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Case No: FL-2015-000008

IN THE HIGH COURT OF JUSTICE
BUSINESS AND PROPERTY COURTS OF ENGLAND AND WALES
FINANCIAL LIST

Royal Courts of Justice
Rolls Building, Fetter Lane,
London, EC4A 1NL

Date: Friday 22 February 2019

Before:

MR JUSTICE SNOWDEN

- -

Between:

LEHMAN BROTHERS FINANCE AG (IN LIQUIDATION)	**Claimant**
- and -	
(1) KLAUS TSCHIRA STIFTUNG GMBH **(2) DR H C TSCHIRA BETEILIGUNGS GMBH & CO KG**	**Defendants**

- -

David Wolfson QC and **Edmund King** (instructed by **Watson Farley & Williams LLP**) for the **Claimant**
Robin Dicker QC and **Henry Phillips** (instructed by **Clifford Chance LLP**) for the **Defendants**

Hearing dates: 31 January, 1-3, 6-9, 14-16 February 2017

- -

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.

....

MR JUSTICE SNOWDEN

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MR JUSTICE SNOWDEN:

Introduction

1. This case raises a series of questions concerning the determination of "Loss" following an "Automatic Early Termination Event" under the ISDA Master Agreement (1992 Multicurrency-Cross-border form).

2. The main issues relate to the date by reference to which the determination of Loss should have been performed, and whether the basis for such determination in relation to a collateralised terminated transaction should be by reference to the cost of a collateralised or uncollateralised replacement transaction, in circumstances in which the determining party was unable at the time either to recover its original collateral from a third party custodian or to borrow alternative collateral.

3. The gulf between the parties is, on any basis, enormous. The Defendants made the determination that a close-out payment was due to them from the Claimant of €411.13 million (plus interest and costs). The Claimant disputes the validity of the determination, and contends that if the determination had been performed on the correct basis, it would have been due a payment from the Defendants of between €141.56 million and €167.92 million (plus interest and costs).

The Parties

The Claimant

4. The Claimant, Lehman Brothers Finance A.G. ("LBF"), is a Swiss company, whose core business consisted of the entry into OTC equity derivatives transactions. LBF was a member of the worldwide Lehman Brothers group of companies whose ultimate U.S. parent company was Lehman Brothers Holding Incorporated ("LBHI"). At the time they were entered into, the transactions in issue in this case represented the largest single stock OTC equity derivatives transactions ever executed by an entity in the Lehman Brothers group in Europe.

5. The bankruptcy of LBHI in 2008, which precipitated the collapse of the entire Lehman Brothers group, marked the beginning of LBF's descent into bankruptcy. On 30 September 2008, the Swiss Federal Banking Commission ordered that LBF become subject to its supervision, and appointed PwC Switzerland as its investigating agent. This meant that all executive functions passed from LBF's board to PwC Switzerland. On 29 October 2008, the Swiss Federal Banking Commission issued an order that LBF be liquidated, and appointed PwC Switzerland as the Liquidator. Finally, on 19 December 2008, and after PwC's conclusion that a successful restructuring of LBF would not be possible, the Swiss Federal Banking Commission ordered that the liquidation proceedings be converted into a bankruptcy on 22 December 2008.

The Defendants

6. The Defendants are German entities established by the late Dr. Klaus Tschira, one of the co-founders of the German multinational software company, SAP SE ("SAP"). Klaus Tschira Stiftung GmbH ("KTS") is a not-for-profit charitable organisation (structured as a limited liability company with tax-exemption due to its charitable

status), which funds projects seeking to advance natural sciences, mathematics, computer science and technology. Dr H C Tschira Beteiligungs GmbH & Co KG ("KG") is an investment vehicle (structured as an incorporated partnership) set up to hold financial investments for the Tschira family. The Defendants' principal assets are very large volumes of shares in SAP. The Tschira family investments, including those of the Defendants, are managed by Aeris Capital AG ("Aeris"), a Swiss company incorporated for this purpose. The relevant individual at Aeris responsible for the transactions in issue in this case was Mr. Bernd Kammerlander ("Mr. Kammerlander").

7. In order to manage their exposure to the risk of falls in the price of SAP stock, the Defendants entered into a number of hedging arrangements in respect of their SAP shares. In particular, the Defendants entered into four collateralised equity derivative transactions with LBF in 2007 and 2008, which are the subject of this claim.

The Transactions

The Variable Forward Sales

8. In May 2007, the Defendants each entered into a collateralised hedge transaction with LBF, known by the parties as the "Variable Forward Sales" or "VFS". The transactions consisted of a "collar" of put and call options in respect of 59 million SAP shares, which effectively provided the Defendants with protection against the price of the SAP shares falling below a specified floor, whilst requiring them to forgo the benefit of any increase in the price of SAP shares above a specified cap.

9. The Variable Forward Sales were divided into 45 tranches of SAP shares. Each tranche was allocated a different valuation date (the KTS tranches matured between 30 January 2012 and 15 February 2013, and the KG tranches matured between 14 April 2014 and 6 May 2015). On the relevant valuation date, if the price of SAP shares was equal to or below the put strike-price, the relevant Defendant was entitled to require LBF to purchase that tranche for an amount equal to the put strike-price. Conversely, if the price of SAP shares was greater than the call strike-price, LBF was entitled to require the relevant Defendant to sell that tranche to it for an amount equal to the call strike-price. The put strike-prices for the Variable Forward Sales were set ultimately at €29.38 in the case of KTS and €30.035 in the case of KG. The call strike-prices were set at €55.70 in the case of KTS and €56.355 in the case of KG.

10. The Defendants each agreed to pay LBF a premium (referred to in the confirmations as a "Final Amount") for entering into the Variable Forward Sales, which was calculated using a specified formula. The KTS premium was ultimately set at €50,510,830 and the KG premium at €66,845,365 (the "Premiums"). Payment of the Premiums was agreed to be deferred until the maturity of the Variable Forward Sales.

The Collateral

11. The Defendants' obligations to LBF under the Variable Forward Sales were secured by the provision by KTS and KG of collateral of a total of 59 million SAP shares (the "Collateral"). LBF could not hold such Collateral in its own name and the Defendants did not wish to transfer title to such a large proportion of the issued share capital of SAP. Accordingly, arrangements were made for the Collateral to be held on behalf of

the Defendants in segregated custody accounts by Lehman Brothers International Europe ("LBIE"), the main UK subsidiary of the Lehman Brothers group.

12. The custody arrangements were documented pursuant to the terms of a Master Custody Deed ("MCD") which was entered into by each of the Defendants with LBIE and LBF. Under each MCD, the Collateral remained at all times the property of the Defendants, but was subject to a charge in favour of LBF to secure the Defendants' obligations under the Variable Forward Sales. The MCDs were required by the confirmations for the Variable Forward Sales to be entered into on or prior to the Trade Date and were identified as a Credit Support Provision.

The Variable Forward Purchases

13. In April 2008, the Defendants entered into two conditional transactions known by the parties as the "Variable Forward Purchases" or "VFP".

14. Like the Variable Forward Sales, the Variable Forward Purchases consisted of collars of put and call options. The Variable Forward Purchases were divided into 45 tranches with the same valuation dates as the corresponding tranches as in the Variable Forward Sales, and with the same strike prices as the Variable Forward Sales. The number of SAP shares to which the Variable Forward Purchases related varied according to a formula but was eventually fixed at 26.2% of the shares which were subject to the Variable Forward Sales. However, the rights and obligations of the parties were reversed, so that the put options were granted to LBF and the call options were granted to the Defendants. This meant that the Variable Forward Purchases were seen by the parties as capable of operating – at least in financial terms - as a partial reversal or "unwind" of the Variable Forward Sales.

15. Unlike the Variable Forward Sales, however, the Variable Forward Purchases were conditional in that they included a "down and in" feature. A "barrier" SAP share price was created for each tranche, at increments of €0.07 between €25 and €28, which was below the put strike price. The settlement conditions in effect provided that LBF's put option could only be exercised if the SAP share price had traded below the "barrier" set for that tranche at any time prior to its expiry date. Once triggered, each barrier would remain triggered regardless of how the SAP share price subsequently moved.

16. An important aspect of the Variable Forward Purchases was that the Defendants were entitled to receive a rebate from LBF if the price of SAP shares fell below the "down and in" barriers, triggering LBF's right to exercise the put options. The rebate was to be calculated as the difference between the barrier level and the put option strike price for a particular tranche.

The Master Agreements

17. Each of the Variable Forward Sales and the Variable Forward Purchases (together "the Transactions") were undertaken pursuant to ISDA Master Agreements (in the 1992 Multicurrency-Cross-border form) which were entered into between the parties on 16 May 2007 ("the Master Agreements"). The confirmations relating to the Variable Forward Sales were executed on 23 May 2007 and those in relation to the Variable Forward Purchases were entered into on 18 April 2008. The Master Agreements were expressly to be governed by and to be construed in accordance with English law.

Unless otherwise defined, capitalised terms used in the remainder of this judgment follow the definitions in the Master Agreements.

18. Under Part 1(e) of the Schedule to the Master Agreements, the Automatic Early Termination provisions of Section 6(a) were agreed to apply to both parties, and under Part 1(h) it was agreed that LBHI failing to maintain a certain ratings level would constitute an Additional Termination Event.

19. Section 5(a)(vii)(4) provided that in respect of any party or Credit Support Provider of such party, it would be an Event of Default if the relevant entity instituted or had instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law. Section 6(a) then provided (in relevant part),

> "If … "Automatic Early Termination" is specified in the Schedule as applying to a party, then an Early Termination Date in respect of all outstanding Transactions will occur…as of the time immediately preceding the institution of the relevant proceeding or the presentation of the relevant petition upon the occurrence with respect to such party of an Event of Default specified in Section 5(a)(vii)(4) …"

20. Under Part 1(f) of the Schedule to the Master Agreements, "Loss and Second Method" was agreed to apply for the purposes of Section 6(e). That section specified:

> "(i) *Events of Default*. If the Early Termination Date results from an Event of Default:-
>
> ….
>
> (4) *Second Method and Loss*. If the Second Method and Loss apply, an amount will be payable equal to the Non-defaulting Party's Loss in respect of this Agreement. If that amount is a positive number, the Defaulting Party will pay it to the Non-defaulting Party; if it is a negative number the Non-defaulting Party will pay the absolute value of that amount to the Defaulting Party."

21. Section 6(d) set out when the Non-defaulting Party was required to calculate its Loss:

> "(i) *Statement*. On or as soon as reasonably practicable following the occurrence of an Early Termination Date, each party will make the calculations on its part, if any, contemplated by Section 6(e) and will provide to the other party a statement (1) showing, in reasonable detail, such calculations (including all relevant quotations and specifying any amount payable under Section 6(e)) …"

22. The definition of "Loss" in Section 14 of the Master Agreements explained how the Non-defaulting Party's "Loss" was to be determined:

> ""Loss" means, with respect to this Agreement or one or more Terminated Transactions, as the case may be, and a party, the Termination Currency Equivalent of an amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related trading position (or any gain resulting from any of them). Loss includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication, if Section 6(e)(i)(1) or (3) or 6(e)(ii)(2)(A) [i.e. Market Quotation] applies. Loss does not include a party's legal fees and out-of-pocket expenses referred to under Section 11. A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable as of the earliest date thereafter as is reasonably practicable. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets."

23. Although not the payment measure which the parties elected to use in this case, for reasons that I shall explain later in the judgment, reference should also be made to the alternative definition of "Market Quotation" in the Master Agreements, which was as follows,

> ""Market Quotation" means, with respect to one or more Terminated Transactions and a party making the determination an amount determined on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to such party (expressed as a negative number) or by such party (expressed as a positive number) in consideration of an agreement between such party (taking into account any existing Credit Support Document with respect to the obligations of such party) and the quoting Reference Market-maker to enter into a transaction (the "Replacement Transaction") that would have the effect of preserving for such party the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties under Section 2(a)(i) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early

> Termination Date, have been required after that date. For this purpose, Unpaid Amounts in respect of the Terminated Transaction or group of Terminated Transactions are to be excluded but, without limitation, any payment or delivery that would, but for the relevant Early Termination Date have been required (assuming satisfaction of each applicable condition precedent) after that Early Termination Date is to be included. The Replacement Transaction would be subject to such documentation as such party and the Reference Market-maker may, in good faith, agree. The party making the determination (or its agent) will request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time (without regard to different time zones) on or as soon as reasonably practicable after the relevant Early Termination Date. The day and time as of which those quotations are to be obtained will be selected in good faith by the party obliged to make a determination under Section 6(e), and, if each party is so obliged, after consultation with the other. If more than three quotations are provided, the Market Quotation will be the arithmetic mean of the quotations, without regard to the quotations having the highest and lowest values. If exactly three such quotations are provided, the Market Quotation will be the quotation remaining after disregarding the highest and lowest quotations. For this purpose, if more than one quotation has the same highest value or lowest value, then one of such quotations shall be disregarded. If fewer than three quotations are provided, it will be deemed that the Market Quotation in respect of such Terminated Transaction or group of Terminated Transactions cannot be determined."

Factual background

24. Much of the relevant factual background is not in dispute and is apparent from the terms of the contemporaneous documents. I find that the following events occurred.

Concerns about the creditworthiness of Lehman Brothers

25. In 2008, there was growing concern in the market about the creditworthiness of Lehman Brothers, particularly following the collapse of Bear Stearns in the spring of that year. On 15 May 2008, LBHI agreed to provide a guarantee of LBF's obligations to the Defendants in respect of the transactions governed by the Master Agreements. That Guarantee was agreed to be a Credit Support Document as contemplated in the Master Agreements and the relevant confirmations, and LBHI became a Credit Support Provider.

26. Aeris also sought further security for the Defendants from LBF in the form of cash collateral. To that end, on 14 July 2008, the Master Agreements were amended to incorporate Credit Support Annexes pursuant to which LBF could be required to provide cash collateral, by way of security for the performance of its obligations under the Transactions.

27. By 9 September 2008 the LBHI share price had fallen significantly. LBIE took the view internally that on a mark-to-market basis, LBF was still "in-the-money" to the tune of €157.5 million payable by the Defendants to LBF on the Variable Forward Sales, offset by €3.09 million payable by LBF to the Defendants for the Variable Forward Purchases. Mr. Kammerlander was aware of that view, but nonetheless on 10 September 2008 he asked LBF to make a credit support payment as security for LBF's obligations under the Transactions. On 12 September 2008, and pursuant to letter agreements amending the Credit Support Annexes in relation to the Transactions, LBF agreed to provide the Defendants with a total of €100 million of cash collateral (€54 million to KG and €46 million to KTS). This amount was known by the parties as the "Independent Amount".

Termination of the Transactions on 15 September 2008

28. At 1:44 am EST on Monday 15 September 2008, and prior to the opening of the markets in the UK, LBHI filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code. It was common ground between the parties at trial that LBHI's filing gave rise to the Automatic Early Termination of the Transactions under section 6(a) of the Master Agreements and that, as a consequence, an Early Termination Date occurred on 15 September 2008.

29. Mr. Kammerlander learned of LBHI's Chapter 11 filing in an early morning call on 15 September 2008 from Christian Meissner, CEO of Lehman Brothers' European business. Mr. Kammerlander's assistant then emailed contacts at the London office of Goldman Sachs (with which the Defendants held several other positions) and the London office of Mediobanca, Banca di Credito Finanziario SpA ("Mediobanca") requesting that two new custody accounts be opened for the possible transfer of the Defendants' SAP shares held by LBIE. That morning, the Defendants also arranged for the contractual documentation for the Transactions to be sent to Mediobanca. The Defendants also arranged for a document prepared by LBIE setting out an overview of the Transactions and the key numbers involved (the "KT Data Sheet") to be sent to both Goldman Sachs and Mediobanca.

Mediobanca values the Transactions

30. That evening, Mr. Samuel Losada of the "Equity Solutions Group" of Mediobanca ("Mr. Losada") sent an email to Mr. Kammerlander with the subject line "Termination Event triggered on Big Hedge Today (!)" which stated that Mediobanca believed that a Termination Event had occurred under the ISDA Master Agreements due to the failure by LBHI to maintain its required credit rating. The email continued,

> "You can choose between Market Quotation or Loss method to determine the amount payable (mark-to-market). We should discuss this tomorrow as we should probably start documenting the 'replacement big hedge' in accordance with the Loss method (market data proving the valuation plus an estimate of the bid-offer spread)."

31. On 17 September 2008, Mr. Losada sent a further email to Mr. Kammerlander (with the subject line "*Valuation of Big Hedge and Contingent Unwind*"). It stated,

> "Could [you] please confirm by email that you want us to value both the Variable Forward Purchase and the Variable Forward Sale executed by both the KG and the KTS with LBF NA. The valuation should be performed as per close of business on Friday 12th September 2008.
>
> We will value the transactions according to the relevant market data and provide you with a memo outlining our assumptions. The value or price we will provide you with will reflect the level at which we would have traded this position."

