabling challenge only on the basis of irrationality or want of good faith, rather than linguistic restriction, and by stressing (by way of contrast) the unlikelihood that the draftsmen would have intended to exclude calibration by reference to such a frequently adopted means of funding a commercial enterprise.

GSI's submissions on Issue 11

104. On behalf of GSI, which was given permission actively to participate in relation to this issue, Mr David Foxton QC advanced submissions from the particular perspective of financial institutions (by whom ISDA was originally founded and which are (by value at least) the principal users of the ISDA Master Agreements).

105. Put shortly, Mr Foxton's argument was that the draftsmen of the ISDA Master Agreements must have understood that financial institutions have to maintain certain ratios of debt to equity. This could well (and, in the context of Lehman's collapse, in fact did) require them on default to raise equity funds. Mr Foxton submitted that the resultant needs of many a financial institution, as the principal class of counterparty, for recourse to equity funding to fill a hole in its capital position caused by a default

"forms a key part of the factual matrix against which the definition must be construed."

106. That factual matrix, he submitted, militated strongly in favour of GSI's contention that the cost to the relevant payee of raising equity is encompassed within the expression, and that this includes any sum paid, or other financial detriment incurred, in raising, maintaining or servicing such equity (or other) funding. Mr Foxton submitted that, properly interpreted, the definition of "Default Rate" does not impose any limit on the type of funding that may be certified, rather that the limit lies in the requirement that any certification be given rationally and in good faith.

107. Mr Foxton bolstered his primary submission, that since a default will directly reduce the financial institution's (or indeed any institution's) level of equity capital and such reductions can only be reversed by raising further equity funding, there will often be a direct link between default and the need for such equity funding, with a secondary submission that the cost of funding language does not in any event require such a direct link. He submitted that there is nothing in the cost of funding language that requires the actual or notional funding to be entered into for the specific purpose of funding the relevant amount. He put forward two principal reasons for this: (a) that the relevant payee may not know the relevant amount, since it may be in dispute, and will very often not know how long it will be outstanding for, and more fundamentally (b) that (as he put it in his oral opening)

> "that is simply not how entities fund themselves in the ordinary course. They will have general debt facilities which will meet aggregate requirements for debt funding, just as they will have equity raised for general corporate purposes available where equity funding is required, and…if they are members of corporate groups it is quite likely that the debt and equity funding is arranged at group level, with companies within the group being able to have an allocation dependent on their particular needs. Certainly looking at the position of financial institutions and the ordinary ISDA default…the idea of going out and obtaining a specific funding facility, debt or equity, to cover the default seems improbable…Much more likely you will be drawing on existing general purpose facilities, be they debt or equity."

108. Mr Foxton submitted further that in such circumstances the attempt to exclude the cost of equity funding as a matter of construction would lead to a "number of very arbitrary divides", especially having regard to the use of hybrid instruments, and "cause consternation". Far better and much more likely to have been intended, he submitted, is that rationality and good faith should be the touchstones in distinguishing recoverable and irrecoverable costs. That would meet the reasonable expectations of the predominant users of the ISDA Master Agreements, recognise the huge variety of funding methods, and at a stroke remove the difficulties inherent in Wentworth's approach, which calls for the adoption of a proxy which, on the one hand, is too simplistic and, on the other hand, introduces complexity and difficulty in discerning the boundaries of the definition.

109. Mr Foxton echoed and amplified Mr Dicker's point that if the draftsmen had intended to limit the application of the cost of funding language to borrowing, they would have said so: far from limiting the methods of funding in respect of which a counterparty could recover the cost, the draftsmen had wisely determined not to prescribe a limitation but to provide latitude for commercial men acting honestly and rationally.

110. Mr Foxton submitted that support for that approach, conceived to make users the arbiters, subject only to the constraints of honesty and rationality, and reduce to the minimum the ambit for time-consuming recourse to court, was clear from the *Intel* case.

111. In that case (see also paragraph [48(5)] above), which concerned the 1992 version of the ISDA Master Agreement, the United States Bankruptcy Court for the Southern District of New York rejected an attempt by a defaulting Lehman Brothers entity to interpret the "Loss" provisions of the 1992 Form restrictively. Intel alleged that it had sustained a loss as a result of the non-delivery by Lehman Brothers of certain Intel shares. "Loss" is defined by the 1992 Form to mean "*an amount that [a] party reasonably determines in good faith to be its total losses and costs...in connection with this Agreement*" including (amongst various other matters) "*any…cost of funding*".[15] The Lehman parties argued that the <u>only</u> method by which the non-defaulting party could calculate its "Loss" was to use the "fair market value" of the undelivered shares, as determined by their value at the close of the markets on the Early Termination Date. Judge Chapman rejected this argument. She noted that there was nothing in the text of the definition of Loss that "*explicitly mandates any particular calculation method or otherwise modifies the plain meaning of that first sentence of the definition*". Intel was accordingly entitled to select any methodology for calculating its loss that it wished, subject only to the requirement to do so reasonably and in good faith.[16]

112. Mr Foxton sought to extrapolate from the *Intel* case, and the grounds on which it was decided, a more general rejection of any attempt to interpret the ISDA Master Agreements restrictively by "reading down" the definition of "Loss" to exclude certain forms of loss even though they might well commercially be sustained. A commercially sensible meaning should not be displaced by a legalistic or semantic approach. He relied especially on the following passage in Judge Chapman's decision:

> "To give effect to the clarity, certainty, and predictability sought by ISDA and by the parties through their adoption of the ISDA Master, the Court finds that, as a general rule, selecting Loss to calculate an Early Termination Payment affords the non-defaulting party discretion and flexibility in selecting the

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[15] It may be recalled that the 2002 Form has been modified significantly from the 1992 Form: the 2002 version provides for a single payment measure if an Early Termination Date occurs, that is, the Close-out Amount, whereas the 1992 version offered two options, that is, Market Quotation or Loss. Although the definition of Close-out Amount in the 2002 version refers to "the losses and costs of the Determining Party" there is no longer need or warrant for any definition of 'Loss' in that version.

[16] *Lehman Brothers Holdings Inc v Intel Corporation* S.D.N.Y. Sep 16, 2015 at page 20. It should be noted that the requirement to act "reasonably and in good faith" is an express requirement of the definition of "Loss"; the equivalent for the definition of "Default Rate" is the requirement to act rationally and in good faith, as set out below.

> means for calculating its Loss, subject to such methodology being reasonable and in good faith….
>
> …
>
> …the fact that Lehman's interpretation of the proper measure of Loss is in accord with the measure of Intel's damages "under New York law"[17] is not persuasive support for Lehman's interpretation of the proper measure of Intel's loss.

113. Mr Foxton concluded on this aspect of the matter by strongly urging against refined distinctions based on English or New York law preconceptions as to the forms of particular types of instruments as opposed to their economic substance, especially where the distinctions are not clear cut and where English and New York law may have different approaches.

My assessment and preferred construction

114. These competing arguments, advanced on each side with great skill and cohesion, have caused me to waver considerably, especially on the most acute issue of whether the cost of funding language extends to equity funding.

115. In the end, however, I have reached the firm conclusion that, as Wentworth has submitted, 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*" 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. "*Cost*" means the transactional cost, that is, the price which is required to be paid in return for the funding for the period it is required. The broader range of costs which the SCG and GSI have submitted the expression encompasses are not, in my judgment, intended to be recovered and are not capable of certification as falling within the cost of funding language.

116. Put shortly, that is because, in my judgment, the more limited construction is necessary in order (a) to remain consistent with the underlying objective of providing for a certified *per annum* rate of interest; (b) 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; (c) to reflect accurately what I consider to be the actual or hypothetical transaction posited by the cost of funding language, which is one of 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; and (d) to keep within sensible boundaries the matters to be subject only to the control of good faith and rationality.

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[17] Which provides that loss in connection with undelivered securities is limited to the fair-market value of those securities on the date they were being delivered.

117. I do not accept the argument that this will confound the legitimate expectations of users of the ISDA Master Agreements, whether financial institutions or others. It does not involve any supposition as to the many and various means that such institutions may utilise whereby to fund their business activities. Nor does it negate the fact (as I accept it to be) that institutions and other entities routinely attribute a cost to all their funding operations, including equity funding, if necessary by modelling (such as a CAPM). Any business will need to know the cost of raising funds, since otherwise it cannot assess whether the rate of return justifies that cost. Once the cost of specific sources has been ascertained, the overall cost will usually be fed into a calculation of a weighted average, commonly called its Weighted Average Cost of Capital (or "WACC").

118. I turn to elaborate on the grounds for my conclusion, in large part by reference to the competing submissions which I have described earlier.

119. In my view, and in agreement with Mr Zacaroli's first point, the key to an understanding of the cost of funding language in all the contexts in which it is used in the various versions of the ISDA Master Agreement 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. The language is directed towards measuring or adopting a rate of interest calculated on the basis of daily compounding and the actual number of days elapsed during which the payee is out of the money in the relevant amount (see especially the last sentence in each of section 6(d)(ii) of the 1992 version and of section 9(h)(iii) in the 2002 version).

120. The rate in every case is a rate of interest with the identified features. 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 to be paid by the payee by way of interest to fund the relevant amount over the period of it being outstanding.

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. (The exception being that in the 2002 version the (new) definition of Non-default Rate prescribes/specifies that the relevant rate shall be that "*offered to the Non-defaulting Party by a major bank in a relevant interbank market for overnight deposits in the applicable currency…*").

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 properly described as interest. This conclusion has an obvious impact on the issue whether (a) equity funding and (b) hybrid instruments fall within the ambit of the cost of funding language, to which I return in paragraphs [140] to [142] below.

123. I also accept Mr Zacaroli's submission that the cost of funding language likewise excludes other costs or expenses that cannot properly be described as interest either. The cost of funding language does not require the payee to be made whole, nor compensated for any opportunity cost. Only the cost of interest (actual or hypothetical) in respect of the relevant amount over the relevant period is required to

be paid: other costs and losses are not within that language. Thus, for example, payments to third parties which, though they may arise in connection with or in consequence of the borrowing, do not constitute payments of interest, and payments under engagements separate or distinct from the transaction of borrowing, are not within the cost of funding language.

124. I further accept Mr Zacaroli's third principal submission, to the effect that the focus of the cost of funding language is on the cost of the transaction (actual or hypothetical) under which the funding of the relevant amount is obtained, rather than the cost of funding the relevant payee's assets (whether a single asset or all of its assets), and that this further supports an interpretation which excludes equity funding. An assessment of the "cost" of equity funding is by its nature directed to the cost of funding the payee's assets, rather than the cost of funding the relevant amount over the relevant time.

125. Further, a default may be the occasion of a need for equity funding; but the cost of that equity funding is a consequential loss arising by reference to some general business need or regulatory requirement; its point of reference may not be the cost of funding the relevant amount but the cost of compliance.

126. As was acknowledged in Wentworth's written submissions, it is true that the cost at which the relevant payee, in the circumstances existing at and following LBIE's default, could borrow a sum equivalent to the relevant amount might well be affected by similar factors as would be taken into account by a potential equity investor: a lender is likely to demand a higher price from a borrower with a higher credit risk. Such potential differences are deliberately reflected in the fact that it is the cost of funding to one or other of the parties that is referenced in the definition. But the two are not the same, and reflect very different risk profiles.

127. This is well illustrated by the examples contained in evidence adduced by the SCG, and in particular those provided in the exhibit to the witness statement of Patrick Michael McKee ("McKee 3"). In the first example, the average cost of debt is 6.1%, but the cost of equity is 10.4%. By taking the weighted average of debt/equity funding, the entity arrives at a cost of funding of 8.7%. Given the information in the example, the inherent likelihood is that the entity could have borrowed the relevant amount at 6.1% or less, such that using the weighted average cost of equity and debt produces a markedly different outcome.

128. It is also dramatically illustrated in the case of GSI which, as explained in more detail below, was in fact able to borrow at the relevant time many billions of dollars at rates of interest ranging from 0.01% to 1.10%, yet seeks to contend it is entitled to rely upon its equity funding costs to certify a rate in excess of the 8% statutory rate.

129. These differences illustrate how different is a proposition for the raising of funds by borrowing a relevant amount for a limited relevant time, where the essential risk is that of default on the borrowing, from a proposition for funding an enterprise in return for reward by way of participation in its fortunes. In my view, "risk capital" is not funding within the purview of the cost of funding language.

130. Nor, as previously indicated, are costs or other detriment which are or may be incidental to the funding transaction but which are not a necessary part of it. In this

context, again, I accept Mr Zacaroli's semantic analysis (see paragraph [75]) above and his further submission that the practical difficulties attendant on permitting the broader interpretation put forward by the SCG and GSI also tell against it (see paragraphs [76] to [78]). I agree that the cost of funding language is not intended to hold the payee harmless and compensate it for any detriment: it is a contractual proxy for calibration of the value to the payee of being out of the money. I would add that it seems to me unlikely that it was the intention of the draftsmen, or those who enter into the ISDA Master Agreements, that they are exposed to the risks of these potentially considerable costs with the protection only of a requirement of good faith and rationality.

131. The question which then arises, and to which Mr Zacaroli's fifth point is directed, is whether (as he submitted) the cost of funding language imports a further requirement that the cost in question should not exceed what the relevant payee was required to pay, as opposed merely to what it could have paid or chosen to pay.

132. On the view which (as I shortly come on to explain) I have taken as to the restricted ambit of the cost of funding language, this is a less extensive point than if that language extended to, for example, equity funding (in which case the sort of differences exemplified in paragraphs [126] and [127] would give fundamental significance to the point). The question becomes a more limited one as to whether the relevant payee must certify that it borrowed at the lowest achievable rate, or that its certified rate is the lowest that would have been achievable.

133. The SCG and GSI rejected this additional restriction (whilst of course accepting that a higher rate might be incapable of being justified on good faith and rational grounds if a demonstrably lower one was or would have been readily available). They submitted that to read in such a requirement as a matter of interpretation would set up in each case a far-ranging inquiry to establish whether the rate certified was indeed the lowest available. I accept that submission: I do not think the additional restriction contended for on Wentworth's behalf is to be read into the cost of funding language; to my mind, it is not semantically easy to justify, and it would lead to practical difficulty unlikely to have been intended.

134. All these points bear on Mr Zacaroli's sixth point, to the effect that only the price of borrowing can be considered to be a "*cost*" and only borrowing imposes an obligation to pay interest, so that the cost of funding language is such as to exclude the cost of equity/risk capital. This point is, in a sense, the "bottom line" of the previous analysis.

135. As will already be apparent, I have concluded that Mr Zacaroli's submission, and the differences between equity (for which the reward to the investor is participation in profit, if any) and borrowing (for which the funder imposes an obligation to pay interest) on which it relies, is well-founded.

136. Interest is payment by time for the use of money: it is an obligation imposed as the cost of being afforded the use of money over the relevant period of time. The obligation is in the nature of a debt established by the transaction under which the use of the money is provided. That obligation is plainly a cost, equal to the rate of interest charged. The obligation of the borrower to pay interest, and that cost, may be brought to an end by unilateral act of the borrower (subject of course to any prescribed

contractual penalty for early payment). The debt neither confers nor reflects any interest in the borrower.

137. A share has very different characteristics. The bundle of rights comprised in a share is classically set out by Farwell J in *Borland's Trustee v Steel, supra* (see paragraph [86]). In particular, the right to dividend which a share may confer (whether prescribed and preferential, as in the case of a preference share, or unspecified and residual, as in the case of an ordinary share) is not a debt (at least until a dividend is actually declared); there is only a right to participate in such dividend as may (or may not) be declared and (depending on the share right prescribed) in capital on a winding up. A share thus imposes no obligation to pay capable of constituting an actual cost. Further, any right to participate in any dividend declared is not a payment by time for the use of money: it is a function of the qualified right to participate which the share confers on its holder (who may have acquired it at any time prior to the dividend date). The right to participate may be relinquished upon redemption or purchase of a share by the company (though this is not, ordinarily at least, capable of being done by the shareholder unilaterally). A share confers an interest, measured by the participation and any voting rights, in the issuer; any return is in right of that interest. In the case of a preference share, the coupon limits the right of participation in distributed profit to the prescribed percentage as the *quid pro quo* for priority.

138. As Mr Zacaroli submitted, interest is to be distinguished from a participation in profit whether prescribed (such as in the case of a preference share) or without limit (such as in the case of an ordinary share): see the quotation from Farwell J in *Bond v Barrow Haematite* in paragraph [88] above. A fixed percentage dividend right may in many ways mimic an entitlement to interest: but it is not the same, because a limited right to participate in profit, if distributed, is not the same as an entitlement to a cost charged for the use of funds by reference to time. Likewise, the cost to the company may be assessed by techniques such as a CAPM; but the cost is not actual: it is simulated or synthetic and developed in accordance with the technique or model adopted.

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.

140. The question then is whether that should be taken to limit the means of funding to pure borrowing, or whether other hybrid means of funding (for example, on the basis of a hybrid instrument such as one issued initially with a rate of interest but convertible into equity) could be within the cost of funding language (subject, of course, to certification). "Interest" and borrowing go naturally together: interest is, as it were, the horse for the carriage of borrowing. But borrowing may take many forms.

141. In my view, part of the cost of a hybrid instrument could theoretically be within the cost of borrowing language, but only if it is possible to disentangle the interest rate element payable in respect of making available to the payee the relevant amount over the relevant period from other costs (in particular, any equity element cost, or some cost not referable to the relevant period during which the relevant amount is outstanding). As a practical matter, since that element would in economic terms be only part of the "cost", it seems unlikely that the recoverable element would exceed the notional cost of borrowing: thus, the issue is, as a commercial matter, unlikely to arise.

142. I have naturally been mindful that these conclusions, and my recognition that "*cost*" bears a broader meaning from a commercial perspective than the meaning I have ascribed to the cost of funding language, is said to run the risk of "consternation" amongst prominent (and by value almost certainly predominant) users of the ISDA Master Agreements, as (in effect) represented by GSI. However, in my view, consternation would be an exaggerated response to a limited finding. 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. It is intended to reflect the fact that, in this particular aspect, the governing objective is the determination of a rate of interest; and interest connotes borrowing. As noted in argument, interest is often an imperfect proxy for opportunity cost; and it may not fully reflect all the costs of being without the money withheld. But it is a commercially as well as legally accepted proxy, and its adoption here is consistent with normal legal and commercial expectation: it is the broader interpretation which would be a departure.

143. I have also considered carefully Judge Chapman's judgment in the *Intel* case, on which both the SCG and GSI placed much reliance. I do not dissent from either its result or its rationale. However, I agree with Mr Zacaroli that neither the result nor its rationale is of any substantial assistance in determining the issue of interpretation that arises in this case.

144. The question confronted in the *Intel* case was essentially whether, as Lehman there argued, a Non-defaulting Party's Loss should be restricted to the loss on the undelivered property and thereby to "Unpaid Amounts" as defined, being an amount equal to the fair-market value of the undelivered property (see page 24 of the judgment). The term "Unpaid Amounts" appears in the 1992 Form only as part of the calculation of an Early Termination Payment using Market Quotation; it does not appear in the definition of Loss and is not referenced in calculating an Early Termination Payment using Loss as the metric. As Judge Chapman pointed out (at page 24):

> "Thus, as pointed out by both Intel and ISDA, to prevail on this argument Lehman must overcome the challenge of deriving a textual mandate based on words that do not appear in the text of the definition of Loss itself but are that are instead used in calculating an Early Termination Payment using Market Quotation, the payment measure the parties could have chosen as an alternative to Loss."

145. That this difficulty was not overcome by Lehman is not surprising; but neither is it, to my mind, instructive in this case. There, the governing concept to which definition was to be supplied was the concept of loss; and what was sought, where two bases of loss were specified, was a restrictive meaning of one basis of loss to be interpolated by importing a particular method of calculation where that method of calculation was already expressly provided for in the alternative basis of claim. Here, the governing concept is the concept of interest, the rate of which is expressly directed to be measured on a daily compounding basis; the components of the applicable rate are the same throughout, whatever the nature of the transaction; the search is for an interest rate in every context in which the cost of funding language applies to compensate the payee for being out of the money in the amount of the relevant amount in the various circumstances identified in the ISDA Master Agreement; and the rate can only be relevant as a proxy for the cost to the party of replacing a sum which has been withheld. The conclusion that this connotes some transaction under which one person borrows money from another at a cost measured by time, rather than some other means of funding rewarded by a profit share, flows naturally, and I think inevitably, from the governing concept. There is, in my view, no impermissible stretch of language, nor any import from a contrasting clause required in this case.

146. I would add that 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 contexts of the Default Rate, the Non-default Rate and the Termination Rate which I have been addressing. It is always a matter of the context. Indeed, I consider that (as the Joint Administrators suggested) in the context of the "Loss" clause, losses arising from the default and consequential termination of the transaction will be encompassed; and that is a further reason in support of my conclusions as to the proper interpretation of the cost of funding language itself, since it would plainly be wrong to include in the calculation of the Default Rate losses which properly fall within the "Loss" clause.

My answers to Question 11

147. Accordingly, in my judgment, the answers to Question 11 are as follows:

(1) As to questions 11(1) and (2), 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.

(2) Similarly, as to question 11(3), 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.

(3) Question 11(4) does not arise. Subject to their competing contentions as regards the preceding questions, the parties were agreed that as regards Question 11(4), the expression "*cost (without proof or evidence of actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount*" is not capable of including the actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE.

Further sub-questions under Question 11

148. As an adjunct of the formal questions, and in light of continuing concerns, especially concerning the division between debt and equity in the context of hybrid instruments, the Administrators have posed various sub-questions which they consider it would be helpful for the Court to consider. Counsel for the Administrators urged me to address these sub-questions so as to "provide helpful practical yardsticks to assist the Administrators and the creditors in obtaining a proper understanding of the meaning and application of the contractual words". Although this is somewhat unusual, since all parties recognised that they might in fact arise, and made submissions on these points which were for the most part an application of the consequences of their arguments on the main points, I set out below my views.

149. The Administrators have, by sub-question 1, asked whether the relevant "cost" must involve the incurring of an obligation (whether actual or hypothetical) to pay a sum of money. Consistently with their case, that the Court should not, by a process of interpretation, narrow the methods of funding which could fall within the cost of funding language, the SCG and GSI submitted that any form of financial detriment could suffice. Likewise, consistently with its case as to the meaning of that language, Wentworth submitted that the cost must be monetary, the price paid for the relevant sum (actually or hypothetically) borrowed over the relevant time. Having accepted Wentworth's argument as to the meaning of the cost of funding language, I agree with its interpretation: the cost is to be measured in or by reference to a sum of money; detriment will not suffice. That also accords with the ordinary meaning of cost in everyday language.

150. The Administrators' second sub-question is whether any such obligation (to pay money) must be incurred in obtaining the funding and as part of the bargain entered into to obtain such funding. The parties' respective submissions followed from those on the first question. In my view, in agreement with Wentworth (whose approach posited such a bargain), the answer is "yes".

151. The third sub-question is whether a "cost" is incurred if any payment obligation is itself discretionary. Again, the rival contentions mirrored the parties' respective positions on the primary issues. In my view, it follows from Wentworth's analysis, which I have favoured, that it will not be so. "Cost" connotes, in my view, an obligation to pay, rather than a promise of a discretionary return.

152. The Administrators' fourth sub-question is whether a "cost" is incurred if the amount of any payment obligation is itself discretionary. My answer is "no", for the same reasons.

153. The fifth sub-question is whether the "cost" must be the cost of funding the relevant amount to address the cash shortfall caused by non-payment, or whether it can be the cost of funding some other amount for other or wider purposes. The Administrators posited, as a practical example, a case in which (a) the relevant amount is $10 million, (b) the relevant payee's cost of borrowing $10 million is 5% per annum, and (c) it would cost 10% per annum for the relevant payee to borrow the substantially larger sum of $100 million. In such a case, it might be said that the relevant payee's cost if it were to fund or of funding the relevant amount of $10 million is 5% per annum and that the Default Rate is therefore 6% per annum. The question is whether, in those circumstances, the relevant payee could rely on its cost of borrowing a sum that is materially in excess of the relevant amount to claim a Default Rate of 11% per annum.

154. For GSI (with the SCG's support), Mr Foxton submitted that, since as a practical matter the funding exercise will not usually be one undertaken for the specific purpose of funding the relevant amount but almost invariably for funding any other needs, the answer is necessarily "yes", subject to there being a process of allocation that relates the cost to the relevant amount and the period of time in question. For Wentworth, Mr Zacaroli submitted that since the cost of funding language very clearly is based on an amount being borrowed (actually or hypothetically) to fund, not the enterprise or other needs, but only the relevant amount, the cost must be that applicable to the actual or hypothetical transaction. Mr Zacaroli accepted that if the relevant payee had in fact gone out and borrowed to cover all its means then the cost of doing so might assist in determining what the cost of borrowing the relevant amount was or would have been; but the "cost" must be the cost to fund the relevant amount in a transaction for that purpose. In my view, Mr Zacaroli is correct. I do not consider that the cost of funding language was directed to the cost of funding the enterprise or making good an inadequate capital ratio: only the cost of borrowing the relevant amount.

155. The Administrators' sixth sub-question is whether the cost of funding the relevant amount includes any loss of profits or consequential losses resulting from the non-payment of the relevant amount. That sub-question puts in sharp focus the inter-relationship between the definitions of "Loss" in the 1992 Form and the provisions for recovery of losses in the definition of "Close-out Amount" in the 2002 Form, and the ancillary risk of double recovery. For GSI, Mr Foxton's answer (which I understood the SCG to adopt) once more lay in the control of certification, which would squeeze out the double recovery risk. He also floated in argument the possibility that

> "there is a sort of chronological limitation in that the loss definition takes you up to the point in time at which the loss amount is calculated and your default rate provision kicks in thereafter. It may be that in practice that avoids any question of double recovery because you are going to be looking at separate periods of time."

156. For Wentworth, Mr Zacaroli relied on his analysis to exclude consequential loss. I agree that this follows from that analysis, which I have adopted.

157. The seventh sub-question on which the Administrators sought guidance is whether the cost of funding the relevant amount includes any professional or arrangement fees incurred by the relevant payee in putting the funding in place. GSI and the SCG submitted that they could be, subject to the control of certification; Wentworth submitted initially that they could not be, but modified this to accept that fees paid to a lender as part of the price of borrowing could be recovered as part of the cost of funding. I accept Wentworth's submission as so amended.

158. The eighth of the Administrators' sub-questions is whether the cost of funding includes only the lowest cost of funding available to the relevant payee on reasonably acceptable terms. The SCG and GSI rejected this suggestion as encouraging second-guessing of commercial decisions and an extended review inimical to swift resolution and which the certification process was intended to avoid.

159. Mr Zacaroli clarified that Wentworth's case had been characterised wrongly by the SCG as being that the relevant payee had to be the lowest available cost; rather, Wentworth's case was that the certified cost should not exceed what the relevant payee had to pay, what it was required to pay. He reasoned that without this "anchorage" the rationality control would not work properly, since certification of an amount actually paid or which could have been required to pay could be in good faith and not irrational, even if a substantially lower cost/rate was available. He put forward the following example of a situation where the borrower could borrow from one bank at 2% and another bank at 10%: since the borrower would not have to pay more than 2%, it should not be entitled to certify in respect of a higher rate.

160. The difficulty is in determining, especially in a hypothetical context, what is the rate that the relevant borrower "has to pay" without opening up the sort of far-ranging process of second-guessing the borrower's available choice. I am not convinced that I was provided with any sufficient answer to this. As it seems to me, the rate must not exceed that which the borrower knows to be or which could be available to it in the circumstances pertaining to its business, having regard to the permitted object of the actual or hypothetical borrowing (to cover the relevant amount).

161. The Administrators also added to their original list of sub-questions a further one: what happens if the relevant payee is not in a position to borrow at all? Although Mr Zacaroli counselled against seeking to determine this, on grounds that it was unlikely to arise and would be fact-sensitive, the SCG and GSI took it up as "an important question to test the viability of the competing constructions…". Mr Foxton, for GSI, put it this way in argument:

> "If the correct answer is, if you can't borrow you get 0 plus 1 per cent, the result of that is that a party that was able to and did raise equity funding and incurred the cost in doing so is assumed by this clause to have no cost of funding at all. We say that is an uncommercial outcome."

162. Mr Foxton dismissed the suggestion that it was most unlikely that a party which could raise equity could not borrow, on the ground that it was perfectly realistic to envisage

a situation where existing equity providers might be prepared to provide further equity funding rather than lose the funding already provided, even where borrowing would not be realistic. Furthermore, he suggested that the issue illustrated a more general danger of a construction which prevents a party which has in fact raised equity funding, rather than incurred borrowing, being able to certify that actual "cost" for the purposes of the Default Rate. Thus, Mr Foxton argued that this conundrum exposed a fundamental flaw in Wentworth's approach.

163. In short, the Administrators' final point, which arose from Wentworth's skeleton argument, raised both a broad point (as to whether it revealed a fundamental flaw in Wentworth's approach) and a narrower point (as to the extreme case where a party can attract equity funding but cannot borrow). As to the broad point, in my view, no such flaw in Wentworth's interpretation of the cost of funding language is thereby revealed. The appropriate measure is a borrowing rate. A party that has chosen to equity fund may still claim the rate it certified it would have had to pay if it had instead borrowed. As to the narrower point, which depends on what must be an unusual circumstance arising, I do not feel able to express a concluded view. I would tend to think of the circumstance of a party not being able to borrow at all, whilst yet able to equity fund, as being remote; and it may be that it was not within the contemplation of the draftsmen. I think the matter should be left unless and until the unusual case arises.

164. I turn to Issue 12.

Issue 12

165. Issue 12 concerns the following questions:

> *If and to the extent that the "cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund…the relevant amount" includes a cost of borrowing:*
>
> *(1) Should such borrowing be assumed to have recourse solely to the relevant payee's claim against LBIE or to the rest of the relevant payee's unencumbered assets?*
>
> *(2) If the latter, should the cost of funding include the incremental cost to the relevant payee of incurring additional debt against its existing asset base or should it include the weighted average cost on all of its borrowings?*
>
> *(3) Should such cost include any impact on the cost of the relevant payee's equity capital attributable to such borrowing?*
>
> *(4) Is the cost to be calculated based on obtaining:*
>
> > *(i) overnight funding; or*

(ii) term funding to match the duration of the claim to be funded; or funding for some other duration?

166. The issues raised by Question 12 arise in circumstances where the relevant payee has not, in fact, raised an amount equal to the sums owed and has decided rationally and in good faith that it would have done so, in whole or in part, through debt funding. The question assumes that the cost of funding language is limited to the cost of borrowing (as I have determined it is).

167. On that assumption, there is no longer any dispute between the parties as to the answer to question 12(1), even if it seems that they are not quite *ad idem* as to their reasons.

168. As to the answer, it is common ground that the lender should be assumed to have recourse to the relevant payee's assets generally and not solely to its claim against LBIE.

169. Wentworth's position was that this naturally followed from the abandonment of any suggestion that the cost of funding was limited to the cost of funding the claim itself. On behalf of the SCG, however, Mr Dicker stressed that its position is that the result followed not as matter of pure construction, but because a relevant payee which funds the relevant amount by borrowing and is able to provide recourse to the whole of its unencumbered assets will be in difficulty in certifying rationally and in good faith borrowing on a limited recourse basis. I take it that this stance is intended to demonstrate consistency and cohesion with the SCG's overall position that the cost of funding language is open-textured and any restriction in its ambit is through the control of certification.

170. In my view, there is simply no basis for assuming or implying any restriction as to the recourse available to the borrower. I suspect, as do the Administrators, that the SCG's point raises a distinction of approach without any substantive difference.

171. On question 12(2) the Respondents are more substantially at odds. The following summary of their respective contentions is taken from the Administrators' skeleton argument:

(1) The SCG's position is that the relevant payee should make a rational and good faith determination of its incremental cost of funding which may be by reference to weighted average cost of all its borrowing or capital.