32. Mr. Kammerlander replied the same day,

> "I confirm that we would like you to price the transactions as of Friday. We may also need one as of Monday morning. See ISDA. On the date of early termination or asap thereafter."

33. In response to this request, on 18 September 2008 Mr. Losada sent an email to Mr. Kammerlander with the subject line "Valuation of VFS/VSP" attaching an incomplete draft memorandum which provided a "valuation and assumptions" for the Variable Forward Sales, with a placeholder for a valuation of the Variable Forward Purchases to be added. The cover email described the memorandum as "still work-in-progress" but gave a preliminary valuation of the Variable Forward Sales on the two dates mentioned by Mr. Kammerlander in his email of 17 September:

> "+€[1]mn (asset for you) if we use Friday's close or at -€[22]mn (liability for you) if we use Monday's open."

The cover email concluded that:

> "We haven't taken into account the VFP yet and will still refine the numbers for the VFS tomorrow in your favour when we take into account the value of the collateral package you have (cash at Libor +24bps !!)."

34. Mr. Losada sent Mr. Kammerlander a further version of the memorandum the next day (Friday 19 September 2008) under cover of an email entitled "Pricing – VFS and VFP". The covering email suggested that the net position as of the close of XETRA in Germany on Friday 12 September 2008 would have been that Mediobanca would have paid €7.45 million to the Defendants to enter into the Transactions, and that as of the opening of XETRA on Monday 15 September 2008 Mediobanca would have paid the Defendants €28.02 million. It is common ground that this email incorrectly reversed the direction of the payments that Mr. Losada had calculated would have been payable by the Defendants to Mediobanca.

35. That error was not repeated in an email that Mr. Losada sent to Mr. Kammerlander shortly thereafter with the title, "Bottom line". Mr. Losada stated:

> "Bernd,
>
> If you apply the *Monday morning pricing*, it means in summary:
>
> - you are sending a bill to [LBF] of €28mm for the VFS and the VFP;
>
> - you are long stock effectively at €34 (!!) given that we have applied a 7% discount to the mkt price and you have made €210mn (on the delta) given the stock is at €40…
>
> Not bad hey?"
>
> (italics in original)

36. On 22 September 2008, under cover of an email headed "Valuation for Short Calls, VFS and VFP", Mr. Losada sent a final version of the memorandum to Mr Kammerlander, along with a valuation of a further transaction for a short call option in respect of 7 million SAP shares. This final version of the memorandum ("the Information Memorandum") corrected some errors in the previous version sent on 19 September: most importantly it reversed the direction of payment of the amounts between Mediobanca and the Defendants.

37. The Information Memorandum stated that Mediobanca had,

> "Priced the four structures at a level where the Bank would have been in a position to enter them as of [the closing of XETRA on Friday 12 September 2008 and the opening of XETRA on Monday 15 September 2008.]"

38. The Information Memorandum set out the terms of the Transactions and noted that the valuation had been done on the basis that to hedge its own risk, Mediobanca would have to borrow and sell short up to 59 million SAP shares (a so-called "delta hedge") and that the costs of so doing would need to be included in the price. The Memorandum also noted that the Defendants would have to pledge the total number of SAP shares underlying the transactions in favour of Mediobanca to cover the bank's risk.

39. The Information Memorandum concluded that as at the close of XETRA on 12 September 2008, (i) KTS would have had to pay €6.04 million to Mediobanca to enter into a replacement for the VFS and €5.92 million to enter into a replacement for the VFP (i.e. a total payment of €11.96 million to Mediobanca); and (ii) Mediobanca would have had to pay KG €11.65 million to enter into a replacement for the VFS, and KG would have had to pay €7.14 million to Mediobanca to enter into a replacement for the VFP (i.e. a net payment of €4.51 million from Mediobanca to KG). Alternatively, Mediobanca concluded that as at the opening of XETRA on 15 September 2008, (i) KTS would have had to pay Mediobanca €14.69 million to enter into a replacement for the VFS and €5.47 million to enter into a replacement for the VFP (i.e. a total payment to Mediobanca of €20.16 million); and (ii) KG would have had to pay Mediobanca €1.21 million to enter into a replacement for the VFS and €6.85 million to enter into a replacement for the VFP (i.e. a total payment of €8.06 million).

40. In summary, according to the final version of the Information Memorandum, if the replacement transactions were priced as at the close of XETRA on 12 September 2008, the Defendants would have had to pay Mediobanca a combined total of €7.45 million, whereas if they were priced as at the opening of XETRA on 15 September 2008, the Defendants would have had to pay Mediobanca a combined total of €28.22 million. The latter figure is consistent with the email which Mr. Losada had sent to Mr. Kammerlander on 19 September 2008 suggesting that if the Transactions were priced as of Monday 15 September 2008 the Defendants would be "sending a bill to [LBF] of €28mm for the VFS and the VFP".

41. All versions of the Information Memorandum concluded with a statement ("the Disclaimer") which included the following,

> "This information document (the "Information Memorandum") which has been drawn up by Mediobanca … in its capacity as financial advisor to and in conjunction with [Klaus Tschira] as part of the procedure to evaluate two Equity Derivatives contract between Lehman Brothers and Klaus Tschira (the "Transaction Valuation") contains solely data and information provided by the Group or already in the public domain and is furnished to potential participants in the Transaction for information purposes only….
>
> The information contained in the Information Memorandum [has] been prepared with the intention of assisting the recipient in making its own assessment of the transaction Valuation, without any claims to being exhaustive. Such information may be subject to change, amendment or update, which neither Mediobanca nor [the Klaus Tschira Group] undertakes or commits to provide. The Information Memorandum must not be taken as the basis for investment decisions by potential counterparties….
>
> The Information Memorandum in no way constitutes a proposal to execute a contract or solicitation or advice or recommendation to purchase or sell any financial instrument. The Information Memorandum does not represent an outright offer or a commitment on the part of Mediobanca to subscribe for a financial instrument of any kind."
>
> (my emphasis)

42. This was bespoke language which differed significantly from Mediobanca's standard email disclaimer. The latter was far shorter and simply stated that the information was confidential and not to be disclosed to any third parties, and that "If the email contains an offer, that should be considered as an invitation to treat."

Goldman Sachs values the Transactions

43. In addition to these exchanges with Mediobanca, Mr. Kammerlander was also in communication with Goldman Sachs in the week following the bankruptcy of LBHI.

44. On 19 September 2008, in response to a request from Mr. Kammerlander and based on the KT Data Sheet, Goldman Sachs sent Mr. Kammerlander its valuation of replacement transactions for the Variable Forward Sales (only) as at the opening of business on Monday 15 September 2008. The email stated that for the "KG Portfolio", Goldman Sachs would have expected to receive over €33.8 million from KG, and for the "KTS Portfolio", Goldman Sachs would have expected to pay over €15.6 million to KTS. A few days later, on 23 September 2018, Goldman Sachs sent Mr. Kammerlander its valuation of the Variable Forward Purchases as at the opening of business on 15 September 2008. The email stated that for the "KG Portfolio", Goldman Sachs would have expected to receive €94,000 and for the "KTS Portfolio", Goldman Sachs would have expected to pay €850,000.

45. In total, therefore, on the basis of Goldman Sachs' valuation of the cost of replacements for the Transactions as at the opening of business on 15 September 2008, the Defendants would have had to make a net payment to Goldman Sachs of €17.46 million.

46. Both the emails of 19 September and 23 September 2008 from Goldman Sachs ended with the following text:

> "You have requested a quotation(s) that may be used for the purposes of estimating a replacement cost for the transaction(s) outlined below. Unless otherwise noted, the quotation provided is the price at which Goldman Sachs […] would have been prepared to execute a transaction at the time as specified in the quotation […] The quotation should not be construed that Goldman Sachs is prepared to enter into a transaction with you. In the event that you wish to enter into a transaction with Goldman Sachs, you should contact your Goldman Sachs representative to obtain a 'firm' price based on specific transaction details, size and current market conditions."

The Defendants and LBIE discuss release of the Collateral

47. In the days following the bankruptcy of LBHI, Mr. Gupta of LBIE had been in contact with Aeris about next steps following the early termination of the Transactions.

48. On 23 September 2008, Mr. Gupta arranged a call between LBF, LBIE, PwC and Aeris to discuss (i) the release of about 16 million SAP shares belonging to the Defendants which LBIE held independently of the Transactions (the "Free Shares"), and (ii) the process to close out the Transactions, release the pledges over the Collateral and to transfer those SAP shares to a new custodian.

49. Following the call, Mr. Gupta proposed twice daily calls between the parties to ensure progress, mentioned the need to escalate the "*potential 'valuation gap'*" in relation to the Transactions to LBF management, and the need for an all-parties call on "the LBF pledge release/cash escrow process". This call took place on 24 September 2008, and the next day Pinsent Masons (acting for the Defendants) circulated a draft deed of release and letter of undertaking to be executed by LBF in relation to the SAP shares which had been provided as part of the Collateral by KTS (indicating that a similar document would be needed for KG once the drafts had been agreed).

The Defendants send informal close-out figures to LBF

50. On 25 September 2008, Mr. Kammerlander collated the information he had received from Mediobanca and Goldman Sachs. He asked Mr. Losada to send a summary of Mediobanca's pricing "without the detailed analysis". Mr. Losada replied by email on the same day, setting out the figures from the Information Memorandum for the opening of XETRA on Monday 15 September 2008. The email made no mention of pricing as at Friday 12 September 2008.

51. Mr. Kammerlander then created a document entitled "Lehman Close-out Sheet", which summarised the pricing figures provided by Mediobanca (€28.22 million) and Goldman Sachs (€17.46 million) in relation to replacements for the Transactions, and then calculated the average of these figures. This resulted in an aggregate net payment of about €22.84 million by the Defendants to a counterparty. This result was portrayed as requiring a close-out payment from LBF to the Defendants.

52. Mr. Kammerlander then emailed a version of this "Lehman Close-out Sheet" summary table, along with the summary emails from Mediobanca and Goldman Sachs, to Mr. Gupta at LBIE under cover of an email which stated,

> "Please find attached the amounts that have been determined by [Goldman Sachs] and Mediobanca based on the OTC contract between KTS/KG and LBF/LBIE.
>
> **Please note that these figures are given without prejudice and on an informal basis only, and do not constitute a statement of "Loss" under the terms of the ISDA Master Agreements dated 16 May 2007.**"
>
> (emphasis in original)

53. On 26 September 2008, Mr. Gupta emailed Mr. Kammerlander to inform him that a "first cut" at the valuation in LBF's trading books indicated a materially different valuation of €109 million as of the opening on Monday 15 September and €133 million as of the close on Friday 12 September 2008. Mr. Gupta commented that in each case he had used "market assumptions" as of the close on Friday 12 September 2008, because these "are the only data points we have given what happened to our books and records on the following Monday." It is clear from his email that Mr. Gupta took the view that LBF should be receiving a substantial close-out payment from the Defendants.

54. Later the same day, Mr. Gupta forwarded an internal Lehman email chain to Mr. Kammerlander, discussing next steps in relation to the release of the Collateral and the close-out of the Transactions. The internal email noted that,

> "The LBHI bankruptcy filing is an event of default under the ISDA Master, hence KT will close-out the collar based on his assessment of the value as of the open on Monday 15 September. The proposed KT close-out amount is significantly lower than the valuation in the books of LBF as of the open on Monday 15 September."

The email went on to say that (in determining whether LBF should challenge the Defendants' proposed close-out amount),

> "It is [very] important we act quickly here as KT wants to execute a replacement collar with another bank and to do this he needs LBF to release the 59mm shares from the pledge."

55. Given the difference in close-out valuations between the parties, in order to facilitate the release of the Collateral shares, Mr. Gupta's email proposed that the Defendants deposit €200 million in cash in a third-party bank account and pledge this to LBF. In his forwarding email, Mr. Gupta warned Mr. Kammerlander that although LBF's board member was supportive of this proposal, LBF was in the process of filing for bankruptcy which would mean that the administrators' agreement would also be needed and that this would take time. He suggested that LBIE's administrators and solicitors should become the administrators/lawyers for LBF and that attempts should be made to get them "on board" with the proposal.

The Defendants investigate a put spread collar

56. In addition to requesting valuations for the Transactions, at about this time Mr. Kammerlander also requested proposals for alternative derivative transactions relating to the SAP shares with Mediobanca and other institutions.

57. On 23 September 2008, Mr Losada sent Mr Kammerlander a short email entitled "Preliminary Pricing on Zero Cost Put Spread Collar" setting out pricing for a put spread collar in relation to 52 million SAP shares (with put strikes at 65% and 90%, and a call strike in square brackets of 141.3%), with zero premium, and with the same maturities and dividends as the Transactions. Mr Kammerlander responded on the same day, "Looks really nice. How big is the delta?"

58. On 26 September 2008, a Ms. Hecker of J.P. Morgan also sent Mr. Kammerlander a price ("As requested") for a put spread collar, the details of which were set out in a presentation attached to her email. The proposed trade had the same put strikes (65% and 90%) and lack of premium as the Mediobanca "Zero Cost Put Spread Collar", priced by Mr. Losada on 23 September. The call strike proposed by J.P. Morgan was 134% and Ms. Hecker's proposal included a "pre-hedge facility" with a three-month term. On 30 September, Ms. Hecker followed this up with another email to Mr. Kammerlander, which attached an updated version of the presentation and referred to a call which had taken place with Mr. Kammerlander on 29 September 2008 and feedback from Mr. Kammerlander on her indicative pricing. Ms. Hecker stated that after further consideration, J.P. Morgan was prepared to hedge "the full amount (approximately 60 million shares)" and could offer improved terms for the benchmark put spread collar, including a call strike of 140%. The price still involved no premium.

59. On 25 September 2008, Mr. Losada emailed Mr. Kammerlander confirming that Mediobanca could execute a "Short Equity Swap" with the Defendants for a notional amount of €1,000 million (which at the time represented approximately 25 million SAP shares) without requiring any collateral from the Defendants. The email indicated that this offer had been made in response to a request from Mr. Kammerlander. The next day (26 September 2008), Mr. Losada followed up to confirm that Mediobanca's

lawyers were working on a draft confirmation for this equity swap. That draft confirmation was sent to Mr. Kammerlander by Mr. Losada on 2 October 2008.

60. On 2 October 2008, Mr. Losada also sent Mr. Kammerlander a draft document which he had prepared for use in a "pricing contest" with Goldman Sachs and JP Morgan. The attached draft (with the Aeris logo at the bottom), included a draft email to be sent by Mr. Kammerlander inviting the recipient bank to bid for a "combined hedge over 52 million SAP shares" split between the two Defendants, and involving collateral being provided by the Defendants in the form of a fixed pledge over 10 million SAP shares and a dynamic pledge of additional shares up to 110% of the mark to market hedge in the bank's favour. The request for pricing required the participating banks to provide the call strikes and number of shares required for the delta for four different variations of the structure.

The SAP share price falls due to a profit warning on 6 October 2008

61. On 6 October 2008, the SAP share price fell significantly following a profit warning issued by SAP. Mr. Losada emailed Mr. Kammerlander to warn him that the SAP share price had fallen to €29.6 per share and asked, "Shall we price with this close?". That evening, Mr. Losada sent Mr. Kammerlander an email setting out Mediobanca's pricing for replacement trades for the Transactions as at the close of business, and attached an updated version of the Information Memorandum. Mr. Losada's covering email stated that as at the close of XETRA that day, the net amount payable by KTS and by KG to Mediobanca to enter into replacement trades for the Transactions would have been €106.78 million and €130.98 million respectively, giving a combined price payable by the Defendants to Mediobanca of €237.76 million. This revised version of the Information Memorandum again ended with the Disclaimer in the same terms as before.

62. The day after the SAP share price fell, 7 October 2008, Mr. Kammerlander met the liquidators of LBF for the first time. Prior to that meeting, on 30 September 2008, Pinsent Masons wrote a letter on behalf of the Defendants to PwC Switzerland, giving formal notice that the Defendants considered that the Transactions had been terminated and that the Early Termination Date for the Transactions was 14 September 2008 [sic]. The letter indicated that the Defendants were considering their position in relation to their Loss (as defined in the Master Agreements) and reserved their rights.

63. On 2 October, Dr. Hess, one of the Defendants' Swiss lawyers from Wenger & Vieli, had also sent to PwC Switzerland a letter enclosing a memorandum from Pinsent Masons explaining their view of the Transactions and stating,

> "One of the goals of the netting and close-out provisions of the ISDA Master Agreements is to allow a swift termination of the pending transactions. We feel that the situation under the Master Agreements concluded by our clients with LBF is sufficiently clear and transparent to come to a solution in a short time."