(2) GSI adopts the same position as the SCG. It contends that the cost of funding may include the incremental cost to the relevant payee of raising additional funding against its existing asset base or the weighted average cost of all of its funding.

(3) Wentworth adopts a different view: this is that the relevant contractual wording is inconsistent with a measure of that "*cost*" in terms of an incremental (increase) to an average cost of borrowing or the weighted average cost on all its borrowings. As set out above, Wentworth's position is that the expression refers to the price which the relevant payee paid, or would be required to pay, to a counterparty to a transaction to borrow an

equivalent sum in the market for the period required "*taking into account all relevant considerations*".

172. The approach of the SCG and GSI is again an incident or reflection of their overall position that the cost of funding language should not be read as outlawing any honest and rational approach to calculating the cost of having to plug the "gap", and that the control mechanism should be good faith and rational certification.

173. Conversely, Wentworth's approach is based on its position that the cost of funding language posits a borrowing transaction (actual or hypothetical), the incidents and costs of which will govern the claim: Wentworth's answer to the question is (as Mr Zacaroli put it in his oral submissions) "what it would cost you to go and raise the relevant sum, the relevant amount, in the market".

174. In my view, the suggestion that the relevant payee's weighted average cost of capital is an available rate for certification is misplaced. By definition, that weighted average cost reflects equity funding as well as debt funding; and it is compiled from historic transactions, not a new transaction to fund an amount equal to the overdue amount. I agree with Wentworth that the certifiable "cost" is the price which the relevant payee paid, or would have to pay, to a counterparty to a transaction to borrow an equivalent sum, taking into account all relevant considerations. That leaves a broad margin, confined by certification, but which is tied to a borrowing transaction (actual or hypothetical) rather than the activities of the relevant payee as a whole.

175. For much the same reason, I agree also with Wentworth's answer to Question 12(3). I do not accept the contrary argument advanced on behalf of the SCG and GSI to the effect that the "cost of funding" may include, in addition to the cost of the actual or hypothetical borrowing transaction relied upon, the additional cost resulting from increased leverage. The "cost" to be certified cannot properly include any impact on the relevant payee's overall cost of borrowing or an increase in the cost of its equity capital. That is not a cost of funding the transaction posited, even if a consequence of the transaction is to increase the cost of equity capital or other funding.

176. As to question 12(4) the Respondents are in substantial agreement, at least as to the applicable test, even if not as to particular illustrations of its application. As is stated in Wentworth's skeleton argument:

> "no particular tenor is prescribed for any transaction to borrow the relevant amount…The question whether it was appropriate to certify costs of funding based on one tenor or another is determined by the application of the test of good faith and rationality.
>
> In other words, where (for example) a party actually borrows funds at a particular tenor, the price it was required to pay for borrowing will represent its cost of funding the relevant amount unless it was irrational to borrow for that tenor…"

177. The SCG and GSI agree, although it is right to record that neither concurred in Wentworth's attempt later in the same passage to provide examples of what might constitute an irrational basis or tenor of borrowing (the particular example posited

being that of a party which locks itself into a long term high rate of interest at a time of high volatility such that any reasonable person would have borrowed at overnight rates so as to take advantage of potential decrease in interest rates): both were concerned to emphasise that whilst such an example might be illustrative of what might be irrational, the question of irrationality should not be pre-judged and would always have to be decided on the facts of the individual case (which I do not understand Wentworth to dispute).

178. The only outstanding disagreement in respect of question 12(4) arises in respect of the Administrators' contention (in their position paper, and not disavowed in their skeleton argument), that, since no relevant payee could have known how long it would take for LBIE to make payment in full, the actual length of that period (as opposed to a good faith estimate of it) is not something which could properly be taken into account by any counterparty performing a rational certification for these purposes (see paragraphs 27(5)(iii) and 30(2)-(3) of the Administrators' position paper on Issues 11-13).

179. This is in point of fact only disputed by GSI, which contends that though improbable it is not impossible. It is not disputed by Wentworth; and in point of fact, the SCG accept that no relevant payee could have known that LBIE's unsecured debts would ultimately be paid in full or precisely how long that would take to occur. However, the SCG suggest that this fact

> "tends to demonstrate why, in the context of LBIE's Administration, it could be rational and in good faith for a relevant payee to determine that it would have obtained long duration funding (including equity funding)."

180. I do not accept the SCG's attempt to extract from this inherently unlikely factual circumstance support for its legal argument. As to the point of fact, it seems to me so unlikely that any relevant payee would certify that term borrowing on such a basis was or would have been arranged that I should leave it to that (to my mind) almost inconceivable event to arise before saying any more.

Issue 13

181. Issue 13 is:

> *"Whether 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' should be calculated:*
>
> *(i) by reference to the relevant payee's circumstances on a particular date; or*
>
> *(ii) on a fluctuating basis taking into account any changes in the relevant circumstances (and if so, whether the benefit of hindsight applies when taking into account such changes),*
>
> *in each case, whether or not taking into account relevant market conditions".*

182. On this point, which the Administrators consider is likely to be of most practical importance where a creditor certifies its cost of funding on the “if it were to fund” (hypothetical) basis, there is now some common ground; but there remain significant areas of disagreement, exacerbated by the longevity of the Administration (so that there may be at least five years between the relevant Early Termination Date and the date upon which the final dividend is paid) and the fact that over a long period interest rates inevitably fluctuate.

183. The remaining dispute is whether the basis for establishing the cost of borrowing should be ascertained as at the time of seeking payment, taking into account fluctuations over the period, or at the time when the relevant default occurs.

184. At the risk of over-simplification, Wentworth’s position is that the relevant date is when the relevant payee is seeking payment of interest, and the calculation of the cost of funding must, deploying hindsight, take into account the relevant market conditions over the period between then and the termination date.

185. At the same risk, the SCG’s position (supported by GSI) is that it all depends on what the relevant payee in good faith certifies it would have done. Thus, if a relevant payee’s habitual mode of borrowing was on a fixed rate basis, hindsight and subsequent circumstances would be irrelevant; whereas, if in good faith the relevant payee certifies that it would have borrowed on a floating rate basis, plainly the actual movements in the rate after that decision would determine the result, unless perhaps that relevant payee could show that at some point it would have changed to a fixed rate. The SCG sought to disparage Wentworth’s approach as being calculated to take advantage of the fall in interest rates after Lehman’s failure to restrict claims to the lower rates which continue to be the norm.

186. To begin with the common ground, all parties are agreed that a relevant payee is not entitled to use hindsight to say how it would have obtained funding (for example, the type and duration of funding it would have used): that determination must be made as at the position when the need to obtain the funding arose, ignoring subsequent events.

187. Also, none of the parties disputes that the facts of subsequent events may be taken into account when calculating the costs that would have arisen as a result of those (hypothetical) funding decisions, according to whether the relevant payee in good faith and rationally determines that such events shed light on the costs that it would have incurred. However, all are agreed also that a retrospective calculation designed to create the highest possible cost is not a rational or good faith determination of the relevant rate.

188. In my view, the “one size fits all” approach advocated on behalf of Wentworth is excessively prescriptive, and undermined by the case postulated by the SCG of a relevant payee whose habit was always to borrow on fixed rates.

189. I would endorse the position adumbrated on behalf of GSI that 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” may be calculated:

(1) by reference to the relevant payee’s circumstances on a particular date, or on a fluctuating basis taking into account any changes in the relevant

circumstances, subject to the requirement to certify the cost of funding rationally and in good faith;

(2) in each case taking into account relevant market conditions, as well as any other relevant facts or circumstances; and

(3) in light of hindsight, insofar as any certification given by the relevant payee at the end of the relevant period will be based on what the relevant payee actually did or could have done to fund the relevant amount throughout the relevant period.

190. Put more shortly, I agree with Mr Dicker that it will be necessary to determine each certificate on its merits and, as he put it, 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."

Issues 14 to 18

191. Issues 14, 15, 16 and 18 (it being agreed that Issue 17 is encompassed within the answers to Issues 11 to 15) are largely agreed: there remains only a dispute as to the ambit of a certificate and points of detail as regards the drafting of the declarations sought. However, I address each (except Issue 17) in turn for clarity and comprehensiveness.

Issue 14

192. Issue 14 asks:

> *"Whether a relevant payee's certification of its cost of funding for the purposes of applying the "Default Rate" is conclusive and, if not, to what it is subject. In particular whether, in order for a payee's certification to be deemed conclusive, a relevant creditor is under any duty to act:*
>
> *(i) reasonably;*
>
> *(ii) in good faith and not capriciously or irrationally; or*
>
> *(i) otherwise than in its own interests".*

193. The parties are largely agreed that the relevant payee's certification is conclusive as to its cost of funding within the meaning of that phrase (as to which see above), save in certain circumstances.

194. These circumstances are agreed to include where the certificate is (a) made irrationally (in the sense of being arbitrary, capricious, perverse, or a decision to which no reasonable person having the relevant discretion could have subscribed) or (b) made otherwise than in good faith.

195. There is, however, a dispute as to whether a certificate may also be challenged on the ground of "manifest error", which is in essence really a dispute as to whether the test of "manifest error" adds anything to the tests of rationality and good faith.

196. Further, and perhaps more importantly, that has widened into a dispute as to whether a relevant payee who misconstrues the definition of Default Rate can only be challenged if its mistaken interpretation was (a) so unreasonable that no reasonable person could have considered it to be correct, or (b) lacking in good faith. That obviously feeds back into Issue 11.

197. As it seems to me, it is best to separate out the narrower point about "manifest error" from the broader point as to challenges on grounds of errors of interpretation.

198. As to the narrower point ("manifest error"), the Administrators consider that it would be helpful for the Court's answer to Issue 14 to identify manifest error as a free-standing category of defect in the certification. They contend that it is possible to conceive of circumstances in which a party, acting in good faith and in a manner that cannot be characterised as *Wednesbury* unreasonable, makes a slip in a calculation or inadvertently copies down a number incorrectly. If it is obvious that the payee has simply made a mistake, it appears to be agreed that the certification should not stand. Since there is no doubt that manifest error will vitiate a calculation, the Administrators consider that it would be helpful for the Court so to declare.

199. GSI is the principal opponent of the submission that there should be wording specifically to state that a certificate can be challenged for manifest error. The SCG now appears to support GSI. On the narrow point as to the overlap between manifest error and irrationality or lack of good faith, it contends that if the phrase adds nothing to the test of rationality and good faith then it is pointless and confusing to promote it and include it in any declaration, whereas if it is does there is neither any basis for its interpolation nor is it sensible to do so. GSI submits that while a test based on rationality is easily stated and (at least as a matter of law) easy to apply, a test based on manifest error is not. GSI suggests that there would be "limitless scope for argument about whether a given point is a relevant "error" and whether it is "manifest", and the addition of such a test would badly undermine the certainty that the certification process aims to offer".

200. Wentworth initially supported the Administrators in their desire for reference to be made to "manifest error", but on the limited basis that if "a manifest error would justify the challenge on the ground of a lack of rationality or good faith, then it would assist the Administrators to record that aspect as a separate declaration". At that stage, however, Wentworth appears to have perceived the issue as simply one of clarifying for the avoidance of doubt that a challenge for manifest error was permissible, as an aspect of the agreed exception to the conclusiveness of a certification in the event of irrationality or lack of good faith.

201. However, in his oral submissions, Mr Zacaroli modified Wentworth's position and submitted that on analysis a numerical or arithmetical error such as the Administrators had in mind would simply render the purported certificate provided not a proper certificate at all, since "the cost of funding is not stated, it is something else that has been stated". On that basis, Mr Zacaroli submitted that the correct approach was to fashion wording which permitted a certificate to be challenged in all cases of a

demonstrable error of fact rendering that certificate something not within the language, whether or not manifest.

202. In that way, Mr Zacaroli also sought to bolster and extend his more fundamental argument in favour of the control mechanism being in effect strict construction of the scope of the cost of funding language, rather than the subjective and more intangible standard of rationality and good faith. He melded his argument as to the effect of factual error with his argument that a relevant payee could not rely on a certificate based on a method of funding not within the scope of the language.

203. Further, Mr Zacaroli, perhaps somewhat opportunistically, embraced wording which had been suggested by GSI to provide, if (contrary to its own view) it were thought necessary to refer to a challenge based on the scope of the definition, that a relevant payee's certification of its costs should be open to challenge if it

> "does not fall within the scope of the expression "cost…if it were to fund or of funding the relevant amount", as those words may be construed by the Court."

Mr Zacaroli submitted that such wording would rightly permit, on his analysis, challenge to any certification based on error (whether or not "manifest").

204. This was not GSI's intention. Mr Foxton clarified that the wording was intended to encapsulate GSI's recognition that a certification must fall within the definition of Default Rate, as properly interpreted by the Court. Both GSI and the SCG accept that it is not sufficient that the certifying party believes that its certified cost of funding falls within the definition, if (applying the Court's proper construction of the definition) it does not actually do so. Mr Foxton made clear that the wording was not intended to permit through the back door, as it were, a challenge whenever some error of fact could be identified.

205. As Mr Foxton put it in his submissions in reply to Mr Zacaroli's modified position:

> "…this is a very significant development of Wentworth's position in relation to the circumstances in which the certification is binding…
>
> …
>
> On any view, an attempt to take issues of fact entirely outside the presumptive effect given to the certificate, we say, would effectively destroy the finality that the process is intended to give, and involve a recognition of a very significant exception under the ISDA form which certainly, as far as we have been able to consider it since we heard this point developed today, does not find recognition in allied areas of the law which consider issues of contractual discretion or certification. The idea you get an untrammelled ability to investigate errors of fact is, we say, a heterodox submission for provisions of this kind."

206. I accept Mr Foxton's submissions in relation to Mr Zacaroli's modified position. To permit challenge to certification on the basis of any error of fact, manifest or not, would undermine the purpose of the process, and be inimical to the special emphasis understandably placed on certainty in the architecture of the ISDA Master Agreements. Subject to the issue raised in relation to manifest error, in my view, a process of certification is to be accepted, at least in a context such as this, to preclude challenge otherwise than for the purpose of ensuring that the discretion contractually vested in the certifier is not abused or polluted by lack of good faith, or irrationality: and see *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] Bus LR 2304.

207. That brings me back to the original dispute as to the inclusion of wording to enable challenge on the basis of manifest error. In my view, it is inconceivable that the draftsmen intended to preclude challenge to a certificate in circumstances where that certificate is shown to have been founded on or infected by a manifest numerical or mathematical error. I agree with the Administrators that such an error might not with certainty fall within the accepted exceptions to conclusiveness of irrationality and bad faith. I do not agree that an express term is the only basis on which a further limited exception can be founded; it is to be interpolated as plain and obvious in all the circumstances. I think language to make this further exception clear in the declaration to be granted should be fashioned. I agree however, that the phrase "manifest error" without restricting the nature of the error to numerical or mathematical error would go beyond implication into refashioning.

208. To summarise my conclusions as to Issue 14, therefore:

(1) Provision should be included expressly to recognise the permissibility of challenge to certification on the ground of manifest numerical or mathematical error.

(2) Consideration is to be given to appropriate wording to recognise also the permissibility of a challenge based on the scope of the definition, such as that suggested by GSI.

Issue 15

209. Issue 15 is:

> *"If the answer to question 14 is that the relevant payee's certification of its cost of funding is not conclusive and one of the requirements in (i) to (iii) set out in that question applies, where does the burden of proof lie in establishing, and what is required to demonstrate, that a relevant payee has or has not met such requirement?"*

210. The answer to Issue 15 is largely agreed. The agreed position is that the defaulting party (if it seeks to challenge the relevant payee's certification of its cost of funding) bears the burden of proving, on the balance of probabilities, that the relevant payee's certification has not met the relevant requirements.

211. The remainder of Issue 15 is in effect determined by my answers to Issue 14.

Issue 16

212. Issue 16 asks whether only the relevant payee (in accordance with the meaning of such term determined pursuant to Issue 10 above), or another party (whether authorised by the relevant payee or not) can provide certification of the cost of funding and, if the former, what the position should be if the relevant payee is not capable of providing such certification (for example because it has been wound up or dissolved).

213. The Respondents for the purposes of this Issue are the SCG and Wentworth. This is not one of the Issues in respect of which GSI was joined.

214. Issue 16 is also agreed. The agreed position is that the relevant payee and anyone expressly or impliedly authorised by the relevant payee can provide certification of the cost of funding and where such certification is not possible, the Court will put itself in the shoes of the relevant payee to determine what decision it would have made had it determined its cost of funding properly.

Issue 18

215. Issue 18 is whether the power of a party under section 7(b) of the 1992 Form to transfer any amount payable to it from a Defaulting Party under Section 6(e) without the prior written consent of that party included the power to transfer any contractual right to interest under that agreement.

216. The Respondents for the purposes of Issue 18 are the SCG and Wentworth. This is not one of the Issues in respect of which GSI was joined.

217. Issue 18 is agreed. The agreed position is that the power of a party under section 7(b) does include the power to transfer any contractual right to interest under that agreement.

Issue 10

218. Before addressing Issue 19, which relates to the application of New York law, I now return to Issue 10, consideration of which I had deferred.

219. Issue 10 arises in the context of the provisions of the ISDA Master Agreements governing the transfer of rights and concerns the meaning of the phrase "*relevant payee*" in the definition of Default Rate where such a transfer has occurred. More specifically, Issue 10 asks:

> *"Whether, on the true construction of the term "Default Rate" as it appears in the ISDA Master Agreement, the "relevant payee" refers to LBIE's contractual counterparty or to a third party to whom LBIE's contractual counterparty has transferred (by assignment or otherwise) its rights under the ISDA Master Agreement."*

220. The Administrators have stressed the importance to them of knowing the answer to this issue because, in numerous cases, LBIE's counterparties have sold their claims against LBIE to third party purchasers, pursuant to the express transfer rights in the

ISDA Master Agreements, in circumstances where the "*Default Rate*" of interest was continuing to run. The persons who will be claiming interest are those third party purchasers, in their capacity as assignees of the claims against LBIE.

221. Section 7 of the 2002 Form of Master Agreement provides:

> "*Subject to Section 6(b)(ii) [i.e. Transfers to Avoid Termination Events] and to the extent permitted by applicable law, neither this Agreement nor any interest or obligation in or under this Agreement may be transferred (whether by way of security or otherwise) by either party without the prior written consent of the other party, except that:-*
>
> *(a) a party may make such a transfer of this Agreement pursuant to a consolidation or amalgamation with, or merger with or into, or transfer of all or substantially all of its assets to, another entity (but without prejudice to any other right or remedy under this Agreement); and*
>
> *(b) a party may make such a transfer of all or any part of its interests in any Early Termination Amount payable to it by a Defaulting Party, together with any amounts payable on or with respect to that interest and any other rights associated with that interest pursuant to Sections 8 [Contractual Currency], 9(h) [Interest and Compensation] and 11 [Expenses].*
>
> *Any purported transfer that is not in compliance with this Section 7 will be void.*"

222. Section 7 is in identical terms in the 1992 Form, save that (i) the words "*and to the extent permitted by applicable law*" do not appear in the first line and (ii) the language of sub-paragraph (b) differs, being "*a party may make such a transfer of all or any part of its interest in any amount payable to it from a Defaulting Party under Section 6(e)".*

223. The change from the 1992 Form is explained in the 2002 *User's Guide* (p.30) as follows:

> *"Also, Section 7 now makes it clear that a Non-defaulting Party may transfer, together with its interest in any Early Termination Amount payable by a Defaulting Party, any amounts payable with respect of that interest pursuant to Sections 8, 9(h) and 11."*

224. The question at the heart of Issue 10 is who, for the purposes of the definition of "*Default Rate*", is to be treated as the "*relevant payee*" following assignment/transfer pursuant to the provisions of section 7 of the ISDA Master Agreements.

225. The phrase "*relevant payee*" appears only in the definition of Default Rate and is not itself a defined term. It is, therefore, necessary to ascertain its meaning from the relevant Master Agreements construed in context as a whole.

226. Both the 1992 and 2002 Forms define the term "Default Rate" to mean:

> *"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".*

227. The "*Default Rate*" is capable of applying in three distinct circumstances:

(1) prior to an Early Termination Date, where a party defaults on its payment obligations under Section 2(a)(i): see Section 2(e);

(2) following an Early Termination Date following an Event of Default, on the amount due by a Non-defaulting Party (or indeed either party following a Termination Event) under Section 6(e), as from the date on which the Section 6(d) notice becomes effective: see paragraph (b) of the definition of Applicable Rate; and

(3) following an Early Termination Date following an Event of Default, on the amount due by a Defaulting Party under Section 6(e): see paragraph (a) of the definition of Applicable Rate.

228. In two out of those three circumstances, there is no possibility of the relevant amount to which the Default Rate is to be applied being assigned to any third party, absent the consent of the other party. That is because Section 7(b) permits a transfer only of an amount due from a Defaulting Party. "*Defaulting Party*" is defined as a party in respect of whom there has occurred an Event of Default: see Section 6(a). Accordingly:

(1) interest under Section 2(e) on amounts due under Section 2(a)(i) is payable only prior to an Early Termination Date, is therefore not due from a Defaulting Party, and is not transferrable under Section 7(b); and

(2) neither the amount due under Section 6(e) from a Non-defaulting Party, nor interest on that amount, is transferrable under Section 7(b).

229. For the purpose of Issue 10, then, the Court is required to determine whether, after a transfer which is permitted by section 7 of the ISDA Master Agreements after default, the phrase "*relevant payee*" in the definition of Default Rate refers:

(1) only to the original contractual counterparty (as the Administrators and Wentworth contend). If that is the case, the Default Rate definition requires the assignee to certify the original contractual counterparty's cost of funding the relevant amount for the entire period for which that amount is outstanding; or

(2) to whoever is entitled to receive the relevant amount from time to time (as the SCG contend, this not being an issue on which GSI advanced separate argument). If that is the case, the Default Rate definition requires the

assignee to certify the cost of funding of whichever entity or person is entitled to payment of the Section 6(e).

Wentworth's arguments on Issue 10

230. Wentworth's arguments (which the Administrators appear to support) in elaboration of its contention that "*relevant payee"* means whichever of the two contracting parties to the ISDA Master Agreement is entitled to receive the relevant payment, and does not extend to an assignee of the right to payment under Section 6(e), can be summarised as follows.

231. First, as explained above (in paragraphs [227 to 228]), in two out of the three circumstances in which the term *"relevant payee"* is intended to apply it can only refer to either party to the agreement: at least in those contexts, the draftsman has deployed the phrase to identify which of the two parties to the original agreement is entitled to receive the payment to which the Default Rate applies. In the absence of any express definition, there is no reason to think that the term *"relevant payee"* was intended to have a different meaning in circumstances where the Default Rate applies to a payment which is transferable under section 7(b): the fact that in two out of the three circumstances in which the Default Rate is to be applied the term is unambiguously intended to identify which of the two parties to the original agreement is owed the relevant amount suggests that it is intended to perform the same function, and have the same meaning, in the third circumstance.

232. Secondly, all that section 7(b) enables is the transfer by a party to the agreement of all or any part of its interest in any amount payable "*to it*" from a Defaulting Party under section 6(e). Interest at the Default Rate on an amount due under Section 6(e) payable <u>to</u> a party to the ISDA Master Agreement is calculated by reference to that party's cost of funding, or if it were to fund, the relevant amount. Accordingly, the right that is transferred is the right to receive interest by reference to the original party's cost of funding.

233. The SCG's construction of "*relevant payee*", which includes any person to whom the right under Section 7(b) is transferred, would require the phrase "*any part of its interest in the amount payable <u>to it</u>*" to include interest at a rate calculated by reference to the (higher) cost of funding of the transferee. Such a higher rate of interest could never have been payable to the transferor. Accordingly, it is not capable of falling within the parameters of that which can be assigned under Section 7(b).

234. The SCG suggest that the wording in Section 7(b) ("*<u>to it</u>*") refers not to interest on the amount payable under Section 6(e) but only to the Section 6(e) amount itself. Wentworth rejects that argument. It submits that the definition of that which is transferable by a party under Section 6(e) of the 1992 Form is "*all or any part of its interest in any amount payable to it from a Defaulting Party under Section 6(e)*". A party's "*interest*" in any amount payable to it under Section 6(e) encompasses the right to interest on such amount. Indeed, if the SCG's argument were correct, then there would be no right to transfer the right to interest on the Section 6(e) amount at all, given that the limited exceptions to the general prohibition on the transfer of any interest in or under the ISDA Master Agreement are those contained in Section 7(a) and (b). On the contrary, Wentworth accepts that the right to interest on the amount

payable under Section 6(e) is transferable within Section 7(b), notwithstanding the lack of express reference to such interest and, accordingly, the words "*payable to it*" in Section 7(b) encompass both the principal amount and interest.

235. Wentworth accepts that the wording of the 2002 Form is different, in that interest payable on the amount due under Section 6(e) is separately identified as being transferable. However, it submits that the words "*any amounts payable on or with respect to that interest*" should be read as referring to the amounts payable to the counterparty referenced by the words "*any part of its interest in any Early Termination Amount payable to it*" in the earlier part of the clause. Mr Zacaroli pointed out that, as noted above, the 2002 *User's Guide* refers to the additional wording in Section 7(b) as clarification of the position under the 1992 Form; there is certainly no suggestion in the 2002 *User's Guide* (or any other ISDA material, text book or case) that the change was intended to produce a radically different result or to impose a substantially greater credit risk on the parties to the agreement than under the 1992 Form.

236. Thirdly, Wentworth submits that the SCG's construction of "*relevant payee*" cuts directly across the overall purpose of the restriction on transfers, and the limited exceptions to it, which is the protection of each party against unknown risks, in particular credit risks, through being forced to face, as counterparty, an unknown entity chosen solely by its original counterparty.

237. One of the risks a party undertakes when entering into an ISDA Master Agreement (in either form) is the risk that it will be required to pay interest calculated by reference to the cost to its counterparty of funding the relevant amount. In this way it is exposed to the credit standing of its counterparty. That is a risk which it can manage so far as its contracting counterparty is concerned: it can choose whether or not to contract in the first place. If the rate of interest which a party has to pay upon its default depends upon the credit standing of potentially anyone to whom its counterparty transfers the right to payment under Section 6(e), then the party is exposed to wholly unknown and unmanageable credit risks.

238. Wentworth emphasises that the objective of insulating each party to the original agreement from such risks is plain from:

(1) the limited exceptions to the general prohibition of transfer/assignment; and

(2) the Merger Without Assumption and Credit Event Upon Merger provisions in Section 5, which prevent the original party being exposed to a counterparty with worse creditworthiness than expected.

239. Wentworth also seeks to rely on the historical antecedents of the 1992 Form, and in particular its fore-runner, the 1987 Interest Rate and Currency Exchange Agreement ("the 1987 Agreement"). The 1987 Agreement contained a definition of Default Rate that was identical to that in the 1992 Form, and thus required the "*relevant payee*" to certify its cost if it were to fund or of funding the relevant amount. It also contained a general prohibition on transfer of either party's rights under the 1987 Agreement, but did not include any provision equivalent to Section 7(b) of the 1992 Form, permitting the transfer of the net sum arising on termination following close-out netting. Accordingly, under the 1987 Agreement, "*relevant payee*" could only mean

whichever of the parties to the 1987 Agreement was entitled to be paid the relevant amount.

240. Wentworth contends that the sole purpose of introducing the provision at Section 7(b) of the 1992 Form was to facilitate certain market transactions in which the amount due under Section 6(e) was transferred as part of another financing transaction. That purpose is achieved by Wentworth's construction of "*the relevant payee*". It was no part of the purpose of introducing the right to transfer the amount due under Section 6(e) to expose each party to a new, un-bargained for and unknown credit risk of any third party to whom the original counterparty chose to transfer the right to payment.

241. Fourthly, Wentworth supports its construction by reference to what it described as a well-established principle of general law that an assignee cannot recover more against the debtor than the assignor could have recovered.

242. Mr Zacaroli referred me in this context to text books (*Snell's Equity* 33rd ed. at 3-027 and *Chitty on Contracts*, 31st ed. at 19-074) and various authorities, including *Dawson v Great Northern & City Railway Co* [1905] 1 KB 260, *Offer-Hoare v Larkstone Ltd* [2006] EWCA Civ 1079, *Linden Gardens Trust Limited v Lenesta Sludge Disposals Limited* 57 BLR 57 (in the Court of Appeal) and *Equitas Limited, v Walsham Brothers & Company Limited* [2013] EWHC 3264 (Comm) at [127]-[133].

243. The summary in *Snell's Equity* 33rd ed. at 3-027 suffices for present purposes:

> "In general, an assignee cannot recover more from the debtor than the assignor would have. The purpose of the principle is to prevent the assignment from prejudicing the debtor. This would happen if, for example, he had to pay damages to the assignee that he would not have had to pay to the assignor if the assignment had not taken place."

244. Although Mr Zacaroli accepted that this principle of law is necessarily subject to express contrary contractual agreement, he submitted that there is no language, let alone clear language, to that effect in the ISDA Master Agreements; and that in the absence of clear language to contrary effect, the general principle of law provides strong support for the conclusion that "*relevant payee*" in the definition of Default Rate does not include an assignee of the right to payment under Section 6(e). He submitted that is because the general law provides an essential part of the background circumstances against which the contract is to be construed. Thus:

(1) To have regard to the general law as part of the relevant background to a contract is reasonable especially in circumstances in which the parties have expressly chosen that law to govern their contract: see Lewison, *The Interpretation of Contracts* 5th ed. at 4.06:

> "Parties do not make contracts in a legal vacuum. They always negotiate against the background of the law. It is, therefore, reasonable to suppose that they take into account the general law in reaching their ultimate consensus. And, accordingly, the proper interpretation of their agreement is

> properly influenced by the legal background against which it is made."

(2) The principle was applied by the Court of Appeal in *The World Symphony* [1992] 2 Lloyd's Rep 115, in construing the terms of a charterparty in order to determine whether it permitted the charterers to order the vessel to undertake a round voyage which on no view would end before the expiration of the period of the charter. Lord Donaldson M.R. (in a judgment with which the other members of the Court agreed) concluded that the charterparty did not permit such a voyage, and noted that:

> "[I]t is for the parties to give expression to the terms of their bargain and this always has to be done against a background of general law and accepted principles, such as the prima facie risk of loss by delay in performance under a time-charter falls upon the charterer."

245. Fifthly, Wentworth submits that the SCG's preferred construction could lead to perverse consequences which cannot have been intended and which do not arise on Wentworth's own construction:

(1) If the relevant payee means whoever has the right to payment under Section 6(e), then the amount of interest payable would be subject to continual fluctuation depending on the cost of funding position of each successive transferee, with the cost of funding of each successive transferee being applied to the period during which it possessed the claim.

(2) Moreover, it would place the paying party at the mercy of debt trading conducted solely for the purpose of extracting as high a rate of interest as possible. Thus, for example, it would incentivise potential purchasers to invest in claims owed by ISDA defaulting parties via shell companies, set up in such a way so as to enable them to assert as high a cost of funding as possible. The greater the shell entity's cost of funding, the greater the interest payable by the defaulting party, and the greater the return on the purchaser's investment.

The SCG's arguments on Issue 10

246. In contending that "*relevant payee*" in the Default Rate clause is capable of being read and in the context should be construed as meaning whichever person or entity was or is entitled to receive payment of the "*relevant amount*" from time to time, the SCG seek to contradict each of Wentworth's arguments, and contend that it is their construction which attributes the ordinary meaning to the disputed phrase and which reflects commercial sense. The SCG identify anomalies in Wentworth's construction, and urge focus on the words of the agreements, and caution in the application of general principles of law where the parties have so carefully sought to regulate their relationship and apportion risks contractually. The SCG's arguments can be summarised as follows, tracking as far as practical the sequence of Wentworth's contrary arguments.

247. The SCG's starting point is the ordinary meaning of the constituent words. Thus they submit that:

(1) The word "payee" should carry its ordinary meaning of "a person to whom payment is, or is to be, made" (Stroud's Judicial Dictionary, 8th ed.).