64. On 8 October 2008, Mr. Losada emailed Mr. Kammerlander outlining a proposed transaction for the Defendants if the SAP share price was to rise again to €32.10. The email noted that in such a case the "aggregated value" of the Transactions would be about €100 million "partially thanks to the knock-in of all the VFP tranches". Mr. Losada suggested that the Defendants could then carry out two steps,

i) execute a "zero cost" Put Spread Collar which Mr. Losada opined would be "not too different" from the Transactions in terms of the protections provided for the Defendants (stating his view that the intention of the VFP had been to protect the Defendants down to €23 per share and the call strike of €47 per share looks "pretty out-of-the-money"); and

ii) simultaneously provide LBF with the valuations by Goldman Sachs and Mediobanca for the Transactions which, assuming a zero discount on the delta hedge, would be close to €100 million.

65. Mr. Losada's proposal concluded,

> "Bottom line is that, if SAP goes to €32.10, you can execute a 'similar' hedge to the 'existing' one without paying premium. On top of this, you keep €100mn in cash which somehow covers some of the inconvenience of the 7mn collateral shares."

66. Mr. Kammerlander replied after a few minutes, thanking Mr. Losada for his analysis and stating,

> "This sounds very good indeed. Now we only have to hope that the stock goes back to 32.10."

67. On 9 October 2008, Pinsent Masons wrote to Linklaters (acting for LBIE) asking for an update on the 16 million Free Shares and the 59 million SAP shares held as Collateral by LBIE. Pinsent Masons wrote:

> "The major obstacle to closing-out the Transactions is that until our clients receive confirmation from LBIE that the Charged Shares and the Free Shares belong to them and that the Charged Shares will be released following the close-out of the Transaction, they are unable to arrange replacement trades (this has been confirmed by our clients in the course of obtaining quotations for replacement transactions from market participants including Goldman Sachs and Mediobanca)."

68. On 16 October 2008, Linklaters sent an email to Pinsent Masons setting out its findings regarding its attempts to identify and locate the Free Shares. At the end of that email Linklaters also briefly stated that the 59 million SAP shares held as Collateral pursuant to the MCDs,

> "subject to your ongoing discussions with LBF, will fall to be dealt with by the Joint Administrators in the due course of the administration."

Events following the Linklaters' email of 16 October 2008

69. On 20 October 2008, Dr. Hess emailed PwC in the following terms,

> "During our meeting on 7 October 2008 we discussed that we would try to procure a replacement transaction in order to be able to calculate the loss. It is a requirement for the replacement

> transaction that the 59 million SAP shares, which are currently in the possession of LBIE as holder of the pledge for LBF, are released.
>
> According to a notice from our English colleagues from Pinsent Masons, which they gave us after a meeting with Linklaters, the release of the shares could take some time since there are more than 60 parties to be considered. Our lawyers report as follows:
>
> Linklaters consider that the timeframe for the reconciliation exercise will be "months to years".
>
> I would be grateful if we could discuss the further line of action in the face of this information."

70. On 29 October 2008, Mr. Losada sent Mr. Kammerlander revised pricing of collateralised replacement trades for the Transactions as at the close on 16 October 2008. Mr. Losada's email stated that as at 16 October 2008, the net amounts payable by KTS and by KG to Mediobanca to enter into replacement trades would have been €163.62 million and €184.64 million respectively, giving a combined total of €348.26 million.

71. On 12 November 2008, Goldman Sachs provided Mr. Kammerlander with a further valuation "that may be used for the purposes of estimating a replacement cost for the [Transactions]" which valued the Transactions on a collateralised basis as at 16 October 2008. Under this valuation, the aggregate amount payable by the Defendants to Goldman Sachs would have been €324.7 million.

The Defendants obtain valuations on an uncollateralised basis

72. On 1 December 2008 Mr. Losada sent Mr. Kammerlander an email entitled "Pricing for Lehman Transactions" and containing what were stated to be indicative numbers for "replacement trades" (quotation marks in the original) for the Transactions as of the close of business on 16 October 2008, assuming that both KTS and KG were not able to provide any collateral to Mediobanca when entering into such transactions.

73. The text of that email of 1 December 2008 – which referred to an "email below" but was edited so as to be divorced from the earlier emails in the chain - was subsequently attached to the Defendants' formal calculation of Loss which is in issue in this case. Accordingly, I should set the material parts of it out in full. It stated,

> "As required by you, we are providing you with indicative numbers for the "replacement trades" 1 and 2 (see the email below) assuming both the KTS and the KG are not able to provide any collateral to Mediobanca when entering into the transactions. Any future collateralization of the VFP/VFS would depend mainly/solely on the release of the pledged shares from PWC to the KTS/KG. The timing of such release is highly uncertain given the magnitude and the number of claims triggered by the Lehman bankruptcy.

Being prudent, our conservative approach would be to price 'credit risk' by applying a "credit spread" to the 95%-VaR of the MTM of each instrument for a substantial part of the remaining life. The resulting MTM of the instruments (as per the close of XETRA on the 16th of October 2008) would be as shown below

1) *Replacement trade for KTS- LBF NA transactions*

- Variable Forward Purchase: KTS receives €12.59mn from Mediobanca

- Variable Forward Sale: KTS pays €236.47mn to Mediobanca

The net amount payable by KTS to Mediobanca is **€223.88mn**

2) *Replacement trade for KG – LBF NA transactions*

- Variable Forward Purchase: KG receives €10.17mn from Mediobanca

- Variable Forward Sale: KG pays €297.42mn to Mediobanca

The net amount payable by KG to Mediobanca would be **€287.25mn**

Overall, as you can see, the present value of the 'incremental credit spread impact' amounts to €163mn (i.e. ~8% of the trade date notional).

It is to be said that such an uncollateralized deal could only happen with Mediobanca obtaining access to all correspondence between KTS/KG and PWC/Lehman since inception of the VFP/VFS and that we would reserve the right to ask KTS/KG for additional due diligence and involvement in the release process of the pledged shares."

74. Mr. Kammerlander replied the next day to Mr. Losada passing on some questions from the Defendants' lawyers about his email. Privilege was claimed by the Defendants for such questions. Mr. Losada replied to Mr. Kammerlander on 9 December, setting out "indicative pricing for replacement transactions based on the 15 September" on the basis that the transactions were uncollateralised. The email stated that, as at 15 September, the net amounts payable by KTS and by KG to Mediobanca to enter into uncollateralised trades would have been €80.42 million and €110.67 million respectively, giving a combined total of €191.09 million.

75. Mr. Losada noted,

"This is obviously our best estimate (ex post) and … Mediobanca would only have agreed to enter such uncollateralized transactions if it were granted additional rights

> with respect to the release of the shares currently sitting with Lehman/PWC."

76. In his email of 9 December 2008, Mr. Losada also responded to what he described as a "request to provide a standalone quote for [an] unsecured borrow of SAP shares". He commented that,

> "our view is that this would be very tricky and probably impossible on a standalone basis. This means that the bank providing the unsecured borrow would at the same time ask for these shares back as collateral to cover the short under the hedge (we would not provide unsecured borrow without executing the replacement trade simultaneously)."

77. Later the same day, Mr. Losada also sent through an email in identical form save that it gave pricing for uncollateralised transactions as at 16 September 2008 (rather than 15 September). The email stated that the net amount payable by KTS and by KG to Mediobanca to enter into uncollateralised trades on 16 September 2008 would have been €65.68 million and €86.35 million respectively, giving a combined total of €152.03 million.

78. On 11 December, Mr. Kammerlander emailed Mr. Losada asking him at what rate (i.e. how much above LIBOR) he would be able to borrow €400 million on an unsecured basis, and clarified that he needed this information to calculate the interest rate he needed to apply to the Loss figure under the Master Agreements.

79. Mr. Losada responded on 13 December, stating that the "Default Rate" which applied under the ISDA Master Agreement is "defined loosely" as the costs of funding plus a spread of 1% and stating that "the cost of funding does not need to be actually incurred and can (should) be estimated by you." He noted that the two Defendant entities had very different credit profiles, thus meaning that they would encounter different funding costs. Mr. Losada stated that for KG, "You could argue for something around EURIBOR +10% +1%" and that for KTS, "You could argue for something around EURIBOR +3.5% +1%." Mr. Losada's email concluded,

> "Obviously the optionality is on your side and you should use it. Remember that this clause was meant to protect Lehman in the first place…
>
> I checked what other non-defaulting parties are doing (for example hedge funds and other weak credits). What I hear is that everyone is trying to argue for high rates in order to achieve a higher final recovery value."

80. On 15 December 2008, Mr. Losada sent Mr. Kammerlander a further email responding to a voicemail from Mr. Kammerlander with the subject "Relevant Rate", in which he proposed two suggested approaches for determining the relevant interest rate to apply to the Loss figure under the Master Agreements.

The Loss Calculation

81. On 16 December 2008, Pinsent Masons sent a letter to LBF in which they set out the formal calculation of the Defendants' Loss under the Master Agreements (the "Loss Calculation"). The letter referred to the 59 million SAP shares held by LBIE as Collateral as the "Pledged Shares". It stated, in material part,

> "TIMING OF LOSS CALCULATION
>
> 4.1 Section 6(d) of the Master Agreements states that the calculation of loss is to be made "on or as soon as reasonably practicable following the occurrence of an Early Termination Date".
>
> 4.2 [In accordance with the definition of Loss], the statement of Loss is to be determined as of the Early Termination Date or, if that is not reasonably practicable, as soon as reasonably practicable thereafter. Our clients are aware that in most circumstances it would be feasible for the Early Termination Date to be used as the date as of which Loss is determined and in a usual situation the calculations would be made by reference to the circumstances prevailing on the Early termination Date. The circumstances, however, are such that the determination should be made at a date later than the Early Termination Date …
>
> 4.3 As you are aware … our clients, LBIE and LBF entered into the Master Custody Deeds contemporaneously with the entry into the Master Agreements. As you are also aware, LBIE holds the [Pledged] Shares under the terms of the Master Custody Deeds. Following the insolvency of LBHI, LBIE was placed into administration in the UK on 15 September 2008. Since that date our clients have been attempting to establish the status and location of the [Pledged] Shares together with confirmation that they will be returned so that our clients could enter into replacement transactions.
>
> ...
>
> 4.6 As our clients first became aware that the [Pledged] Shares would not be returned quickly on 16 October 2008 we consider that this is the earliest date upon which it was reasonably practicable to determine and calculate the Loss.
>
> 4.7 The [Pledged] Shares were not available to our clients in order to use as collateral for replacement transactions. Accordingly, under normal contractual principles our clients could use two bases on which to calculate the Loss:-
>
> > 4.7.1 The cost of replacement trades on the basis that such replacement trades were uncollateralised – i.e.

> that the Pledged Shares were not available as collateral for replacement trades; and
>
> 4.7.2 The cost of replacement trades on the basis that such replacement trades were collateralised in the same manner as the terminated Transactions, plus the cost of acquiring shares to replace the Pledged Shares to be provided as collateral for such replacement trades.
>
> We are informed by our clients that they are unable to obtain quotations from leading dealers in the relevant market for borrowing shares equivalent to the Pledged Shares. This position has been tested with Mediobanca as a possible replacement counterparty.
>
> STATEMENT OF LOSS
>
> 5.1 We attach a market quotation for replacement Transactions which has been prepared on the assumption that the replacement trades were entered into on 16 October 2008 and that the [Pledged] Shares were not available as collateral at that time. The market quotation has been provided to our clients by a leading dealer in the relevant market in good faith. We would point out that as "Loss" is specified under the Master Agreements (and not "Market Quotation") our clients are not obliged to provide any such quotation."

82. The Loss Calculation then attached the email which Mr. Losada had sent to Mr. Kammerlander on 1 December 2008, giving "indicative numbers" for "replacement trades" as at the close of XETRA on 16 October 2008 assuming that both KTS and KG were not able to provide any collateral to Mediobanca when entering into such transactions. As indicated above, the email stated that the net amounts payable by KTS and KG to Mediobanca would be €223.88 million and €287.25 million respectively, giving a total claim (excluding interest) of €511.13 million.

83. The Loss Calculation then took into account the €100 million Independent Amount (€46 million of which had been paid to KTS and €54 million of which had been paid to KG), with the result that it stated that the Loss amounted to €177.88 million under the KTS Master Agreement and €223.25 million under the KG Master Agreement. It is common ground that the latter figure contained an arithmetical/typographical error and should have been €233.25 million rather than €223.25 million, giving a total of €411.13 million.

84. Finally, the Loss Calculation set out how the Defendants had calculated interest. The letter attached a spreadsheet from Mediobanca providing the Euro OverNight Index Average ("EONIA") rates from 15 September to 12 December 2008. The Defendants claimed the cost of funding would have been EONIA plus 3.5% for KTS and EONIA plus 10% for KG. As the "Applicable Rate" under the Master Agreements was stated to be the "Default Rate", which was defined as the cost of funding plus 1% per annum, the Defendants claimed that the interest which had accrued on the Loss amounts from 15 September 2008 to 12 December 2008 was €3,635,624.88 under the KTS Master

Agreement and €8,335,749.23 under the KG Master Agreement. Pinsent Masons noted that interest continued to accrue on a daily basis at the same rates.

85. On 17 December 2008, Dr. Hess sent a further letter to LBF, enclosing a copy of Pinsent Masons' letter of 16 December 2008. Dr. Hess' letter repeated the Defendants' claims for Loss and interest, and added a series of legal fees said to have been incurred by the Defendants in the UK (£140,762.05), US ($4,208.76), Switzerland (CHF48,624.60) and Germany/Netherlands Antilles (€175,484.82).

Movement of the SAP share price

86. As I understand the evidence as to the movement of the SAP share price and the valuation evidence that I received from both experts, the date of 16 October 2008 was considerably more favourable to the Defendants for the purposes of making a claim against LBF (i.e. it gave a much higher claim) than a date at or around the Early Termination Date. This was largely because of the fall in value of the SAP share price over the intervening period. That fall had been from €38.150 at the PX close on 15 September 2008 to €25.415 on 16 October 2008, and included, in particular the fall of about 16% on 6 October 2008 as a result of the profit warning issued on that date.

87. However, 16 October 2008 was not the date that would have produced the highest claim for the Defendants over this period (which was when the SAP share price reached a low of €23.450 on 28 October 2008). Moreover, the share price at the PX close on 16 October 2008 (€25.415) was not dissimilar to the price on 1 December 2008 when the Mediobanca valuation for an uncollateralised trade was obtained (€25.915).

Subsequent events

88. LBIE returned the 16 million "free shares" to the Defendants on 7 June 2010. The 59 million SAP shares provided as Collateral were finally released by LBIE in May 2011, subject to a proportion being held by State Street as collateral for LBF under new arrangements involving the Defendants.

89. Neither of the Defendants ever entered into any replacement transactions for the Transactions.

The Issues

90. The parties are agreed that the ultimate issue that I have to decide is whether the Defendants' Loss Calculation was made in accordance with the Master Agreements and hence is contractually valid and binding on LBF.

91. LBF contends that the Defendants did not determine their Loss reasonably or in good faith in accordance with the requirements of the Master Agreements, and hence that the Loss Calculation is not binding. LBF contends that the Loss Calculation was based on a non-executable valuation of materially different (i.e. non-collateralised) transactions which the Defendants could never have entered into. LBF contends that if the Defendants were relying upon non-executable valuations to calculate their Loss, the valuations should have been obtained by reference to the Early Termination Date itself, and ought to have been for collateralised replacement transactions.

92. The Defendants contend that the Master Agreements did not prescribe the method that they had to use to determine Loss, and did not require them to base their determination on live market quotations. They contend that the Master Agreements simply required them to determine an amount that would be required to put themselves into the position that they would have been in if the Transactions had not terminated. The Defendants submit that this permitted them (i) to take into account their efforts to mitigate their loss by investigating entering into replacement transactions on the same terms as the terminated Transactions and attempting to recover their Collateral to use in collateralising such transactions; (ii) to determine their Loss as at the earliest date on which they became aware that they could not recover their Collateral quickly; and (iii) in the absence of the Collateral, to rely upon valuations for replacement transactions on an uncollateralised basis.

93. In any event, the Defendants say that this was a reasonable and honest approach for them to take given the position that they found themselves in, and hence that their determination cannot be challenged unless LBF can demonstrate that no Non-defaulting Party acting reasonably and in good faith could have acted in the same way.

<u>The disputes of fact</u>

94. The essential background which I have narrated above, based largely on the documents, was not in material dispute between the parties. There were, however, a number of other factual issues that were raised in the Defendants' evidence and which were the subject of detailed cross-examination and submission at trial. Three of these are issues upon which I believe I should express a conclusion because they potentially relate to the basis advanced by the Defendants for their Loss Calculation.

95. The three issues are (i) whether, after the Early Termination Date, the Defendants actually intended to enter into replacement transactions on the same (like-for-like) terms as the terminated Transactions; (ii) whether 16 October 2008 was the date on or about which the Defendants turned their attention to calculating Loss on the basis of uncollateralised replacement transactions; and (iii) whether it would actually have been possible for the Defendants to enter into the uncollateralised transactions used as the basis for the Loss Calculation.

Did the Defendants intend to enter into like-for-like replacement transactions?

96. Paragraphs 34-35 of the Defence asserted,

> "34. Following the termination of the [Transactions] neither KTS nor KTB had free shares in SAP at their disposal to conclude a replacement transaction on fully collateralised terms.
>
> 35. Accordingly, on 15 September 2008 KTS and KTB immediately took steps to obtain a release of the SAP Collateral from LBF and LBIE (as custodian) in order to conclude a replacement transaction on fully collateralised terms."

97. In the Reply and Defence to Counterclaim, LBF expressly put the Defendants to proof of the (implicit) allegation that the Defendants were seeking to conclude a replacement transaction on fully collateralised terms in the period 15 September 2008 – 16 October 2008.

98. In that respect, Mr. Kammerlander's witness statement stated that after receiving the news that LBHI had filed for bankruptcy protection and receiving the email from Mr. Losada on 15 September 2008,

> "I wanted to retrieve the Collateral and the 'free' shares from LBIE as soon as possible, and to replace the terminated Transactions quickly, so as to restore both the protection that they offered to [the Defendants] without delay."

99. Mr. Kammerlander's written evidence was that he "immediately set about trying to find a counterparty which was willing and able to write replacement transactions", and that he approached three institutions as potential replacement counterparties: namely Mediobanca, Goldman Sachs and JP Morgan. In cross-examination, Mr. Kammerlander sought to give the same impression,

> "Q. So as I understand your evidence, as soon as you heard that Lehman's had got into an insolvency procedure on 15 September, you wanted to go out and get a quote for a replacement transaction; is that right?
>
> A. I wanted the trade again. That entails a number of things. But it does not just mean that you go out and ask for a quote. But I wanted to start out to make sure that I got this transaction back.
>
> Q. What did you understand you had to do in order to get a quote for a replacement transaction? What did you need to ask the potential counterparty for as regards terms, date, executability, et cetera?
>
> A. What happened is in order to get that quote precisely I needed to get the counterparties that I selected, to familiarise them with the terms of the transaction.
>
> Q. Is that because you understood that a quote for a replacement transaction had to mirror the terms of the original transaction in every respect?
>
> A. Well, I wanted the exact trade. A lot of effort went into exactly these transactions so I wanted to replace these transactions. They had a number of features in them that I wanted to replace, and of course the replacement had to be as close as possible -- or I mean in terms of the strikes, maturities, all these things, it had to be the same."

100. Mr. Losada's evidence was also that he understood from the outset that the Defendants actually wanted to replace the terminated Transactions with replacement transactions on the same terms, and he denied that he thought that Mr. Kammerlander was seeking information from him to determine the Defendants' Loss under the Master Agreements. For example, he was asked about his initial email to Mr. Kammerlander on 15 September 2008,

> "Q. I suggest that you were not thinking at this time that Mr. Kammerlander would necessarily want to enter into the big replacement hedge, but that what he would need to do is to document the position in accordance with the loss method, yes?
>
> A. So actually no. What I was doing -- and so again to put this into context, as you recall, on the 12th I am already talking about an assignment of the trade. So in my view the KT entities want to remain protected against the SAP share price going forward. So as I move from an assignment, now I'm moving to a replacement transaction and I want to make sure -- and this is me not being a lawyer, but I want to make sure that the way we do it, the way we document that transaction, the way we structure the replacement trade is as close as possible to the previous trade because at some stage KT will have to go back to Lehman and say, I have done this transaction, it is a replacement one, it is extremely identical in all possible aspects, and so I want to make sure we don't start wandering away from the original one, so we need to stick to the big hedge docs."

101. Mr. Kammerlander was asked about the early email exchange with Mr. Losada on 17 September 2008 in which he confirmed that he wished Mediobanca to price the transactions as of the previous Friday 12 September or possibly Monday 15 September 2008, adding "See ISDA. On the date of early termination or asap thereafter." Mr. Kammerlander suggested that he had asked for a price from Mr. Losada to "orientate" himself for the purpose of actually entering into a replacement for the terminated Transactions,

> "Q. So clearly by this time, and I'm not asking you to tell me the content of the legal advice, but clearly by this time it appears that you had turned your mind to the ISDA contract or a lawyer had shown you the ISDA contract; that is fair, isn't it?
>
> A. I had a better understanding of what that default situation meant to me and didn't change what I wanted to do -- which was the replacement transaction. But again, I didn't know where values were.
>
> Q. If all you wanted to do was get a rough feel as to where the market was for a replacement transaction, you would not need to ask for a price both at Friday close and at Monday open, would you, if all you are doing is orientating yourself?

A. At that time it wasn't clear whether -- which dates and what price would actually be used. For example, is it Friday close, is it Monday morning, will it be Friday evening? At that point I had no idea and … I think very few people knew at that point in time what it was really.

Q. Mr. Kammerlander, if you had really wanted to do a replacement transaction and what you were using Mediobanca for was to orientate yourself as to how much that would cost you, you would say to Mr. Losada, please tell me how much it is going to cost me to replace the trade today. I may not be able to do it today, but to orientate myself I need today's price. Not Friday night's price or Monday morning's price; that must be right, mustn't it?

A. First, I needed to establish my position to see where I am. It is not today. It is not -- these were in significant times, so the 15th, it turned out, then was a time which was relevant and I needed to know what the value was at that time for my -- because I was the one, and what I understood back then also was that I was the one who had to calculate that price. I could not just rely on Lehman's quote or whatever Martin Gupta would give me. I had to do this myself.

So I checked with Goldman, and with Mediobanca for that matter, what the price would be at that time so that -- again now I needed clear figures, now I couldn't do the -- I think from the chart it is around 90 million or it is around 25 million or all this, because I was trying to get certainty on to what I would have to look at in terms of price if I wanted to do this replacement transaction, right."

102. Mr. Kammerlander was also challenged on the reference in his witness statement that he, "needed prices for the Transactions at specific dates in order to orientate myself and to standardise parameters for quotes for replacement transactions",

"Q. Mr. Kammerlander, what I put to you is that this sentence in your witness statement saying that you need prices at specific dates to orientate yourself and to standardise parameters for quotes for replacement transactions, first of all makes no sense whatsoever, and is secondly untrue. What you were doing was getting, as your email says, a valuation from Mediobanca for ISDA purposes, and the doubt in your mind was whether you needed that figure as of close Friday or open Monday. You understand what I'm putting to you?

A. Sure.

Q. This statement in your witness statement about "standardising parameters for replacement transactions" is all part of your story that from the moment of the 15th you were

looking to replace a transaction which I'm going to be suggesting to you is false and you know that is false, because that is not what you were trying to do?

A. It is absolutely -- I cannot -- I cannot agree to this. This is something -- this is -- for someone in an organisation like we were at that time, this is the worst that can happen. Legal -- legally kind of in terms of ISDA suddenly in that world you are in the midst of a financial crisis. When I say I wanted to orientate myself, then it is actually that because we were literally lost at that moment what we should do.

So we didn't have a proper price, we knew that we wanted to replace this transaction, and it is absolutely incorrect for you to suggest that at that time I already used something, whatever, the memo was a big plan or something. I had no idea and Mr. Losada sent this on his own account to me, this memo."

103. Mr. Losada sought to support Mr. Kammerlander, and even went further, testifying that from the outset he thought that he was being asked to provide a quotation for a firm executable price for a real replacement transaction, and that it was only very much later that he thought he was being asked to provide information relating to interest for the purposes of an ISDA close-out. For example, he was taken to the email exchange on 17 September 2008 in which he had sought confirmation from Mr. Kammerlander that he wished Mediobanca "to value" the Transactions as per the close of business on Friday 12 September 2008 and had stated that, "the value or price we will provide you with will reflect the level at which we would have traded this position",

"Q. You did not understand this to be a request for a firm executable price, did you?

A. Yes, I did. In fact when I say, "Could you please confirm by email", what I really meant here is I wanted to show to the senior management of the bank that this was real, that the client was engaging with me and that we wanted to go into negotiations and this was coming. So I actually wanted to have is a formal response from Bernd outlining he was serious about this and, yes, he wanted us to do this and it was not just me coming up with a hypothetical new transaction.

Q. It is quite clear that this is a request for a valuation, isn't it?

A. Well, the title says "Valuation of big hedge and contingent unwind", and if you go on it says:

"The value or price ..."

Q. Yes. But it is as of the past, isn't it? It says, "As of Friday 12 September".

A. Yes, it is of the past.

> Q. So you clearly understood, didn't you, that this was related to ISDA close-out. You thought he wants a valuation for the purposes of ISDA close-outs, didn't you?
>
> A. It is much later in the process when he actually asked me -- I think it is around the times where I was asked about interest rates -- that I clearly understood that he was -- that said ... the valuation part, which is the price, was changing.
>
> Q. That is not true. You understood immediately that the reason that he was asking for a price about 12 September was with a view to ISDA close-out, didn't you?
>
> A. No, and if I would have thought that, why would I say, would you please confirm by email? As I say, I wanted to show to my management line, this is a real trade, we should focus here, see, the client is asking me to work on this.
>
> Q. Not true. The reason you were offering to provide a memo was to be helpful because you thought it would help him. Not because you wanted to use it internally but because you thought it would help him with his loss calculation.
>
> A. Not at all. I always thought this was a trade and we were working towards it and I wanted him to confirm it to me in writing. I could then forward that email internally to show people this is a real engagement, we are really live on this trade."

104. There were, however, no internal communications in the evidence from Mr. Losada to others at Mediobanca concerning a proposed trade with the Defendants. The only evidence of the basis upon which Mr. Losada had communicated with others within Mediobanca about what he was doing in the days after 15 September 2008, was the text of the Disclaimer that appeared at the end of the Information Memorandum. Mr. Losada confirmed that the text had been prepared by Mediobanca's legal department on his initiative. As set out above, that Disclaimer made it clear that the Information Memorandum was provided,

> "as part of the procedure to evaluate two Equity Derivatives contracts between [LBF and the Defendants]".

105. Notwithstanding this, Mr. Losada's evidence was that he had asked for the Disclaimer because he was concerned that his memorandum might be regarded by the Defendants as a live quote for an actual trade,

> "What went through my head is this is very big, it is live, it is happening, I want legal to review, I don't want to send a quote on a 2 billion trade without legal having read and reviewed the content and they came back with the disclaimer."

106. However, Mr. Losada then testified that when the text of the Disclaimer came back from Mediobanca's legal department he did not read it, but just pasted it into his document,

> "Q. MR JUSTICE SNOWDEN: But you would get into trouble, wouldn't you, if it didn't actually correspond with what you had told legal because there was a misunderstanding...
>
> A. Just because when you send really something which is very close to a transaction actionable price on a big size, you always include legal. Always. They need to review the docs which go out and they will, on a case-by-case basis, give you a disclaimer or a paragraph you need to add at the bottom. They will advise you how to do it such that you disassociate the commercial commitment you are making from the legally binding commitment. So we want to commit commercially, but from a legal standpoint only transaction documents are relevant.
>
> …..
>
> A. The purpose of the memo -- we have discussed it many times -- was to provide them with a detailed analysis of the pricing. That kind of disclaimer we use not just in this situation, in other situations, and typically we use them when situations get live on big transactions and legal wants to protect the bank such that there is always a last check -- it is kind of a "subject to docs".
>
> Q. This doesn't say that at all. This says that:
>
>> "The information contained has been prepared to assist the recipient in making its own assessment."
>
> A. I haven't drafted the disclaimer myself. As I say, I spoke to legal. They gave me this disclaimer. So for me to comment on what is in the disclaimer I think is irrelevant because I haven't written it myself."

107. Having sought to distance himself from the terms of the Disclaimer, Mr. Losada then avoided answering the question of whether, in identifying its purpose as being part of the process for evaluating the transactions between LBF and the Defendants, the legal department had misunderstood his instructions and intentions, or had correctly understood his intentions. Instead he drew attention to the part of the Disclaimer that identified Mediobanca as acting as a financial adviser to the Defendants, which he contrasted with acting "just as a valuation desk". He was then asked,

> "Q. Where it says "financial adviser" --
>
> A. Mm-hm.
>
> Q. -- you are becoming someone's financial adviser, but you wouldn't normally do that to a counterparty to a trade. That is indication that what you are doing is you are advising them of

> the value of your opinion of the value and not that you are considering becoming their counterparty. That's right, isn't it?
>
> A. No, because I don't think it is mutually exclusive."

108. When the same point relating to the Mediobanca Disclaimer was put to Mr. Kammerlander, he also stated that he had not read it, but that it looked like a normal disclaimer. The following exchange then took place,

> "Q. What [the Disclaimer] makes absolutely clear, Mr. Kammerlander, is that what he is not doing is providing any sort of price for a replacement transaction, but rather what he is doing is valuing your position on a historic basis as of Friday close and Monday open?
>
> A. Yes.
>
> Q. Because he knew, which was true, that what you were not looking for was a replacement transaction but what you were looking for was a valuation for an ISDA close-out?
>
> A. I was looking for a valuation of these, on these two dates, full stop."

109. I have also set out above the documents that were received by Mr. Kammerlander from Goldman Sachs on 19 and 23 September 2008 and which valued the terminated Transactions by reference to the opening of the market on 15 September 2008. They both concluded with a statement that the quotation was the price at which Goldman Sachs would have been prepared to execute a transaction on the dates indicated, but that they were not live quotations for actual transactions,

> "The quotation should not be construed that Goldman Sachs is prepared to enter into a transaction with you. In the event that you wish to enter into a transaction with Goldman Sachs, you should contact your Goldman Sachs representative to obtain a 'firm' price based on specific transaction details, size and current market conditions."

110. Some further light was cast upon Mr. Losada's view of the purpose of the Information Memorandum by his "Bottom Line" email to Mr. Kammerlander of 19 September 2008. Mr. Losada clearly advised that on the basis of his calculations in the Information Memorandum, if Mr. Kammerlander applied the "Monday morning pricing", he could "send a bill" to LBF for €28 million for the Transactions. That was plainly a reference to the Defendants notifying LBF of the result of their determination of Loss under the Master Agreements.

111. Mr. Losada's email also explained that the Defendants would be,

> "long stock effectively at €34 (!!) given that we have applied a 7% discount to the market price and you have made €210 million (on the delta) given the stock is at €40."

That was a clear reference to the fact that for the purposes of calculating the cost of the delta hedge under the Information Memorandum, Mediobanca had applied a 7% discount to the opening price of €36.56 per share on 15 September 2008 so as to use a price of €34 per share in the valuation, and that on the assumption that the Defendants would then be entitled to recover the Collateral from LBIE, they would be "long" on the SAP shares, which on 19 September 2008 had a market price of about €40 each.

112. In cross-examination, Mr. Losada eventually appeared to accept that his comment about the Defendants being "long stock" was made on the basis that there would be no replacement transaction; and that what was important was that he should "document the replacement trade in a way which is consistent with the loss method",

> "Q. So you are saying if you apply Monday morning pricing you are effectively long stock at 34, yes? That is what you are saying?
>
> A. If you don't put a replacement transaction on, yes.
>
> Q. And therefore you have just made a lot of money?
>
> A. If you were able to crystallise that, you would have made a lot of money. But it is hypothetical, as we all know. Because as you know, Lehman would not release the shares, so at this stage this was all very hypothetical.
>
> Q. That is as may be, but what this does show, Mr. Losada, is that you fully understood that the purpose of you providing the valuation memos was with a view to the loss calculation, didn't you?
>
> A. For me what was important, again, was that we set out the replacement trade and we document the replacement trade in a way which is consistent with the loss method such that Bernd and the KT entities would not be in an asymmetrical world where they have entered a transaction which is not considered later on, like today, nine years later, like not being a replacement trade. That was my only worry."

113. Mr. Kammerlander was also asked about his written evidence that he had approached JP Morgan for a replacement transaction. In cross-examination, however, he accepted that he had only sent JP Morgan transaction documents with the essential details of strike prices redacted and that he had not sent JP Morgan the KT Data Sheet, so that it would have been unable to price a replacement transaction. He then accepted that he was not actually asking JP Morgan to replace the Transactions at that time,

> "Q. You didn't send the prices at this stage or at any stage to JP Morgan because you were not interested in replacing this transaction with these prices. You were sending it to them because you wanted to show them the sort of transaction you might be interested in?

> A. Correct.
>
> Q. But you were not asking them to replace the LBF hedge, were you, because that is not what you wanted to do?
>
> A. No, not at that time."