(2) The word "*relevant*" suggests that, in respect of any outstanding amount, there may be two or more potential payees such that it is necessary to identify the payee who is most closely connected to, or appropriately associated with, the payment in question (by reason of being the payee entitled to receive the payment from time to time).

248. Mr Dicker stressed that the definition of Default Rate refers to the cost "*to the relevant payee*" and not to a, or the relevant, "*party*".

249. In specific answer to Wentworth's contention that under the Master Agreements there are circumstances in which interest is payable at the Default Rate by one *party* to the agreement to the other *party* to the agreement, the SCG submit that, to the contrary, these provisions support the SCG's position and indicate that "*relevant payee*" is meant to carry its ordinary meaning of a person to whom payment is to be made. Mr Dicker relied especially on the following:

(1) The 1992 and 2002 Forms each contain separate provisions governing interest payable before and after the designation of an Early Termination Date.

(2) The provisions requiring payment of interest at the Default Rate prior to the designation of an Early Termination Date uniformly specify, in terms, that such interest will be paid "*to the other party"* (see Section 2(e) of the 1992 Form; Section 9(h)(i) of the 2002 Form).

(3) By contrast, the provisions requiring the payment of the Default Rate *after* the designation of an Early Termination Date – the situation here – uniformly *omit* any such reference (see Section 6(d)(ii) of the 1992 Form; Section 9(h)(ii) of the 2002 Form).

(4) This distinction corresponds to the fact that the Default Rate on amounts due after designation of an Early Termination Date may be payable to a "*payee*" who is not a "*party*" by virtue of the freedom to assign without counterparty consent under Section 7(b) of both Forms.

250. Furthermore, the SCG contend that the premise of Wentworth's reliance on the concept of "*party*" is in any event incorrect: it is, they submit, simply not the case that every reference to "*party*" in the Master Agreements is necessarily limited to the original contracting parties. The SCG relied on the following as examples:

(1) A transfer by reason of consolidation, amalgamation or merger for the purpose of Section 7(a) of the Master Agreements may mean that the original "*party*" ceases to exist or has no ongoing interest in the agreement (even though it continues to govern outstanding Transactions). "*Party*" as

used elsewhere in the Master Agreements must in such a scenario be capable of extending to the transferee following such a transfer.

(2) A transfer pursuant to Section 7(b) of the 2002 Form may include all or any part of the original counterparty's interest in any Early Termination Amount, as well as "*any other rights associated with that interest pursuant to Sections 8, 9(h) and 11*":

(a) Where that has occurred, the right of any "*party*" to receive payment in the Contractual Currency (and any corresponding obligation to refund an excessive payment) pursuant to Section 8 ought to be capable of extending to the assignee. "*Party*" for the purpose of, for example, Section 8(d) ought also to extend to the assignee as the entity which will have suffered any loss if payment is not made in the Contractual Currency; and

(b) The obligation of a Defaulting Party under Section 11 to indemnify and hold harmless the other "*party*" for and against all reasonable out-of-pocket expenses, including legal fees, execution fees and Stamp Tax incurred by such other "*party*" by reason of the enforcement and protection of its rights under this Agreement must, in light of the express reference to Section 11 in Section 7(b), be capable of extending to the assignee's own legal fees, execution fees and other reasonable out-of-pocket expenses.

251. Secondly, and as may be apparent already, the SCG reject as misplaced Wentworth's reliance on the "*to it*" language of section 7(b) in the 1992 Form. They contend that neither Section 6(e) of that agreement (the only section cited in Section 7(b)), nor Section 7(b) itself expressly addresses the issue of interest. Rather, where the amount payable under Section 6(e) upon early termination is assigned under Section 7(b), the assignee's right to interest on that amount results from Section 6(d)(ii), which provides, in substance, that interest on the Early Termination Amount calculated under Section 6(e) will be paid "*together with*" that amount – without any limitation on the person or entity to whom this combined payment will be made.

252. Furthermore, Mr Dicker submitted that the position is made express under the 2002 Form, which provides that a party is entitled to transfer its interest in any Early Termination Amount "*payable <u>to it</u> by a Defaulting Party, together with any amounts payable on or with respect to that interest…*" (Wentworth's emphasis). Although the phrase "*to it*" follows and qualifies the phrase "*Early Termination Amount payable*", the phrase does *not* appear after the word "*payable*" in the subsequent phrase "*all amounts payable on or with respect to that interest and any other amounts associated with that interest…*". An assignment under Section 7(b) of the 2002 Form clearly refers to *any* right to interest associated with the assigned right to the Early Termination amount, and not simply a right to interest *"payable to it*" (i.e. the original counterparty). The SCG submit that the same is true of rights in respect of currency losses under Section 8 and expenses under Section 11, both of which expressly pass to the assignee under Section 7(b).

253. As to Wentworth's (third) argument centred on the purpose of the restrictions on transfer, and risk allocation, the SCG counter argue that if Wentworth's and the

Administrators' construction of "*relevant payee*" was correct, the consequence would be that an assignment between a Non-defaulting Party with a high cost of funding, and an assignee with a lower cost of funding, would require the payor to continue to pay the Default Rate based on the high cost of funding, irrespective of the fact that such cost was no longer being borne by the assignor and irrespective of the fact that the assignee was suffering loss at a lower level (reflecting its lower cost of funding).

254. The SCG submit that there is no unfairness or lack of commerciality in construing "*relevant payee*" to mean the person entitled to payment of the sum on which the Default Rate is payable from time to time. Further, and generally as to risk allocation, if the original contracting parties wished to avoid this possibility, assignment could have been prohibited or made subject to a requirement for consent in every instance. The Defaulting Party can also avoid any continuing liability to pay the Default Rate (including any risk of paying cost of funding by reference to the assignee's position) by paying what it owes.

255. The SCG relied also on the practical commercial difficulties which would be caused by Wentworth's construction, since it would require an assignee to certify the original counterparty's cost of funding potentially in respect of a period of years after the original counterparty has disposed of its interest in the relevant amount and in circumstances where the real cost of the Defaulting Party's continued failure to pay is now being borne by the assignee.

256. In relation to Wentworth's fourth argument, based on generally accepted principles relating to the law of assignment, the SCG primarily contend that it would be wrong to approach the question of construction raised by assuming that the parties intended to mirror any general principle of common law, or that they are to be treated as having done so unless they indicated to the contrary. They submitted that this was particularly important in circumstances like the present case where:

(1) the ISDA Master Agreement may be governed by New York law, rather than by English law; and

(2) even where the relevant ISDA Master Agreement is governed by English law, the parties, who may well be based in a civil law jurisdiction, may have little or no knowledge or understanding of common law principles of assignment and there is no reasonable basis for treating them as if they did.

257. Secondly, the SCG submit that the result for which they contend is consistent with general principles on the basis that:

(1) Such general principles themselves recognise that the proposition that an assignee cannot recover greater damages than would be recoverable by the assignor (as expressed in *Dawson v Great Northern & City Railway Co* [1905] 1 KB 260; *Offer-Hoar v Larkstone Ltd* [2006] EWCA Civ 1079 at [38] to [42], [48] to [53], [75] to [83] and [86]) is necessarily subject to the terms of the contract and the assignment. If a contract, properly construed, is intended to be of benefit to all parties who may subsequently acquire an interest in the contractual rights because the original parties anticipated future assignments, the original parties cannot complain about the existence of claims for loss suffered by the assignees.

(2) In every such case, a question arises as to the scope of the rights created by the original contract which are the subject of the assignment. An assignment of contractual rights may be such as to limit the ability of the assignee to recover anything other than the loss that the assignor would have suffered: see, for example, *Linden Garden Trust Ltd v Lenesta Sludge Disposals Ltd* (1992) 57 BLR 57 (CA) at 92 (the assignee was only able to recover for the assignor's loss, and evidence of its own loss would only assist in quantifying the assignor's loss). Alternatively, the contractual rights assigned may in substance be such that the measure of recoverable damages varies over time and depends on the factual position of the particular assignee.

(3) Thus, for example, where the contractual rights assigned pursuant to a contract contain an agreed quantification mechanism (applicable whether or not there has been assignment), such that the amount contractually payable may vary from time to time by reason of the circumstances then existing, the fact that an assignee may claim a greater amount by reference to the contractually agreed quantification mechanism than the assignor could have claimed if there was no assignment is entirely consistent with the general principle. If the contract does not prevent assignment, there can be no objection to the operation of the contractual mechanism as it applies to the assignee. In such a case, there is no relevant "*prejudice*" arising from the assignment: the assignee is not recovering damages "*greater*" in any relevant sense; rather it is simply recovering the damages that are provided for by the contractual mechanism contained in the original agreement.

(4) In other words, there is a difference, as was said by Millett LJ in *L/M International Construction Inc (now Bovis International Inc) and another v The Circle Ltd Partnership* 12 July 1995 at 14, between the heads of damage which can be recovered (which are subject to the general principle at common law) and the measure of damage (which is not).

(5) This may be illustrated by *Lordsvale Finance plc v Bank of Zambia* [1996] 3 All ER 156, which concerned a provision for calculating the default rate formula in a syndicated loan agreement (which was expressly based on a debt cost of funding component for each lender, namely "*the cost as determined by such Bank of obtaining dollar deposits (from whatever source or sources it shall think fit) to fund its participation in the unpaid sum for such period or periods as the Agent may from time to time determine*"). The definition of "*Bank*" included any of its assignees. The specific issue was whether, where the loan in question had been acquired by the claimants by way of assignment at a discount, interest should be calculated based on the face amount of the debt or, as the defendant argued, on the amount paid by the assignee (see 164c-e). No point appears to have been taken as to whether the claimants were entitled to determine their own cost of obtaining dollar deposits, or were limited to the cost of the original Bank in that respect. On the contrary, the defendant's arguments proceeded on the basis that the assignee's costs were relevant, but had to be calculated with reference to the discounted amount actually paid for the loan (see 164b). There is no indication in the judgment of Colman J that the assignee was not entitled to claim default interest based on its own cost of obtaining dollar deposits.

(6) The remedy for the contractual counterparty, if it did not want to expose itself to the potential of a higher cost of funding being certified by an assignee pursuant to the terms of the agreement, was to modify the terms of the Master Agreement in order to prevent assignment without its consent. Alternatively, as in the case of certain of the LMA standard form documentation, the position of the assignee could be addressed expressly and recovery from the contractual debtor could be limited to the same extent that it would have been liable if there had not been an assignment[18]. LBIE did not take such steps and cannot complain about the consequences of not having done so.

258. As to the risk of perverse consequences and abuse asserted by Wentworth (in its fifth argument on Issue 10), the SCG contend as follows:

(1) Certification must, however, be rational and in good faith. Any risk of a deliberately excessive cost of funding is catered for by such requirements.

(2) Furthermore, an assignee with a high cost of funding will need to receive a correspondingly high Default Rate to compensate it for its high cost of funding. There is therefore no "*windfall*", so far as such an assignee is concerned, which it can share with the assignor. If the assignee does not receive its cost of funding, it will suffer a loss for which it will not be compensated.

(3) Accordingly, there should be no benefit for an assignor in effecting an assignment to an entity with a high cost of funding relative to any other entity, and no or no realistic potential for abuse arises.

(4) Correspondingly, if an assignor with a high cost of funding assigns to an assignee with a low cost of funding, the Default Rate will (on the SCG's construction) reduce so as to reflect that lower cost of funding. Wentworth and the Administrators may perceive the likelihood in the present case to be that assignees will certify costs of funding at a rate higher than the original contractual counterparty. But in other cases, the consequence of their argument will be to require the payor to pay the Default Rate at a level that exceeds the actual cost of funding, and therefore loss, being suffered by the assignee if that cost of funding is lower than the cost of funding of the original contractual counterparty.

(5) Ultimately, and in any event, there is no reason to conclude that those involved in drafting the Master Agreements would have had such concerns in mind, or that, as a result, they intended to ensure that the assignee could only recover the assignor's cost of funding.

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[18] See, for example, Clause 29(2)(f) of the LMA Senior Facilities Agreement (Leverage) which applies where there has been a change of lender.

Adjudication of Issue 10

259. As both parties agreed in point of approach, the question raised and its answer is essentially one of contractual interpretation. At heart, it turns on whether section 7 of the relevant ISDA Master Agreement permits and enables the transfer of a bundle of rights exercisable by and to be calculated according to the position of the transferee, or (more restrictively) only such rights as the transferor had calculated according to that transferor's position.

260. As previously noted, the wording of section 7 is different in the two versions. As Mr Zacaroli implicitly acknowledged, the wording of section 7 in the 2002 Form is more helpful to the SCG than the wording in section 7 of the 1992 version; and this was reflected in the fact that although all concerned accepted that the same meaning should be attributed to both versions, the SCG based their arguments on the 2002 version (which distinguishes between the Early Termination Amount payable and the interest and any other associated rights) and invited the same meaning for the 1992 version, whereas Wentworth started with the 1992 version (which refers generically only to the transferring party's interest in amounts payable under section 6(e)) and invited the Court to adopt the same meaning for the 2002 version.

261. In my judgment, and in agreement with Wentworth, the better construction is that section 7, in both versions of the Master Agreements, restricted the right of transfer to the amounts which had become payable and would become payable to the transferor as at the time immediately before the transfer, in each case measured according to the position of the transferor. Put figuratively, the transferee is entitled to the tree planted by the transferor and such fruit as had grown and would grow on it when transferred, and not to fruit of a different variety or quantity which might have grown had the transferee planted the tree.

262. As to the competing arguments of the parties, in summary, in my view:

(1) The wording in each of the versions, though capable of being construed in accordance with the SCG's submissions, more naturally refers to amounts receivable as distinct from rights exercisable, and confines that which can be transferred to amounts which would have been payable to the transferor.

(2) There is force in Wentworth's argument that consistency requires the phrase "*relevant payee*" to be accorded the same application in each of the contexts in which it appears, and thus to be construed as identifying which of the parties to the original agreement is entitled to payment.

(3) Further, I accept that the SCG's argument does entail that in all ordinary circumstances, there being a period of time between the early termination date and the date on which the amount payable under Section 6(e) is assigned, there will in effect be two "*relevant payees*", one before transfer and the other after it. It seems to me to follow that to cater for this the SCG's approach would require more substantial re-writing of the agreements than is warranted.

(4) I accept also Wentworth's submission that the purpose of the restriction on the right of transfer is to protect against unknown credit risks and that

purpose is undermined if the SCG's construction is adopted. Whilst there is also force in the SCG's argument that the parties are free to deal with risk allocation by specific provision, the default position contended for by Wentworth seems to me more likely to accord with the likely intentions of the draftsmen.

(5) Wentworth's construction also accords with the default position more generally established by ordinary principles to the effect that the transferee cannot usually recover more than the transferor could have recovered; and although the SCG sought to dissuade me from looking at the matter through the lenses of English and New York common law, I consider that the selection of those laws both permits and encourages their deployment.

(6) As to the competing arguments as to perverse consequences and potential abuse, I doubt that the control of certification would be effective, for the reasons given by Wentworth.

263. In conclusion as to Issue 10, in my judgment the term "*relevant payee*" refers only to LBIE's contractual counterparty and does not extend to a third party to whom LBIE's counterparty has transferred its interest in any amount payable to it under Section 6(e) of the relevant ISDA Master Agreement. For the avoidance of doubt, the answer is the same for both versions of the ISDA Master Agreement in issue.

Issue 19: whether answers different under New York law

264. Issue 19 is:

> *"Whether the answer to questions 10 to 18…is different if the underlying Master Agreement is governed by New York rather than English law."*

265. So far as I am aware, there is no authority in New York which considers the meaning of the expressions under consideration in Issues 10 to 13.

266. Neither the SCG nor Wentworth suggests that the answer to any of questions 10 to 18 for which they contend as a matter of English law would be any different if decided as a matter of New York law. Indeed, both of them contend that the ISDA Master Agreements are intended to be capable of being governed by either law and that it is likely that they were intended to have the same effect under both laws: accordingly each party relies on principles of New York law as lending weight to their analysis. GSI was not involved separately in the argument.

267. In those circumstances, there being no dispute as to the answer to Issue 19, it is sufficient for me to identify the principal conclusions of the experts on New York law who gave evidence and any possible differences of approach in reaching the same answer.

268. The principles of New York law as to the construction of contracts were largely matters of common ground between the experts (who in such circumstances were not called or cross-examined). These were summarised at paragraph 3-10 of the joint

statement of Robert S Smith ("Judge Smith", Wentworth's expert) and Neil B Cohen ("Professor Cohen", the SCG's expert) as follows:

(1) It is the Court's task to enforce the parties' agreement, not to reform it.

(2) The words used are considered the best evidence of the parties' intent.

(3) Extrinsic evidence (evidence outside the contract itself) is generally not admissible unless there is found to be an ambiguity. New York law takes a narrow view as to what constitutes an ambiguity.

(4) All contracts contain an implied covenant of good faith and fair dealing. The obligation of good faith and fair dealing includes a promise not to act arbitrarily or irrationally in exercising a discretion contemplated by the contract.

(5) An interpretation that renders the parties' agreement absurd is to be avoided.

(6) It is a principle of New York law that an interpretation of a contract that places one party at the mercy of another, or permits one party to take unfair advantage of the other, is not favoured (although Professor Cohen believes that the implied covenant of good faith and fair dealing largely prevents situations in which a party would be allowed to take such an unfair advantage).

269. It appears that New York law may be stricter in its application of the "four corners of the contract" principle and less prepared to consider the factual matrix except in cases of real ambiguity (in the narrow and strict sense of being inherent in the words rather than being conjured from the factual context) than is now the case in English law. That position may be closer to English law prior to its restatement by the House of Lords in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896. However, subject to one point as to the admissibility of predecessor versions (the 1987 version) of the relevant ISDA Master Agreements and certain differences of emphasis, neither party deployed, or contended the other was deploying, material which would be considered inadmissible under New York law; and, otherwise, it was common ground that the principles expounded under New York law are materially similar to English principles. Further, neither party suggested there was any such ambiguity as to justify stepping outside the four corners of the Agreements (the SCG noting that the New York courts have never thus far concluded that any provision of the ISDA Master Agreements is ambiguous in the requisite narrow sense).

270. The particular caveat relating to previous versions of the ISDA Master Agreements arises out of a disagreement between the experts as to the extent to which a New York court might have regard to the 1987 Agreement in the context of Issue 10 and the meaning to be given to "*relevant payee*". As recorded above (see paragraph [239]) one of Wentworth's arguments was that the fact that the term was used in the 1987 Agreement, but no assignment of the sum payable on close-out netting was permitted, supports the conclusion that the term is intended to refer to which of the counterparties is owed the relevant amount and not to any third parties.

271. Judge Smith (Wentworth's expert) considers that a New York court could consider the 1987 Agreement in construing "*relevant payee*" in the 1992 Form and 2002 Form, and cites a recent decision of the United States Bankruptcy Court for the Southern District of New York (*Lehman Brothers Holding Inc v Intel Corporation*) which supports his view. Professor Cohen (the SCG's expert) agrees that prior dealings between the parties to a contract may be relevant to interpretation of that contract, but notes that the predecessor version of the ISDA Master Agreement does not represent a prior dealing between LBIE and the parties here. He seeks to distinguish the *Intel Corporation* decision on the basis that it appeared to be a situation where the documentation between the parties (the 1992 Form and its *User's Guide*) explicitly referred to earlier forms.

272. Mr Zacaroli contended that the ground given by Professor Cohen for distinguishing *Intel Corporation* is a bad one, since Wentworth's argument (based on the 1987 Agreement) relies on page 30 of the 1992 *User's Guide* under the heading "Section 7", which explains the reason why the right of transfer under Section 7(b) "was added", which from the context (he submits) is clearly a reference to its being added to the provisions formerly contained in the 1987 Agreement.

273. Given the process of review, revision and explanatory notes to explain alterations which is undertaken in respect of successive versions of the ISDA Master Agreements I would find it surprising if broadly analogous forms likely to have been used as building bricks were inadmissible. However, although adding further support to Wentworth's construction and the answer to Issue 10 which I have given, I should perhaps make clear that I would have reached the same conclusion without reference to the 1987 Agreement.

274. Another difference between the experts which also relates to Issue 10 is the extent to which a New York court would have regard and attach weight to the existence of a principle of New York law, also reflected in section 9-404(a) of the New York Uniform Commercial Code ("NY-UCC"), to the effect that an assignee stands in the shoes of an assignor and can assert no greater entitlement than the assignor. (This, of course, mirrors the general or default position under English law, as discussed above.)

275. Judge Smith suggests that this would be given significant weight in deciding whether on the true construction of the ISDA Master Agreements an assignee should be entitled to an interest rate higher than the rate the assignor could have recovered. Professor Cohen takes a slightly different view, and suggests that under New York law the court is required to determine the meaning of the ISDA Master Agreement as between LBIE and the assignor, and *"does not authorize the application of a presumptive meaning of the agreement derived from the 'stand in the shoes' maxim if the agreement is not explicit as to the meaning of Relevant Payee*".

276. Wentworth clarified that it did not suggest that the "stand in the shoes" maxim requires a presumptive meaning to be given to the term *"relevant payee"*; and Professor Cohen did not contend it was irrelevant. The disagreement appears to be only as to the weight to be attached to this background consideration. I think it supportive; but again not such as to make the difference: I would have reached the same conclusion under both laws, even attaching no weight to the principle.

277. There is some disagreement also as to the weight to be given to the rule "*disfavoring an interpretation that places a party at the mercy of another or that permits one to take an unfair advantage of the other*". Judge Smith thinks that this would carry weight in the present context, while Professor Cohen thinks that the obligation of good faith and fair dealing already serves to prevent such unfair advantage. Once more, I do not think the difference is material: it may tend to support my conclusions under English law but not in any determinative way; and it has not upset the overall (agreed) conclusion that the answers are the same under both laws.

278. The only other difference between the experts which I should mention is as to the weight that a New York court would give to the Federal Court's decision in *Finance One v LBSF* 2003 WL 21638214 (SDNY 11 July 2003), and in particular to the statement that "*the ISDA explicitly precludes an issue of fact contest with regard to the proper default rate*".

279. The experts are agreed that the decision (being of a Federal Court) is not binding on a New York State Court, but could be of persuasive authority. Judge Smith considers that the decision would not be treated as persuasive in New York, in particular because it failed to have regard to the principles (under New York law) of fair dealing and to the obligation not to act irrationally or arbitrarily. Professor Cohen's disagreement is largely based on the principles of precedent, and on a suggested distinction between matters of discretion (which he accepts are subject to the principle not to act irrationally or arbitrarily) and matters of fact (which he suggests may only be subject to challenge on grounds of bad faith).

280. SCG concedes that the dispute may be less substantive than appears. To my mind, even if there may be relevant differences in similar contexts between a factual determination and the exercise of discretion, they are not material in the present context, taking into account the agreed position between the experts that the fetter on the certification process is, like that under English law, a requirement that the certifying party act in good faith and (to the extent that they are exercising a discretion) not arbitrarily or irrationally.

281. Overall as regards Issue 19, I see no reason to depart from the agreed position of the parties that the answers to the questions of interpretation posed would be the same in New York law as I have concluded they are under English law.

282. That concludes my analysis of the issues arising in respect of the 1992 and 2002 ISDA Master Agreements.

THE GERMAN MASTER AGREEMENT

283. I turn next to Issues 20 and 21, which relate to the provisions of the German Master Agreement ("the GMA"). The GMA is a standardised master agreement governed by German law which is utilised for financial derivatives transactions. Its provisions differ substantially from those of the ISDA Master Agreements, though it governs similar transactions and probably has similar objectives.

284. The Administrators have so far received 15 claims under the GMA aggregating approximately to £311 million. These claims will generate statutory interest at 8% per annum (that is the Judgment Acts Rate); but if a creditor can establish that its proved debt under the GMA has an applicable interest rate of higher than 8% per annum apart from the administration, then such creditor may be entitled to that higher rate.

Brief summary of Issues 20 and 21 and the competing arguments

285. The essence of the dispute between the parties which has given rise to Issues 20 and 21 concerns:

(1) the basis on and the time from which creditors are entitled under German law to compensation for delayed payment of a compensation claim arising under Sections 7 to 9 of the GMA following automatic termination of the agreement by reason or in consequence of the administration application in respect of LBIE (Issue 20);

(2) the nature and limitations imposed on such a claim as a matter of German law where there has been an assignment or transfer of the entitlement to a third party (Issue 21).

286. The SCG contend that the overall objective of the GMA is to replicate under German law, as best as possible, the manner in which the ISDA Master Agreement and its close-out netting provisions in particular are intended to operate. On the SCG's case, a party to a Master Agreement, who is entitled to payment of the close-out amount on termination, may be entitled to interest (as such or by way of '*further damage*' under the German Civil Code) reflecting the cost to it of funding the relevant amount, whether he was a party to an English or New York law governed ISDA Master Agreement or was a party to a GMA, and in each case such interest will rank as a rate applicable to the debt apart from the administration for the purposes of Rule 2.88(9).

287. Wentworth does not accept this. In addition to its main case on the ISDA Master Agreements it makes the point that the GMA does not make provision for any contractual entitlement to interest on the close-out amount which becomes due from LBIE following its termination; it follows that the GMA claims are very different to those made by creditors under the ISDA Master Agreements considered above.

288. The way in which the SCG seeks to overcome the absence of any provision in the GMA for interest on the close-out sum after termination is by developing a case based on section 288 of the German Civil Code (the "BGB"), a statutory provision which is engaged in circumstances where a party is in default of a payment obligation within the meaning of section 286 of the BGB.

289. In that context, the SCG acknowledge that whether "default" for the purpose of section 286 of the BGB has occurred in respect of any payment obligation of LBIE under the GMA before, as at, or after the commencement of the administration is a question of fact, which will need to be determined on a case by case basis. However, the SCG maintain that there is one generally applicable basis for default which it is appropriate for the Court to consider at this hearing. The SCG contend that default in respect of all close-out amounts due under the GMA occurred at the point when LBIE applied for an administration order (and at the same time that the close-out amount

became due) on the basis that LBIE had "*seriously and definitively refused performance*" of its obligations under the GMA by reason of applying for an administration order (which application was made on the basis that LBIE was unable to pay its outstanding debts at the time of making the application).

290. If such default at that point is established, section 288(1) of the BGB enables a party to claim interest at a rate of 5% above the basic rate of interest applicable during the period of the default. The basic rate of interest, which is addressed at section 247 of the BGB, has been set at a rate of less than 1% since 1 July 2009. Indeed, the rate has been a negative rate since 1 January 2013. Thus, the rate applicable under section 288(1) of the BGB would not give rise to a rate in excess of 8% per annum.

291. The SCG seek to overcome this further difficulty by relying also on section 288(4) of the BGB which provides that "*the assertion of further damage is not precluded*". The SCG contend that this constitutes a statutory provision which makes provision for an interest rate applicable to the proved debt under the GMA apart from the administration for the purposes of Rule 2.88(9).

292. Questions 20 and 21 relate to and track these contentions, both of which Wentworth rejects. Wentworth contends that the SCG's claims fall at the first hurdle, since there was no defaulted payment obligation, as required by section 286 of the BGB prior to LBIE's entry into administration and no default can occur thereafter. In any event, Wentworth contends that even if that is incorrect, the SCG cannot establish a default under section 286 of the BGB because the necessary precondition for a default to qualify for such purposes is a legally effective warning notice, and none was ever served; nor, it submits, can the SCG show fulfilment of another requirement, which is that the obligor "seriously and definitely refuses performance".

293. The answers to these questions depend on German law. That is, of course, a question of fact in the context of proceedings in England and it must be determined on the basis of expert evidence as to the relevant German law.

Expert evidence on relevant principles of German law

294. As to the relevant rules and principles of German Law expert evidence has been provided to me by:

(1) Professor Peter Mülbert ("Professor Mülbert"), who was instructed on behalf of the SCG and who (amongst his other posts, including a visiting professorship at Harvard Law School) is a professor of law at the Faculty of Law and Economics of Gutenberg Research College, and Director of the Centre for German and International Law of Financial Services at the University of Mainz;

(2) Dr Gero Fischer ("Dr Fischer"), who was instructed on behalf of Wentworth and who held office as a judge at the Federal Court of Justice in Germany (Germany's highest appellate court) from 1990 until his retirement in 2008, specialising in bankruptcy law, liability of attorneys and tax advisors, guarantees and the acknowledgement and enforceability of foreign decisions.

295. Each of these experts filed three reports (their first, reply and supplemental reports) and they agreed a Joint Statement. Their Joint Statement was incomplete in the sense that Professor Mülbert sought to add new points too late for these to be included. (I identify these points, and the other points in dispute between them, later.) The experts were called and cross-examined. Professor Mülbert gave his evidence in English. Dr Fischer gave his evidence in German.

296. Both experts are plainly distinguished lawyers; they were impressive and sought to, and did, give me much assistance. In the end, however, in the absence of determinative commentary or authorities, the findings of fact I must make must ultimately be based on my own analysis, applying as best I can what their guidance has taught me of the likely approach of a German court.

297. Before turning to address Issues 20 and 21 specifically, it may assist first to identify provisions of the GMA which are relevant to both.

Relevant provisions of the GMA

298. I take this synopsis of the relevant provisions of the GMA largely from Wentworth's skeleton argument, which was not suggested to me to be either inaccurate or contentious in this regard.

299. The GMA treats as a single agreement all derivative transactions (each referred to as a Transaction) entered into pursuant to its terms: see clause 1(2). The purpose and scope of the GMA is described in clause 1(1):

> *"In order to manage interest and exchange rate risks and other price risks arising within the scope of their business operations, the parties hereto intend to enter into financial derivatives transactions the object of which is:*
>
> > *i. the exchange of amounts of money denominated in various currencies or amounts of money calculated by reference to floating or fixed interest rates, exchange rates, prices or any other calculation basis, including average values (indices) relating thereto, or*
> >
> > *ii. the delivery or transfer of securities, other financial instruments or precious metals, or the performance of similar obligations.*
>
> *Financial derivatives transactions also include options, interest rate protection and similar transactions that require a party to render performance in advance, or a performance that is subject to a condition."*

300. Payment and performance of obligations falling due under a Transaction before the termination of the GMA are governed by clause 3. In summary:

(1) payment or performance is to be made on the due dates specified in the Transaction: see clause 3(1);

(2) all payments are to be made to the payee's account in the specified contractual currency: see clause 3(2);

(3) there is a netting of simultaneous payment obligations owed by one party to the other: see clause 3(3); and

(4) there is a provision for interest for late payment which operates prior to the termination of the GMA: see clause 3(4). Clause 3(4) provides as follows:

> *"If a party fails to make a payment in due time, interest shall accrue on the amount outstanding, until such amount is received, at a rate which shall be equal to the interbank interest rate charged by prime banks to each other for call deposits at the place of payment and in the currency of the amount outstanding for each day on which such interest is to be charged, plus the interest surcharge referred to in Clause 12 sub-Clause (3). The right to make further claims for damages is not hereby excluded."*

301. Clause 7 concerns the termination of the GMA. The relevant provisions are clause 7(2) which makes provision for automatic termination of the GMA and clause 7(3) which addresses the consequences of termination. They provide as follows:

> *"(2) The Agreement shall terminate, without notice, in the event of an insolvency. An insolvency shall be given, if an application is filed for the commencement of bankruptcy or other insolvency proceedings against the assets of either party and such party either has filed the application itself or is generally unable to pay its debts as they become due or is in any other situation which justifies the commencement of such proceedings.*
>
> *(3) In the event of termination upon notice by either party or upon insolvency (hereinafter called "Termination"), neither party shall be obliged to make any further payment or perform any other obligation under Clause 3 sub-Clause (1) which would have become due on the same day or later; the relevant obligations shall be replaced by compensation claims in accordance with Clauses 8 and 9."*

302. Clauses 8 and 9 make provision for the calculation and payment of a close-out amount in respect of the damages flowing from the termination of the GMA. Clause 8 requires a calculation by reference to actual or hypothetical replacement transactions. It provides as follows:

> *"Claims for Damages and Compensation for Benefits Received*

(1) In the event of Termination, the party giving notice or the solvent party, as the case may be, (hereinafter called "Party Entitled to Damages") shall be entitled to claim damages. Damages shall be determined on the basis of replacement transactions, to be effected without undue delay, which provide the Party Entitled to Damages with all payments and the performance of all other obligations to which it would have been entitled had the Agreement been properly performed. Such party shall be entitled to enter into contracts which, in its opinion, are suitable for this purpose. If it refrains from entering into such substitute transactions, it may base the calculation of damages on that amount which it would have needed to pay for such replacement transactions on the basis of interest rates, forward rates, exchange rates, market prices, indices and any other calculation basis, as well as costs and expenses, at the time of giving notice or upon becoming aware of the insolvency, as the case may be. Damages shall be calculated by taking into account all Transactions; any financial benefit arising from the Termination of Transactions (including those in respect of which the Party Entitled to Damages has already received all payments and performance of all other obligations by the other party) shall be taken into account as a reduction of damages otherwise determined.

(2) If the Party Entitled to Damages obtains an overall financial benefit from the Termination of Transactions, it shall owe the other party, subject to Clause 9 sub-Clause (2) and, where agreed, Clause 12 sub-Clause (4), a sum corresponding to the amount of such benefit, but not exceeding the amount of damages incurred by the other party. When calculating such financial benefit, the principles of sub-Clause (1) as to the calculation of damages shall apply mutatis mutandis."[19]

303. Clause 9(1) provides for the final payment of a single compensation claim to the Party Entitled to Damages. It provides as follows:

"Unpaid amounts and any other unperformed obligations, and the damages which are payable, shall be combined by the Party Entitled to Damages into a single compensation claim denominated in Euro, for which purpose a money equivalent in Euro shall be determined, in accordance with the principles set forth in Clause 8 sub-Clause (1) sentences 2 to 4, in respect of claims for performance of such other overdue obligations."

304. Clause 9(2) concerns a single compensation claim *against* the Party Entitled to Damage and the set-off of Counterclaims against that claim. That sub-clause provides:

[19] Clause 8(2) may be varied by certain elections provided for in the standard form GMA in clause 12(4).

> *"A compensation claim against the Party Entitled to Damages shall become due and payable only to the extent that such party does not, for any legal reason whatsoever, have any claims against the other party ("Counterclaims"). If Counterclaims exist, their value shall be deducted from the total amount of the compensation claim that is due and payable. For the purpose of calculating the value of the Counterclaims, the Party Entitled to Damages shall (i) to the extent that they are not payable in Euro, convert such Counterclaims into Euro at a selling rate to be determined, if possible, on the basis of the official foreign-exchange rate applicable on the day of computation, (ii) to the extent that they are not claims for the payment of money, convert them into a claim for damages expressed in Euro and (iii) to the extent that they are not yet due and payable, take them into account at their present value (also having regard to interest claims). The Party Entitled to Damages may set off the compensation claim of the other Party against the counterclaims calculated in accordance with sentence 3. To the extent that it fails to do so, the compensation claim shall become due and payable as soon as and to the extent that it exceeds the aggregate amount of Counterclaims."*

305. Clause 12 provides an option for the specification of an interest rate under clause 3(4) by the parties. There is, however, no other provision for interest in the GMA. In particular, and as I have previously noted, there is no contractual provision for interest in respect of the single compensation claim amount payable pursuant to clauses 8 and 9 following the termination of the GMA.

306. Further, it is apparent and was also agreed by the parties and their respective experts (see below) that the GMA does not expressly stipulate the date on which the single compensation claim falls due.

307. It is, in essence, these latter two matters, which the express terms of the GMA do not expressly address and thus leave open for determination in accordance with general rules and principles of German law, which have given rise to the issues now under consideration.

Relevant provisions of the BGB

308. Turning to the relevant provisions of the BGB, I can again largely repeat the synopsis provided in Wentworth's skeleton argument (which again was not suggested to be inaccurate or contentious in this regard), as follows.

309. Section 286 of the BGB addresses the issue of whether there has been a default in respect of a payment obligation:

> *"(1) If the obligor, following a warning notice from the obligee that is made after performance is due, fails to perform, he is in default as a result of the warning notice. Bringing an action for performance and serving a demand for payment in summary debt proceedings for*

recovery of debt have the same effect as a warning notice.

(2) There is no need for a warning notice if:

1. a period of time according to the calendar has been specified,

2. performance must be preceded by an event and a reasonable period of time for performance has been specified in such a way that it can be calculated, starting from the event, according to the calendar,

3. the obligor seriously and definitively refuses performance,

4. for special reasons, weighing the interests of both parties, the immediate commencement of default is justified."

310. The provisions of the BGB relevant to the interest payable on a defaulted obligation can be found at sections 288(1), 247 and 248:

(1) Section 288(1) provides that a defaulted money debt bears interest during the period of default at 5% per annum above the basic rate of interest:

"*Any money debt must bear interest during the time of default. The default rate of interest per year is five percentage points above the basic rate of interest.*"

(2) Section 247 makes provision for the basic rate of interest to which 5% is to be added under section 288(1). The basic rate of interest is presently -0.83%:

"(1) The basic rate of interest is [-0.83%][20]*. It changes on 1 January and 1 July each year by the percentage points by which the reference rate has risen or fallen since the last change in the basic rate of interest. The reference rate is the rate of interest for the most recent main refinancing operation of the European Central Bank before the first calendar day of the relevant six-month period.*

(2) The Deutsche Bundesbank announces the effective basic rate of interest in the Federal Gazette without undue delay after the dates referred to in subsection (1) sentence 2 above."

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[20] The zero rate reflects prevailing monetary policy in the Euro-zone, which supports negative interest rates in real terms.

(3) Section 248(1) outlaws agreements for the payment of compound interest:

> *"An agreement reached in advance that interest due should in turn bear interest is void."*

311. Section 288(4) provides that a claim for interest pursuant to section 288(1) does not prevent a claim for *further damage* suffered by reason of late payment of the money debt. It provides as follows:

> *"(4) The assertion of further damage is not excluded."*

312. The key provisions relevant to claims for damages are sections 249, 252 and 280:

(1) Section 249 provides as follows:

> *"(1) A person who is liable in damages must restore the position that would exist if the circumstance obliging him to pay damages had not occurred.*
>
> *(2) Where damages are payable for injury to a person or damage to a thing, the obligee may demand the required monetary amount in lieu of restoration. When a thing is damaged, the monetary amount required under sentence 1 only includes value-added tax if and to the extent that it is actually incurred."*

(2) Section 252 provides:

> *"The damage to be compensated for also comprises the lost profits. Those profits are considered lost that in the normal course of events or in the special circumstances, particularly due to the measures and precautions taken, could probably be expected."*

(3) Section 280(2) makes clear that a default under section 286 of the BGB is required in order for the obligee to pursue a claim for *further damage* under section 288(4) of the BGB:

> *"(2) Damages for delay in performance may be demanded by the obligee only subject to the additional requirement of section 286."*

313. Although the effect of a recent decision of the Bundesgerichtshof (the "2016 BGH Decision") handed down on 9 June 2016 has, at the least, now marginalised its importance in the particular context, the experts, in presenting their arguments before that decision, also agreed that section 271(1) of the BGB is relevant [Auth 2/83J]. Section 271(1) provides:

> *"Where no time for performance has been specified or is evident from the circumstances, the creditor may demand performance immediately."*

314. The experts further agree that section 271(1) is a gap-filling rule under which a claim becomes immediately due only where (1) no due date can be inferred from an express or implied agreement, and (2) no due date can be inferred from the circumstances, including having regard to the nature of the contractual obligation.

315. Also of relevance to Issue 20, especially in light of the 2016 BGH Decision which was handed down after the conclusion of oral argument and whilst I was in the process of completing the drafting of this judgment, is s.104 of the German Insolvency Code ("s104 InsO"). This provides in relevant part as follows:

> *"(1) If the delivery of goods with a market or stock exchange price was agreed to take place exactly on a definitely fixed date or within a definitely fixed period, and if such date or expiry of the period occurs after the insolvency proceedings were opened, performance may not be claimed, but only claims for non-performance.*
>
> *(2) If financial performance with a market or stock exchange price was agreed to take place at a fixed date or within a fixed period, and if such date or expiry of the period occurs after the insolvency proceedings were opened, performance may not be claimed, but only claims for non-performance. In particular the following shall be regarded as financial performance:*
>
> *1. the delivery of precious metals,*
>
> *2. the delivery of securities or comparable rights if it is not intended to obtain a participation in a company in order to establish a long-term association,*
>
> *3. performances in specie which have to be effected in foreign currency or in a mathematical unit,*
>
> *4. performances in specie the amount of which is indirectly or directly determined by the exchange rate of a foreign currency or mathematical unit, by the interest rate prevailing for claims or by the price of other goods or services,*
>
> *5. options and other rights to deliveries or performances in specie in the meaning of nos. 1 to 4,*
>
> *6. financial securities within the meaning of section 1 subsection (17) of the Banking Act.*
>
> *If transactions in financial services are combined in a framework contract for which agreement has been reached that if grounds for insolvency exist it may only be terminated uniformly, the totality of these transactions shall be regarded as a mutual contract in the meaning of sections 103 and 104.*

> *(3) Such claim for non-performance shall cover the difference between the agreed price and the market or stock exchange price prevailing at a point in time agreed by the parties,* ***at the latest, however, on the fifth working day after the opening of the insolvency proceedings*** *at the place of performance for a contract with the agreed period of performance.* ***If the parties do not enter into such an agreement, the second working day after the opening of the insolvency proceedings shall be decisive.*** *The other party may bring such claim only as an insolvency creditor."* (Emphasis added.)

316. The experts were agreed on the required approach to the interpretation of contracts governed by German law, being as follows:

    (1) The interpretation of contracts is governed by the general principles set forth in sections 133-157 of the BGB.

    (2) The interpretation exercise requires the Court to ascertain the objective intentions of the parties.

    (3) The starting point of interpretation is the wording of the contract. The primary source for ascertaining the intentions of the parties is the words chosen in the contract.

    (4) Contracts have to be interpreted according to the requirements of good faith, considering common usage, the purpose of the contract and the circumstances in which the contract was entered into.

    (5) General terms and conditions shall be interpreted according to their objective meaning, i.e. independently of the will of the contracting parties.

317. With that introduction as to the applicable German law I turn to Issue 20.

Issue 20: circumstances in which a "damages interest claim" lies under the BGB

318. Issue 20 is in two parts, as follows:

> *"20(1): Following LBIE's administration, is a creditor entitled (and if so in what circumstances) to make a "damages interest claim" within the meaning of section 288(4) of the German Civil Code (BGB) on any sum which is payable pursuant to clauses 7 to 9 of the German Master Agreement?*
>
> *20(2): If the answer to Issue 20(1) is yes, can (and if so, in what circumstances) all or part of such "damages interest claim" constitute part of "the rate applicable to the debt apart from the administration" for the purpose of Rule 2.88(9)?"*

319. I address these two parts in turn.

Issue 20(1)

320. In addressing this issue it may be helpful to identify at the outset what is common ground between the experts and where, conversely, they remain in disagreement.

Common ground between the experts

321. As is recorded in their Joint Statement and apparent from their reports and cross-examination, there is considerable common ground between the experts:

(1) Sections 247, 280, 286 and 288 of the BGB permit a creditor to claim compensation by way of damages for late payment of a debt.

(2) However, no claim for *further damage* may be brought by a creditor of LBIE unless it can establish that LBIE was in "default" within the meaning of section 286 of the BGB.

(3) A default cannot arise under section 286 prior to the time at which the performance of the payment obligation has fallen due.

(4) A claim for *further damage* under section 288(4) – or indeed a claim for default interest under section 288(1) – cannot be made in a German insolvency proceeding unless there had been a defaulted payment obligation in respect of the proved debt prior to the opening of the insolvency proceedings.

(5) A warning notice (which is the normal means of triggering a default under section 286) cannot be served against an obligee so as to trigger a default by the obligee's estate after it has entered into German insolvency proceedings.

(6) The formal requirements for a warning notice under section 286(1) require that the obligor must receive a clear, definitive demand from the obligee for payment of an amount that is due.

(7) The filing of a proof of debt in a German insolvency proceeding does not under German insolvency law establish a default.

(8) A warning notice cannot be served once the debt has been repaid. The debts have been repaid by LBIE in the present case, so a warning notice can no longer be served.

322. At the hearing in November 2015 the principal areas of disagreement between the experts as to the German law relevant to issue 20 were as follows:

(1) the time at which the close-out amount under clauses 7 to 9 of the GMA ("the Single Compensation Claim") becomes due for payment (what Wentworth termed "the Accrual Issue");

(2) the circumstances in which a default can be triggered in response to a delay in the payment of the Single Compensation Claim either (what Wentworth termed "the Default Issue"):

(a) by a warning notice under subsection 286(1) of the BGB; or

(b) by the inference of a serious and definitive intention not to perform the contract, the proof of which is an admitted exception to the general rule that a warning notice is required under subsection 286(2) of the BGB.

(3) The circumstances in which a claim for '*further damage*' can be expressed as a rate and how and by reference to what principal sum the rate is to be determined (which Wentworth termed "the Rate Issue").

323. I turn to discuss these three disputed areas, with the preface that the Accrual Issue has become rather different and more limited in light of the 2016 BGH Decision.

The Accrual Issue

324. As noted previously, the GMA does not expressly stipulate the date on which a Single Compensation Claim falls due. In their respective submissions, both written prior to, and oral at, the hearing, both the SCG and Wentworth contended that the Accrual Issue was thus to be determined by interpreting the terms of the GMA in the light of general rules and principles of German law.

325. At that stage, and until the parties appreciated the fact and consequences of the 2016 BGH Decision, the focus of all parties was on the application of the fall-back rule in section 271 of the BGB, providing that where no time for performance is specified or evident from the circumstances, the obligee may demand performance immediately. The issue between them was whether the terms or overall structure of the GMA, or the surrounding circumstances, should be taken to displace the fall-back rule, or alternatively what "immediately" should be taken to mean in the context of the relevant provisions of the GMA. This required analysis of the effect of the relevant clauses in, and the overall structure of, the GMA to determine whether they left room for the application of section 271 of the BGB (as was Professor Mülbert's view) or, in effect, displaced it (as was Dr Fischer's view).

326. Wentworth's submissions on the Accrual Issue at the hearing in November 2015 can be summarised as follows:

(1) The obligation to pay the single compensation claim under clauses 7 to 9 of the GMA did not become due until after LBIE's administration. This was based on Dr Fischer's view to the effect that clauses 7 to 9 apply together and, construed in the round, provide for steps to be taken after the termination of the GMA which are inconsistent with an intention that performance should be regarded as immediately due from the time of termination. In those circumstances, either section 271 of the BGB should be taken to be displaced, or the right to demand payment "immediately" should be taken to mean immediately upon determination of the single compensation claim (but not before).[21]

[21] Dr Fischer initially regarded sub-clause 9(2) as particularly indicating that no amounts fell due unless and until the net amount had been calculated. However, he came to accept that Clause 9(2) is only engaged where

(2) The consequence was that LBIE could not be said to have been in default of a payment obligation within the meaning of section 286 of the BGB prior to LBIE's entry into administration: no such payment obligation had yet accrued.

(3) Until a default there could be no claim for *further damage*. The experts were agreed that such a claim cannot exist until a default has occurred within the meaning of section 286 of the BGB.

(4) It followed that the counterparty to the GMA could not have any claim for *further damage* at the commencement of administration.

(5) That was dispositive of the SCG's claim: it was agreed by the experts that under German law a default after the commencement of German insolvency proceedings could not trigger or entitle the creditor to any such claim; and according to Dr Fischer (though Professor Mülbert disagreed) the same result followed in the case (as here) of an English insolvency process: default after any such insolvency process, whether German or English, was too late and could not be the basis of any claim for interest.

327. Against this, the SCG's submissions on the Accrual Issue before and at the November hearing can be summarised as follows:

(1) LBIE's application for an administration order caused an automatic termination of the GMA and all underlying transactions. This was agreed by the experts.

(2) There was nothing to displace the application of the fall-back rule in section 271 of the BGB providing for the obligee to be entitled to demand performance immediately.

(3) Nor was there any impracticability in determining that the Single Compensation Claim falls due immediately upon termination, except in the particular circumstance expressly provided for in Clause 9(2), which only has any relevance where there is a counterclaim against the Party Entitled to Damages (i.e. the Non-defaulting Party) such that such Party is, overall, the paying party.

(4) Accordingly, and on the true construction of the GMA, read together with section 271 of the BGB, the Single Compensation Claim became immediately due upon the occurrence of that automatic termination. The fact that the calculation of the Single Compensation Claim would not take place until later did not affect this analysis. Professor Mülbert's evidence was that for the claim to fall due immediately it is not necessary for the creditor to have calculated the exact amount of compensation due. He supported his view by reference both to the language of section 271 and to authorities such as those concerned with claims for prepayment of fees on loans, which have

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the close-out amount or Single Compensation Claim is in fact owed by the Party Entitled to Damages to the Defaulting Party, and thus is of less, if any, assistance to his contention.

been held by the German courts to be immediately due on termination (albeit for breach rather than automatically) even though the creditor has a choice of methods of calculating his claim, and regardless of the fact that it will take the creditor some time to determine the exact amount.

(5) Thus, according to the SCG, the Single Compensation Claim is clearly due from the point of termination and thus from the moment of the commencement of the bankruptcy proceedings.

(6) It followed that the counterparty to the GMA could have a claim for *further damage* at the commencement of administration, subject of course to satisfaction of section 288(4) of the BGB.

The 2016 BGH Decision and its consequences

328. Such, in outline, were the battle-lines on the Accrual Issue prior to June/July 2016. Given the time devoted to the development of these matters, and since I had already completed that part of my draft judgment when notified of the 2016 BGH Decision, I set out in a schedule my analysis and assessment of the arguments advanced before and at the hearings, which (it will already be apparent) focused on the terms and structure of the GMA and whether section 271 of the BGB was displaced or to be implied into them.

329. However, by letter dated 22 June 2016 Wentworth's solicitors drew the attention of the Court to the 2016 BGH Decision which they contend is relevant to Issue 20 (as plainly it is).

330. As elaborated later, in its 2016 BGH Decision the Bundesgerichtshof (on appeal from the Frankfurt Court of Appeal in a claim in fact between LBIE and a counterparty governed by the GMA) emphasised the mandatory nature of s104 InSo (see paragraph [315] above) and determined that clauses 7 to 9 of the GMA were valid only to the extent that they complied with its provisions. It held that, on that basis, the single compensation claim under the GMA must be calculated in accordance with s104 InsO (see paragraph [315] above). There could be no room in such circumstances for the application of the fall-back rule in section 271 of the BGB.

331. This was not quite a bolt out of the blue. It is fair to acknowledge that Dr Fischer had referred to s104 InsO in his first report and, indeed, had expressed the opinion that:

> "[T]he amount of [the single compensation claim] must be calculated not according to Cl.8 and 9 GMA, but by the abstract method laid out in [section 104(3) of the German Insolvency Code ("InsO")], which belongs to the substantive terms of German law." [see Fischer 1/paragraph 7]
>
> "As the single claim for compensation arising under sec. 104(3) InsO only comes into existence as a consequence of the initiation of insolvency proceedings, the claim does not bear interest. A claim for damage due to default is only justified if the debtor was in default before the opening of insolvency proceedings." [see Fischer 1/paragraph 8]

> "If one follows my opinion that the single compensation claim is to be computed not as a compensation claim pursuant to Cl. 8 and 9, but as a claim for non-performance pursuant to sec. 104(3) InsO, the claim only comes into existence as a consequence of the opening of insolvency proceedings, and matures a few days later, after the computation as provided there is complete." [see Fischer 1/paragraph 81.]

332. However, and for whatever reason, in its written and oral submissions for the November hearing Wentworth did not seek to advance a case based on s104 InsO, except as what it described as background to its submissions on the effect of sections 7 to 9 of the GMA (which it appeared to accept therefore as valid and enforceable).[22] In those circumstances, I accept the SCG's submission that it is not surprising that Dr Fischer was not cross-examined on the point. I think I should also indicate some surprise, if the case was moving through the German appellate structure, that nothing was said by any of the parties about it until June 2016.

333. Nevertheless, all parties are now agreed that the 2016 BGH Decision must of course be given full recognition and effect as a decision of Germany's highest court. The parties have thus re-formulated their positions in supplemental submissions as to its effect, to which I now turn.[23] It is fair to say that Wentworth has embraced the decision as in effect determinative of, at least, the Accrual Issue; whereas the SCG has sought to minimise its effect.

334. Section 104 InsO provides, relevantly, that absent the contractual specification of a settlement date within a window of five working days of the opening of insolvency proceedings, the single compensation claim must be calculated by netting the

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[22] I should also record that following service of Dr Fischer's first report (which expressed the view that sections 7 – 9 of the GMA were unenforceable) the SCG entered into lengthy correspondence with Wentworth asking it to clarify what reliance (if any) it sought to place on the provisions of the German Insolvency Code as it could have impacted upon the SCG's choice of expert. The Administrators suggested that revised position papers be exchanged. Wentworth provided its revised position paper on 11 September 2015. It placed no reliance on section 104(3) InsO and proceeded on the basis that sections 7 – 9 of the GMA were valid and enforceable. On 23 September 2015, the SCG therefore wrote to Wentworth suggesting that re-stated expert reports should be provided, since the reports provided to date referred to matters which appeared to be irrelevant to the application: "for example, Judge Fischer's original report deals with the effects of German insolvency law…which were not referred to in Wentworth's original or revised position papers and which do not appear now to be relied on". In the correspondence that followed, Wentworth did not seek to suggest that the SCG's conclusion was incorrect or that it relied on section 104 InsO.

[23] At a hearing on 24 June 2016 it was broadly agreed that the parties should first seek to agree an English translation of the 2016 BGH Decision, which in fact arose out of another dispute in relation to LBIE, then determine whether further expert evidence might be required, and subject to that, exchange written submissions, leaving it to the Court whether it required a further oral hearing. After some procedural refinements (and disputation in the correspondence) the parties proceeded accordingly. They have since confirmed that no additional expert evidence is to be brought forward. In the event no one pressed for, and I have not thought it necessary to have, a further oral hearing.

underlying transactions at prices on the second working day after the opening of insolvency proceedings. The BGH held (in paragraph 76c of its judgment):

> *"Since the compensation claim is determined by Section 104 para. 3 Insolvency Code and not by the invalid Clause 8 para. 1 of the Master Agreement, the Court of Appeals should not have referred to September 15, 2008 for its calculation, but rather, as set forth in Section 104 para. 3 sentence 2 Insolvency Code, it should have referred to the second business day after the commencement of the insolvency proceedings, i.e. September 17, 2008. The Parties did not agree on any other point in time after the commencement of the insolvency proceedings, which may at the latest be the fifth business day after the commencement of the insolvency proceedings (Section 104 para. 3 sentence 1 Insolvency Code). For this reason, the claim must be recalculated in such respect."*

335. The BGH, therefore, remitted the claim to the Frankfurt Court of Appeals with a direction that the claim be recalculated.

336. As regards interest on that claim, the BGH rejected LBIE's claim for interest. It held that LBIE's counterparty had a claim for the return of its collateral and, pending the resolution of that claim, the counterparty had a right of retention under clause 9.2 of the GMA. The BGH's reasons are recorded at paragraphs 90 to 95 of the judgment. It made no order as regards interest, any such order being consequent on the recalculated amount of the claim, if any.

337. The BGH stated, in paragraph 96, as a further reason in support of its conclusion as regards interest, that:

> *"To the degree Clause 3 para. 4 of the Master Agreement would require interest payments also for the compensation payment already starting at maturity, this rule would be invalid because it deviates from Section 104 para. 2 and 3 Insolvency Code; this regulation does not provide for any interest payment obligation starting already at maturity."*

338. The BGH also indicated that a delay is required post-computation before default interest might start to run. It said, at paragraph 71(c) and 84:

> *"However, in the course of finally concluding the terminated transaction, damages may come to exist as a result of default [Verzug] or other breach of duty."*
>
> "*As explained, there would be no concerns against damages claims on the basis of an attributable delay in finally concluding the claims under Section 104 Insolvency Code.*"

339. It is clear from the 2016 BGH Decision that the single compensation claim cannot be taken as having become due on or before the commencement of LBIE's administration. If clauses 7 to 9 of the GMA would have that effect (as the SCG

contended)[24] then to that extent they must be treated as invalid. The single compensation claim can, consistently with the 2016 BGH Decision, only become due after the commencement of LBIE's administration. S.104 InsO provides that, absent the contractual specification of a settlement date within a window of five working days of the opening of insolvency proceedings, the single compensation claim was to be calculated by netting the underlying transactions at prices on the second working day after the opening of insolvency proceedings.

340. The consequence of that is not disputed: LBIE cannot have been in default of a payment obligation within the meaning of section 286 prior to LBIE's entry into administration; and since the experts agree that a claim to *further damage* does not exist unless and until a default has occurred within the meaning of section 286, the counterparty to the GMA cannot have had any such claim at the commencement of LBIE's administration.

341. It follows, as indeed the parties now accept, that to that extent at least the Accrual Issue has substantially been resolved by the 2016 BGH Decision. No obligation to pay the single compensation claim can have existed and become due until after LBIE's administration.

342. It necessarily follows that, unless the fact that LBIE is not in a German but an English insolvency proceeding makes all the difference (as to which, see paragraphs [345*ff*] below) the SCG are unable to establish that LBIE was in default of a payment obligation within the meaning of section 286 of the BGB prior to LBIE's entry into administration: as Professor Mülbert put it:

> "*The first element of a default within the meaning of section 286 BGB is that the debtor fails to perform at the time performance is due.*"

343. Since the experts agree that a claim to '*further damage*' cannot exist unless and until a default has occurred within the meaning of section 286, it also follows that the counterparty to the GMA cannot have had any claim for '*further damage*' at the commencement of LBIE's administration.

344. That is fatal to any claim in the context of a German insolvency proceeding for *'further damage'* or interest. The experts agree that (a) where an obligee was not in default prior to the opening of German insolvency proceedings, a default cannot be established as against the insolvent estate following the commencement of the German insolvency proceedings and (b) a claim for '*further damage*' under section 288(4) of the BGB, or indeed a claim for default interest under section 288(1), cannot be made in a German insolvency proceeding unless there had been a defaulted payment obligation in respect of the proved debt prior to the opening of the insolvency proceedings.

[24] Though it will be seen from the schedule in which I have set out the arguments as put for and against at the November hearing that in fact I reached a consistent conclusion on the effect of sections 7 to 9 of the GMA.

Is the Accrual Issue affected by the fact that LBIE is in an English not a German insolvency proceeding?

345. The question, then, in assessing the consequences in terms of the overall determination of Issue 20(1), is whether the fact that the insolvency proceeding in place is an English administration, rather than a German insolvency proceeding, makes all the difference in this context, it being the SCG's case that "there is no principle of German law which prevents a default from occurring following the commencement of an English administration".

346. If a post-commencement default in an English administration will not suffice for the purposes of section 286 of the BGB that is an end of the SCG's case.

347. It is I think worth noting that, although the parties' submissions tended to elide the two, the question whether a default after the commencement of an English administration can fulfil the requirements of section 286 of the BGB is (at least analytically) distinct from, and a gateway question to, the question as to how such a default could be triggered. Only if it could does the further 'Default Issue' arise as to whether the SCG can establish that a default could be triggered by the filing of a proof of debt or on the basis that "the facts relating to LBIE's administration application amounted to a serious and definite refusal" within the meaning of section 286(2) no.3.[25]

348. However, both require an analysis of the interaction between principles of English insolvency law (which govern LBIE's administration) and German civil and insolvency law (which respectively govern the prerequisites of such a claim and the effect of on any such claim of German insolvency proceedings). In consequence, and as will appear later when I specifically address, under the Default Issue, the question as to how for the purposes of section 286 of the BGB a default can be triggered, much of the analysis is common to both issues. Indeed, the reasons relied on by the SCG for its contention that a post-commencement default in an English administration can satisfy section 286 of the BGB, though a post-commencement default in a German insolvency proceeding cannot, appear to be the same as, or at least inextricably connected with, its submissions as to the effectiveness of a post-administration warning notice by way of a proof of debt.

349. Nevertheless I turn to discuss what I have called the gateway issue, which in light of my view of the effect of the 2016 BGH Decision has become crucial for the SCG's overall case on Question 20, under the heading of the Accrual Issue, since it seems to me that, strictly, that is its proper context.

350. The SCG's basic proposition, based on Professor Mülbert's evidence, is that there is no provision or principle of German substantive law (whether statutory or based on case authority) which prevents a default from occurring following the commencement of an English administration.

[25] To put it another way: the SCG's arguments depend on showing both (a) that because LBIE is in an English, and not a German, insolvency proceeding, the fact that any default relied on can only take place after the commencement of the proceeding is not fatal and then (b) that a default which would be recognised as such under German law (and in particular section 286 of the BGB) has been triggered.

351. Professor Mülbert and the SCG ascribed the reason for the position under German insolvency law to what they described as 'particularities' of a German insolvency proceeding, and submitted that as the same 'particularities' do not apply in an English administration there is no reason why a payment which only becomes due after its commencement should not be relied on as the basis for triggering a default for the purposes of section 286 of the BGB.

352. The 'particularities' Professor Mülbert and the SCG especially relied on were as follows:

(1) It would be contrary to the German law articulation of the policy of treating all creditors equally to permit a creditor to improve his position after the commencement of an insolvency proceeding.

(2) German insolvency law makes a distinction, for certain purposes, between the insolvency estate *(Insolvenzmasse)* and the insolvent debtor as person or entity. The debtor loses its power of disposition and the insolvency administrator (to quote Professor Mülbert's written evidence) "*does not act as representative of the entity and is generally not empowered to receive declarations of intent…and quasi declarations of intent…on behalf of the debtor as an entity*".[26]

(3) In order for a default to occur, a claim must not only be due and payable, but it must also be "enforceable". Dr Fischer's view is that after German insolvency proceedings have started, claims are no longer enforceable because the creditor is not allowed to bring a claim against the debtor and must instead satisfy his claim against the assets in the estate. As I understood it, Professor Mülbert agreed in the result; but he considered that it followed, not as matter of the general law, but from the combination of sections 80(1) and 81(1) of InsO, pursuant to which the debtor (a) loses any power over his assets and thus cannot be subject to measures of forced execution and (b) no longer has standing to be sued with respect to insolvency claims (*cf* Professor Mülbert's contrary view in the appendix to Freshfields' letter of 23 October 2015).

353. By reference to those features the SCG submitted that these 'particularities' do not apply, or at least do not apply to the same effect, in the case of an English administration. The SCG put forward the following as being material differences:

(1) Whilst the principle of *pari passu* distribution is also a key feature of English administration proceedings, the policy underpinning the English collective regime does not mean that no new rights can be triggered during administration. It is well-established that notices triggering contractual entitlements can be served during the course of an administration: *Re Olympia & York Canary Wharf Ltd* [1993] BCC 154.

[26] Dr Fischer agreed that as the debtor has lost the power to dispose of his assets in a German insolvency, a warning notice cannot take effect.

(2) In an English administration, the policy of treating all creditors equally does not mean that no rights to interest can be triggered during the period of the insolvency. This is because, under Rule 2.88(7) of the Insolvency Rules 1986, interest is only payable from any surplus remaining after the payment of the debts proved. The subordination of claims to interest by Rule 2.88 ensures that the collective regime is not disrupted where the conditions for an interest claim (i.e. default) are satisfied post-insolvency.

(3) In an English administration, there is no necessary distinction between the insolvency estate and the debtor as an entity of the kind that appears to exist in a German insolvency[27] and, unlike in a German insolvency, an English administrator acts as an agent of the debtor: Insolvency Act 1986 Sch B1 para.69.

(4) The English moratorium does not constitute a *legal defence* to a claim. It merely presents a procedural bar to bringing an action in respect of an otherwise enforceable right.