114. In my judgment, the terms of the documents passing between the Defendants, Mediobanca, Goldman Sachs and JP Morgan, to which I have referred are clear and unambiguous. The documents provided by Mediobanca and Goldman Sachs were valuations of the prices that the two institutions would have quoted if they had been asked for prices on the historic dates in question, and they were requested and provided for the purpose of the Defendants calculating their Loss under the Master Agreements. As Mr. Kammerlander himself put it, "See ISDA": or as Mediobanca's legal department put it,

> "in its capacity as financial advisor to [the Defendants] … as part of the procedure to evaluate the terminated Transactions between [LBF and the Defendants]."

115. I do not believe that such documents were intended to "orientate" Mr. Kammerlander for the purposes of actually entering into replacement transactions. Everyone knew this was a fast-moving market. If Mr. Kammerlander was intent from the outset on entering into replacement transactions once he had retrieved the Collateral, I believe that he would have sought live quotations or valuations using up-to-date prices. He did not do so, and it is notable that there are no documents passing between the Defendants and any of the institutions showing any practical steps such as the agreement of documentation to prepare for the execution of replacement transactions on the same terms as the terminated Transactions.

116. I also consider that Mr. Losada's evidence to me as to his perception of the task that he was performing was untrue. In my judgment it is clear from the documents that Mr. Losada was well aware that he was being asked by Mr. Kammerlander to provide valuations of the terminated Transactions on a historical basis for the purposes of assisting the Defendants in their determination of Loss so as to be able to close out the Transactions with LBF under the Master Agreements. That is, I find, what Mr. Losada told Mediobanca's legal department when asking it to draft the Disclaimer, and I do not accept that it is remotely credible that Mr. Losada thought that he was providing live quotations or that Mediobanca was close to entering into a new transaction with the Defendants on the same terms as the terminated Transactions. Mr. Losada's evidence that he did not check the lengthy text that he received from Mediobanca's legal department was incredible, and his suggestion that Mediobanca could be a financial adviser to the Defendants as well as the prospective counterparty to them on the terms of such a large and complex transaction was absurd.

117. The conclusion that the Defendants were not, from the outset, approaching the three institutions for the purpose of entering into replacement transactions on the same terms as the terminated Transactions is also borne out by the evidence that the Defendants sought to investigate alternative transactions using the 59 million SAP shares that had been pledged as Collateral.

118. So, for example, Mr. Kammerlander discussed with both Mediobanca and JP Morgan the possibility that the Defendants might enter into a "Zero Cost Put Spread Collar" in relation to 52 million SAP shares. Mr. Losada gave Mr. Kammerlander indicative pricing for such a transaction on 23 September 2008 using a then current share price of €38.8 per share as the basis for his computations; and JP Morgan priced a similar transaction with the same put strikes on 26 September. At the beginning of October 2008 Mr. Losada also produced a draft document for such a transaction to be used in a "pricing contest" with Goldman Sachs and JP Morgan.

119. Mr. Losada's evidence clearly distinguished between these alternative transactions and a replacement for the terminated Transactions. He was taken to his first email of 23 September 2008 providing indicative pricing for a "Zero Cost Put Spread Collar" in relation to 52 million SAP shares,

> Q.This is something that's very different from a replacement transaction, isn't it?
>
> A. Yes.
>
> …
>
> Q. But you clearly had been having calls with Mr. Kammerlander by this time, discussing this; yes?
>
> …
>
> A. The zero cost put spread collar -- so going back again, this is something I knew the KT entities had entered into with Goldman prior to the bankruptcy. Again, I knew JPM was in the mix showing something along those lines. So this is proactive from me, showing him by the way, I can do other things, not just a replacement trade. As you can see, this comes after I have done all the work on the replacement trades.
>
> Q. So Mr Kammerlander had told you, then, about the JP Morgan proposals, had he?
>
> A. No, I don't think he had. I -- the GS transaction, I think, yes. The JPM one, that was more our network of people, we heard about it. We heard they were quoting on that -- specifically a woman called Jana Hecker who used to work at JP Morgan. We kind of knew she was quoting split collars to the client and we didn't want to miss out.
>
> …
>
> Q. You had clearly said to him, would be you be interested in a zero-cost put spread collar, and he had said, show me some indicative pricing.
>
> A. I think the way how it went was we heard other banks were quoting that to him so I probably called him, by the way, saying,

I'm going to send you quotes, this is for something -- we want to make sure we are considered if you are ever going to do something like this.

I didn't want to be boxed into, Samuel Losada is replacement trade; for other things I will talk to GS, JPM and others."

120. Mr. Kammerlander was also asked about Mr. Losada's indicative pricing for a zero cost put spread collar,

"Q.Was this a transaction which appealed to you?

A. It sounded interesting at that point. But why he may have come to the conclusion to offer that to me was because I had a put spread collar on with Goldman. But as I said, that put spread collar had also other reasons why we had to put it on as a put spread collar.

Q. You thought this was attractive because you reply in about five minutes on the following page. You say,

"Looks really nice. How big is the delta?"

You don't say, "Well, just a minute, Mr. Losada, what are you bothering me with this for, I want a quote on the same basis for a replacement of the LBF hedge"? You didn't tell him that, did you?

A. No, I did not.

Q. Why?

A. Because it looks -- it doesn't look not attractive. But it is not what I wanted.

Q. It is not a replacement, is it?

A. No, it is not.

Q. But this is what you wanted, I'm putting to you; this is precisely the sort of thing you were interested in?

A. This is what they offered me.

MR JUSTICE SNOWDEN: But Mr. Kammerlander, if it wasn't what you wanted, why did you ask him for more information about it?

A. I can't remember. But it is clearly the -- I came to the conclusion -- to the opinion that the replacement transaction was the only thing that I had – that I wanted, this transaction. They were all interesting. And potentially at that time I was, you know

> -- in those meetings, they looked, they sounded interesting, all this, and then I wanted more information. But eventually I came to the conclusion that this is not what I wanted. This is just not what I wanted."

Although Mr. Kammerlander stated that "eventually" he had come to the conclusion that he did not want a put spread collar, this is not consistent with the impression that he had sought to convey that after 15 September 2008 he was simply intent on replacing the terminated Transactions quickly.

121. A similar point arose in relation to Mr. Losada's email of 8 October 2008 making a proposal for what the Defendants should do if the SAP share price went up to €32.10,

> "Q. What [Mr. Losada] is suggesting to you is first put on a zero cost put spread collar which gives you some downside protection but different downside protection to the LBF hedge, correct?
>
> A. Yes.
>
> Q. And you also get to keep the Lehman 100 million which had been posted by them to you shortly before termination, correct?
>
> A. Yes.
>
> Q. I suggest to you that this mirrors precisely your thinking. It shows those two points which I have been putting to a lot of yesterday and this morning. First, your focus here so far as the big hedge was concerned, the Lehman's hedge, was limited to getting a valuation figure which you could put to Lehman. Secondly, when we are looking at what transactions you want to enter into, it is not a replacement for the LBF hedge, but is a different transaction, the put spread collar. You understand that I'm putting that to you?
>
> A. Yes, I do.
>
> Q. And this email makes it absolutely clear, doesn't it?
>
> A. This is an analysis of Mr. Losada of what options I would have and what the outcome could be….
>
> …
>
> Q. Just pausing there, you knew by this stage it wasn't a matter of you having to agree a number with LBF, didn't you? You knew that you could give a valuation under the ISDA to LBF to fix the amount?
>
> A. Or a replacement transaction.
>
> ….

Q. So you knew that, so to speak, you were holding the pen. It wasn't a matter that you had to bargain with them or haggle with them about?

A. Well, clearly they didn't think so. But I knew by that time, I knew that there were two ways. But I pursued from the beginning the replacement one.

….

Q. You go back to Mr. Losada then, do you, and say, look, Mr. Losada, you have really got this wrong. What I actually want to do is to have a figure I can put to Lehman and I want a replacement transaction for the Lehman hedge. Is that what you do?

A. No.

Q. Why not?

A. Because it is one scenario that he picks, that he describes, that is fine, so he says if this happens, then this happens. I read that and then --

Q. And then what?

A. Then I take that into my consideration.

Q. Well, … what you do is you say:

> "Thank you very much for this analysis. This sounds very good indeed. Now we only have to hope that the stock goes back to 32.10. Have a good evening."

A. Yes.

Q. So your position was if the stock went back to 32.10 this is precisely the sort of thing you would want to do?

A. I mean, this looks great and if this happens that would be wonderful. But --

Q. But if the stock had gone back to 32.10 I thought your evidence is that if the stock went back to 32.10 or 31.90 or 32.50 what you want to do is to replace the big -- the Lehman hedge?

A. Yes. And this sounds good, all fine, the email says -- it is an interesting analysis, if it goes up, that would be -- but what I wanted was the replacement transaction. The replacement transactions. It doesn't mean anything else."

122. That evidence demonstrates that although Mr. Kammerlander's case was that from the outset the Defendants intended to replace the terminated Transactions with replacements on the same terms, he in fact had an open mind throughout as to what the Defendants should do. That was also evident from the following exchange in cross-examination,

> "Q. You use the phrase, "A true replacement transaction", don't you, in your witness statement?
>
> A. Correct, yes.
>
> Q. And that is meant to mean a replacement transaction with the same terms as the LBF hedge?
>
> A. Absolutely. That doesn't mean that I couldn't explore other options because it was a time when -- during this time a lot of things were happening, lots of uncertainty also about the question: what is a true replacement transaction? But for me the most conservative route given all these proposals, all these things, all these alternatives that were analysed, is eventually the most conservative was to stick with the original transactions. It would give me the exact product and it would have been clearly the easiest way then to agree on a close-out or an amount with LBF. Other things, if I had entered into any of this, there would have been a discussion around yes, it is not the same, you didn't even get something or you didn't have to pay something. So this is why this was something that again I analysed, I entertained, but it wasn't enough to push me from the original stand that I wanted to replace these transactions….
>
> …..
>
> Q. ….. I'm not putting to you that you couldn't do this, what I am putting to you is that in fact this is what you were interested in doing and you were not interested in doing the LBF hedge. Just to be clear, yes?
>
> A. The LBF hedge was something that was very clear. It was there. It was designed. It was something that I spent a long time on, designing, evaluating and so for me there was no point in discussing with banks all the time on, "What do you think about this trade?" It was very clear. And it was also clear that once the deal would be kind of live in the sense that once I have the shares, the datasheet would be the only thing that I would have to send out to the ones I wanted to invite to the auction.
>
> So for me there was no reason, whereas the put spread collar, given the new circumstances, was something I wanted to look in just that little bit further until I decided that wasn't it."

123. Pulling the threads together, it is clear to me that this was not a situation in which, as the Defendants contend, they were determined from the start to enter into replacement transactions on the same terms as the terminated Transactions, and that they needed to retrieve the Collateral for that purpose. As I have indicated, Mr. Kammerlander's evidence in cross-examination was inconsistent as to when he decided that the Defendants should enter into direct replacements for the terminated transactions. At times he indicated that he had done so from the start: at other times he indicated that he did so "eventually". In my judgment, Mr. Kammerlander did not have any such definite intention from the start of the relevant period on 15 September 2008 as he suggested.

124. The true position was, as LBF contends, the Defendants were focused on two things: (i) retrieving their Collateral – which SAP shares were the Defendants' main assets, and (ii) the close-out of the terminated Transactions under the Master Agreements. The two were related, because it would not be known whether the Collateral was required to support any payment to be made by the Defendants until the determination of Loss had been made, and either agreed or adjudicated upon in some way.

125. Against that background, and consistent with the clear terms of the documents, I find that Mr. Kammerlander obtained historic valuations of replacement transactions on a collateralised basis from Mediobanca and Goldman Sachs because he believed that this is what was required under the Master Agreements, and he did so as part of his efforts to obtain the release of the Collateral. At the same time, however, Mr. Kammerlander was investigating or allowing various institutions to pitch various ideas to him for alternative derivative transactions relating to such of the 59 million Collateral shares as might be returned to the Defendants and become available for that purpose. What (if any) transactions Mr. Kammerlander would ultimately have advised the Defendants to enter into with the SAP shares, once they had retrieved them from LBIE, would have depended upon what was available and the most advantageous use for those shares in the circumstances.

126. In short, it was not the case, as the Defendants contend, that they were attempting to retrieve the Collateral from LBIE in order to mitigate their Loss by entering into replacement transactions on the same terms as the terminated Transactions.

127. Those conclusions lead to the second question: was 16 October 2008 in fact the date on or about which the Defendants turned their attention to calculating Loss on the basis of uncollateralised replacement transactions?

When did the Defendants turn to investigate calculating Loss on the basis of uncollateralised replacement transactions?

128. The Defendants' pleaded case in this respect was that

> "As of 16 October 2008, KTS and KTB concluded that they could no longer reasonably expect the Collateral would be returned to them …
>
> On or around 16 October 2008 KTS and KTB therefore requested Goldman Sachs and Mediobanca to provide quotations for uncollateralised replacement transactions as of 16 October 2008."

129. LBF's pleading put the Defendants to proof of that allegation, and denied that the date upon which the Defendants might have appreciated that they could not obtain the return of the Collateral quickly had any relevance to the calculation of Loss.

130. Mr. Kammerlander's witness statement broadly supported the Defendants' pleading, stating,

> "So far as I recall, 16 October 2008 was the turning point on which our main focus shifted. I therefore requested the provision of quotations on an uncollateralised basis from Mr. Losada. I cannot remember the exact date on which I did so."

131. However, although 16 October 2008 was the date upon which Linklaters wrote to the Defendants' solicitors indicating that the release of the Collateral would fall to be dealt with in the due course of the administration of LBIE, it does appear that the Defendants continued thereafter to investigate the valuation of replacement transactions on a collateralised basis.

132. In particular, on 29 October 2008 Mr. Losada sent Mr. Kammerlander an email stating that "as discussed" he had priced for collateralised replacement trades as at the close of XETRA on 16 October 2008. Mr. Kammerlander's response was simply to thank him and ask him also to price the short calls as of the close of XETRA on 16 October 2008.

133. Further, on 12 November 2008 Mr. Lanz of Goldman Sachs also sent Mr. Kammerlander valuations for collateralised replacement transactions using the closing price for SAP shares on 16 October 2008, indicating that it was in response to a request from Mr. Kammerlander for a quotation to be used for the purpose of estimating a replacement cost for the terminated Transactions.

134. It was not until 1 December 2008 that Mediobanca provided indicative numbers for replacement trades on an uncollateralised basis. Mr. Losada accepted, as I think is consistent with his general speed of response to Mr. Kammerlander, that this document would have been produced in response to a request made shortly before 1 December 2008.

135. These documents were put to Mr. Kammerlander in cross-examination,

> "Q. But we agree [Mr. Losada's email of 29 October 2008] is a collateralised price. What we don't see is you coming back to Mr. Losada and saying, "What on earth are you doing giving me a collateralised price as of 16 October"?
>
> A. No.
>
> Q. "I'm not getting the collateral, I want an uncollateralised basis." You don't do that, do you?
>
> A. No, because at that point the thought process was that the calculation of what I had -- so the idea was, as I said, we moved then to loss determination, because we couldn't enter into a replacement transaction, collateralised. That was clear then. So

one way to approach this was to take the collateralised one, that would be that price, plus any cost of acquiring the collateral….

…

Q. Where do we see you asking anybody for the collateralised price plus the cost of acquiring the collateral?

A. Nowhere.

Q. Right.

A. That is something that I analysed or discussed, but this is something, because it was an alternative, that I wouldn't do because of the risks associated with it, the idea was a collateral -- uncollateralised one where the cost would be in one sum and Mediobanca would have to live with that risk for the entire period. That is the conclusion.

Q. I'm putting it to you that this answer and this explanation is untrue. Because the basis of this whole part of your evidence is untrue, which is that on 16 October you suddenly realised the collateral wasn't coming back and from then on you were asking for uncollateralised prices. I have shown you the documents on that. You understand?

A. I didn't ask for uncollateralised prices.

Q. No.

A. But I had to work out what to do from the 16th on, which was a point in time where the likelihood of the shares coming back, I got a message finally from LBIE saying that and I hadn't heard back from PwC for a long time.

Q. But you agree with me that you never asked anybody for the price of obtaining the collateral which was part of that first option you just explained?

A. Correct."

136. I do not accept Mr. Kammerlander's evidence on this point. His explanation in cross-examination for continuing to seek valuations on a collateralised basis after 16 October 2008 was singularly unconvincing; it had not appeared in the Defence or in his witness statement and it was wholly unsupported by the contemporaneous documents.

137. In my judgment, the Defendants made the decision to switch from investigating the value of collateralised replacement transactions to investigating the prices of uncollateralised transactions for the purpose of determining their Loss under the Master Agreements at the end of November 2008 and not at or around 16 October 2008.