354. Wentworth does not dispute the above features of a German insolvency proceeding. What it disputes is that they are sufficient to distinguish the position in such a proceeding from the position in an English administration. In this context, Wentworth emphasised particularly the following features of an English administration:

(1) Following the commencement of an administration there is a moratorium on legal process against the debtor: see para 43 Sch B1 of the IA 1986. The moratorium commences on the application for administration under para 44 Sch B1.

(2) The company's assets are to be dealt with in accordance with the statutory scheme of administration. They are no longer available to be used to meet claims in the ordinary course: see *Re Polly Peck International plc (No. 4)* [1998] 2 BCLC 185, especially at pp 201-202 (in the Court of Appeal); *Bloom v Harms Offshore* [2010] Ch 186-187 (at [22]-[24], also in the Court of Appeal); and the decision of Briggs J (as he then was) at an earlier stage of this administration in *Re Lehman Brothers International Europe (in administration)* [2010] 2 BCLC 301 at [204]).

[27] This is the case notwithstanding the fact that for certain purposes and in certain contexts English corporate insolvency proceedings have been described as giving rise to a "statutory trust" in favour of creditors. The concept of a "statutory trust" is used in the context of English corporate insolvencies to convey an impression of the relationship between an insolvent company and its creditors. It is not intended to suggest that property is in fact held on trust by an insolvent company, still less by a third party insolvency practitioner, for the company's creditors. See, in this regard, *Ayerst v C & K (Construction) Ltd* [1976] AC 167 *per* Lord Diplock at [180]: "All that was intended to be conveyed by the use of the expression "trust property" and "trust" in [previous judicial statements on the nature of the statutory trust] was that the effect of the statute was to give to the property of the company in liquidation that essential characteristic which distinguishes trust property from other property, viz., that it could not be used or disposed of by the legal owner for his own benefit, but must be used or disposed of for the benefit of other persons".

(3) From the time that an administrator gives notice of an intention to distribute, the assets are held on a statutory trust for the purpose of distribution to meet the claims of creditors who have proved their claims in the administration.

(4) As to enforceability, (a) an English administration brings about a moratorium on proceedings against the debtor and (b) at least without the permission of the Court, creditors may no longer make claims but must file proofs of debt according to the process contained in Part 2 of the IR 1986.

355. Whilst these similarities and differences are culled from a comparison of the features and effects of (a) a German insolvency proceeding as described by the experts and (b) an English administration as set out in the agreed Administration Summary and amplified in the authorities and commentaries cited, the question is ultimately one of German law.

356. Professor Mülbert stated his conclusion as a matter of German law in his third report at paragraph 82 as follows:

> "It is not clear to me whether Dr Fischer is saying…that there is a general principle of German law that no default can occur (including by the giving of a warning notice) following the commencement of insolvency proceedings, wheresoever these insolvency proceedings may be commenced, or if Dr Fischer is saying that this only applies where the insolvency proceedings have the effect of depriving the debtor of the power to dispose of its assets. I am not an expert in English insolvency law but, based on the description provided to me of an English administration proceeding, it would appear that an administrator is able to act as agent of the company with the broad power range of powers specified in Schedule 1 to the UK Insolvency Act 1986 including the power to dispose of its assets. Clearly on the facts of the present case, no insolvency proceedings were commenced in Germany and so I do not see how the effects of a German insolvency proceeding could be relevant."

357. That, as it seems to me, was a rather restrictive presentation of Dr Fischer's approach. It is true that Dr Fischer emphasised the importance under German insolvency law of the fact that "the debtor has forfeited the power to dispose of its assets". However, after an analysis of the characteristics and objectives (what Professor Mülbert had called "particularities") of German insolvency proceedings, Dr Fischer's conclusion as to this was stated as follows in his third (consolidated) report:

> "It is apparent from the Administration Summary that an administration under English law brings about a moratorium on proceedings against the debtor, that the creditors must file their proofs of debt in accordance with English insolvency laws, and that they will receive a percentage of their claims as provided under English insolvency law. The effects of an English administration on the enforcement of creditors' claims against a

> debtor are therefore equivalent, at least in the essential points, with German insolvency law...”

In a further passage more especially relevant to the Default Issue, but also indicative of his approach, he continued:

> “Therefore, in my opinion, the provision under sec. 286(1) BGB must be construed as meaning that the creditor cannot use a warning notice under sec. 286(1) to establish default on the part of the debtor against whom an administration has been ordered.”

358. I prefer the view of Dr Fischer. I consider that the similarities brought out by Wentworth and relied on by Dr Fischer are compelling. I accept that there are points of difference: but these do not seem to me to provide a sufficient basis for concluding either that German law would permit and recognise as compliant for the purposes of section 286 of the BGB a default declared in an English administration after its commencement.

359. Accordingly, I conclude that the fact that the insolvency proceeding here is an English administration does not make any difference to my previous analysis of the Accrual Issue.

360. In my judgment, therefore, what Professor Mülbert termed the essential “first element” of a section 286 BGB default cannot be satisfied where the payment default follows the insolvency proceeding, whether the insolvency proceeding is German, or an English administration.

The Default Issue

361. My conclusion on the Accrual Issue means that the Default Issue only arises if that conclusion is wrong. However, even if that conclusion is wrong, to succeed in establishing a right to “Further Damages” the SCG would also have to show a “default” before or as at the commencement of the administration.

362. As appears from its terms as quoted in paragraph [309] above, section 286 of the BGB specifies the requirements for a default. Section 286(1) of the BGB provides that a default will occur where:

    (1) the debtor fails to perform when performance is due; and

    (2) a warning notice (*Mahnung*) is provided by the creditor to the debtor requesting performance.

363. Section 286(2) of the BGB sets out circumstances in which a default will occur *without* the provision of a warning notice. In particular, section 286(2) no.3 provides that a default will occur where “*the debtor seriously and definitively refuses performance*”.

364. As regards the timing of a default under section 286:

(1) The experts agree that the default occurs upon the receipt of a warning notice; or

(2) Upon the events occurring that give rise to one of the exceptions to the need for a warning notice.

365. It is common ground that (a) no warning notices have been served against LBIE with a claim under the GMA (whether before or after the administration) and (b) no warning notice can be served now as the proved debts under the GMA have already been paid in full.

366. It is also agreed that neither an application to commence insolvency proceedings nor the commencement of insolvency proceedings of itself constitutes an exception to the requirement to serve a warning notice.

367. However, it is the SCG's position that it can demonstrate that (a) LBIE's application for an administration order amounted, without more, to a "*serious and definitive refusal of performance*" constituting a "default" within the meaning of section 286(2) no.3 of the BGB and further or alternatively (b) the filing of a proof of debt suffices as a "warning notice" within the meaning of section 286(1) of the BGB.

368. Wentworth does not accept either proposition. As to the first, it contends that no serious and definitive refusal to perform the GMA can be inferred from the fact or grounds of LBIE's administration application or the administration order made, and that it would be very surprising to reach the contrary conclusion in circumstances where the GMA expressly provides that the insolvency application terminates the contract without any indication that the termination gives rise to an immediately defaulted claim for a close-out payment under clauses 7 to 9. As to the second, it contends that a proof of debt in a German insolvency does not constitute a warning notice because it does not contain a request for payment of a debt, but rather a request to participate in a collective insolvency proceeding which may result in a rateable distribution.

369. In the context of the Default Issue the issues between the parties are, therefore, whether:

(1) the particular facts and circumstances of LBIE's administration application constituted a "default" by virtue of a "serious and definitive refusal of performance" within the meaning of section 286(2) no.3 of the BGB;

(2) alternatively, the filing of a proof of debt in LBIE's administration triggered a default on the basis that it complies with the requirements of a "warning notice" within the meaning of section 286(1) of the BGB.

370. There is very little German case law or academic authority on either point.

The test for serious and definitive refusal (sec. 286(2) no.3)

371. The experts agreed that there is no need for a warning notice if the debtor seriously and definitively and manifestly refuses performance. The reason for this is that

requiring the creditor to send a warning notice to the debtor who refuses to perform would be a mere formality.

372. The experts agreed further that there are strict requirements for a serious and definitive refusal. The test for a serious and definitive refusal is also largely agreed:

(1) A refusal under section 286(2) no.3 of the BGB can be explicit or implicit: it does not depend upon an express declaration of intent.

(2) However, in order for a refusal to trigger section 286(2) no.3 of the BGB in the absence of an express declaration, there must be an unequivocal and definitive demonstration to the other party of refusal by an act or conduct such as to be solely explicable as a final refusal to perform (rather than be just a negotiating stance on the part of the debtor).

373. Some of Professor Mülbert's answers under cross-examination might have appeared to suggest that he considered it would be sufficient for the purposes of establishing a serious and definitive refusal to perform if it was "obvious" (in the sense of a virtual certainty) that there would be non-fulfilment of performance before the due date. Mr Allison QC cross-examined at some length as to this, and Wentworth's closing submissions chose to depict Professor Mülbert's supposed position as an "essential error" in his approach, based on a misconceived conflation of sections 323(4) of the BGB, which relates to a creditor's right to withdraw for non-fulfilment, and section 286(2)(iii) of the BGB, which (see above) propounds the exception from the need for a warning notice in the case of serious and definitive refusal. The "essential error" supposedly identified was to confuse the test of "virtual certainty" with the test of "serious and definitive refusal".

374. However, although I tend to agree that certain of Professor Mülbert's answers did give an impression that he was conflating the two tests, and in particular that he considered that virtually certain prospective non-fulfilment would equate with an anticipatory serious and definitive refusal to perform, his answers taken as a whole seemed to me to acknowledge and accept a difference between the two tests.

375. The experts also disagreed as to whether the declaration or unequivocal act or conduct relied upon as demonstrating refusal must have been communicated, or at least known, to the other party. As to this:

(1) Professor Mülbert's view was that a serious and definitive refusal does not need to be communicated to the other party to become effective (although obviously the creditor will need to become aware of it at some point in order to rely upon it). He suggested an objective test such that (as he put it)

> "*if somebody had looked at the behaviour of the debtor, it would have been obvious for him that the debtor would not perform.*"

(2) Mr Dicker suggested that Dr Fischer was unclear; and I accept that in some of his answers in cross-examination on one interpretation seemed to support the sort of objective test propounded by Professor Mülbert. However, in my view, Dr Fischer ultimately did not depart from his written report and (on a

fair overall view of his oral evidence) maintained a subjective test, to the effect that the declaration or act or conduct relied upon had to be communicated, or at least made known, to the other party.

Does the opening of insolvency proceedings itself amount to serious and definitive refusal within the meaning of section 286(2) no.3 of the BGB?

376. The experts also disagreed on the more specific question whether the facts relating to the application for LBIE's administration and thereby the opening of insolvency proceedings amounted to a serious and definitive refusal within the meaning of section 286(2) no.3 of the BGB. Put shortly:

(1) Professor Mülbert considers that such application "conveys the message that LBIE would not pay its outstanding debts (including those such as the Single Compensation Claims that became due upon the presentation of the application) at the time of such filing or within a reasonable grace period" and, as such, constitutes a "serious and definitive refusal".

(2) Dr Fischer is of the view that there was no automatic and immediate default by LBIE at the time of its administration application. He considers that an administration application would not constitute a declaration of intent not to perform, and, further, that no inference of serious and definitive refusal to perform arises given, in particular (in his view):

(a) that the fact of insolvency is indicative only of a general inability to pay debts, not a refusal to perform a specific contract or pay a specific debt;

(b) the fact that an administrator has the option to carry on all or part of the company's business, including whether or not to adopt a contract or cause a contract to be performed.

377. The experts agree that there is no German authority on the point whether the commencement of insolvency proceedings should be viewed as a serious and definite refusal to perform by the debtor. Professor Mülbert acknowledged that this of itself is of some note: it would be a matter of some considerable importance generally in German law if an application for the commencement of an insolvency process such as an administration is to be treated as an exception to the usual requirement of a warning notice to establish a default.

378. I turn to address these points of disagreement in turn, in the course of which I address in most detail the most specific and important issue as to the effect of the application for administration itself.

379. I accept Wentworth's submission that virtual certainty of future default on the part of one party sufficient to enable the other party to withdraw pursuant to section 323(4) of the BGB does not necessarily equate with a serious and definitive refusal for the purposes of section 286(2) of the BGB. On true analysis of his evidence taken as a whole, I do not think Professor Mülbert wished to be taken as contending otherwise; but if he did, I do not accept the contention.

380. In my view, the declaration or unequivocal act or conduct relied on as constituting a serious and definitive refusal must be communicated to the other party at least in the sense that the conduct can be seen and is (to adopt one of Dr Fischer's answers) "recognisable without doubt by the parties" as a final refusal.

381. Those conclusions provide the context for my views as to the most specific and relevant issue as to whether the application for administration by itself amounts to a serious and definitive refusal within the meaning of section 286(2) of the BGB.

382. In my view, and as both parties seemed to agree, the answer is ultimately dependent on the facts surrounding and the nature of the application and its consequences under the law by which it is governed (here, of course, English law, being the law of LBIE's administration).

383. As to the facts, the SCG pointed out and emphasised the following in support of its contention that the Court can be satisfied on the facts that LBIE's application amounted to a serious and definitive refusal, at least in respect of contracts constituted by the GMA:

(1) The basis on which LBIE applied for and then entered administration is described in the first witness statement of Peter Sherratt ("Mr Sherratt"), the Chief Legal Officer at the time that the application for administration was made (15 September 2008), and a director of LBIE.

(2) The application was made by the directors of LBIE on the basis (to quote from Mr Sherratt's witness statement at paragraph 1.2.1) that:

> "LBIE was reliant upon receipt of cash from LBHI each day "*to enable it to make any payments*" (para 6.5) and required some US$800 million in cash to settle payments contractually due to other financial institutions within the next 24 hrs (para 6.6);
>
> LBHI was no longer in a position to and will not provide any further cash to LBIE such that LBIE could not continue to trade (para 6.7);
>
> In light of such cash requirements over the next 24 hours, LBIE was unable to pay its debts within the meaning of section 123 of the Insolvency Act 1986 (paras 7.2 and 7.4);
>
> The purpose of the administration was to achieve a better realisation of LBIE's assets than would be achieved in a liquidation (para 8.1); it was not to try and ensure the survival of the company."

(3) As Dr Fischer accepted, making an application for an administration order for a company like LBIE is bound to have further consequences, including the closing out of certain contracts and an acceleration of liabilities. The reality is that once the application has been made, there is no turning back.

384. The SCG submit by reference to the basis of the application and the evidence used to support it that:

(1) Mr Sherratt was saying very clearly that LBIE would not be continuing to trade.

(2) He was thereby making it clear that LBIE would not be performing its obligations in respect of contracts such as the GMA, which would instead terminate automatically as a result of the making of the application and potentially give rise to large claims for compensation for loss and damage which LBIE would not be able to satisfy.

(3) The statements were not a negotiating stance. They were LBIE's final word on the matter. This is necessarily the case, given the consequences for an entity like LBIE of applying for an administration order.

(4) The giving of a warning notice in such circumstances would have been a "mere formality".

(5) The statements were made in a witness statement to Court on an application and would inevitably become publicly known. Creditors were capable of having knowledge of it.

(6) If Mr Sherratt had said all those things to an individual creditor, in the circumstances in which he said them, that would have amounted to a serious and definitive refusal.

385. Against this, Wentworth contends that the key facts relevant to the administration application by LBIE's directors are as follows:

(1) The application was made on a Monday morning before markets opened at around 7:30am.

(2) The administration order was made at 7:56am.

(3) The administration application was issued later pursuant to an undertaking given to the Court to do so.

(4) No creditor was given notice of the application.

(5) The application was made in this way to put administrators in place before markets opened.

(6) The administration order was only made public after it had been made.

(7) Mr Sherratt's Witness Statement 1 does not support a finding that LBIE seriously and definitively refused to perform its obligations for the purpose of section 286(2)(iii). In particular:

(a) LBIE was said to be balance sheet solvent (with net assets as at 31 August 2008 of US$7.122bn).

(b) At paragraph 7.4 it is not said that LBIE will not pay only that it is unable to pay.

(c) The inability was the result of a cash shortfall of $800m required in 24 hours in circumstances in which there had been a cash sweep to the US and LBIE was to enter Chapter 11 in the US.

(d) It is also clear from paragraph 8.1 that LBIE was to be a trading administration, i.e. necessarily that at least some payments would be made and some contracts would be performed.

(e) No contract was referenced specifically in Mr Sherratt's witness statement and no mention was made of any GMA contract.

386. Wentworth submits that, having regard to the nature and effect of an application for administration under English law, and when seen in its proper context and especially against that factual background, there is no substance in the SCG's argument that the administration application by LBIE's directors should be characterised as a serious and definitive refusal to perform for the purposes of the relevant German law.

387. Wentworth argues, contrary to the SCG's position, that it is relevant to consider what in English law is the nature and effect of an application for administration, even though ultimately the question whether in fact the application constitutes a serious and definitive refusal to perform for the purposes of the BGB is obviously a question of German law. As to that, Mr Allison submitted:

(1) English authorities show that the commencement of administration does not permit the inference of an intention to repudiate or inevitable non-performance by the debtor or its representatives (see *Astor Chemicals Ltd v Synthetic Technology Ltd* [1990] BCC 97; *Re P&C v R&T (Stockport) Ltd* [1991] BCC 98; *Re Olympia and York Canary Wharf Ltd (No 2)* [1993] BCC 159; *Re Joint Administrators of Rangers Football Club plc* [2012] SLT 599, at [52]; Fletcher, Higham and Trower (2nd ed.), at p153).

(2) The making of an administration application, including the jurisdictional condition of the company's inability or likely inability to pay its debts, does not therefore of itself permit the inference of inevitable non-performance or of an objective intention not to perform, applying the tests for repudiation and anticipatory breach under English law, still less a refusal to perform having the characteristics described previously.

(3) That is particularly so in the case of a trading administration (as it is clear from LBIE's application its administration was to be): LBIE's administration was not converted into a distributing administration until December 2010.

388. Having regard to these considerations it seems to me, in the absence of any German case law or commentary to the contrary, that LBIE's administration application of itself cannot be equated, on the facts, to the serious and definitive refusal to pay required by section 286(2)(iii) if default is to be found where no warning notice has been sent.

389. I reach that conclusion primarily by applying the tests discussed to the facts as described, having regard also to the nature and effect in English law of the application made.

390. However, I am also supported in that view by the conclusion of Dr Fischer, whose experience in insolvency matters under German law, especially as the presiding judge of the 11th Senate of the BGH charged with dealing with insolvency cases, is considerable and impressive. Whilst I would accept that Dr Fischer did, as Mr Dicker suggested, tend to look at all issues through the lens of German insolvency law and practice, his opinion in this particular context is obviously a weighty matter. That is not to say that Professor Mülbert was either unclear or not impressive; on the contrary, his evidence was both clear and compelling. However, Professor Mülbert acknowledged that he is not an insolvency expert; and in determining the proper characterisation in German law of the English insolvency process I prefer the evidence of Dr Fischer.

391. I have reached the conclusion that it is at best doubtful that an application to commence German insolvency proceedings would be so regarded, not least because, as it seems to me:

(1) The proposition that the making of an administration application should not itself be an exception to the requirement to serve a warning notice and yet give rise to an inference of serious and definitive refusal of performance, is sufficiently counter-intuitive as to require clear authority or at least supportive commentary, and there appears to be none.

(2) The decision of the Reichgericht referred to in paragraph [401] below, and the other commentary on the effect of a proof of debt, would not have had to consider the effect of the filing of a proof if the proceeding itself had triggered an immediate default.

(3) The general tenor of available case law and commentary is to the effect that the exceptions provided in section 286(2) of the BGB to the general requirement to trigger default by warning notice should be narrowly construed.

(4) The above seems to be supported also by the decision of the Munich Higher Regional Court in its *Judgment* of 6/7/2001 – 25 U 1549/01 that the opening of a bankruptcy alone does not justify the assumption of a refusal to perform (although the decision may also be consistent with a fact-based approach to the application of the exception).

(5) Professor Mülbert was not able to cite any German authority or commentary in support of his argument that an application to commence German insolvency proceedings would be regarded by a German Court as a serious and definitive refusal to perform by the debtor. In the circumstances, and given what Professor Mülbert accepted would be the importance of the point generally, the absence of such authority suggests the opposite.

(6) Furthermore, the additional reasons advanced by Dr Fischer as to why a German insolvency application does not amount to a serious and definitive

refusal, including the fact that in German law the application (a) is procedural, addressed only to the court, and does not constitute a declaration to any individual party to the contract and (b) does not contain a statement referring to the intent to perform but expresses only a possibility and not a certainty that the debtor will not perform, seem to me to be substantial.

392. Two facts seem to me further to militate against the conclusion sought by the SCG. First, I would accept Wentworth's submission that the question would be whether LBIE's application is to be considered to be the final word by LBIE on whether it would pay any compensation claim under the GMA. Until the netting process it is not certain whether LBIE would be the payee or the payor. Secondly, in the absence of an express provision in a contract, administration does not, as a matter of English law, automatically terminate a contract or trigger a default under a contract. It is not easy to understand why German law should treat an application as a definitive refusal to pay if its governing English law would not.

393. Some further support for my conclusion may be derived by a case decided by the Higher Regional Court in Munich in 2002 (judgment of 6/7/2001-25v1539/01). There the Court stated expressly that:

> "the opening of bankruptcy alone does not justify the assumption of a refusal to perform".

394. This apparently clear statement does, however, need some qualification by reference to its special circumstances, and considerations specific to the German Insolvency Code which may have influenced the Court. First, that case concerned what was described as "only a temporary liquidity bottleneck, which is supposed to be cleared away and make the bankruptcy proceedings superfluous". Secondly, Mr Dicker put to Dr Fischer that there were policy reasons why a German Court in the context of German insolvency proceedings might be reluctant to find that the opening of such proceedings constituted a serious and definitive refusal for the purposes of section 323 of the BGB: such a finding might cut across section 103 of the German Insolvency Code and prevent an insolvency office holder from enforcing a right to perform the contract and demand performance from the counterparty. Dr Fischer's answer was to the effect that this might be so, but other considerations, such as that an insolvency process is considered under German law to be "procedural only" and may not indicate absolute refusal to pay might be more important: that supports the view that the Munich decision needs to be understood in its particular context. Thirdly, Mr Dicker also put to Dr Fischer that under German law a debtor may in certain circumstances be under an obligation to open insolvency proceedings, breach of which may constitute a criminal offence: that might militate against drawing a conclusion as to there being a serious and definitive refusal. Dr Fischer accepted that there is indeed such an obligation in certain circumstances; he was not pressed to agree with the conclusion Mr Dicker sought to draw.

395. Nevertheless, the Munich case does seem to me to offer some support for my conclusion. The features of the German Insolvency Code on which Mr Dicker sought to rely as explaining the decision have analogies in the English administration regime, which also provides for the administrator to continue with contracts, and which may also follow a decision by its directors that a company cannot safely and lawfully continue to trade. The context is, in other words, not as different as Mr Dicker

suggested; and the statement of the Munich Court has resonance in this context as well, and does support Dr Fischer's conclusion, which I have adopted.

396. Before turning to the SCG's alternative case that, in light of differences between the insolvency proceedings in England compared to those in Germany, a proof in LBIE's administration should be taken to constitute a warning notice for the purposes of the BGB, I should note a further point made on behalf of Wentworth. It urges that the real question is not whether there had been a serious and definitive refusal to perform the transactions under the GMA which are terminated on the administration application and made subject to the netting procedure: it is whether the fact of the administration application can be said to be a serious and definitive refusal to pay the single compensation claim under clauses 7-9 GMA. As explained above, under the netting procedure LBIE could be the payee or payor. Wentworth submits that this fact alone shows that the mere making of the application cannot be considered to be the final word by LBIE on whether it would pay any compensation claim under the GMA. On the basis of my earlier conclusions, there seems to be force in this point also.

397. I turn to the SCG's alternative argument on the Default issue, that the filing of a proof of debt in LBIE's administration triggered default for the purposes of section 286 of the BGB.

Should a proof in LBIE's administration be taken to constitute a warning notice for the purposes of the BGB?

398. As noted previously, the SCG's alternative argument is that a proof of debt filed in the LBIE administration could, depending on its terms, amount to a warning notice for the purpose of section 286 of the BGB.

399. The experts are agreed as to the formal and substantive requirements for a warning notice:

(1) It is an unequivocal demand for payment of a sum due.

(2) In general, the warning notice has to be submitted by the creditor to the debtor.

(3) It must be specific, not conditional, and definite and serious.

(4) It requires no special form. Neither the specification of a date for payment or its designation as a warning notice are obligatory.

400. The experts are also agreed that a warning notice cannot be served after the principal debt has been repaid.

401. Furthermore, the experts agree that the filing of a proof of debt in German insolvency proceedings cannot constitute the service of a warning notice under section 286 of the BGB. In essence this is because under German insolvency law it does not comprise a demand made of the obligor for payment of a debt: it is a request to the insolvency administrator to participate in the insolvency estate. This seemed to be confirmed, the experts agreed, by a decision of the Reichsegericht as the predecessor to the BGH in

1928, that a proof of debt does not constitute a warning notice as it does not entail a demand for payment.

402. Thus, the question becomes whether that reasoning applies to a proof of debt in an English administration. It is on this that the experts were disagreed. As previously indicated, their disagreement largely reflects their difference in view on the question whether a default can be triggered after the commencement of an English administration (it being common ground that a default cannot be triggered after the commencement of a German insolvency proceeding). By reference to those differences, Professor Mülbert submitted that:

(1) Unlike the position in a German insolvency process, a proof of debt in an administration in England is a demand for payment made by "*a person claiming to be a creditor of the company and wishing to recover his debt in whole or part*": Rule 2.72(1) Insolvency Rules 1986.

(2) It relates to a debt which remains due by the debtor to the creditor: the administration does not affect the underlying debt due to the creditor (*Wight v Eckhardt Marine GmbH* [2004] 1 AC 147 at [26]; *Re LBIE (Joint Administrators of LBHI v Lomas)* [2015] BCC 431 at [139] and [249]). Where the debt is due at the time that the proof is filed, the proof amounts to or can be treated as a clear and definitive demand from the creditor for payment by the debtor of an amount that is due. In contrast to what appears to be the position as a matter of German insolvency law and civil procedure, there is no principle, or underlying policy, of English insolvency law which ought to prevent the proof from amounting to a warning notice.

(3) Although in England, as in Germany, the proof of debt is required to be submitted to the insolvency administrators, it is nevertheless in an English administration a demand for payment by the company in administration and not merely a request for participation in a separate insolvency estate. That is because in an English administration (a) there is not the same distinction between the insolvency estate and the insolvency debtor (see paragraph [352] above); (b) the entity does not lose its powers of disposition (see *ibid.)* and (c) the administrators act as its agents, and receive the proof of debt on its behalf.

(4) In the respects and for the reasons already explored in paragraph [353] above, the commencement of administration does not permit the inference of an intention to repudiate or inevitable non-performance by the debtor or its representatives; and in a trading administration new obligations may be contracted in the interests of the company. (LBIE's administration was not converted into a distributing administration until December 2010.)

403. Dr Fischer and Wentworth accepted there were differences, but submitted that these were not such as to negate the reasons why under German law a proof of debt cannot constitute the service of a warning notice under section 286 of the BGB. Wentworth stressed the following similarities in the English process:

(1) Proofs of debt are only submitted in response to a notice of intention of distribution and they are necessarily for the purpose of participating in any distribution by the payment of dividends in the insolvency.

(2) The filing of a proof of debt in an administration is a request to participate in a collective insolvency proceeding which may ultimately result in the payment of a dividend from the assets of the insolvent estate. In this regard:

(a) See Oliver J in *Re Dynamics Corp of America (No. 2)* [1976] 1 W.L.R. 757:

> "*The provisions of both the Companies Act 1948 and the Bankruptcy Act 1914 with regard to the submission of proof are I think all directed to this end, that is to say, to ascertaining what, at the relevant date, were the liabilities of the company or the bankrupt as the case may be, in order to determine what at that date is the denominator in the fraction of which the numerator will be the net realised value of the property available for distribution. It is only in this way that a rateable, or pari passu, distribution of the available property can be achieved…* (p. 764).
>
> *…Secondly, even if these rights could be considered as of uncertain value, one has, I think, to inquire what it is that the creditor is seeking to do when he lodges his proof. What he is directed to do by the form of proof (and what all the previous authorities direct him to do) is to indicate the value of the claim at the date of the winding up order*" (p. 767).

(b) Also, *Rubin v Eurofinance* at [165] to [167], citing *Robertson, Ex p; In re Morton* (1875) LR 20 Eq 733:

> "*[W]hat is the consequence of creditors coming in under a liquidation or bankruptcy? They come in under what is as much a compact as if each of them had signed and sealed and sworn to the terms of it— that the bankrupt's estate shall be duly administered among the creditors*"

(c) And see *per* Lord Toulson and Lord Sumption in *Stichting Shell Pensioenfonds v Krys and another* [2015] A.C. 616 at [31]:

> "*For by submitting a proof the creditor obtains an immediate benefit consisting in the right to have his claim considered by the liquidator and ultimately by the court according to its merits and satisfied according to the rules of distribution if it is admitted.*"

404. As in the context of my assessment whether the characteristics of an English administration differ from those of a German insolvency proceedings so as to permit what would be regarded as a default for the purposes of section 286 of the BGB after the commencement of the administration, and in large part for the same reasons, I have concluded that the similarities brought out by Wentworth and relied on by Dr Fischer outweigh the differences. I accept that there are points of difference: but these do not seem to me to provide any sufficient basis for concluding that a proof of debt in an English administration should be characterised as a warning notice whereas it is agreed that a proof of debt in a German insolvency would not. In my judgment, therefore, the SCG's alternative argument fails also.

Conclusion on Issue 20(1)

405. It follows that, in my judgment, the answer to Question 20(1) is in the negative.

406. Following LBIE's administration, a creditor is not entitled to make a claim for "further damage" under section 288(4) of the BGB.

407. Issue 20(2) and Issue 21 are, on that basis, academic; but in case I am wrong in my conclusion on Issue 20(1) I turn next to address them.

Issue 20(2)

408. Question 20(2) asks whether, if a creditor is entitled to make a "damages interest claim" on a close-out amount payable under the GMA, all or part of such "damages interest claim" can constitute (as a matter of English law) part of the "*rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9).

409. The SCG contend that such a damages interest claim (a) accrues on the date of default and can (under German law) be expressed as a percentage rate of interest accruing on the unpaid close-out amount for a period of default, and (b) where expressed as a rate, can constitute part of the rate applicable in the sense required by Rule 2.88(9).

410. Wentworth contends that even if there could be a claim for further damage by way of a damages interest claim (as I shall call it for present purposes) it would not (as a matter of English law) constitute part of the "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9).

411. In light of the decision of David Richards J in *Waterfall IIA* (though it is subject to appeal) the issue must be answered by reference to the rights actually held by the creditor at the commencement of the administration. The essential question, on the assumption (contrary to my conclusion) that the SCG are able to establish default before the administration order, is whether a claim which is contingent, in the sense that the rate is one to which the creditor would only become entitled if it took certain steps or if certain events occurred after the commencement of the administration: if so, it would not appear to satisfy the test as propounded by David Richards J.

412. Before addressing the matter in more detail I should note two introductory matters. First, the parties' submissions were made on the basis that the relevant conclusions of David Richards J are correct (as is plainly appropriate), whilst at the same time (as is

equally appropriate) fully reserving their rights in respect of the appeal to be heard in the Court of Appeal.

413. Secondly, (and although Wentworth does not accept this) there may be some overlap between this Issue 20(2) in relation to the GMA and Supplemental Issue 1(A) in relation to the ISDA Master Agreements which has arisen from Issue 4 in the *Waterfall II Part A application* and which I address in the last part of this judgment. That is because David Richards J answered the question posed by Issue 4 as to whether the words "*the rate applicable to the debt apart from the administration*" in Rule 2.88(9) of the Insolvency Rules are apt to include foreign judgment rate of interest or other statutory rate in the negative in circumstances where the creditor had not in fact obtained a relevant foreign judgment at the date of the commencement of the administration. He did so on the basis (put summarily) that the words could not be read as including a hypothetical rate of interest which would be applicable if the creditor took certain steps, but which was not in fact applicable at the date of administration because such steps had not in fact been taken by the creditor at that time (see his judgment at paragraph 177). Some aspects of overlap will become apparent in my discussion of Issue 20(2): but I also discuss further the extent of the overlap between the issues later in this judgment.

414. To return to Issue 20(2) itself, the SCG's case is as follows:

(1) Where a damages interest claim accrues as a consequence of a default arising on or before the commencement of LBIE's administration, it forms part of a creditor's rights as at the commencement of the administration.

(2) Even if, contrary to the SCG's primary case, the default occurs (and the claim were to accrue) after the commencement of LBIE's administration, the entitlement to damages arising under the BGB applies to the debt proved (i.e. the close-out amount) and is part of a creditor's rights as against LBIE at the commencement of the administration.

(3) Therefore, the claim permitted by section 288(4) of the BGB (like any entitlement to interest under sections 288(1) and (2) of the BGB) is capable of constituting part of the "*rate applicable to the debt apart from the administration*" for the purposes of Rule 2.88(9).

(4) The fact that an element of contingency may exist in relation to the determination of the quantum or value of a damages interest claim is not sufficient to prevent it from being a "*rate applicable to the debt apart from the administration*" in the relevant sense.

(5) This is illustrated by the position of admitted provable debts which are contingent as at the date of administration. In relation to such debts, interest runs from the date of administration at the rate applicable to the debt apart from the administration, even though the interest entitlement is subject to the same contingency as the debt: see *Waterfall IIA* ibid. at [225].

(6) The same analysis can apply even where the default has not occurred prior to administration: the right under the BGB exists, even though the applicable

rate is subject to the contingency of the default occurring and determination of the quantum or value of the damages interest claim.

(7) The damages interest claim is no different, for these purposes, from any other right to interest of which the value is uncertain or undetermined as at the date of administration (such as a right to a variable interest rate).

(8) As to David Richards J's distinction (in answering Issue 4) between rights which have an existing legal foundation at the date of administration and rights which have no existing legal foundation at the date of administration, whereas a right to interest on a foreign judgment obtained after the administration would fall in the latter category, the right to further damages should be classified as a pre-existing right in the former category: all that is left undecided at the administration date is the assessment or proper quantification of the interest entitlement that always existed in the form of the interest damages claim. The right exists even though its quantification is prospective.

415. Wentworth's response can be summarised more quickly:

(1) Since no default can be said to have occurred prior to the administration order, and it is common ground that a claim to interest damages does not exist unless and until a default has occurred within the meaning of section 286 of the BGB, a creditor cannot be said to have, by reason of a prospective claim for interest damages, any existing right at the commencement of the administration.

(2) Secondly, it is also common ground that a claim for interest damages under section 288(4) of the BGB must be pleaded and proved to the satisfaction of the relevant court, and its award is in the court's discretion: it is therefore subject to contingencies which mean that it cannot constitute a *"rate"* within section 2.88(9). In that regard, the contingencies are no different from those relating to claims for foreign judgment rate of interest.

(3) Thirdly, the experts appeared to agree that the practice of the German court is to allow a claimant to elect to have a claim for *further damage* expressed as a rate if, as a result of the delay in payment of the debt due, the claimant has either incurred an interest expense to close the "funding-gap" as a result of the delay or suffered a loss of interest income by reason of an investment opportunity lost by reason of the "funding gap". In such a case, the rate awarded is based upon the sum borrowed or which would have been invested and not the amount owed to the claimant. The significance of the need for an election by the claimant and the ultimate control of the remedy by the Court is that it cannot be said that there is any necessary connection in terms of a "*rate*" between *further damage* and the unpaid amount. If awarded at all, it can only be said that such *further damage* might be expressed as a rate.

(4) Accordingly, a claim for *further damage* is not to be characterised as a "*rate*" applicable to the debt proved at the commencement of the

administration. It cannot, therefore, be "*the rate applicable to the debt apart from the administration*" for the purpose of Rule 2.88(9).

416. I prefer Wentworth's arguments, which appear to me to be logically compelling. The SCG's arguments in this context seem to me to be ingenious, but stretched. In my judgment, the interest damages claim which a creditor might have cannot be equated to a right existing at the date of administration, and even if it is established and quantified in terms of a rate, that rate is not applicable to the debt proved at the commencement of the administration.

417. Accordingly, if Issue 20(2) arises (contrary to my conclusion in respect of Issue 20(1)) in my judgment the answer to it is in the negative.

Issue 21

418. Issue 21 relates to the assignment of any further claim for damages and is in three parts, none of which arises on my view of the answers to Issue 20. I address these issues in case those answers are subsequently found to be wrong.

419. Issue 21 asks:

> "*If the answer to question 20 is that a further claim for damages can be included as part of the "rate applicable to the debt apart from the administration" for the purposes of Rule 2.88(9), how in such circumstances, is the relevant rate to be determined? In particular:*
>
> *(i) In circumstances where the relevant claim under the German Master Agreement has been transferred (by assignment or otherwise) to a third party is it the Damages Interest Claim which could be asserted by the assignor or the assignee which is relevant for the purposes of Rule 2.88(9)?*
>
> *(ii) Where the relevant claim under the German Master Agreement has been acquired by a third party, in what circumstances (if any) is such a third party precluded from asserting a Damages Interest Claim under principles of German law?*
>
> *(iii) Where does the burden of proof lie in establishing a Damages Interest Claim, and what is required to demonstrate, that a relevant creditor has or has not met such requirement?*"

Issue 21(i)

420. Issue 21(i) is focused on whether a claim for "further damages" by an assignee of a claim against LBIE under the GMA since the date of administration should be treated as part of the "*rate applicable to the debt part from the administration*" for the purpose of Rule 2.88(9).

421. As recorded in the SCG's written closing submissions (and not contradicted by Wentworth) the experts are agreed that as matter of German law:

(1) It is possible for a counterparty to assign rights to the Single Compensation Amount under the GMA.

(2) The transferee may assert a claim to compensation for default damage under section 288(4) of the BGB which has already accrued to the transferor, if the terms of the assignment expressly or impliedly include such a claim.

(3) For the period before the transfer, the only default damages claim that can be asserted is the default damages claim belonging to the transferor.

(4) For the period after the transfer, the focus of any default damages claim is on the transferee and not the transferor ("*the reason and amount for the damage are guided by the person of the transferee*").

(5) The fact that the transferee was aware of the obligor's default at the date of the assignment does not preclude the transferee from asserting the assigned claims.

(6) The burden of proof for establishing any default damages claim lies with whoever asserts the claim.

422. However, as matter of English law, the question remains whether any such claim as under German law may be available to the assignee can be characterised in such a way as to fall within Rule 2.88(9).

423. The SCG did not fully address this question, and assumed that if (contrary to my conclusion) the claim or interest damages was a right existing at the date of administration, the only relevant dispute is whether a transferee can claim a greater level of damages for the period after assignment than the transferor could have claimed (which really relates to the second sub-issue of Issue 21).

424. Wentworth, on the other hand, although Mr Allison floated the attractive suggestion that I might find it unnecessary to deal with this sub-issue (i) at all (a suggestion which was tempting but which I felt I should resist), put forward detailed submissions to the effect that the further damage which could be asserted by the assignee under section 288(4) of the BGB following the assignment of the claim is, on the basis of the reasoning of David Richards J in *Waterfall IIA,* simply not relevant for the purposes of Rule 2.88(9) of the Insolvency Rules.

425. Mr Allison on Wentworth's behalf put forward the following four-step analysis:

(1) First, as developed above, the *Waterfall IIA* judgment establishes that the "*rate*" applicable to the proved debt "*apart from the administration*" is to be determined by reference to the rights of the creditor as at the commencement of the administration: see *Waterfall IIA*, at [177]-[183].

(2) Secondly, the "*rate*" applicable to the proved debt under the GMA (i.e. the close-out amount claimed by the assignor) at the commencement of the administration is determined by reference to the damages incurred by the

assignor – it is the only person that held a claim for *further damage* at the commencement of the administration.

(3) Thirdly, the assignment of the proved debt has taken place after the commencement of the administration. This means that there is no way in which the assignee could be described as having any actual rights to *further damage* under section 288(4) of the BGB at the commencement of the administration. It is agreed by the experts that an assignee can assert a claim for *further damage* only by reference to the period following the assignment – a claim for *further damage* prior to an assignment is based on the rights of the assignor and is not even transferred to the assignee unless it is included in the assignment.

(4) Fourthly, having regard to the agreed position between the experts, there is no basis on which an assignee's claim for *further damage* under section 288(4) can be characterised as a "rate" applicable to the debt proved at the commencement of the administration as required by *Waterfall IIA*. Any rights of the assignee to *further damage* as a rate necessarily post-date the commencement of the administration.

426. Professor Mülbert sought to meet this argument by suggesting that what is transferred is a "*future (potential) Damages Interest Claim*". However, under cross-examination he was constrained to agree both (a) that "*The assignee cannot make a claim for further damage in respect of the period before the assignment*" and (b) that the assignee can only claim "*in his own right*" in respect of his post-assignment *further damage*, which he further accepted "*did not materialise*" or become "*fully existent*" until the assignee sustained actual damage post-assignment.

427. In my judgment, in light of Professor Mülbert's acceptance of the nature of the claim for further damage which the assignee might assert as and when it materialises, it is plain that the SCG's attempt to characterise the assignee's claim as falling within the scope of Rule 2.88(9) must fail. As Mr Allison submitted, to hold otherwise would be to fall into the contingencies analysis applicable to the proof of debts but rejected by David Richards J in relation to the wording of Rule 2.88(9), which is focused upon applicability of a rate at the commencement of the administration.

Issue 21(ii)

428. Issue 21(ii) is concerned with whether, as a matter of German law, an assignee can recover a greater amount of *further damage* than that which could have been recovered by the assignor.

429. The background for this issue in terms of the expert evidence is that they were agreed that:

(1) It is only the assignor that can assert a claim for *further damage* for the period prior to the assignment.

(2) The assignor's claim for *further damage* may be retained by it or may be transferred to the assignee as provided for in the assignment.

(3) For the period after the assignment, it is the *further damage* of the assignee that is relevant.

430. The experts disagree as to whether there is a cap on the amount of any further damage recoverable by the assignee. The issue is similar to that considered in the context of the ISDA Master Agreements.

431. The experts agree that the only decision of the German courts which expressly considers the issue (a decision of the Federal Court of Justice on 25 September 1991) (VIII ZR264/90, WM 1991, 2036) expressly left open the question whether an assignee might claim further damage in excess of that which might have been claimed by the assignor.

432. Professor Mülbert's position is that:

(1) It is the position of the assignee alone which is relevant when determining the damage suffered as a consequence of the default for the period after the assignment: the issue is restricted to whether there is "a cap".

(2) The (agreed) position under German law that it is the position of the transferee alone which is relevant when determining the damage suffered as a consequence of the default for the period after the assignment holds true even if the debtor has to pay more as a result, absent express restriction.

(3) There is nothing in the language of section 398 of the BGB, which is the provision permitting assignment of claims, which purports to restrict the rights of an assignee following assignment.

(4) The prevailing view in the commentaries on the effect of an assignment is that there is no cap or limit on the extent of the damages that the assignee can recover.

433. Dr Fischer's position, on the other hand, is that:

(1) German law recognises a principle that the debtor should not be prejudiced by an assignment of a claim, such that the assignee cannot recover a greater amount of *further damage*.

(2) The principle that the debtor should not be prejudiced by an assignment of a claim is implicit in the BGB and recognised by the German Federal Court: in particular, in sections 404, 406 and 407 of the BGB. The effect of the principle is that the assignee is necessarily limited to the *further damage* claim that the assignor could have asserted.

(3) There are strong policy reasons why an assignee should not be able to recover a greater loss than the assignor; such a conclusion would encourage "debt-trafficking" to the detriment of the debtor: for example, an assignment on the footing that some part of the higher damages be rebated back to the assignor.

434. The dearth of German case law and commentary in relation to the particular issue obviously makes more difficult a determination by an English court, which obviously

cannot have the broader experience and knowledge of a German court, of this point of German law of potentially broad importance. However, on the basis of the evidence of the experts and the cases and commentaries they have provided to me, my views on the matters in dispute between them can be summarised as follows.

435. There is no doubt that the prevailing view in the various (and numerous) articles and commentaries identified by the experts is that there is in general no cap or limit as to the extent of damages that the assignee can recover. The following extract from *Staudinger, Burgerliches Gesetzbuch (Commentary on the German Civil Code)* rev. ed. 2012 exemplifies that prevailing view:

> "*The assignee is entitled to all subsequent claims resulting from the claim, in particular those under section 280 et seq. The assignee can therefore…autonomously assert claims if the debtor is in default towards the assignee…The amount of the default damages is, in principle, calculated based on the person of the assignee". The principle applies even if the damages incurred by the new creditor are higher than those presumably incurred by the old creditor. The debtor, who must expect the assignment at any time, cannot reclaim protection of confidence with regard to a less beneficial development of damages. It is, however, imaginable that the new creditor, in certain cases, is subject to a duty to minimise damages in the form of an obligation to provide notice of potential of increase damages.*"[28]

436. The real question is whether Dr Fischer is correct that the provisions of the BGB which he relied on, sections 404, 406 and 407, support a cap or limit in order that the debtor should not be disadvantaged by the assignment and exposed to unquantifiable risks at the instance of a person whom he did not choose to contract with. Dr Fischer accepted that those sections do not expressly stipulate any cap or limit; but he was firm in his evidence that it is implicit in them that the legal position of the debtor cannot be made worse by an assignment. He relied especially on the broad view which the German Federal Court appears to have taken of section 404 of the BGB in a number of decisions, and especially on its decision of 11 May 2006, where it was stated:

> "*…The granting of a subsequent performance determination right follows from the principle of sec. 404 et seqq. BGB, i.e. that the assignment of the claim against the debtor should not place the debtor in a worse position than he would be in without it.*"

437. Professor Mülbert accepted in his oral evidence that the BGH had stated the principle of debtor protection in general terms, but he took the view that the protection afforded

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[28] In cross-examination, Dr Fischer noted when taken to this authority that it was always possible to assign a claim under German law unless there was a prohibition on assignment.

was restricted to the imposition of additional rights against the debtor or the loss of legal defences or objections that the debtor would have had against the assignor.

438. In cross-examination it was put to Dr Fischer that the general principle he had identified in the case law simply protected against a worsening of the legal position and did not protect against a worsening of the factual position, which would include a higher damages claim by an assignee. Dr Fischer rejected this.

439. Thus, the question may be further refined to whether any restriction implicit in sections 404, 406 and 407 of the BGB are confined to preventing the worsening of the debtor's legal position but do not protect against a worsening of the factual position, and if so, whether a higher damages claim by an assignee signifies a change in the legal position or the factual position.

440. The experts cited a variety of cases and commentaries on these questions also. Dr Fischer cited academic commentary in support of the general proposition that freedom of contract and choice of contracting party should restrict the assignment from being disadvantageous to the debtor; but Dr Fischer accepted that, subject to that, all the cases, on analysis, concerned the worsening of the legal position of the debtor, and did not address the question here of detriment to the debtor resulting from a greater loss incurred by the assignee.

441. In my view, the cases and commentaries offer no real guidance on the question as to the proper characterisation of such detriment, nor specifically on whether such detriment is implicitly precluded.

442. I have concluded that, on the basis of the material cited, Professor Mülbert's view that the debtor's protection is limited to its "legal position", and that this does not extend to the factual consequences of a change in the identity of the person asserting the same legal rights, is to be preferred. Accordingly, in my judgment the position in German law is that there is no cap or limitation on the amount of further damage that an assignee may claim.

Issue 21(iii)

443. Issue 21(iii) concerns the way in which a claim for *further damage* under section 288(4) of the German Civil Procedure Code would be assessed by the court, including matters such as the burden of proof and whether there are any rules or presumptions which are to be applied when determining such a claim.

444. I propose to adopt the two-stage analysis of this issue which Wentworth adopted and to consider in turn:

(1) the general position in relation to the assessment of damages; and then

(2) the simplified ("abstract") method of demonstrating lost profits and whether this is available only to banks, or to all investors.

General position

445. The experts are agreed on the following points:

(1) The Court assesses damages according to section 286 and 287 German Civil Procedure Code: these provisions make it clear that the assessment of damages is in the discretion of the Court.

(2) The obligee bears the burden of proof and must establish both the causal connection for the damage and its amount.

(3) A claim for lost profits under section 252 of the BGB requires the claimant to plead and prove the type of investment that it would have made in the usual course.

(4) The burden of proof under section 252 of the BGB is a balance of probabilities.

Simplified or "abstract" method of quantification

446. The experts also agree that, when it comes to calculating damages for late payment of a defaulted debt, banks are entitled to perform the calculation in the "abstract". In other words, they are not required to demonstrate that non-payment has led to the frustration of a particular transaction. Instead, "*the bank can calculate its damages based on an average profit based on its overall business activities*".

447. However, the experts disagree on whether other investors, such as non-bank financial institutions and hedge funds can rely on the same abstract approach to damages. It is agreed that there is no case specifically considering the position.

448. Professor Mülbert's view is that non-bank financial institutions and hedge funds are also entitled to rely on the so-called abstract approach to damages. In this regard he refers to *Staudinger* 'Commentary on the German Civil Code' revised ed. 2014:

> "*If the creditor is a bank, it must be assumed that the sum of the funds intended for investment in its overall business, is reduced by the amounts that are paid late…What applies for banks also applies for other commercial capital investors such as investment companies and insurance companies that invest incoming sums unless they are required for ongoing business operations*."

449. By contrast, in his expert report Dr Fischer asserts that the "*overwhelming opinion in legal literature*" is that commercial investors are not entitled to rely on the abstract approach. Further, Wentworth relies on the following:

(1) There is no decision which has enabled an investor other than a bank to utilise the simplified or abstract approach.

(2) The only decision in the materials provided which considers the issue for another investor (an insurer) rejects it as a possibility and concludes that the method was available only to banks based on the publicly available rates for banks.

(3) Professor Mülbert agreed that there were no publicly available published rates in relation to investors other than banks which could form the basis for the application of the simplified or abstract method to other investors.

(4) Judge Gruneberg, a member of the BGH Senate responsible for banking and finance, has expressed the view that it is only banks that are able to utilise the simplified method for lost profits, and that "*all other creditors*" must prove their interest loss specifically.

(5) Although there is one commentary that expresses the contrary opinion, that commentary cited a decision in 1967 which was not followed by a later decision of the Cologne Court.

450. In cross-examination, it was put to Dr Fischer that there is no logical basis for distinguishing between two entities, both of which always invest their surplus money, on the basis that one of them is called a "bank" and the other, which does exactly the same thing, is not. In answer, Dr Fischer did not suggest any logical basis for that distinction. Instead, he suggested that, in his view, no investors (including banks) should be entitled to rely on the abstract calculation.

451. Again, I am required to express a conclusion on German law on an issue of general importance where there is no settled guidance. However, it is plain, in my view, that the materials available favour the view expressed by Dr Fischer and apparently supported by Judge Gruneberg, that the abstract approach is only available to banks, where there are publicly available published rates which can be relied on. Even if there is no more definite logic, it seems to me that the fact that such rates are available distinguishes the positions of banks sufficiently for these purposes, and that the absence of any contrary authority is telling and supportive of that conclusion.

452. That concludes my assessment of the German law issues and leaves only Supplemental Issue 1(A) as a contentious matter: this relates, and requires me to return, to the ISDA Master Agreements.

ISDA Master Agreements: Supplemental Issue 1(A)

453. Supplemental Issue 1(A) is:

> "*Whether, and in what circumstances, the words 'the rate applicable to the debt apart from the administration' in Rule 2.88(9) of the Rules include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration*".

(The "*Rules*" mentioned in Supplemental Issue 1(A) are the Insolvency Rules 1986. The "*Date of Administration*" mentioned in Supplemental Issue 1(A) is the date of the commencement of LBIE's administration.)

Genesis of Supplemental Issue 1(A)

454. Supplemental Issue 1(A) derives from Issue 4 in the *Waterfall IIA* application. Issue 4 was:

> "*Whether the words "the rate applicable to the debt apart from the administration" in Rule 2.88(9) of the Rules are apt to include (and, if so, in what circumstances) a foreign judgment rate of interest or other statutory rate*."

455. The parties to *Waterfall IIA* were agreed that if a creditor has obtained a foreign judgment before the commencement of the administration, and that judgment carries interest at a rate higher than the English judgment rate, the foreign judgment rate will be the "*rate applicable to the debt*".

456. However, as recorded in paragraph 173 of the judgment of David Richards J (as he then was) in *Waterfall IIA* (in this part of this judgment, "the Tranche A Judgment"), there was a dispute as to whether those (italicised) words

> "are apt to include not only a rate which is in fact applicable to the debt but also a rate which would be applicable to the debt if the creditor obtained judgment for it."

457. There was also a dispute, if the answer to that question was "no", whether, in the case of a creditor who in fact obtains a foreign judgment in the course of the administration, the rate applicable to that foreign judgment would be the "*rate which is in fact applicable*" for the purposes of Rule 2.88(9).

458. David Richards J answered both sub-issues in the negative.

459. In circumstances where the creditor had not in fact obtained a relevant foreign judgment as at the date of commencement of the administration, the Judge's conclusion was (at paragraph 177):

> "[t]he words the *'rate applicable to the debt apart from administration'* cannot be read as including a hypothetical rate which would be applicable to a debt if the creditor took certain steps."

460. David Richards J further stated that the words

> "should be given their obvious meaning of the rate **in fact applicable** to the debt" (emphasis added).

461. As to the second sub-issue, David Richards J's conclusion was that the words do not apply in respect of a judgment debt actually established after the commencement of the administration either. He accepted the submission that this is because

> "…at the date of the administration [the creditor] had no right to interest at the relevant judgment date."

462. In the round, as to both sub-issues, David Richards J stated his conclusion as follows (in paragraph 183):

> "I conclude therefore that the words 'the rate applicable to the debt apart from the administration' in rule 2.88(9) do not include interest on a judgment entered after the commencement of the administration nor, still less, do they include interest at a rate which would have been applicable to a judgment entered after the commencement of the administration but which is not in fact entered."

463. The issue which now arises as Supplemental Issue 1(A) is whether, having regard to the reasoning in the Tranche A Judgment (which, without prejudice to their contentions on appeal, all concerned accept for present purposes is to be taken to be correct), the words *"the rate applicable to the debt apart from the administration*" in Rule 2.88(9) do or do not include a contractual rate of interest which only applies after the Date of Administration due to action taken by the creditor post-administration.

464. Although emerging out of Issue 4 and matters decided by David Richards J, it was agreed between all concerned that, especially since he (now David Richards LJ) has been elevated to the Court of Appeal, Supplemental Issue 1(A) might impact on, and in any event could conveniently be determined by me as an adjunct to, the other matters addressed earlier in this judgment.

The opposing parties and their perspectives

465. As previously noted, York had not been represented in respect of the other issues addressed in this Judgment, but it appeared to me to be appropriate to accede to its application to advance arguments on Supplemental issue 1(A) to the effect that the relevant words in Rule 2.88(9) of the Rules do not include a contractual rate of interest which only applies after the Date of Administration due to action taken by the creditor post-administration.

466. York, which I note contended for an affirmative answer to both sub-issues raised by Issue 4 in *Waterfall IIA*, has a considerable interest in this regard since (a) the claims of the Liberty View funds which it represents as a respondent consist only of prime brokerage related claims and not ISDA Claims, (b) those claims are substantial and (c) in right of those claims York (in common with other holders of the £7.8 billion of admitted claims in the LBIE estate that are not ISDA Claims) would benefit from a negative answer to the issue, since that could result in lesser amounts of interest being payable to ISDA claimants.

467. More particularly, a material diversion of the surplus towards payment of higher statutory interest rights on ISDA Claims particularly adversely affects the holders of non-ISDA Claims who did not benefit from a contractual rate of interest in excess of 8%. Such creditors (apart from possible recoveries on any non-provable Currency Conversion Claims) have, as things stand, no entitlement to recover anything more than statutory interest at 8% simple, with no compensation payable at all for the delay in paying such statutory interest since 30 April 2014 (the first date on which most admitted proved claims received dividends equal to 100% of their admitted claims in

sterling). Indeed, York's position is that it is the only respondent to the *Waterfall II Application* which clearly can be said to be (albeit not formally) a representative of those £7.5 billion of admitted claims and not ISDA Claims[29].

468. Put shortly, York's case is that the rationale and conclusions of David Richards J in deciding Issue 4 are applicable and should be applied to Supplemental Issue 1(A). Its primary argument is that there is no material difference, as a matter of principle or policy, between a creditor taking steps subsequent to the administration to obtain a judgment based on his contractual rights (the point in Issue 4) and his taking steps subsequent to the administration by serving a demand (the point in Supplemental Issue 1(A)), since in both cases the creditor is invoking and relying on his existing contractual rights in order to obtain greater rights. If an interest rate applicable as a result of obtaining judgment by invoking those contractual rights is not a rate applicable to the debt apart from the administration, then (the argument goes) the same applies to an interest rate applicable as a result of invoking contractual machinery, for example, by serving a demand or notice.

469. By letter from its solicitors dated 14 December 2015, Wentworth advised the Court that it supported York's position, but did not itself see the need or wish to advance separate submissions. That has remained its position throughout, including at a further hearing which (I shall come on to explain) I felt necessary to elucidate further the parties' respective written submissions.

470. With the agreement of the Administrators, the SCG (which, like York, contended for an affirmative answer to both sub-issues raised by Issue 4 in *Waterfall IIA*) has taken on the role of advancing arguments in effect on behalf of unsecured creditors to enable the Administrators to obtain the Court's directions. I was and remain content with that course.

471. The SCG's position is that the answer to the question raised by Supplemental Issue 1(A) is in the affirmative. The SCG submit that this result follows from the terms of the relevant provisions of the ISDA Master Agreements and the Court's earlier determination of Issues 6 to 8 in *Waterfall IIA.* For these purposes, the SCG submit that York's contentions are based on an incorrect understanding of the judgment in *Waterfall IIA* in respect of Issue 4 and, furthermore, overlook the effect of that judgment in determining Issues 6 to 8.

472. Put shortly, the SCG's case is that there is an essential difference between rights to interest, or other compensation for delayed payment, which, on the one hand, have an existing legal foundation at the date of the administration (as the SCG contend is the position in the case of a provable debt that is a close-out sum under a contract) and, on the other hand, rights to interest, or other compensation for delayed payment, which have no legal foundation at the date of the administration and arise only after the administration (such as pursuant to a hypothetical judgment).

[29] It is understood by York that both the Senior Creditor Group and Wentworth hold some prime brokerage related claims, but it will be obvious from the size of the potential higher entitlements on ISDA Claims that both such respondents have material economic incentives to seek to increase the statutory interest and other entitlements on their ISDA Claims, effectively at the expense of creditors not represented in the Application other than through York.

473. The Administrators themselves have also played a more active role in relation to this issue: they too submit that York's argument is wrong and that Supplemental Issue 1(A) should be answered in the affirmative.

474. The Administrators' position (albeit of course subject to the directions of the Court) is that a contractual right to a given rate under a pre-administration contract, being a legal right existing on the Date of Administration (even if it may not yet be running, as explained further below) is plainly different from a right which depends upon and arises only in consequence of a judgment obtained after that date. The former (contractual right to a rate) plainly falls within Rule 2.88(9) and will always be a "*rate applicable to the debt apart from the administration*"; the latter (founded on a subsequent judgment, whether hypothetical or actually obtained) plainly does not, and will never be so.

475. I have been provided with full written submissions by York, the SCG and the Administrators (including written submissions in reply from York). I have also received a letter from Wentworth's solicitors confirming its support for York's submissions. It was agreed that I should determine the matter on the basis of those submissions, unless any party or I felt the need for an oral hearing. In the event, I did feel it necessary to have a relatively short hearing. In the event, and for a number of reasons, this did not take place until 24 June 2016.

Relevant contractual provisions

476. Before explaining in more detail the parties' respective submissions, it is convenient (especially having regard to the length of this judgment, but with apology for any repetition) to rehearse the relevant provisions of the ISDA Master Agreements, especially in respect of the determination of when amounts fall due on early termination and any entitlement to interest on them, which is the context in which Supplemental Issue 1(A) arises.

477. While the provisions governing the determination of amounts due on early termination are different in the 1992 and 2002 Forms, the provisions governing when such sums fall due and when the entitlement to receive interest on them arises are materially identical.

478. I take this summary largely from the SCG's skeleton argument:

(1) Under Section 6(a) of the Master Agreements, if an Event of Default with respect to a party (the "Defaulting Party") has occurred and is continuing, the other party (the "Non-defaulting Party") may (but is not required to) designate an "Early Termination Date" in respect of all outstanding transactions. Where "Automatic Early Termination" is specified in a Schedule, an Early Termination Date will occur immediately on the occurrence of certain specified Events of Default.

(2) Events of Default are defined in Section 5 of the Master Agreements. They include "Bankruptcy Events" at Section 5(a)(vii), including where a party seeks or becomes subject to the appointment of an administrator.

(3) Prior to the occurrence or effective designation of an Early Termination Date, each party is required to make the payments or deliveries specified in the relevant Confirmation.

(4) Unless there has been a default in performance, there is no contractual right to interest on such payments or right to compensation for late delivery (which in any case was only applicable to the extent provided for in the Confirmation or elsewhere in the Master Agreement).

(5) Upon the occurrence of an Early Termination Date, all transactions entered into pursuant to the Master Agreement are terminated and no more payments or deliveries in respect of the Terminated Transactions are required to be made. In those circumstances the amount, if any, payable in respect of an Early Termination Date is calculated in accordance with Section 6(e) (Section 6(c)(ii)). Pursuant to Section 6(d)(i) the parties are required to make the calculations contemplated by Section 6(e) "*on or as soon as reasonably practicable following the occurrence of an Early Termination Date*".

(6) The payment date for sums due on Early Termination is governed by Section 6(d)(ii). Where an Early Termination Date arises as a consequence of an Event of Default, section 6(d)(ii) provides that an amount calculated as being due in respect of any Early Termination Date under Section 6(e) "*will be payable on the date that notice of the amount payable is effective*".

(7) In each case, the ISDA Master Agreements provides for interest to accrue on the early termination amount from the Early Termination Date:

  (a) Section 6(d)(ii) of the 1992 Form provides that if an early termination amount is due in respect of an Early Termination Date, that amount "*…will be paid together with…interest thereon (before as well as after judgment) in the Termination Currency, from (and including) the relevant Early Termination Date to (but excluding) the date such amount is paid, at the Applicable Rate*". Where the early termination amount is owed to the Non-defaulting Party, the Applicable Rate is the Termination Rate from the Early Termination Date to the date on which the early termination amount is payable (i.e. upon delivery of a calculation statement) and the Default Rate for the period thereafter.

  (b) Section 6(d)(ii) of the 2002 Form provides that an amount due on early termination is payable "*together with any amount of interest payable pursuant to Section 9(h)(2)(ii)*". Section 9(h)(2)(ii) provides that if an early termination amount is due in respect of an Early Termination Date, that amount "*will…be paid together with interest thereon (before as well as after judgment) on that amount in the Termination Currency for the period from (and including) the Early Termination Date to (but excluding) the date the amount is paid, at the Applicable Close-out Rate*". Where the early termination amount is owed to the Non-defaulting Party, the Applicable Close-out Rate is the Default Rate both for the period from the Early Termination Date to the date on which the early termination amount is payable (i.e. upon delivery of a calculation statement) and for the period thereafter.