Would it have been possible for the Defendants to enter into substitute transactions on an uncollateralised basis?

138. The Defendants' pleaded case was that,

> "Although the [valuation provided by Mediobanca on 1 December 2008] was priced as of 16 October 2008, an uncollateralised replacement transaction could have been readily concluded on or very shortly after 1 December on the basis of the [valuation], subject to adjusting the underlying share price and volatility."

139. That allegation was not admitted, its relevance was denied, and LBF pleaded that,

> "The Defendants did not seek to, and would not have been able to enter into a transaction on the terms of the 16 October 2008 valuation on or very shortly after 1 December 2008."

140. Dealing with this issue, I first note that Mr. Losada's email to the Defendants of 1 December 2008 giving a valuation of replacement transactions using prices as at 16 October 2008 itself made clear that,

> "It is to be said that such an uncollateralised deal could only happen with Mediobanca obtaining access to all correspondence between KTS/KG and PWC/Lehman since inception of the VFP/VFS and that we would reserve the right to ask KTS/KG for additional due diligence and involvement in the release process of the pledged shares."

141. Further, in Mr. Losada's subsequent emails of 9 December 2008 to Mr. Kammerlander, which responded to some questions from the Defendants' lawyers, Mr. Losada provided indicative pricing for uncollateralised substitute transactions based on the 15 and 16 September 2008 and added,

> "This is obviously our best estimate (ex post) and as explained in our previous email(s) where we provided numbers for 16th of October, Mediobanca would only have agreed to enter into such uncollateralised transactions if it were granted additional rights with respect to the release of the shares currently sitting with Lehman/PWC."

142. In reality, no such access to documentation had been obtained and no agreement of any "additional rights" with respect to the release of the Collateral had been even debated, still less agreed, by 16 October 2008. Mr. Losada's evidence was that the possibility of an uncollateralised substitute transaction with the Defendants had only been raised with the more senior management at Mediobanca, whose approval would have been required, in November 2008.

143. Even then, Mr. Losada's evidence in cross-examination, was merely that there had been positive initial feedback in November for a transaction provided that Mediobanca could be assured that it would get a second lien over the Collateral and a "rock solid" legal

opinion that there was no other encumbrance over it. Beyond that, it was apparent to me that Mr. Losada was simply speculating as to the likely outcome of such a process,

> "A.….So we would be unsecured, uncollateralised for a portion of time and at some stage the shares would come back and, through the second lien, we would be first in line to get the shares into the security account.
>
> Q. You cannot say whether those in the bank who are not within your team would have said no, can you?
>
> A. This was socialised all the way up to the CEO in a meeting which took place in November.
>
> ….
>
> Q. If there had been an approval given by Mr. Nagel at the meeting in November, then Mr. Kammerlander would have known of that, wouldn't he, because he was there?
>
> A. There was no specific approval because we didn't know the final collateral package. The format of the second lien, we didn't know. We asked for access to the email traffic between the KT entities and PwC and the Lehman administrator. We wanted to have additional information in order to formalise our approvals. But we did have serious internal conversations about getting that approval and the initial feedback was positive, all the way up to the CEO.
>
> Q. But you don't know whether ultimately they would have said yes or no, do you?
>
> A. I know that if we would have gotten a rock solid [legal] opinion, as we discussed yesterday, on the second lien and if the result of the review of the correspondence between the KT entities and the Lehman estate would have shown that there is no other effectively encumbrance under the shares, the answer would have been yes."

144. In contrast to Mr. Losada's speculation, Mr. Downey gave clear and persuasive expert evidence that in the risky and volatile conditions following the collapse of Lehman Brothers in late 2008, no bank would in fact have been willing to enter into uncollateralised replacement transactions of the size in issue in this case with the Defendants, whose only significant asset apart from the SAP shares was an investment of €800 million in a company called Bardeen Investmentfonds, which was illiquid and subject to a three year notice period.

145. In his rival expert report, Dr. Gandhi suggested that uncollateralised transactions of an equivalent size could take place in the market, and he gave a put option transaction by Berkshire Hathaway with Lehman Brothers in 2007-2008 as an example. That was exposed in cross-examination as a wholly inappropriate comparison, and Dr. Gandhi's

attempt to defend it was, in my judgment, entirely unconvincing. His evidence also involved considerable speculation that some unparticularised solution could have been found,

> "Q. …. Berkshire Hathaway has about $25 billion in cash and about $250 billion in assets, doesn't it?
>
> A. Well, if you say that is the case, I agree, and it sounds very reasonable.
>
> Q. It is actually a better credit than Mediobanca, isn't it?
>
> A. I would guess so.
>
> …
>
> Q. But the point, Dr. Gandhi, is this: with the greatest of respect, giving an example of Berkshire Hathaway as an entity which can enter into put options without putting up collateral is no support whatsoever for the proposition that the KTs would be able to enter into a replacement of the LBF transaction without putting up collateral. It is chalk and cheese, isn't it?
>
> A. Do you know, you have a fair comment, but you also have to read the rest of the report where I say it is very typical for life insurance companies to not put up collateral and Berkshire Hathaway is not a life insurance company; it is actually a property and casualty insurer. But there are lots of life insurance companies, not great credits, that don't put up collateral. In fact, it is their business model that which stop them putting up collateral and they do what are called variable annuity structures constantly. They are in the derivative market all the time doing equity derivatives, but they don't put up collateral either.
>
> Q. The problem, you see, Dr. Gandhi, is that if you don't give examples and you just put in generalised terms of insurance companies, you are now talking about life insurance companies
>
> --
>
> A. AIG, Aviva --
>
> Q. Dr. Gandhi, it is all very well to mention them now. You don't mention them in your report. They are also a million miles away from KTS, which is a charity, and KTB, which has next to nothing, we are told, in assets apart from the SAP shares.
>
> A. Okay, so I really -- okay. I agree that the KT entities are a terrible credit -- were a terrible credit at the time. That doesn't stop a bank being able to transact with them one way or other on an uncollateralised basis if a pricing mechanism could be found

> that could be made to work which would allow them to mitigate their credit exposure one way or the other."

146. I find Mr. Downey's evidence entirely convincing and I am not remotely persuaded by Mr. Losada's or Dr. Gandhi's speculative evidence. I am satisfied that neither Mediobanca (nor any other bank) would actually have been prepared to enter into an uncollateralised replacement transaction with the Defendants on 16 October 2008 or any other date.

Can LBF allege bad faith?

147. Although the factual issues which I have addressed above were squarely raised on the pleadings, Mr. Dicker QC contended that the basis upon which LBF could contend that the Loss Calculation was invalid was limited. He contended that the definition of Loss only required the Non-defaulting Party to make its determination "reasonably" and "in good faith". He accepted that LBF could contend that the Loss Calculation was not binding because it had not been made reasonably (which, for reasons that I shall explain, he interpreted as meaning "rationally"); but he contended that it was not open to LBF to contend that the Loss Calculation had not been made "in good faith".

148. LBF's pleaded case in this regard contained a "rolled up" assertion that,

> "Wrongfully and in breach of contract, the calculation of Loss by [the Defendants] was not in accordance with the provisions of the [Master Agreements]. Further or alternatively, [the Defendants] calculated Loss in a manner which was arbitrary and/or capricious and/or irrational and/or not objectively reasonable and/or in contravention of the obligation to act in good faith."

149. That plea was followed by seven sub-paragraphs under the heading "Particulars of breach", none of which were expressly identified as an allegation of breach of the obligation to act in good faith. These sub-paragraphs did, however, identify as wrongful the calculation of Loss as of 16 October 2008 rather than as of the close of business on 15 September 2008, and the assumption that a replacement counterparty would not have the benefit of any security over the 59 million SAP shares (i.e. that the replacement transactions were valued on an uncollateralised basis).

150. The pleading then alleged that by reason of such matters, the Loss Calculation did not comply with the requirements of the Master Agreements, and set out three sub-paragraphs under the heading "Particulars of Non-compliance" as follows,

> "(1) In several material respects (as pleaded above) [the Defendants] misinterpreted the meaning and effect of the [Master Agreements] and/or applied the wrong legal test and/or departed from the assumptions and/or methodology required by the [Master Agreements].
>
> (2) Further or alternatively, by adopting the approach set out above, [the Defendants] calculated loss in a manner

> which was arbitrary and/or capricious and/or not objectively reasonable and/or irrational.
>
> (3) Further or alternatively, by making assumptions which were designed to give rise to substantial claims against LBF, [the Defendants] did not act in good faith."

151. The Defence asserted that this was embarrassing for lack of particulars, but the Defendants made no attempt to press for further information or to strike out the pleading at any time. The agreed List of Principal Issues between the parties did not identify an allegation of lack of good faith as being for decision, and LBF's Skeleton Argument for trial also made no direct mention of such an allegation. The temperature rose, however, when Mr. Wolfson QC indicated in his oral opening that he would be pursuing an allegation that the Defendants had engaged in a "blatant attempt to game the system" with the aim of getting the highest possible figure from Mr. Losada with which to "stuff" LBF, or picking numbers which would give the highest amount for the Loss Calculation.

152. Mr. Dicker objected in his opening submissions in response that LBF should not be entitled to contend that the Defendants had acted other than in good faith. He said that the particulars failed to meet the standards required of a pleading of bad faith or dishonesty, and that there was no pleaded case at all against Mr. Losada in this respect. This objection led to Mr. Wolfson indicating by way of a written submission in response that whilst he would contend that parts of Mr. Kammerlander's written evidence were untrue and explore that contention in cross-examination, he did not suggest that Mr. Kammerlander had done anything in relation to the Loss Calculation that might be regarded as dishonest.

153. What, however, Mr. Wolfson contended was within the scope of LBF's pleading and properly particularised was an allegation that,

> "In calculating Loss [Mr. Kammerlander] was taking account of the [Defendants'] interest in generating as large a loss calculation as possible."

154. Mr. Wolfson suggested that this was really all about a legal issue, namely whether a party contractually obliged to act in good faith in making a determination which will be binding upon itself and the other party can take into account its own interests in making the determination, or whether it is obliged to put its own interests to one side. He identified the cases of Socimer International Bank v Standard Bank London [2008] 1 Lloyd's Rep. 558 ("Socimer") and Lion Nathan v CC Bottlers [1996] 1 WLR 1438 ("Lion Nathan") as potential authorities for the opposing sides of that argument.

155. I accept Mr. Dicker's arguments that there was insufficient particularity in LBF's pleaded case as regards what Mr. Kammerlander was supposed to have done (whether in conjunction with Mr. Losada or Goldman Sachs or anyone else) by way of "making assumptions which were designed to give rise to substantial claims against LBF" so as to amount to bad faith. I also do not consider that such a case was put clearly to Mr. Kammerlander or to Mr. Losada in cross-examination.

156. I therefore propose to approach the issues that I have to decide purely on the basis that LBF's challenge to the Loss Calculation was made on the two other bases identified by LBF – namely (i) that the Loss Calculation was not in accordance with the Master Agreements (properly interpreted), or (ii) that it was unreasonable (irrational).

The general approach to interpretation of the ISDA Master Agreement

157. In Lomas v JFB Firth Rixson Inc [2011] 2 BCLC 120 ("Lomas") at [53], Briggs J observed,

> "53. It is necessary to begin with some preliminary observations about the correct approach to construction. The ISDA Master Agreement is 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. It is axiomatic that it should, as far as possible, be interpreted in a way that serves the objectives of clarity, certainty and predictability, so that the very large number of parties using it should know where they stand: see Scandinavian Trading Tanker Co, v. Flota Petrolera Ecuatoriana [1983] 1 QB 529 … per Robert Goff LJ at 540."

158. Briggs J returned to this theme in his later decision in Anthracite Rated Investments (Jersey) v LBF and Fondazione Enasarco v LBF [2011] 2 Lloyds Rep 538 ("Anthracite"). After referring to Lomas, he commented, at [115],

> "115. Nonetheless, … the 1992 Master Agreement has come to be incorporated into a bewildering variety of different types of derivative transactions, so that caution needs to be exercised against a slavish assumption that the meaning of a particular provision of the Master Agreement in one type of transaction is necessarily to be transported lock stock and barrel as its precise meaning in some very different type of transaction. To a large extent the Master Agreement caters for this internally. For example, the definition of Settlement Amount in Section 14 provides in terms that where the use of a Market Quotation would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result, the Settlement Amount is to be determined by reference to that party's Loss. As a further example, the definition of Loss itself expressly contemplates that the method chosen by the non-defaulting party, including the use of replacement transaction quotations, may be inapplicable if it produces an unreasonable result. Thus the overriding control tests of commerciality and reasonableness provide a measure of flexibility within the Master Agreement sufficient to enable it to be applied across a wide range of different types of transaction, in an infinitely variable combination of different circumstances."

159. The key definition in the instant case is that of "Loss", which I have set out in full above. Stripped down to its essentials, the definition is as follows,

> ""Loss" means … an amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with ... [the] Terminated Transactions … including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related trading position (or any gain resulting from any of them) … A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable as of the earliest date thereafter as is reasonably practicable. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets."

160. The first and most obvious source to which the Court can legitimately look for guidance as to the meaning of the ISDA Master Agreement is the User Guide published by ISDA, which would have been available to all parties contracting on the basis of the 1992 Master Agreement. That Guide states, at Section II.G.3, under the heading "Payments on Early Termination – General",

> "The 1992 Agreements have been modified significantly from the 1987 Agreement in terms of calculating payments owed if an Early Termination Date occurs. First, the 1992 Agreements allow the parties to elect in Part 1(f) of the Schedule a payment measure based upon either Market Quotation or Loss … Although Loss remains a fallback provision in the event a Market Quotation cannot be determined or (in the reasonable belief of the party making the determination) would not produce a commercially reasonable result, the 1992 Agreements also provide that Loss may be the primary choice as a payment measure. This change was made to address products documented under a 1992 Agreement for which it may not be possible to obtain a Market Quotation (e.g. products in a thinly-traded market or products for which quotations are given on a future value basis) or for which Loss may be a more appropriate payment measure (e.g. transactions that settle by physical delivery) and to provide parties with greater flexibility in measuring their payments on early termination…"

161. The Guide continued, at Section II.4.b, under the heading "Payments on Early Termination - Explanation",

> "Loss, which is a general indemnification provision, is a payment measure in which a party reasonably determines in good faith its total losses (expressed as a positive number) and

> gains (expressed as a negative number) in connection with either an entire 1992 Agreement, a Terminated Transaction or a group of Terminated Transactions … As in the case of the definition of "Market Quotation" the definition of "Loss" now acknowledges the practical difficulties of determining Loss as of the Early Termination Date and, accordingly, permits a party to determine its Loss as of the earliest date reasonably practicable after the Early Termination Date. Again, as in the case of Market Quotation, parties should be careful in utilizing this additional flexibility in Loss, because any abuse of this flexibility could undermine its enforceability. Finally, in language added to the 1987 formulation, the definition of "Loss" acknowledges that a party may determine its Loss based upon quotations obtained from leading dealers in the relevant markets in a manner similar to Market Quotation (although not necessarily in accordance with the technical requirements set forth in Market Quotation)."

<u>"Reasonably determines in good faith"</u>

162. As an overarching point, the Defendants contend that their determination of Loss cannot be challenged in any respect unless LBF can demonstrate that no reasonable Non-defaulting Party acting in good faith could have come to the same result. In support of that contention, the Defendants placed considerable reliance upon what they contended was the deliberate choice of the framers of the 1992 ISDA Master Agreement not to provide an exhaustive definition or to prescribe a specific methodology for determining Loss under the Master Agreement, but instead simply to provide that Loss is what the Non-defaulting Party "reasonably determines in good faith to be its total losses and costs … in connection with the terminated transactions".

163. In that regard, in addition to the comments of Briggs J in <u>Lomas</u> (above), the Defendants relied upon the adoption by Judge Shelley Chapman of the US Bankruptcy Court for the Southern District of New York of evidence from one of the drafters of the 1992 ISDA Master Agreement as to the flexibility and certainty required. In <u>LBHI v. Intel Corporation</u> (SDNY 16 September 2015) ("<u>Intel</u>") Judge Chapman commented, at pages 21-22,

> "The ISDA User's Guide makes clear that Loss is intended to provide parties flexibility in selecting a method to calculate their Early Termination Payments and thereby functions as an express alternative to the rigid methodology and procedure of determining an Early Termination Payment using Market Quotation. Given the text of the definition of Loss, as well and the background and explanation in the ISDA User's Guide, there is strong textual support for reading the definition of Loss as generally permitting non-defaulting parties…to select any methodology for calculating Loss, so long as such methodology is reasonable and in good faith. This rather unremarkable conclusion is consistent with market participants' desire for certainty and predictability in the interpretation of ISDA standard form documents and definitions….