479. Accordingly:

(1) Where Automatic Early Termination has been specified: (a) an Early Termination Date arises immediately upon the occurrence of the relevant Event of Default; (b) the early termination amount becomes immediately due; (c) interest immediately starts accruing on the early termination amount payable to the Non-defaulting Party at the Termination Rate (1992 Form) or the Default Rate (2002 Form); (d) the early termination amount becomes payable following delivery of a calculation statement under Section 6(d)(i); and (e) interest continues to accrue on the early termination amount at the Default Rate until payment.

(2) Where Automatic Early Termination has not been specified: (a) following an Event of Default, the occurrence of an Early Termination Date is contingent on the Non-defaulting Party designating an Early Termination Date under section 6(a); (b) upon designation of an Early Termination Date, the early termination amount becomes immediately due; (c) upon designation of an Early Termination Date, interest immediately starts accruing on an early termination amount payable to the Non-defaulting Party at the Termination Rate (1992 Form) or the Default Rate (2002 Form); (d) the early termination amount becomes payable following delivery of a calculation statement under Section 6(d)(i); and (e) interest continues to accrue on the early termination amount at the Default Rate until payment.

480. I should also note what the Administrators described as "seven key points implicit within Supplemental Issue 1(A) itself" and thus relevant to all parties' submissions, which they stated as follows:

(1) Supplemental Issue 1(A) is concerned with a close-out sum that is a provable debt. It refers expressly to a "*provable debt that is a close-out sum*".

(2) The close-out sum is a provable debt within Rule 13.12(1)(b), namely "*any debt or liability to which* [LBIE] *may become subject after* [the Date of Administration] *by reason of any obligation incurred before that date*". The wording of Supplemental Issue 1(A) makes clear that the close-out sum "*became due and payable ... after the Date of Administration*"; in other words, the close-out sum is a debt to which LBIE became subject after the Date of Administration.

(3) It follows that the contract under which the close-out sum became due and payable is necessarily a pre-administration contract, that is, a contract entered into by LBIE before the Date of Administration, which was binding on LBIE as at that date. Indeed, if the contract giving rise to the close-out sum did not pre-date the administration, the close-out sum payable under it would not be provable within Rule 13.12 at all and the question of statutory interest (at any rate) being payable on the close-out sum under Rule 2.88 would not arise.

(4) The terms of that pre-administration contract contained an obligation on LBIE to pay interest in certain circumstances. This is reflected in the

wording of Supplemental Issue 1(A), which refers expressly to a "*contractual rate*".

(5) Although the close-out sum itself is a provable debt under Rule 13.12(1)(b), post-administration contractual interest is not provable, as a result of Rule 2.88(1), which provides: "*Where a debt proved in the administration bears interest, that interest is provable as part of the debt except in so far as it is payable in respect of any period after* [the Date of Administration]". Post-administration interest is payable only in the event of a surplus, pursuant to Rule 2.88(7).

(6) It follows from the third and fourth points identified above that Supplemental Issue 1(A) is concerned with contractual rights which existed as at the Date of Administration. Both the right to the close-out sum and the right to interest on that close-out sum were rights under a pre-administration contract, which existed (and were binding on LBIE) as at the Date of Administration.

(7) Supplemental Issue 1(A)'s specific focus is on circumstances where the precondition to the running of contractual interest (as specified in the contract) is first satisfied after the Date of Administration. The precondition posited by Supplemental Issue 1(A) involves action by the creditor; but it could equally involve action by a third party or an event which occurs automatically, such as automatic termination following an event of default or the effluxion of a specified period of time.

York's submissions

481. As previously indicated, York's fundamental submission is that, on the basis of the Tranche A Judgment, there is no distinction to be drawn between a rate of interest which became applicable by reason of a *post-administration foreign judgment* and a rate of interest which became applicable by reason of steps taken after the administration pursuant to a *pre-administration contract*.

482. York contends that, in both cases, the rate is only contingently applicable as at the Date of Administration because its application depends on further steps being taken which may never be taken; and that, on this basis, neither of these rates is capable of being a *rate applicable to the debt apart from the administration* within Rule 2.88(9).

483. More particularly, York submits that the Judge's conclusion was that the concept of a "*rate applicable to the debt apart from the administration*" required the relevant interest rate to be *in fact* applicable to the debt as at the date of commencement of the administration; a debt subject to a contingency which may never be fulfilled cannot be said to be accruing interest and no interest rate can be said to be in fact applicable to it at all.

484. According to York's analysis, the references in paras. 180 and 181 of the Tranche A Judgment to the "*rights*" of the creditors existing as at the date of the commencement of the administration were to present and accrued rights of the creditor to receive interest on the relevant debt, and not to rights the accrual of which was dependent on one or more further steps being taken subsequent to the commencement of the

administration. York submitted that a right to interest, the accrual of which was dependent on some future step being taken, was contingent, and would not constitute a rate of interest "*in fact*" applicable to the debt as at the Date of Administration.

485. York contends that the essence of the Judge's conclusion was that the words "*the rate applicable to the debt apart from the administration*" mean the interest rate which was in fact applicable to the debt as existing and proved as at the date of the administration. It submits that the rationale of the Tranche A Judgment in this regard (which it submits should be applied to the present case) is that a rate which, at the commencement of the administration, was only contingently applicable because its application depended on further steps being taken would not suffice for this purpose.

486. Further, York relies on paragraph 180 of the Tranche A Judgment, where the Judge stated this:

> "If the creditor does not have a judgment at the date of administration, the debt proved by the creditor is not a judgment subsequently obtained but the debt as at the date of administration. In the case of an unascertained claim, the later judgment quantifies the claim but it is not the judgment debt which is the subject of proof."

York submitted that the like analysis should be applied to distinguish between (a) the right to receive payment and delivery constituting the debt proved by the creditor in the case of an open transaction under an ISDA Master Agreement (that is, a transaction which has not yet been closed out as at the Date of Administration) and (b) the right to Termination Amount/Settlement Amount arising after the automatic occurrence or effective designation of an Early Termination Date. The two debts should be regarded as different, just as the debt proved by a creditor who has not obtained a judgment at the Date of Administration is different from a later judgment debt established once judgment has been obtained.

York's contentions as to the application of its analysis of the Judge's reasoning

487. Where the creditor's rights at the date of the administration comprise rights under open transactions under an ISDA Master Agreement (that is, prior to Early Termination, whether automatic or elective), York's case is in two parts.

488. First, York submits that in the case of an open transaction, the debts which are the subject of proof are the contingent rights to payment and delivery together with any Unpaid Amounts/Amounts due, and not the later Termination Amount/Settlement Amount: the latter quantifies the claim but is not itself the debt which is the subject of proof.

489. York submits that it follows that any interest rate applicable to the subsequent Termination Amount/Settlement Amount is not in any case "*a rate applicable to the debt apart from the administration*" for the purposes of Rule 2.88(9): to conclude otherwise is to confuse the debts which are the subject of the proof with the subsequent Termination Amount/Settlement Amount which is a different debt (albeit one which has the practical effect of quantifying the debts which are the subject of the proof).

490. Secondly, York submits that it equally cannot be said that the contractual interest rate which may be applicable under the terms of the relevant Master Agreement to the payment and delivery obligations under any open transactions is a "*rate applicable to the debt apart from the administration*". As to this, York makes three further points:

(1) Any right to interest for late payment and compensation for late delivery under open transactions provided under the ISDA Master Agreements (by section 2(e) of the 1992 version and section 9(h)(i)(l) of the 2002 version) is dependent on steps being taken subsequent to the commencement of the administration: first, the defaulting party must fail to make the relevant payment, and secondly the creditor must then make a demand for the relevant interest.

(2) Secondly, the rights to interest under the ISDA Master Agreements are only applicable contingently since they are always subject to being disapplied by the occurrence or designation of an Early Termination Date. The contractual rates expressly only apply *prior* to the occurrence of an Early Termination Date. Where an Early Termination Date has been designated or occurred there is no continuing entitlement to such rights of interest.

(3) Thirdly, insofar as the relevant rights under the open transactions under ISDA Master Agreements at the Date of Administration concern rights to *delivery* rather than rights to *payment*, it is difficult to see how there can be any interest rate applicable to such claims as at the date of the administration. That is so because:

(a) Under the 1992 Form, there is no right to interest in those circumstances and, even if a right to compensation for late delivery can be said to be a right to interest (which it cannot), there is no right to compensation except as provided for in the relevant Confirmation.

(b) Under the 2002 Form, there is a right to interest for late delivery (albeit subject to being disapplied by the relevant Confirmation), but this is dependent on the party entitled to delivery having determined the fair market value of the delivery obligation at the delivery date in good faith and using commercially reasonable procedures. Where this has not been done as at the Date of Administration, then this is a further reason why such interest is not a "*rate applicable to the debt apart from the administration*".

491. York sought to bolster these submissions further by praying in aid the distinction in law, confirmed by the Supreme Court in *Tael One Partners Ltd. v Morgan Stanley & Co International plc* [2015] UKSC 12, [2015] Bus LR 278, between (a) an accrued right to payment of sums which will definitely fall due at some point in the future, even though the timing is not certain and (b) a right entitling a creditor to interest on his debt only upon the occurrence of a contingency and which is not, therefore, an "accrued" right. York built on or borrowed this distinction to submit that (1) a contractual right which is subject to a contingency which has not yet been and may never be fulfilled cannot be said to be an "accrued right" and (2) a rate of interest cannot be said to be "applicable" (the word actually used in Rule 2.88(9)) in the case of a right to interest that has not yet "accrued". Put another way, York submitted that

as long as there is some unfulfilled condition before an entitlement to interest crystallises, the interest does not accrue, and the rate cannot be said to apply.

Administrators' position and contentions

492. As previously indicated, the Administrators have adopted a definite position rather than their usual one of neutrality. They submit that York's argument on Supplemental Issue 1(A) is wrong.

493. In their submission, the key distinction which emerges from the Tranche A Judgment is that between:

(1) a rate of interest which becomes applicable to the debt pursuant to the rights of the creditors which existed as at the Date of Administration; and

(2) a rate of interest which becomes applicable to a debt pursuant to new rights which were first acquired by the creditor after the Date of Administration.

494. On that analysis, the Administrators contend that the critical question, therefore, is to identify whether the source of the right to interest exists as at the Date of Administration or is created or awarded *de novo* after the Date of Administration.

495. In that regard, the Administrators contend, the fact that a right conferred under a pre-administration contract (at least where governed by English law or, I would think, New York law)[30] may yet have to be perfected to set the entitlement running (for example, by service of a notice), or is not yet enforceable, does not mean that it is not applicable (and in that sense "accrued").

496. Further, and contrary to York's case, the fact that the contractual right to interest in question relates to the close-out sum, which is only established after the Date of Administration, does not mean that such right is not in existence and applicable prior to the Date of Administration. The right to the close-out sum and interest thereon itself suffices. As Mr Trower QC put it in his oral submissions at the hearing on 24 June 2016:

> "The core of our position is that the moment it's possible to identify an existing contractual right by which the parties are bound and which entitles a creditor to payment of interest on a provable debt, the rate for which that contractual right provides can be said to apply to the provable debt."

497. The Administrators also drew attention in this context to Rule 13.12(1)(b) of the Insolvency Rules, the effect of which is that the close-out sum, though it may become due after the Date of Administration, is a provable debt, being "*any debt or liability to which* [LBIE] *may become subject after* [the Date of Administration] *by reason of any obligation incurred before that date*".

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[30] Where the right in question is governed by a foreign law, it will be necessary to analyse the position in accordance with the proper law of the right.

498. By contrast, a right to interest not conferred as such by contract but based on a judgment after administration is a new right, its source or footings being in the judgment rather than the contract, even in circumstances where the judgment is the mode of enforcing a pre-existing contract.

499. The Administrators also rely in support of their position on the answers given to issues 6 to 8 in the Tranche A Judgment. These issues were as follows:

> "*6. Whether, for the purposes of establishing, as required under Rule 2.88(9) of the Rules, 'whichever is the greater of the rate specified under paragraph (6) and the rate applicable to the debt apart from the administration', the amount of interest to be calculated based on the latter is calculated from:*
>
> *(i) the Date of Administration;*
>
> *(ii) the date on which the debt became due; or*
>
> *(iii) another date.*
>
> *7. Whether Statutory Interest is payable in respect of an admitted provable debt which was a contingent debt as at the Date of Administration from:*
>
> *(i) the Date of Administration;*
>
> *(ii) the date on which the contingent debt ceased to be a contingent debt (including in circumstances where the contract was 'closed out' after LBIE entered administration); or*
>
> *(iii) another date,*
>
> *having regard to whether:*
>
> *(i) the contingent debt remained contingent at the time of the payment of:*
>
> *a) the final dividend; or*
>
> *b) Statutory Interest; and/or*
>
> *(ii) (to the extent applicable) the Joint Administrators revised their previous estimate of the contingent debt by reference to the occurrence of the contingency or contingencies to which the debt was subject.*
>
> *8. Whether Statutory Interest is payable in respect of an admitted provable debt which was a future debt as at the Date of Administration from:*
>
> *(i) the Date of Administration;*

> *(ii) the date on which the future debt ceased to be a future debt; or*
>
> *(iii) another date,*
>
> *having regard to whether the future debt remained a future debt at the time of the payment of:*
>
> *(i) the final dividend; or*
>
> *(ii) Statutory Interest.*"

500. The declarations made by David Richards J in respect of Issues 6 to 8 in the Tranche A Order are in the following terms:

> "*<u>Issue 6 (paragraph 6 of the Application Notice)</u>*
>
> *(xiii) For the purpose of establishing 'whichever is the greater of the rate specified under paragraph (6) and the rate applicable to the debt apart from the administration' (as required by Rule 2.88(9) of the Rules), the amount of interest to be calculated based on the latter is to be calculated from the Date of Administration.*
>
> *<u>Issue 7 (paragraph 7 of the Application Notice)</u>*
>
> *(xiv) Statutory Interest is payable in respect of an admitted provable debt which was a contingent debt as at the Date of Administration from the Date of Administration.*
>
> *<u>Issue 8 (paragraph 8 of the Application Notice)</u>*
>
> *(xv) Statutory Interest is payable in respect of an admitted provable debt which was a future debt as at the Date of Administration from the Date of Administration.*"

501. These declarations reflect the conclusion of David Richards J in para 225 of the Tranche A Judgment:

> "*I conclude therefore on Issues 7 and 8 that, in the case of both future and contingent debts, interest is payable under rule 2.88(7) from the date that the company entered administration, not from the date (if any) on which any such debt fell due for payment in accordance with its terms. The parties are agreed that it follows that the comparison under Issue 6 is between judgment rate and the rate applicable apart from the administration, <u>in each case from the date of administration</u>*" (emphasis added).

502. The Administrators submit that David Richards J's conclusion that, where the debt was future or contingent at the Date of Administration, the "*rate applicable to the debt apart from the administration*" in Rule 2.88(9) is to be calculated from the Date

of Administration, is inconsistent with York's suggestion that, where interest at the contractual rate was not running on the Date of Administration, there will never be any rate applicable to the debt apart from the administration.

503. In the Administrators' further submission, it is clear that David Richards J proceeded on the basis that contractual interest on future and contingent debts was capable of being the rate applicable apart from the administration; and this suggests strongly that he considered a rate which, according to the terms of the contract, did not begin to run until a point in time after the Date of Administration, could nevertheless constitute a "*rate applicable to the debt apart from the administration*" for the purposes of Rule 2.88(9).

504. The Administrators did not accept that the decision in *Tael* (see paragraph [491] above) was of any assistance or even relevance in the present context. That decision concerned the contractual interpretation of the word "accrue" in a particular context; here, the word "accrue" is not used in the relevant rule or context at all. Furthermore, what is in issue in this case is not whether, and if so at what rate, interest is accruing; it is whether there is a contractual right to interest in existence at the Date of Administration which specifies the rate applicable pursuant to that right. Neither the fact that interest is not yet accruing nor the fact that the rate of interest will not be payable until a later date is legally relevant in the requisite analysis.

505. The Administrators' final submission is that in cases of financial collateral arrangements (such as derivatives governed by an ISDA Master Agreement incorporating a Credit Support Annex) the conclusion that a post-administration contractual rate is relevant and applicable is fortified by Regulation 12 of the Financial Collateral Arrangement (No 2) Regulations 2003. That provides for a close-out netting provision to take effect in accordance with its terms notwithstanding that the collateral-provider or collateral-taker is subject to winding up proceedings or reorganisation measures. A close-out netting provision which provides for interest to be payable on the close-out sum must therefore take effect, even where one or other of the parties goes into administration. The Administrators submit that York's proposed answer to Supplemental Issue 1(A) is inconsistent with Regulation 12 of the 2003 Regulations since, according to York, the interest due under the close-out netting provision will not be payable, with the result that the close-out netting provision will not take effect in accordance with its terms. The Administrators contend that this provides a further ground for rejecting York's submissions.

The SCG's submissions on Supplemental Issue 1(A)

506. The SCG, to whose submissions I now turn, also referred to the determination of Issues 6 to 8 in the Tranche A judgment in support of their position (in common with the Administrators) that the contractual interest rates accruing on close-out sums arising under the 1992 and 2002 Forms are a "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9). The SCG submit that in light

of the way Issues 4 and 6 to 8 were determined in the Tranche A judgment, York's contrary view is misconceived.[31]

507. The SCG made the point that it was Issues 6 to 8 which were concerned with future or contingent contractual rights to interest, whereas Issue 4 was concerned with rights to the Judgments Act Rate in respect of a judgment which the creditor had not obtained by the date of the administration and might never have obtained. The SCG submit that the contrast is between (a) a creditor's existing contractual or other rights to interest (or other compensation for delayed payment) existing as at the date of administration (whether actual, future or contingent) and (b) rights to interest, or other compensation for delayed payment, which have no existing legal foundation as at the Date of Administration and only legally come into being thereafter (pursuant to an actual or hypothetical judgment). Issues 6 to 8 addressed the former; Issue 4 addressed the latter.

508. Thus, in the SCG's submission, David Richards J's conclusion that "*the words 'the rate applicable to the debt apart from the administration' cannot be read as including a hypothetical rate which would be applicable to a debt if the creditor took certain steps*" (paragraph [177] of the Tranche A Judgment (and see also paragraphs [461] to [464] and [487] above) apply only to the non-contractual context examined in Issue 4, and not to contractual rights to interest under contracts already existing as at the Date of Administration. The fact that the contractual right might call for further steps to be taken by the creditor after the Date of Administration to assess or quantify the applicable rate does not preclude the rate so assessed or quantified from qualifying as "*the rate applicable to the debt apart from the administration*".

509. Put another way, the SCG submit that a rate of interest to which the creditor is contractually entitled as at the date of administration, even if not immediately then in the future or on the satisfaction of a contingency, is just as much a "*rate applicable to the debt apart from the administration*" as a rate already accruing at the date of administration. It is the pre-existing and contractual source of the right which is important, and distinguishes the position from a judgment not yet obtained at the date of administration. Issue 4 had nothing to do with the former; only the latter.

510. The SCG further submit that, at least pending any successful appeal in relation to Issues 6 to 8, it is not open to York to argue that a contractual rate of interest is not a "*rate applicable to the debt apart from the administration*" merely because it arises in respect of a contingent (or future) debt. That is said to be because in relation to Issues 6 to 8(a) it was agreed between the parties (and, it is said, held by the Court in the Tranche A Judgment at paragraph [225]) that interest runs on contingent (or future) debts from the date of administration at the rate applicable to the debt apart from the administration even if the interest entitlement is subject to the same contingency as the debt; and (b) it "necessarily follows from the determination of Issues 6-8 in *Waterfall IIA*" that, in the case of contingent (and future) debts the "*rate applicable to the debt apart from the administration*" is the rate which applies to such debts when they become due and payable.

[31] The SCG made clear, however, that though their arguments proceed on the basis that David Richards J's conclusions in relation to Issue 4 are correct, this is without prejudice to their pending appeal against that aspect of his decision.

511. The SCG also submit that York's submission that in the case of transactions which remain open at the date of the administration (where there has been no previous elective, or contemporaneous automatic, Early Termination), the later Termination Amount/Settlement Amount quantifies the claim but is not itself the debt which is the subject of proof, is likewise misconceived.

512. More particularly, the SCG submit that a Non-defaulting Party under a transaction governed by an ISDA Master Agreement which remains open as at the date of administration has the right either to keep the transaction open or to terminate by designating an Early Termination Date in accordance with section 6(a). If it elects to terminate, the early termination amount owed to it is a contingent debt, provable as such. Similarly, where an Automatic Early Termination has been specified, any early termination amount owed is a future debt. Thus, contrary to York's submission, the later Termination Amount/Settlement Amount is itself the debt which is the subject of proof; and where such a proof is submitted, the contingent or future rights include the right to interest, which (according to the determination of Issues 6 to 8 in the Tranche A Judgment) accrues on the Early Termination Amount (discounted back to the date of administration if they have not fallen due for payment before the date a dividend is declared).

513. It follows, the SCG submit, that York is incorrect to contend that the effect of David Richards J's judgment in respect of Issue 4 prevents the Default Rate under an ISDA Master Agreement from being the "*the rate applicable to the debt apart from the administration*" merely because such rate did not start running until after the Date of Administration.

514. Like the Administrators, and for substantially the same reasons, the SCG contended that York's attempt to rely on the decision in *Tael* is misplaced.

515. On all these grounds the SCG contend that Supplemental Issue 1(A) should be answered on the basis that the words "*the rate applicable to the debt apart from the administration*" in Rule 2.88(9) of the Rule, include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration.

My assessment and conclusions as to Supplemental Issue 1(A)

516. I turn to assess these competing contentions, and then to state my determination of Supplemental Issue 1(A).

517. The central dispute is as to whether or not there is a meaningful distinction for present purposes between, on the one hand, a rate of interest the entitlement to which arises by virtue of a judgment obtained after the date of administration, and, on the other hand, a rate of interest prescribed by contract as applicable to a contractual entitlement contingently or prospectively available to a non-defaulting party but which has not been triggered prior to the date of administration and which cannot be crystallised and/or quantified without further action by that non-defaulting party after that date (for example, by designating an Early Termination Date and/or then taking steps to establish a particular rate of interest).

518. In my view, there is such a distinction. The distinction lies in the source of the right or entitlement, and the existence or not of that source as at the date of administration.

519. A right or entitlement which arises, not because of any contractual term but because a judgment for a money sum attracts interest at a rate prescribed for judgments of that nature, owes its existence to and has its source in that judgment and the rules relating to interest in respect of such a judgment once obtained. The Tranche A judgment determined (in the context of Issue 4) that a right derived only from a judgment (or some other ancillary order dependent on that judgment) obtained after the date of administration cannot be said to exist as a source of entitlement to interest at the date of administration: until such judgment the creditor had no right to interest at all, still less to interest at any particular rate (and see paragraph [179] of the Tranche A Judgment).

520. That is to be contrasted with a right conferred by contract, which, even if its exercise and quantification post-dates the date of administration, is in existence at that date, whether as a contingent or future right.

521. I agree, therefore, with the Administrators' submission that York's submissions fail to recognise the difference between (a) the possibility of a future right to payment and (b) the existence of a present right to payment on the fulfilment of a condition. Whereas the interest that would be payable under a foreign judgment not yet obtained involves merely the possibility of a future right to interest at a foreign judgment rate, the interest which will become payable under a presently existing contract if certain stipulated conditions are fulfilled is in a different category.

522. I do not, therefore, consider that, in stating in the Tranche A Judgment in determining Issue 4 that the words "*rate applicable to the debt apart from the administration*" "*cannot be read as including a hypothetical rate which would be applicable to a debt if the creditor took certain steps*", David Richards J was addressing, inferentially or at all, the question now under consideration, where the entitlement to a specified rate in certain circumstances is a component of the creditor's contractual rights at the Date of Administration, as distinct from having its source in some legal relationship (such as judgment creditor and judgment debtor) established after that event.

523. I accept the submissions of the Administrators and the SCG that the decision in *Tael* does not undermine this analysis or otherwise support York. To my mind, if a creditor's contractual rights in existence (whether actually or contingently) at the date of administration include a right to a particular rate of interest (whether fixed, floating or formulaic) then when that right is exercised or vindicated, that is the rate applicable for the purposes of the rule. That is so, in my judgment, whether or not the contractual right to a close-out sum and a particular rate of interest can be described as having "accrued" prior to the Date of Administration. I do not read anything in the judgments in *Tael* as stating that where the entitlement is contingent the right giving rise to it has not yet accrued: I would tend to think that a contingent entitlement may have accrued, and suffice, even if the sums due pursuant to the entitlement have not yet commenced actually to accrue.

524. In any event, in my view, the focus on whether the right to a rate of interest has accrued or not simply re-states the same question whether the satisfaction of the

contingencies after the date of administration perfects the right which existed at that date, to which I have already given my answer.

525. The determination of Issues 6 to 8 in the Tranche A Judgment, confirming that once the contingencies to which a contractual entitlement to interest was subject have been fulfilled, the interest payable will be calculated from the date of the administration, seems to me to lend further support for my conclusion that the rate provided for by the right may be relied on, and date back to the Date of Administration, even though the contingencies to which the right was subject were only satisfied at a later date.

526. Lastly, the Administrators suggested that the Financial Collateral Arrangement (No.2) Regulations may provide further support for the answer they assert. However, when I invited further explanatory submissions at the later oral hearing this was not pursued; and I am not convinced that there is anything in those Regulations which really bears on the point at issue.

527. In the circumstances, I need not determine that point, and given its possible wider repercussions, I prefer not to do so.

528. In conclusion, in my judgment, Supplemental Issue 1(A) is to be answered in the affirmative. The words "*the rate applicable to the debt apart from the administration*" in Rule 2.88(9) will include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that begins to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration.

529. For completeness, and for the avoidance of doubt, I should also record that all parties were in agreement that the rate applicable to the debt apart from the administration may be a floating or variable rate: it does not have to be fixed.

Issue 27

530. I should also record that Issue 27 posed the question whether the answers to questions 10 to 16 and 18 to 21 would be impacted where the "relevant payee" is (i) a Credit Institution or Financial Institution, (ii) a Fund Entity, or (iii) a corporate or other type of counterparty.

531. None of the parties contended for an affirmative answer, and indeed no submissions were made by any of them on this issue.

Conclusion

532. I would ask Counsel to prepare a draft Order in a suitable form to record these answers to the issues raised. If that process reveals that there are any sub-issues which remain outstanding I would be grateful if these could be indicated.

533. Finally, I record my thanks to all Counsel and their teams for their submissions, which have been of the highest quality, and for their assistance and patience throughout in addressing the various supplemental matters which have arisen after the main hearings.

SCHEDULE

[This is the schedule referred to in paragraph [328] of the main judgment. It sets out my analysis and assessment of the arguments advanced before and at the hearings, which (it will already be apparent) focused on the terms and structure of the GMA and whether section 271 of the BGB was displaced or to be implied into them.]

1. The GMA does not expressly stipulate the date on which a Single Compensation Claim falls due. The issue (which Wentworth labelled "the Accrual Issue") is thus to be determined by reference to the terms of the GMA in the light of general rules and principles of German law.

2. The argument between the parties before and at the oral hearing, before the handing down of the decision of the Bundesgerichtshof (the "2016 BGH Decision") handed down on 9 June 2016, was in essence as to whether the terms and overall structure if the GMA displaced the default or fall-back rule in section 271 of the BGB, or whether that provision should be read in to the GMA.

3. As noted previously, by virtue of section 271 of the BGB the fall-back rule under German law is that where no time for performance is specified or evident from the circumstances, the obligee may demand performance immediately. The question therefore is whether the terms or overall structure of the GMA, or the surrounding circumstances, displace the fall-back rule, or alternatively what "immediately" should be taken to mean in the context of the relevant provisions of the GMA.

4. As to the terms and overall structure of the GMA, the SCG focused almost exclusively on Clause 9, whereas Wentworth submitted that Clause 9 could only properly be understood and construed in the context of Clauses 7 and 8. The parties also differed as to the construction of Clause 9 itself, and in particular as to the scope of and relationship between sub-clauses 9(1) and (2).

5. Put shortly (and the matter is further analysed in the next following paragraphs):

    (1) Professor Mülbert considers that nothing in those Clauses or in the GMA as a whole indicates any reason sufficient to displace section 271 of the BGB or any impracticability in determining that the Single Compensation Claim falls due immediately upon termination, except in the particular circumstance expressly provided for in Clause 9(2), which only has any relevance where there is a counterclaim against the Party Entitled to Damages (i.e. the non-defaulting party) such that such Party is, overall, the paying party.

    (2) Dr Fischer's view is to the effect that Clauses 7 to 9 apply together and, construed in the round, provide for steps to be taken after the termination of the GMA which are inconsistent with an intention that performance should be regarded as immediately due from the time of termination, so that either section 271 of the BGB should be taken to be displaced, or the right to demand payment "immediately" should be taken to mean immediately upon determination of the close-out amount (but not before). Dr Fischer initially regarded sub-clause 9(2) as particularly indicating that no amounts fell due unless and until the net amount had been calculated. However, he came to

accept that Clause 9(2) is only engaged where the close-out amount or Single Compensation Claim is in fact owed by the Party Entitled to Damages to the defaulting party, and thus is of less, if any, assistance to his contention.

The SCG's case on the first aspect of Issue 20 (the "Accrual Issue")

6. The SCG's case on this first aspect of Issue 20 (which Wentworth referred to as "the Accrual Issue"), based on Professor Mülbert's evidence, was elaborated by reference to (a) the terms of the GMA, (b) the surrounding circumstances and (c) general principles of German law, as follows.

7. As to the terms of the GMA, the SCG contended as follows:

   (1) Clause 3, in providing for contractual interest (together with a surcharge specified in Clause 12) whilst at the same time (by sub-clause 3(4)) expressly reserving the right to make further claims for damages, demonstrates and emphasises that payment of interest on sums not paid when due is a core feature of the GMA.

   (2) The scheme of the relevant sections is that:

      (a) whether termination is automatic or upon notice, Clause 7 provides that neither party is obliged to make any further payments pursuant to Clause 3(1) and for their relevant obligations to be replaced by compensation claims in accordance with Clauses 8 and 9;

      (b) Clause 8 provides that for the party giving notice or the solvent party to be entitled to damages ("the Party Entitled to Damages") to be determined on the basis of replacement transactions assumed to be effected without undue delay and to be calculated by the Party Entitled to Damages on the basis of what it would need to pay for such replacement transactions *"at the time of giving notice or upon becoming aware of the insolvency, as the case may be"*; and

      (c) Clause 9(1) deals with the final payment obligation, and provides that all unpaid sums, unperformed obligations and the damages payable are to be combined into a single compensation claim denominated in Euros, and (in effect) netting off claims and cross claims in the process.

   (3) Nothing in that scheme is inconsistent with the application of section 271 of the BGB so as to require performance by payment immediately upon termination of the GMA; in particular (and in answer to a specific point made by Dr Fischer as appears below), the scheme does not call for any process of co-operation between the parties in determining the single compensation claim, which is left to the Party Entitled to Damages, nor any other reason for deferral of the time for performance/payment.

   (4) The provisions of sub-clause 9(2) do not alter this analysis. That sub-clause 9(2) operates separately from sub-clause 9(1) and only in the very limited circumstances of where (a) the Party Entitled to Damages obtains an overall financial benefit from termination and (b) that Party Entitled to Damages has

other claims against the defaulting party. According to the SCG, its purpose is to ensure that the Non-defaulting Party (the Party entitled to Damages) does not have to account for the benefit to the extent of any claims it may have against the Defaulting Party (of whatever nature).

(5) Accordingly, the terms of the GMA are consistent with the general rule prescribed by section 271, and the close-out amount, even if not determined quantitatively until later, is due and payable immediately upon termination.

8. As to the surrounding circumstances for the purposes of section 271 of the BGB, the SCG contended that:

(1) There are no circumstances applicable to the GMA which militate against the application of the general rule; rather, there is good reason why the Single Compensation Claim must be due immediately upon termination: that is, that any other conclusion would fail to put the innocent party in the position that it would have been, had the contract been performed, and will lead to there being a period in which no compensation for delayed payment (i.e. interest) is payable because the principal debt is not regarded as due.