> … As the expert report of Professor Jeffrey Bruce Golden, one of the principal drafters of the 1992 ISDA Master Agreement, makes clear, the drafters desired the certainty that an Early Termination payment, once determined, would be conclusive and legally enforceable – not necessarily the certainty that the Early Termination Payment would be calculated in a particular way. As Professor Golden explains:
>
>> '… the wide discretion afforded the non-defaulting party…the considerable advantages given to the non-defaulting party, and the marked reluctance to allow second guessing of a party that determines a settlement amount can only be understood if market interest in 'certainty' and the perceived difficulties encountered in otherwise discovering facts and confirming consensus in a global marketplace are fully appreciated…Setting specific fixing times or process was not the game. Neither was searching for the 'correct' or 'perfect' (or even 'best') answers. The goal was to stay within acceptable parameters based on the particular objectives of the parties. In 1992, this goal was reflected in the general terms of reasonableness and good faith. Assuming an outcome based on these principles, an early termination determination was expected to be conclusive. Whether a different result might also have been reached was irrelevant ….'
>
> 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 means for calculating its Loss, subject to such methodology being reasonable and in good faith."

164. I was also provided by the Defendants with an expert report of Professor Golden dated 20 September 2016 filed in connection with another case in the US Bankruptcy Court for SDNY (LBHI v Federal Home Loan Bank of New York). In that report, Professor Golden emphasised the desire of the drafters of the 1992 ISDA Master Agreement to give flexibility to the Non-defaulting Party to determine Loss, and stressed that there was not intended to be one "correct" measure of Loss. Professor Golden also commented,

> "25. There is intentional generality in the definition of Loss in the 1992 ISDA Master Agreement, and that generality, including the possibility that it would be read differently by different parties especially when they were differently situated or during periods of market disruption, was an inevitable by-product of a standard form of relational contract which was to be necessarily and usefully constrained in length.

> 26. What was likewise intentional, and a clear direction to the drafters, was to foster party self-determination, particularly in such circumstances and in such a way as to reduce the likelihood of an extended period in which a party would not know whether it could rely on a close-out amount and reduce the likelihood of a Defaulting Party going to court to challenge determinations honestly made.
>
> 27. The cost of such intervention, both in time and out-of-pocket expense, but especially in a global marketplace, accounts in no small measure for the considerable party autonomy afforded a Non-defaulting Party in a close-out context. In relevant ISDA documentation working groups, especially among ISDA members and their counsel in meetings outside the United States, there was particular concern voiced about extensive US-style discovery procedures and concomitant delays and costs."

165. Evidence of the subjective intentions of the parties during the process of negotiation of a contract is not admissible as an aid to interpretation of the final text of a contract under English law. On this basis, Mr. Wolfson duly objected, in particular, to the admission of Professor Golden's report of 20 September 2016. I accept that submission as regards the statements concerning the intentions of the various interested parties during the drafting process leading to the 1992 ISDA Master Agreement.

166. That said, I do agree with the general observations of Judge Chapman in Intel to the effect that the text of the 1992 ISDA Master Agreement strongly suggests that the Non-defaulting Party should be entitled to select any methodology for calculating Loss, so long as that methodology is reasonable and is used in good faith. I would also accept as a general proposition that in interpreting the ISDA Master Agreement in its intended context of the financial markets, the Court should have in mind the obvious desirability that the Non-defaulting Party should be able to make a binding determination of its Loss quickly and with certainty.

167. However, as all of the commentaries and authorities acknowledge, the discretion given by the contract to the Non-defaulting Party is not unlimited. By the express terms of the definition of Loss, the discretion has to be exercised "reasonably and in good faith".

168. Under English law, as Baroness Hale explained in the course of her review of the authorities in Braganza v BP Shipping Ltd [2015] 1 WLR 1661 ("Braganza") at paragraphs [18]-[24], the concept of "reasonableness" can have two very different potential meanings: the first involves the application of an external objective standard such as a duty to take reasonable care, or to fix an objectively reasonable price; the second reflects the test of reasonableness of an administrative decision adopted by Lord Greene MR in Associated Provincial Picture Houses v Wednesbury Corporation [1948] 1 KB 223 at 233-234.

169. In the contractual and commercial context of the ISDA Master Agreement, English courts have unhesitatingly adopted the second meaning so as to give the determining party greater latitude. So, for example, in Fondazione Enasarco v Lehman Brothers Finance SA [2015] EWHC 1307 ("Enasarco") at [53], David Richards J observed,

> "…the relevant authorities now quite clearly establish that in considering whether the non-defaulting party has "reasonably determined" its Loss, that party is not required to comply with some objective standard of care as in a claim for negligence but, expressing it negatively, must not arrive at a determination which no reasonable non-defaulting party could come to. It is essentially a test of rationality, of the type developed in the quite different context of public law duties in Associated Provincial Picture Houses Ltd v Wednesbury Corporation [1948] 1 KB 223: see ANZ Banking Group v Societe Generale [2000] CLC 833; Peregrine Fixed Income v Robinson [2000] CLC 1328."

170. The interpretation of "reasonably" as "rationally" in this way does not, however, resolve all uncertainties. In Braganza, at paragraph [24], Baroness Hale referred to the formulation of an "irrational" decision as a determination which no reasonable non-defaulting party could come to, and then commented,

> "24. The problem with this formulation, which is highlighted in this case, is that it is not a precise rendition of the test of the reasonableness of an administrative decision which was adopted by Lord Greene MR in Associated Provincial Picture Houses Ltd v Wednesbury Corpn [1948] 1 KB 223, 233–234. His test has two limbs:
>
> > "The court is entitled to investigate the action of the local authority with a view to seeing whether they have taken into account matters which they ought not to take into account, or conversely, have refused to take into account or neglected to take into account matters which they ought to take into account. Once that question is answered in favour of the local authority, it may still be possible to say that, although the local authority have kept within the four corners of the matters which they ought to consider, they have nevertheless come to a conclusion so unreasonable that no reasonable authority could ever have come to it."
>
> The first limb focuses on the decision-making process - whether the right matters have been taken into account in reaching the decision. The second focuses on its outcome - whether, even though the right things have been taken into account, the result is so outrageous that no reasonable decision-maker could have reached it. The latter is often used as a shorthand for the Wednesbury principle, but without necessarily excluding the former."

171. Even with the test of "rationality" there is thus some uncertainty. So, for example, the commentary in *Firth on Derivatives Law and Practice* ("*Firth*"), at paragraph 11.153, appears to envisage some possibility of review by a court of the process by which the determination of Loss is made,

> "In determining its Loss, the determining party must act "reasonably" and "in good faith". This does not, however, mean that there is an objective standard against which the determination must be measured. The requirement to act reasonably is, in effect, a requirement to act rationally. This requires the determining party to give proper consideration to the matter, after making any necessary enquiries. Where a determination is based on, or involves the use of market prices, therefore, the determining party probably has to take reasonable steps to ascertain the true market price. It must also take into account all considerations that are obviously relevant to the determination and exclude irrelevant considerations. For example, where a valuation model is used but the surrounding circumstances (such as market disruption) suggest that its outputs may be unreliable, the determining party needs to consider whether it is nevertheless appropriate to use the model, and whether any adjustments should be made to the results. However, as long as the determining party has considered that matter properly, and in good faith, and can provide logical reasons for its decision, the court will not intervene unless the result is one that no reasonable decision-maker could have come to. This reflects the fact that, where a discretion is given to a party, it is that party which is the decision maker rather than the court. The court's role is merely to ensure that the discretion has not been abused."

172. *Firth* also clearly envisages that the obligation upon the determining party to act in good faith might restrict its approach to the selection of a method of determining Loss, because the commentary continues,

> "The obligation to act in good faith means that there must be an honest and genuine assessment of the loss or gain that the determining party has incurred as a result of the early termination. The determining party should, therefore, not be influenced by a desire to secure a better financial outcome for itself. Where the Loss could be determined in a number of different ways, although the determining party can decide which methodology to adopt (as long as it acts rationally), it cannot simply choose the methodology that would maximise its loss or minimise its gain unless it honestly believes that this most accurately reflects the loss or gain it has incurred."

173. A less interventionist approach to the exercise of a contractual discretion can be seen from the comments of Blair J in a slightly different context in LBIE v Exxonmobil Financial Services [2016] EWHC 2699 (Comm) ("Exxonmobil"). Blair J was required to construe a valuation provision in the standard form Global Master Repurchase Agreement (GMRA) (2000 edition). He commented, obiter, at paragraph 287,

> "287. The contractual discretion in the present case is given to a commercial party to a contract with another commercial party on the wholesale financial markets where the decision is as to the

> valuation of securities in the case of default. The decision is one which can be (and may need to be) taken without delay, and in which the Non-defaulting Party is entitled to have regard to its own commercial interests. In this kind of situation, I do not agree with LBIE that Braganza requires the kind of analysis of the decision-making process that would be appropriate in the public law context…"

That approach was applied by Knowles J and affirmed on appeal by the Court of Appeal in LBI v Raiffeisen Bank [2018] EWCA Civ 719.

174. I accept that the ISDA Master Agreement should not be interpreted so as to require a court to conduct the type of analysis of the discretionary decision-making process by the Non-defaulting Party that would be appropriate in a public law context. In particular, I do not think that the court should readily become involved in a detailed assessment of whether the determining party took into account all relevant factors and ignored all irrelevant factors. That would encourage challenges to be made to the determination by the Non-defaulting Party which would cut across the desire for speed and commercial certainty of determination.

175. However, I do not think that any of the authorities or the wording of the ISDA Master Agreement provide support for a proposition at the opposite end of the spectrum, namely that the definition of Loss means that the parties to the ISDA Master Agreement are to be taken to have agreed that the determining party should be free to decide for itself not only what method it should use to determine its "total losses and costs (or gain)", but also what that expression actually means. The debate over the concepts of good faith and reasonableness/rationality should not, in my view, be allowed to obscure the logically prior point that the determining party is only given its power to bind the other party by, and in accordance with, the terms of the contract. So while I accept (as did Judge Chapman in Intel) that the 1992 ISDA Master Agreement was designed to give the Non-defaulting Party discretion and flexibility in selecting the method for calculating its Loss, subject to such methodology being reasonable and in good faith, I do not think that the Non-defaulting Party has similar freedom to decide what matters can be included within the meaning of Loss.

176. This approach has been applied in relation to other, similar, contracts in the financial markets. In Exxonmobil, after his analysis of the cases on rationality, Blair J commented, at paragraph 281,

> "281. The present case illustrates another bound to the discretionary decision. As well as being rational, the decision has to be one which is permissible under the contract. The extent of a contractual discretion depends on its terms, and the test of rationality applies within those terms (see e.g. Braganza at [32], Baroness Hale, and at [54], Lord Hodge)."

177. I respectfully agree with that analysis. The same point is made in a footnote to the passage from *Firth* cited in paragraph 172 above. As a footnote to the proposition that the determining party can decide which methodology to adopt, as long as it acts rationally, *Firth* comments,

> "For example, [the determining party] is not required to use the valuation methodology that would have been used by an objective third party. As long as the requirements of rationality and good faith are satisfied, it can use an in-house valuation methodology: Socimer (valuation of securities under a bespoke master repo agreement). In that case, the agreement in question was held to entitle the determining party to base its determination on the value of the assets to itself (effectively, how much it would have been willing to pay to keep them). This is a different exercise from a determination of what loss or gain has been incurred. Although the determining party has a discretion as to the choice of method, it probably has to attempt to assess what, as a matter of construction, can properly be regarded as its loss or gain, not merely what it considers to be its loss or gain."
>
> (my emphasis)

178. A similar approach can also be seen in the analogous situation of a valuer appointed by the parties to a commercial contract who agree that they will be bound by the result. In such a case the valuer is given considerable latitude to exercise discretion and make mistakes, provided that he does not depart from what the contract, properly and objectively construed, requires him to do: see e.g. Begum v Hossain [2015] EWCA Civ 717. Likewise, in addition to the possibility of review on the grounds of unreasonableness, it has always been a ground for judicial review in public law that a decision-maker has acted on an erroneous view of what the law requires (see e.g. Wednesbury itself at page 229 and Bromley LBC v GLC [1983] 1 AC 768 at 821A-B).

179. Accordingly, whilst I accept that the Defendants had latitude and flexibility in choosing the method by which they should determine their Loss, I reject the suggestion that it was up to them to decide for themselves what Loss meant in the Master Agreements, provided that they did so in good faith and reasonably. Put another way, whilst LBF agreed to be bound by the method selected by the Defendants to determine their Loss (provided that it was selected and applied reasonably and in good faith), I do not consider that LBF also agreed to be bound by the Defendants' own interpretation of what the Master Agreements permitted them to include in the expression "total losses and costs (or gain)" in the Loss definition.

180. I therefore turn to consider the meaning of "Loss" as a matter of interpretation of the 1992 ISDA Master Agreement.

The meaning of "Loss"

181. The meaning of Loss has been discussed in a number of authorities. In Lomas in the Court of Appeal, [2013] 1 BCLC 27 at [129]-[131], the Court of Appeal endorsed the following summary of the earlier cases by Briggs J in Anthracite at [116],

> "116. A significant body of recent case law has developed in relation to the interpretation and application both of Loss and Market Quotation under the 1992 Master Agreement. The decisions to which I was referred are ANZ Banking Group v SocGen [2000] CLC 833 (CA); Peregrine Fixed Income Limited

v. Robinson Department Store Public Co Limited [2000] CLC 1,328; Britannia Bulk plc v. Pioneer Navigation Limited & ors [2011] EWHC 692 (Comm); and Pioneer Freight Futures Company Limited v. TMT Asia Limited [2011] EWHC 778 (Comm). Those authorities establish the following broad propositions:

(1) Loss and Market Quotation are, although different formulae, aimed at achieving broadly the same result, so that outcomes derived from one may be usefully tested by way of cross-check by reference to the other: see per Mance LJ in the ANZ case at paragraphs 2, 15 and 22. This derived from a concession in that case, but has subsequently been reaffirmed after adversarial argument in the Peregrine case at paragraph 30, in the Britannia Bulk case at paragraphs 44 to 46 and 51, and in the Pioneer case at paragraphs 98 and 105. It is one of those sensible concessions which has hardened into hornbook law.

(2) The identification of the non-defaulting party's loss of bargain arising from the termination of the Derivative Transaction requires a 'clean' rather than 'dirty' market valuation of the lost transaction. This means that the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion, and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world: see in the ANZ case at paragraphs 5, 22 to 27 and 30-31, the Britannia Bulk case at paragraphs 11 to 14 and 34-35, and in the Pioneer case at paragraphs 112 to 117.

(3) The termination payment formulae under Section 6(e) are not to be equated with, or interpreted rigidly in accordance with, the quantification of damages at common law for breach of contract. They are methods of calculating close-out positions on the termination of a derivative transaction or series of transactions: see the Britannia Bulk case per Flaux J at paragraph 37. This is, in particular, because the Second Method works both ways, and may lead to a close-out payment due to the defaulting party."

182. Importantly for present purposes, Briggs J then continued, at [117]-[118],

"117. The extended definition of Loss in Section 14 of the 1992 Master Agreement nonetheless uses certain words and phrases which were, I think, intended to be illuminated by reference to the general common law (or New York law) meaning. For present purposes the relevant phrase is 'loss of bargain'. It is precisely for the purpose of identifying the non-defaulting party's loss of bargain that Market Quotation requires, and Loss permits, the use of quotations for replacement

> transactions. This methodology precisely reflects the principle by then well established at common law, namely that where damages are sought for loss of bargain occasioned by the breach (leading to termination) of a commercial contract then, subject only to the availability of a market for the obtaining of a replacement contract, the cost of such a replacement contract as at the breach date is likely to prove the most reliable yardstick for measuring the claimant's loss of bargain: see in particular Golden Strait Corp v Nippon Yusen [2007] 2 AC 353 in which, at paragraph 20, Lord Bingham approved the following dictum of Toulson J in Dampskibsselskabet "Norden" A/S v Andre & Cie [2003] 1 Lloyd's Rep 287, at 292:
>
> > "The availability of a substitute market enables a market valuation to be made of what the innocent party has lost, and a line thereby to be drawn under the transaction."
>
> 118. The value of being able to draw a line under the transaction by the use of a breach date basis of valuation of the claimant's loss is that, save in special cases, for example where the claimant is locked into a disadvantageous position by reason of the breach, it provides a neat and precise distinction between matters relevant to the claimant's loss of bargain and matters such as his subsequent dealings, which are for his own risk and benefit and therefore in principle irrelevant to the damage flowing from the defendant's breach. There is a penetrating analysis of these principles in *McGregor on Damages* (18th ed) at paragraphs 7-106 to 7–168 which suggests that, in certain respects, they are no longer to be regarded as beyond question. Nonetheless the continuing vitality of the principle upheld in the Golden Strait case, in the context of derivatives governed by the ISDA Master Agreement, appears to have been resolutely affirmed by the four ISDA cases to which I have referred, not least because of the requirement laid down in all four of them to "value clean". On its face, the determination of Loss is required to be made as at the Early Termination Date, which broadly corresponds with the breach date used by the common law."