(2) In particular:

(a) Clause 9(1) gives rise to a Single Compensation Claim (which includes sums due under Clause 3(1) and the damages payable pursuant to Clause 8(1)).

(b) It is automatically triggered on the application for insolvency proceedings in order to adjust the contract to the particularities of German insolvency law.

(c) When termination occurs under Clause 7, outstanding sums payable under Clause 3 may have been carrying interest (see Clause 3(4)). But such an entitlement to interest on the underlying debt will stop as a consequence of the operations of Clauses 7 to 9 and the replacement of such sums by the Single Compensation Claim.

(d) The aim of the close-out netting mechanism in Clause 9(1) is to make the Party Entitled to Damages whole in economic terms; i.e. to place the non-defaulting party in the same economic situation as it would have been in if the individual transactions had matured in the normal course. Dr Fischer accepted that this was the case. In order to be consistent with that aim, the Single Compensation Claim must be capable of attracting interest from the date of termination.

(e) For example, under Clause 8 the Party Entitled to Damages is entitled to calculate damages on the basis of what it would need to pay for such replacement transactions "*at the time of giving notice or upon becoming aware of the insolvency, as the case may be*". In other words, the calculation is required to be performed by reference to the position at the time of the giving of notice of termination (for example) and not by reference to the position as of the date of calculation, if later. In those

circumstances, it makes commercial sense for interest to be capable of arising from the date of termination (i.e. the date on which damages are valued) and not from some later date such as the date of calculation.

(3) On Wentworth's case, the time value of money during the period of calculation is lost, notwithstanding the fact that damages are calculated as of the termination date. Such a consequence is uncommercial, and inconsistent with the approach taken in the context of ISDA. Professor Mülbert maintained that it would be surprising from the perspective of market participants if there was a wide deviation between the operation of the GMA and the ISDA Master Agreement.

(4) Dr Fischer, when cross-examined, appeared to accept that sums can fall due under Clause 3(1) and accrue interest under Clause 3(4) before early termination, and that termination cannot have the effect of stopping interest running on that sum and for interest only to start running again after the calculation has been done under Clause 9(1). This led Dr Fischer ultimately to accept that, if the contract was terminated by notice under Clause 7(1), the Party Entitled to Damages would be entitled to interest from the date notice of termination was given and not merely from the date of calculation, if later. That supports the proposition that the Single Compensation Claim falls immediately due upon termination.

(5) In short, there is no reason why the draftsman of the GMA would have wanted to ensure that the Single Compensation Claim did not fall due immediately on termination or to deprive the Party Entitled to Damages of interest to which it would otherwise have been entitled, or to lead to a situation in which interest which was already running on a sum due under Clause 3(1) ceased accruing interest following termination unless and until the Single Compensation Claim had been calculated.

9. As to German law generally, the SCG submitted that there was no basis for treating the fall-back rule prescribed by section 271 of the BGB as inapplicable on the basis of it being unfair to the debtor (as Wentworth contended it is) for the debt to become due prior to determination and notification to the debtor of the final amount payable. Professor Mülbert relied in this context on two decisions, both of which Dr Fischer agreed were correctly decided, and applied in principle to contractual damages claims as well as tort or delictual claims:

(1) One was a decision of the Bundesgerichtshof ("BGH" or "Federal Court of Justice" in 2008) concerning damage to a motor car. The question arose as to the application of section 271 of the BGB. It was held that

> "The concept of the due date refers to the point of time when a creditor may demand performance… If the time for performance is not defined or is not apparent from the circumstances, then the creditor may demand immediate performance (Section 271(1) …). If the injured party may demand restoration of a damaged object (Section 249(1) BGB) or the amount of money required to restore the object (para 249(2) sentence 1 BGB), then the due date is the same

as the date when the damage to the legally protected interest occurs. **The fact that the scope of the responsible party's liability can usually only be determined after some time has passed because a damage report need to be prepared or it is necessary to wait for an invoice from an accounts department of the repair shop, does not have an impact on this.** As soon as the injured party has the information needed to assert his claim, he can in principle put the liable party or his liability insurer in default (Section 286 BGB) by making the claim due and may possibly enforce the consequences of the default (Sections 287 and 288 BGB). Even when the separate damage claims are disputed between the injured party and the liable party and the legal grounds may have to be clarified through potentially lengthy litigation, this does not change the due date of the damage claim, insofar as it (later) proves to be justified and also does not change the fact that the liable party, if he is effectively put in default, must be liable for the damages resulting from the default and pay interest on the default." [emphasis added]

(2) The other case is a decision of the Higher Regional Court in Frankfurt [Judgment case no. 9 U 76/10]. It concerned a claim for damages for breach of contract following its termination for cause. As Dr Fischer agreed under cross-examination, the court concluded that the damages claim in respect of the prepayment compensation was due immediately and that this was the case despite the fact that the claimant needed to calculate the amount of the prepayment. Dr Fischer stated: "*In German prevailing opinion, such a damages claim can arise immediately with the prepayment before the actual due date*".

10. On all these grounds, the SCG contend that there is nothing to displace, and indeed business sense or commerciality supports, the application of section 271 of the BGB.

Wentworth's case on the first aspect of Issue 20

11. I turn to Wentworth's contentions in this regard, and its reasons for rejecting the SCG's position.

12. The essence of Wentworth's case in this respect is that Clauses 7 to 9, taken together, are incompatible with the application of section 271 of the BGB (which both experts agreed to be a "gap-filling provision") so as to require payment immediately upon termination of the GMA. The close-out provisions prescribed by those clauses, Wentworth submits, render (a) inapposite any analogy with the general law of damages on which the SCG rely and (b) impractical Professor Mülbert's theory that a liability to pay is established even before it is known who should pay and in what amount.

13. On the basis of Dr Fischer's evidence, Wentworth contends that:

(1) Clause GMA 7(1) permits termination on notice for a "*material reason*" such as non-payment.

(2) Clause 7(2) terminates the GMA automatically upon an application for insolvency.

(3) The effect of termination, on whatever basis, is to discharge unperformed prospective obligations and to entitle a claim for compensation under clauses 8 and 9 in substitution of those obligations. This is the effect of clause 7(3).

(4) Under clause 7(2) accrued but unpaid amounts, or accrued but unperformed obligations (e.g. for delivery), are not replaced by the damages claim under clause 8 but, under clause 9(1), are to be combined with the damages claims calculated under clause 8.

(5) Clause 9(1) provides for a "two-way" netting process by combining "*Unpaid amounts and any other unperformed obligations, and the damages which are payable*". Wentworth contends that the unpaid amounts to be combined are not only those owed by the notified/insolvent party: the combination is to account for those unpaid amounts as well as (by a deduction) unpaid amounts owed by the notifying/solvent party to the notified/insolvent party; and it is by the combination directed by that clause that the "single compensation claim" is to become due. The "single compensation claim" is the final product of the netting calculation.

(6) Clause 8 is the logically prior step in the netting process. It is the key provision for the calculation of damage.

(7) Clause 8 permits the calculation of a damages claim on the basis of actual or hypothetical transactions. A choice has to be made in this respect and the choice and calculation is to be made without "*undue delay*".

(8) The reference time for the alternative basis of a claim – that is, a calculation of damages where the Party Entitled to Damages refrains from entering into replacement transactions, including matters such as the exchange rates to be applied when determining the claim – is the time at which the counterparty became aware of the insolvency. This would not have been until after the making of the administration order in respect of LBIE.

(9) Clause 8 is a "two-way" close-out provision because the financial benefit from termination must be accounted for. If the benefit exceeds the loss, the amount is owed by the notifying/solvent party to the notified/insolvent party. The consequence of the two-way close-out is that until the calculation is done it cannot be known whether the "Party Entitled to Damages" is the payee or the payor.

(10) It is very difficult to see how performance can be regarded as being immediately due from the time of termination of the GMA when the key drivers for the determination of whether a payment has to be made and, if so, the quantum of the payment, are dependent upon steps to be taken only after the termination of the GMA.

14. In the light of the nature of the two-way close out, Wentworth contends that:

(1) Section 271(1) of the BGB, even if applicable (which it is Wentworth's primary contention it is not), would be applied by a German court to require the calculation to be completed in what Dr Fischer termed "a reproducible manner" before any claim for damages is due.

(2) This is because, looking to the circumstances and the content of the two-way calculation provision, it cannot be right that any party is immediately liable to make payment before it is known, as between the parties, who is liable and for what amount.

15. As to the scope of each and the interrelationship between sub-clauses 9(1) and (2), it is Wentworth's contention that:

(1) Clause 9(1) simply refers to unpaid amounts and unperformed obligations without restricting those to such amounts or obligations owed to the notifying solvent party. The language works both ways. It is a "two way" provision.

(2) Clause 9(1) contrasts with clause 9(2) which deals with "Counterclaims" owed by the notifying/solvent party to the notified/insolvent party "for any legal reason whatsoever". This is a right of postponement and set-off for the benefit of the notifying party/solvent party. Clause 9(2) does not imply the single compensation claim is payable immediately. It simply confers on the solvent/notifying party a right to postpone the compensation claim to any Counterclaims. It does not imply that the compensation claim is immediately due on termination. It simply entitles a postponement relative to whatever date the compensation claim is due, whether on termination (on the SCG's case) or upon completion of a reproducible calculation (on Wentworth's case).

(3) Indeed Clause 9(2) assists Wentworth:

(a) The single compensation claim calculated under clause 9(1), if owed to the notified/insolvent party, is payable only if either: (i) there are no Counterclaims of the notifying/solvent party; or (ii) the notifying/solvent party "*fails*" to deduct such Counterclaims and the single compensation claim exceeds the value of those Counterclaims.

(b) The notified/insolvent party cannot know whether or not it is entitled to be paid anything without the co-operation of the notifying/solvent party.

16. In the latter context, Dr Fischer cited and placed reliance on a decision of the BGH dated 19 December 2012, concerning the application of a time bar in respect of a claim by a landlord against a tenant for reimbursement of heating and hot water costs exceeding the monthly prepayments made by the tenant. The claim was brought in April 1989 and, insofar as it related to the heating period for 1983/1984, was held to be subject to a limitation defence. The tenant had not been provided with a bill until 23 February 1988 and the issue for the BGH was whether the period of limitation began to run at the end of the year in which the billing periods ended or only at the end of the year in which the tenant received the bill. The decision was that the limitation period began running when the tenant received a "verifiable" bill. The central reasoning was that the debt could not be due before calculation of who owed what:

> "…the tenant cannot ascertain and therefore cannot pay the amount owed without a bill."

17. Professor Mülbert appeared to accept, when cross-examined on this, that the court was there saying that until the tenant knew what it had to pay and had been required to pay the relevant amount, the debt should not be treated as due.

18. Wentworth rejected the SCG's reliance on the point that on Wentworth's construction there would be a gap during which (pending ascertainment of the amount of the Single Compensation Claim in the two-way process mandated). Wentworth contended, in particular, that:

    (1) The SCG's case was based on a misunderstanding:

    (a) Interest due on unpaid amounts will continue to accrue throughout the calculation process, i.e. it is the unpaid amounts plus interest accrued on those amounts to the date of the combination which are to be combined with the compensation claim under clause 8 to form the single compensation claim under clause 9.

    (b) There is therefore no interest lost in respect of unpaid amounts.

    (2) Furthermore:

    (a) The fact that there is no interest on the single compensation claim until calculated simply reflects the fact that the GMA does not contain any contractual provision for interest on the single compensation and that, in these circumstances, German law provides that interest cannot be claimed until payment is due.

    (b) The "loss" of interest on the claim as ultimately calculated, i.e. post-termination to the end of the calculation period, is overplayed by the SCG. The literature does not contemplate a protracted calculation process and clause 8 in fact requires that it be done without "*undue delay*".

19. As to the two cases cited by Professor Mülbert in support of his argument that section 27(1) applies and operates to make the single compensation claim under clauses 7 to 9 of the GMA fall due immediately, Wentworth contends that neither provides, on proper analysis, any support.

20. In the road traffic accident case, Mr Allison's principal points, which he put to Professor Mülbert, were that (1) the court had made clear that the due date was not before "the injured party has the information needed to assert his claims" and (2) later in its judgment (in paragraph 19) the court referred to the claim being due

> "at the latest at the time the letter of 14 February 2007 was sent in which the defendant wrongly made payment of the difference between the replacement expenditure and the full amount of the repair cost conditional on proof of a six month period of continued use of the vehicle."

21. Mr Allison put these two together to submit that the court had determined that the due date was not the date of the car crash (which was 12 December 2006) but the later date, which he took to be when the amount of the claim became fixed. From one of Professor Mülbert's answers Mr Allison furthermore urged that the witness had in effect agreed this, though (as I explain later) I think that the benefit of hindsight and reflection reveals Counsel and the witness to have been at cross-purposes.

22. Wentworth did not dispute the effect, but denied the relevance, of the case concerning a breach of a loan agreement. It was common ground that the case concerned a breach of contract by the borrower and that this gave rise to an immediate right in the bank to claim damages. On that basis, Mr Allison contends that the case offered no insight into the different circumstance where (as here) there is a dispute as to when an amount which can only be ascertained after a two-way process falls due. (Again, Mr Allison contended in his written closing notes that Professor Mülbert had accepted that since the case concerned only termination for breach of contract in which there is no doubt that there is an immediate right to assert a damage claim, it had no bearing on the present case: but I do not think that is an entirely correct reading of Professor Mülbert's answers, as I shall later explain.)

23. Looking more generally at the surrounding circumstances, which (citing a Commentary on the German Civil Code by Judge Gruneberg[32]) Wentworth submits includes a consideration of the nature of the contractual obligation, Wentworth contends that it cannot as a matter of commercial sense have been the intention of the parties that the close-out (as it preferred to describe the resultant sum after application of clauses 7 to 9) or the Single Compensation Claim (the SCG's preferred description) should become due even before the net amount is established.

24. These include:

    (1) A corollary or consequence of the SCG's preferred approach is that the person ultimately determined to be the debtor after the two-way process of account will not know that he is so, still less how much he has to pay to stop interest accruing: and that person will also be liable to be served with a warning notice (and hence put in default and exposed to default interest) even before the due amount is calculated.

    (2) Other contexts in which similar difficulties would arise include the relevant limitation period, a right of a creditor to appropriate property of the debtor, and a right to liquidate claims by way of set-off.

25. Dr Fischer referred me in this context to a landlord and tenant case concerning a tenant's security deposit, in which it was decided that following termination of the lease, the tenant could not demand repayment of the deposit unless and until the landlord had had time to determine and quantify any claims it might have on the deposit. Whilst accepting its obviously different legal context, he put this case forward as illustrative of a broader proposition that where there is a requirement for co-operation and two-way calculation between the parties to establish loss, no claim should be due until completion of that process. However, when cross-examined Dr

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[32] See *Palandt, Burgerliches Gesetzbuch (Commentary on the German Civil Code), 74th ed.*

Fischer accepted that the true basis for the decision was that the deposit could not become repayable until its purpose as security was fulfilled or dissolved, and that no real analogy could be drawn.

26. On the other hand, Wentworth rejected Professor Mülbert's reliance on an analogy with the ISDA Master Agreement as misplaced and superficial. Mr Allison summarised the differences between the agreements in this regard as follows:

(1) The ISDA Master Agreement provides a detailed framework governing termination which is very different from the GMA.

(2) The ISDA Master Agreement does not provide for automatic termination on the insolvency of a party unless this option is chosen by the parties.

(3) The close-out payments under the ISDA Master Agreement do not become due until after the close-out calculation has been performed and the notice served on the other party. If relevant, this militates in favour of the claim under the GMA falling due after the netting under clauses 8 and 9 has been performed.

(4) The ISDA Master Agreement provides a contractual basis for a claim to default interest on the close-out amount – the GMA does not provide any contractual entitlement for interest on the single compensation claim under clauses 7 to 9.

(5) To the extent that any comparison is to be made with the ISDA Master Agreement in terms of the expectation of market users, it tells us that market users would **not** expect a close-out amount to become payable until notified of the amount – the section 6(e) amount is "*payable*" only upon its notification. Accordingly, it is consistent with Wentworth's case.

27. Taken through these differences when cross-examined, Professor Mülbert (who acknowledged at the outset of his oral testimony that he needed help on the terms and effect of the ISDA Master Agreements since he had not been asked specifically to opine on them) acknowledged that they were such that any attempt to draw a parallel between the GMA and the ISDA Master Agreements could be "at a very high level of generality only". Indeed I accept that Professor Mülbert never intended to suggest anything more than that in general terms market participants might be surprised if there was a difference in overall operation and effect between the two sets of agreements.

28. Wentworth also relied on Dr Fischer's evidence to the effect that the provisions of clause 7 of the GMA, in providing for a contracting out of section 104 of the German Insolvency Act ("InsO") and for a more flexible calculation of the close-amount than the set-off procedures otherwise mandated by InsO, were inconsistent on that ground also with the notion of the payment obligation being immediately due on termination.

29. Lastly on the Accrual Issue, and as an alternative to its principal case that section 271 of the BGB, Wentworth submitted that even if section 271(1) applies, "*immediately*" is understood objectively, and permits some, albeit limited, necessary amount of

preparation time to perform. Dr Fischer referred me in this context to a Commentary on the BGB[33] in which it is stated:

> "This means that the debtor must pay as quickly as possible by objective standards…taking into account an approximately necessary preparation…"

30. In this case the administration application was made without notice to any party at around 7:30am on a Monday morning and the administration order was made before 8am. No party would have been aware of the automatic termination of the GMA until after the administration order. Wentworth submitted that there is no sensible basis on which an objective meaning of "immediate" could require performance prior to the commencement of the administration.

31. Professor Mülbert accepted that the word "immediately" in section 271 of the BGB is to be understood objectively, and will depend "on the specific situation". He said that, nevertheless, he

> "…would be surprised if German courts in a case like this…would not hold that 'Immediate' means right after, immediately after the termination notice in a case of a termination notice, immediately after the termination notice has been served."

However, that does appear to cover the case of automatic termination; and it is Wentworth's case that at the least a *locus penitentiae* is permitted, which would permit the 20 minutes or so in this case between the application for and the grant of an administration order.

My conclusions on the Accrual Issue

32. The absence of any directly applicable German case law or commentary in the context of claims in relation to the operation of netting procedures on termination, the very different factual contexts of the cases cited by analogy, and the divergence in view between two well qualified experts make this a particularly difficult issue for an English court, seeking conscientiously to apply German law, to determine.

33. I have eventually concluded that the provision in clause 9(1) for unpaid amounts, any other unperformed obligations, and the damages (determined on the basis of a replacement transaction as provided by clause 8(1)) which are payable to be combined by the Party Entitled to Damages into a single compensation claim, denominated in Euros, postpones the due date for payment until the ascertainment of the single compensation sum (whereupon that sum is payable "immediately", in accordance with section 271 of the BGB).

34. I reach that conclusion as a matter of contractual interpretation principally because, as it seems to me, the essential scheme for the substitution in place of the original obligations of a particular party's liability for a single compensation claim, which can

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[33] *Kruger, Munchener Commentary on BGB,* 12th ed (2012)

only be determined to exist and calculated after (in effect) a taking of a two-way account, does connote that until both determination and calculation no liability is established or fixed.

35. Put another way, the question to be asked is: "Prior to the ascertainment of the single compensation sum is it possible to be sure which of the parties will be entitled to payment, quite apart from in what amount?" The negative answer seems to me to negate any intention to entitle demand or oblige payment before that time. I think it most unlikely that it was the parties' objective intention to accept what both experts acknowledged were the very real difficulties otherwise implicit and inevitable.

36. I should perhaps clarify that my conclusion on contractual interpretation is not based on reading into clause 9(1) of the GMA the provisions of clause 9(2) which expressly provide for a compensation claim *against* the Party Entitled to Damages only to become due and payable as soon as and to the extent that it exceeds the aggregate amount of any Counterclaims which the Party Entitled to Damages may have. I accept Mr Dicker's argument (on behalf of the SCG) that Clause 9(2) operates separately from Clause 9(1) and only in limited circumstances. Contrary to what appears to have been Dr Fischer's view (i.e. that the entirety of Clauses 7 to 9 constituted a "*united unified regulation*" which applies in every instance), Clause 9(2) only has any relevance where the Party Entitled to Damages (i.e. the non-defaulting party) is the paying party. If it is not (i.e. whenever the Party Entitled to Damages concludes that it has suffered damages and is entitled to receive the single compensation claim) Clause 9(2) has no role to play.

37. In reaching my conclusion, I have taken carefully into account that the two cases cited by Professor Mülbert seem to confirm (not unexpectedly) that German law does not perceive it to be unfair or impermissible for a debt to fall due before it has been calculated. But in neither of the cases was there any doubt as to the existence of a claim and which of the parties would be the payor and which the payee: in both, one party's liability was established even though quantum was not.

38. A closer analogy seems to me to be offered by the case (referred to above) concerning a landlord's heating costs claim, on which Dr Fischer based most reliance. The fact that in that case it was held that the landlord could only require payment from the tenant of heating costs in excess of those prepaid by the tenant only after the net excess had been calculated and payment of that excess demanded by bill or invoice "because the tenant cannot ascertain and therefore cannot pay the amount owed without a bill" is in some material respects similar to the position in this case where neither party can know who owes what until after the determination of the Single Compensation Claim. However, the analogy is imperfect. In that case a billing process was expressly required, and the actual decision of the court, in determining when liability was crystallised for the purposes of a limitation defence, was (favouring the tenant) that mandatory supplemental provisions to the letting agreement stipulated that any excess could only become due when the bill or invoice was presented: and that was that.

39. The reality is that each case is different; and in the contractual context, it is a question of identifying the particular intent of the parties in the absence of any generally applicable or overriding rule. My abiding impression is that neither of the experts ultimately contradicted this.

40. As to other and broader commercial considerations, and especially the SCG's argument that Wentworth's case (and my interpretation) supposedly involve the allegedly uncommercial consequence of denying the "innocent party" full recovery because interest would not run during the period of two-way or netting calculation, since on that interpretation the principal is not yet due, I accept the resolution urged on behalf of Wentworth to the following effect:

(1) The unpaid amounts or unperformed obligations as at termination date may be owed by or to either party.

(2) The unpaid amounts are "overdue" relative to an express payment date under clause 3.

(3) The fact that such amount or obligations are unpaid or overdue as at termination provides no assistance in determining when the compensation claim under clause 8 becomes due.

(4) The compensation claim under Clause 8 exists, but is not due until calculated in a manner that can be reproduced to the other party.

(5) Interest due on unpaid amounts will continue to accrue throughout the calculation process, i.e. it is the unpaid amounts plus interest accrued on those amounts to the date of the combination which are to be combined with the compensation claim under clause 8 to form the single compensation claim under clause 9.

(6) There is therefore no interest lost in respect of unpaid amounts.

(7) The fact that there is no interest on the single compensation claim until calculated simply reflects the fact that the GMA does not contain any contractual provision for interest on the single compensation and that, in these circumstances, German law provides that interest cannot be claimed until payment is due.

(8) The "loss" of interest on the claim as ultimately calculated, i.e. post-termination to the end of the calculation period, is overplayed by the SCG. The literature does not contemplate a protracted calculation process and clause 8 in fact requires that it be done without "*undue delay*".

41. As to the SCG's suggestion that the inconsistency between the result I have preferred and the position under the ISDA Master Agreements was also uncommercial, I accept, of course, that commercial men prefer consistency, and to some extent, in choosing standard forms, expect it. However, the fact is that the ISDA Master Agreements and the GMA are materially different, at least in part in consequence of the different legal systems (and, in particular, bankruptcy regimes) in which they take effect. I do not accept that any surprise on behalf of the market that the GMA and the ISDA Master Agreements might differ is relevant or helpful as a tool of construction; nor do I think the fact of such differences is any real argument against the conclusion which I have reached. The two sets of agreements differ materially, especially as regards their close-out provisions. It is a matter for market participants to bring them closer, if and

insofar as the different legal systems permit. There should be no surprise that different legal agreements governed by markedly different systems of law differ in their result.

42. In my judgment, therefore, the Single Compensation Claim should be regarded as due and payable by the party who, after the two-way process required by Clauses 8 and 9, has been established to be the payor and has been notified of the amount due and payable accordingly.

43. It follows that the obligation to pay the Single Compensation Claim cannot have become due until after LBIE's administration.

44. The consequence is that LBIE cannot have been in default of a payment obligation within the meaning of section 286 of the BGB prior to LBIE's entry into administration.

45. Since the experts were agreed that a claim to *further damage* does not exist unless and until a default has occurred within the meaning of section 286 of the BGB, a counterparty to the GMA, though a Party Entitled to Damages within the meaning of the GMA, does not have a claim for "further damage" at the commencement of LBIE's administration.

APPENDIX 1

Waterfall IIC Questions

ISDA

10 Whether, on the true construction of the term "Default Rate" as it appears in the ISDA Master Agreement, the "relevant payee" refers to LBIE's contractual counterparty or to a third party to whom LBIE's contractual counterparty has transferred (by assignment or otherwise) its rights under the ISDA Master Agreement.

11 Is the meaning that should be given to the expression *"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"* capable of including:

(1) The actual or asserted cost to the relevant payee to fund or of funding the relevant amount by borrowing the relevant amount; and/or

(2) The actual or asserted average cost to the relevant payee of raising money to fund or of funding all its assets by whatever means, including any cost of raising shareholder funding; and/or

(3) The actual or asserted cost to the relevant payee to fund or of funding and/or carrying on its balance sheet an asset and/or of any profits and/or losses incurred in relation to the value of the asset, including any impact on the cost of its borrowings and/or its equity capital in light of the nature and riskiness of that asset; and/or

(4) The actual or asserted cost to the relevant payee to fund or of funding a claim against LBIE.

12 If and to the extent that the *"cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund ... the relevant amount"* includes a cost of borrowing:

(1) Should such borrowing be assumed to have recourse solely to the relevant payee's claim against LBIE or to the rest of the relevant payee's unencumbered assets?

(2) If the latter, should the cost of funding include the incremental cost to the relevant payee of incurring additional debt against its existing asset base or should it include the weighted average cost on all of its borrowings?

(3) Should such cost include any impact on the cost of the relevant payee's equity capital attributable to such borrowing?

(4) Is the cost to be calculated based on obtaining:

(i) Overnight funding; or

(ii) Term funding to match the duration of the claim to be funded; or

(iii) Funding for some other duration?

13 Whether 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"* should be calculated:

(i) by reference to the relevant payee's circumstances on a particular date; or

(ii) on a fluctuating basis taking into account any changes in the relevant circumstances (and if so, whether the benefit of hindsight applies when taking into account such changes),

in each case, whether or not taking into account relevant market conditions.

14 Whether a relevant payee's certification of its cost of funding for the purposes of applying the "Default Rate" is conclusive and, if not, to what it is subject. In particular whether, in order for a payee's certification to be deemed conclusive, a relevant creditor is under any duty to act:

(i) reasonably;

(ii) in good faith and not capriciously or irrationally; or

(iii) otherwise than in its own interests.

15 If the answer to question 14 is that the relevant payee's certification of its cost of funding is not conclusive and one of the requirements (i) to (iii) set out in that question applies, where does the burden of proof lie in establishing, and what is required to demonstrate, that a relevant payee has or has not met such requirement?

16 Whether only the relevant payee (in accordance with the meaning of such term determined pursuant to question 10 above), or another party (whether authorised by the relevant payee or not) can provide certification of the cost of funding and, if the former, what the position should be if the relevant payee is not capable of providing such certification (for example because it has been wound up or dissolved).

…

18 Whether the power of a party under section 7(b) of the 1992 form ISDA Master Agreement to transfer any amount payable to it from a Defaulting Party under Section 6(e) without the prior written consent of that party included the power to transfer any contractual right to interest under that agreement.

19 Whether the answer to questions 10 to 18 above (or any of them) is different if the underlying Master Agreement is governed by New York rather than English law.

<u>*German Master Agreement*</u>

...

20.1 Whether and in what circumstances, following LBIE's administration, a creditor would be entitled to make a "damages interest claim" within the meaning of section 288(4) of

the German Civil Code (**BGB**) on any sum which is payable pursuant to clauses 7 to 9 of the German Master Agreement.

20.2 If the answer to question 20.1 is yes, whether (and if so, in what circumstances) all or part of such "damages interest claim" can constitute part of *"the rate applicable to the debt apart from the administration"* for the purposes of Rule 2.88(9)?

21 If the answer to question 20.2 is that a further claim for damages can be included as part of the *"rate applicable to the debt apart from the administration"* for the purposes of Rule 2.88(9), how in such circumstances is the relevant rate to be determined? In particular:

(i) in circumstances where the relevant claim under the German Master Agreement has been transferred (by assignment or otherwise) to a third party, is it the Damages Interest Claim which could be asserted by the assignor or the assignee which is relevant for the purposes of Rule 2.88(9)?

(ii) where the relevant claim under the German Master Agreement has been acquired by a third party, in what circumstances (if any) is such a third party precluded from asserting a Damages Interest Claim under principles of German law?

(iii) where does the burden of proof lie in establishing a Damages Interest Claim, and what is required to demonstrate that a relevant creditor has or has not met such a requirement?

…

Status of Payee

27 Whether, and if so how, the answers to questions 10 to 16 and 18 to 21 should be impacted where the "relevant payee" is:

(i) a Credit Institution or Financial Institution;

(ii) a Fund Entity; or

(iii) a corporate or other type of counterparty.

Supplemental Issue 1(a)

Whether, and in what circumstances, the words *"the rate applicable to the debt apart from the administration"* in Rule 2.88(9) of the Rules include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration.

APPENDIX 2

(as referred to in paragraph [38] of the main judgment)

Wentworth's selected permutations for calculation of interest under Section 6(e) of the 1992 Form

1. The following permutations are based on the following example:

   (1) Either (a) an Event of Default ("**EoD**"), or (b) a Termination Event, occurs with respect to Party A on 15 September. 18 September is designated by Party B as the Early Termination Date.

   (2) Party B, having calculated the amount due under Section 6(e) (the "**Termination Amount**") provides notice of such amount, which notice becomes effective on 10 October.

2. First possibility:

   (1) Party A suffers an EoD. The parties have opted for Second Method and Loss and the Termination Amount is owed *by* Party A.

   (2) Interest is calculated for the period from 18 September until the Termination Amount is paid at the Default Rate (i.e. by reference to the cost of funding of **Party B**).

3. Second Possibility:

   (1) Party A suffers an EoD. The parties have opted for Second Method and Loss and the Termination Amount is owed *to* Party A.

   (2) Interest is calculated for the period from 18 September to 10 October at the Non-default Rate (i.e. by reference to the cost of funding of **Party B**).

   (3) Interest is calculated for the period from 10 October until the Termination Amount is paid at the Default Rate (i.e. by reference to the cost of funding of **Party A**).

4. Third possibility:

   (1) Party A suffers a Termination Event. The parties have opted for Second Method and Loss and the Termination Amount is owed *by* Party A.

   (2) Interest is calculated for the period from 18 September to 10 October at the Termination Rate (i.e. by reference to the respective costs of funding of **Party A** *and* **Party B**).

   (3) Interest is calculated for the period from 10 October until the Termination Amount is paid at the Default Rate (i.e. by reference to the cost of funding of **Party B**).

5. Fourth possibility:

(1) Party A suffers a Termination Event. The parties have opted for Second Method and Market Quotation, and the component parts of the Termination Amount (payable *to* Party A) include: (a) the Termination Currency Equivalent of the Market Quotations, (b) Unpaid Amounts owing to Party A, and (c) Unpaid Amounts owing to Party B.

(2) Interest on Unpaid Amounts is calculated on Unpaid Amounts owing both *to* and *by* Party A, and also on the Termination Amount from 18 September to 10 October, at the Termination Rate (i.e. calculated by reference to the respective costs of funding of **Party A** and **Party B**).

(3) Interest is calculated on the Termination Rate from 10 October until payment at the Default Rate (i.e. by reference to the cost of funding of **Party A**).