183. The common law concept of "loss of bargain" set out in the Golden Strait case has recently been reviewed and affirmed by the Supreme Court in Bunge SA v Nidera BV [2015] Bus LR 987 ("Bunge"). At paragraph [14] of Bunge, Lord Sumption explained,

> "14. The fundamental principle of the common law of damages is the compensatory principle, which requires that the injured party is "so far as money can do it to be placed in the same situation with respect to damages as if the contract had been performed": Robinson v Harman (1848) 1 Exch 850, 855, Parke B. In a contract of sale where there is an available market, this is ordinarily achieved by comparing the contract price with the price that would have been agreed under a notional substitute

> contract assumed to have been entered into in its place at the market rate but otherwise on the same terms."

184. At paragraph [17], Lord Sumption also explained the basis for determining the date upon which the substitute contract is to be assumed to have been entered into,

> "Normally … the injured party will be required to mitigate his loss by going into the market for a substitute contract as soon as is reasonable after the original contract was terminated. Damages will then be assessed by reference to the price which he obtained. If he chooses not to do so, damages will generally be assessed by reference to the market price at the time when he should have done: Koch Marine Inc v d'Amica Societa di Navigazione (The Elena D'Amico) [1980] 1 Lloyd's 75, 87, 89. The result is that in practice where there is a renunciation and an available market, the relevant market price for the purposes of assessing damages will generally be determined not by the prima facie measure but by the principles of mitigation."

185. In Bunge, at paragraphs [78]-[79], Lord Toulson explained that the use of a substitute contract for measuring loss of bargain at common law also reflects the principles of remoteness of damage derived from the well-known case of Hadley v Baxendale,

> "78. The broad principle deducible from The Elena d'Amico and the cases there considered is that where a contract is discharged by reason of one party's breach, and that party's unperformed obligation is of a kind for which there exists an available market in which the innocent party could obtain a substitute contract, the innocent party's loss will ordinarily be measured by the extent to which his financial position would be worse off under the substitute contract than under the original contract.
>
> 79. The rationale is that in such a situation that measure represents the loss which may fairly and reasonably be considered as arising naturally, i.e. according to the ordinary course of things, from the breach of contract: Hadley v Baxendale (1854) 9 Exch 341. It is fair and reasonable because it reflects the wrong for which the guilty party has been responsible and the resulting financial disadvantage to the innocent party at the date of the breach. The guilty party has been responsible for depriving the innocent party of the benefit of performance under the original contract (and is simultaneously released from his own unperformed obligations). The availability of a substitute market enables a market valuation to be made of what the innocent party has lost, and a line thereby to be drawn under the transaction."

186. Lord Toulson also went on to explain why this approach to the assessment of damages does not require the innocent party actually to enter into a replacement contract at all,

> "80. Whether the innocent party thereafter in fact enters into a substitute contract is a separate matter. He has, in effect, a second choice whether to enter the market - similar to the choice which first existed at the time of the original contract, but at the new rate prevailing (the difference being the basis of the normal measure of damages). The *option* to re-enter or stay out of the market arises from the breach, but it does not follow that there is a causal connection between the breach and his *decision* whether to re-enter or to stay out of the market, so as to make the guilty party responsible for that decision and its consequences. The guilty party is not liable to the innocent party for the adverse effect of market changes after the innocent party has had a free choice whether to re-enter the market, nor is the innocent party required to give credit to the guilty party for any subsequent market movement in favour of the innocent party. The speculation which way the market will go is the speculation of the claimant."

The relevant date for the determination of Loss

187. In paragraph [118] of Anthracite (above), Briggs J drew a clear parallel between the ISDA Master Agreement and the common law rules for the date upon which to measure loss by reference to a replacement transaction, and he stated that "on its face" the Loss definition required the determination to be made "as at the Early Termination Date".

188. Taken literally, that interpretation of the definition of Loss would mean that the Defendants' Loss Calculation was not made by reference to the correct date. Whilst I entirely accept the validity of having regard to the common law principles, Briggs J's observation as to the meaning of the Loss definition in that respect was *obiter*, and I respectfully consider that the position is not quite so straightforward.

189. To understand the wording of the Loss definition in context, it is necessary first to consider the equivalent provisions of Market Quotation definition. The relevant part of the Market Quotation definition is as follows,

> "The party making the determination (or its agent) will request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time (without regard to different time zones) on or as soon as reasonably practicable after the relevant Early Termination Date."

190. There is clear authority that where the Market Quotation definition refers to "quotations" for replacement transactions, it is referring to "live" (firm) quotations which are capable of being taken up (executed) there and then, rather than simply a hypothetical assessment of the price at which the market-maker would have been

prepared to deal at an earlier date and time. That was held to be the case by Burton J in LBF v SAL Oppenheim Jr & Cie [2014] EWHC 2627 (Comm) ("Oppenheim") at paragraphs [16] – [17].

191. The commercial reasons for that approach are set out very clearly in *Firth* at paragraph 11.130, which, after referring to the Oppenheim decision, states,

> "This excludes prices which are provided for valuation purposes only and do not represent the price at which the Reference Market-maker is prepared to trade (sometimes referred to as "indicative quotations"). Such prices could be less reliable than actual trading prices, given that there will be no financial consequences for the Reference Market-maker if the figure it quotes is inappropriate. This is particularly true in the case of more complex transactions, where the Reference Market-maker may not have analysed the economics of the transaction in the same level of detail as a normal trade."

192. However, *Firth* continues, at 11.132, in a passage approved by Burton J in Oppenheim,

> "Where quotations are not obtained on the Early Termination Date, the Reference Market-makers must provide quotations for the entry into of replacement transactions at the time the quotations are submitted. They are not required to backdate their quotations to the Early Termination Date so that they represent market prices that were prevailing on that date. This follows from the fact that *firm* quotations must be provided. If the Reference Market-maker is stating the price at which it is prepared to deal, this will necessarily reflect market rates prevailing at the time the quotation is provided. A statement of the price that *would have been available* on the Early Termination Date is not sufficient, as this is not a quotation but a hypothetical assessment of the price at which the Reference Market-maker (or a third party) would have been prepared to deal.
>
> It follows that, if quotations are not sought on or as soon as reasonably practicable after the Early Termination Date, the problem cannot be cured by asking the Reference Market-makers to provide quotations for transactions with a term commencing on the Early Termination Date. Although the definition of Market Quotation refers to quotations being provided "as of" the Early Termination Date or as soon as reasonably practicable thereafter, this is a reference to the timing of the quotations, not the commencement date of the transactions.
>
> The transactions quoted for must, in any event, be for a term commencing on the Early Termination Date and so the words "as of" are not intended to address this issue. Indeed, the requirement for the determining party to select "the day and time

> as of which those quotations are to be obtained" would be otiose if it always had to select the Early Termination Date. Instead, the fact that the quotations must be provided "as of" the Early Termination Date, or as soon as reasonably practicable thereafter, reflects the fact that the purpose of the Market Quotation provisions is to ascertain the replacement cost of the transactions at that time. It is the time at which the quotations have to be provided, therefore, that is critical".

193. Following on from this point, Section II.G.4.a of the ISDA Guide explains the reasons behind the inclusion in the Market Quotation definition of the words "on or as soon as reasonably practicable after the relevant Early Termination Date",

> "In a significant change from the 1987 Agreement the definition of "Market Quotation" acknowledges the practical difficulties that may arise in obtaining quotations from Reference Market-makers on the relevant Early Termination Date and, accordingly, provides that a party making the determination of Market Quotation may request quotations "on or as soon as reasonably practicable after the relevant Early Termination Date". Parties should be careful in utilizing this additional flexibility in Market Quotation, however, because any abuse of this flexibility could undermine its enforceability."

194. The position in relation to the Loss definition is less clear cut. The relevant part of the definition is,

> "A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable as of the earliest date thereafter as is reasonably practicable. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets."

195. As indicated above, the addition of these words is explained in Section II.4.b of the ISDA Guide,

> "As in the case of the definition of "Market Quotation" the definition of "Loss" now acknowledges the practical difficulties of determining Loss as of the Early Termination Date and, accordingly, permits a party to determine its Loss as of the earliest date reasonably practicable after the Early Termination Date. Again, as in the case of Market Quotation, parties should be careful in utilizing this additional flexibility in Loss, because any abuse of this flexibility could undermine its enforceability."

196. In <u>Enasarco</u>, David Richards J considered the validity of a determination under the Loss definition in the 1992 ISDA Master Agreement. The determination was based upon a live quotation obtained on 6 May 2009, which was about 8 months after the Automatic Early Termination Date which, as in the instant case, was the date upon which LBHI filed for Chapter 11 protection in the US, namely 15 September 2008.

197. At paragraph [56], David Richards J expressed the view, *obiter*, that for the same reasons that Burton J had given in Oppenheim, the reference in the last sentence of the Loss definition to the possibility of use of quotations was a reference to the use of live quotations. However, he observed that no point arose on this in Enasarco, because there was no dispute that the quotation which had been obtained on 6 May 2009 was a live quotation: the issue between the parties was the factual issue of whether it had been obtained on the first reasonably practicable date after the Early Termination Date. In the event, David Richards J decided that because of the difficulties caused in the markets after the collapse of LBHI, 6 May 2009 was the earliest practicable date upon which such a live quotation could have been obtained.

198. I agree with David Richards J that the reference to the use of quotations in the definition of Loss was intended to refer to live quotations, and that the Non-defaulting Party has a degree of latitude as to when it is obliged to obtain such quotations in order to reflect the problems that might arise in practice. This might, for example, be because the Non-defaulting Party does not find out about the occurrence of an Automatic Early Termination Date for a period during which it would be impossible for it to obtain live quotations; or because, as in Enasarco, there might simply be no available market for a period of time after termination. That also appears to be the situation to which the comments in Section II.4.b of the ISDA Guide are primarily directed.

199. The instant case is, however, clearly distinguishable from Enasarco. Although the Loss Calculation from Pinsent Masons presented the email from Mediobanca of 1 December 2008 as a "market quotation" for replacement transactions, it is readily apparent that the email of 1 December 2008 was not a live quotation in the sense of a quotation which was capable of being executed or taken up by the Defendants there and then. Instead, the email of 1 December 2008 was the provision of an "indicative" assessment by Mr. Losada of the historic price at which he considered that Mediobanca would have been prepared, subject to certain conditions, to enter into replacements for the terminated transactions, but on an uncollateralised basis, six weeks earlier on 16 October 2008. That much is clear from the opening and closing paragraphs of the email,

> "As required by you, we are providing you with <u>indicative numbers</u> for the "replacement trades" 1 and 2 (see the email below) <u>assuming</u> both the KTS and the KG are not able to provide any collateral to Mediobanca when entering into the transactions….
>
> …..
>
> <u>It is to be said that such an uncollateralized deal could only happen with Mediobanca obtaining access to all correspondence between KTS/KG and PWC/Lehman since inception of the VFP/VFS and that we would reserve the right to ask KTS/KG for additional due diligence and involvement in the release process of the pledged shares</u>."
>
> (my emphasis)

200. Mr. Wolfson did not suggest that the Defendants could not use indicative valuations as the basis for their determination of Loss. However, he contended that although the Loss definition gives some latitude to a Non-defaulting Party to obtain a live quotation after

the Early Termination Date for practical reasons, the Loss definition gives no such latitude where indicative valuations are used, because it will always be practicable to obtain a retrospective valuation by reference to the Early Termination Date itself. Hence, relying on Briggs J's observation in Anthracite, Mr. Wolfson submitted that the Defendants' Loss Calculation was invalid, because it relied on Mr. Losada's indicative numbers as at 16 October 2008, which did not purport to value the terminated transactions on the Early Termination Date of 15 September 2008.

201. I do not accept that submission. It would give a very restrictive interpretation to the Loss definition which would in effect mean that a Non-defaulting Party would be forced to use live market quotations rather than any other method of valuation in any circumstance in which the market had moved against it before it had even learned of an Automatic Early Termination. A similar problem would also arise if, for example, there was no available market for a replacement transaction at the time of the Early Termination Date. The Loss definition clearly indicates that the Non-defaulting Party might, but is not obliged to, use such quotations.

202. Taking these factors into account together with the clear indication in the Guide that the words "or, if that is not reasonably practicable as of the earliest date thereafter as is reasonably practicable" are intended to give flexibility to the Non-defaulting Party under the Loss definition, it seems to me that in certain (limited) circumstances the Loss definition should permit a Non-defaulting Party to determine its loss of bargain using valuations prepared by reference to a date after the Early Termination Date. That should be the case if, for example, it did not know until later that the contract had been terminated, or if there was no available market for a replacement contract at any earlier date. Such an interpretation also means that the determination of Loss is more likely to equate to the determination under the Market Quotation method (a point made in paragraph [116(1)] of Anthracite).

Did the Defendants validly determine their Loss?

203. My conclusion that the Loss definition does not necessarily limit the Non-defaulting Party to valuations by reference to the Early Termination Date leads to the area of main dispute between the parties: namely whether the Defendants were entitled to choose as the reference point for determination of their Loss, the date upon which they claimed to have appreciated that they were not going to be able to get their Collateral back from LBIE quickly (16 October 2008); and whether they could also assess their Loss on the basis of Mediobanca's valuation of the cost of uncollateralised replacement contracts at that later date.

204. As I have indicated, Mr. Dicker contended that the determination of Loss is intended to mirror the common law compensatory principle, so that the Non-defaulting Party is entitled to determine the monetary amount that would put it, so far as possible, into the position that it would have been in if the contract had been performed.

205. Mr. Dicker also contended that the authorities (including Anthracite, Golden Strait and Bunge to which I have referred) showed that this monetary amount was to be measured by reference to the first date at which it would be reasonable to expect the Non-defaulting Party to go into the market for a replacement contract to mitigate his loss. On the facts of the instant case, Mr. Dicker contended that it would not have been reasonable to expect the Defendants to go into the market for replacements for the

terminated Transactions whilst they were attempting to retrieve their Collateral from LBIE, and that when it became apparent that the Collateral would not be forthcoming, the Defendants were entitled to value their loss of bargain with LBF on the basis of what it would then cost them to enter into uncollateralised replacement contracts.

206. I therefore turn to consider whether this approach by the Defendants was a determination of their "total losses and costs (or gain) … in connection with … [the] Terminated Transactions" within the true meaning of that expression in the Loss definition.

The Defendants' Loss

207. As I have already set out, in Bunge, at paragraph [79], Lord Toulson explained that the use of a substitute contract for measuring loss of bargain at common law reflects principles of remoteness of damage derived from the well-known case of Hadley v Baxendale. Ever since that case was decided in 1854, English law has placed a limit upon the width of the compensatory principle, and hence upon the ability of the claimant to recover damages for breach of contract.

208. The reason for the limitation was explained by Asquith LJ in Victoria Laundry v Newman [1949] 2 KB 528 as follows,

> "It is well settled that the governing purpose of damages is to put the party whose rights have been violated in the same position, so far as money can do so, as if his rights had been observed. This purpose, if relentlessly pursued, would provide him with a complete indemnity for all loss *de facto* resulting from a particular breach, however improbable, however unpredictable. This, in contract at least, is recognised as too harsh a rule."

209. The restatement of the law in Victoria Laundry was reviewed by the House of Lords in Koufos v C. Czarnikow (The Heron II) [1969] 1 AC 350. Referring to these cases, *Chitty on Contracts* (33rd ed.) states, at 26-121,

> "The combined effect of these cases may be summarised as follows: a type or kind of loss is not too remote a consequence of a breach of contract if, at the time of contracting (and on the assumption that the parties actually foresaw the breach in question), it was within their reasonable contemplation as a not unlikely result of that breach."

210. An alternative approach was suggested by Lords Hoffmann and Hope in Transfield Shipping v Mercator, "The Achilleas" [2009] 1 AC 61. At paragraph [16] Lord Hoffmann explained that in the case of breach of a contractual obligation,

> "the consequences for which a contracting party will be liable are those which the law regards as best giving effect to the express obligations assumed and not extending them so as to impose on the contracting party a liability greater than he could reasonably have thought he was undertaking."

211. Although Mr. Dicker was an enthusiastic advocate of the illumination which the principles of the common law provided to the meaning of the Loss definition because he wished to use concepts of mitigation to explain why the Defendants were entitled to delay the reference date for assessing the value of replacement contracts whilst they attempted to obtain the Collateral from LBIE, his enthusiasm did not extend to the principles of remoteness, and he disputed that the determination of Loss should be limited by such principles. He emphasised that the words of the Loss definition require the Non-defaulting Party to determine its "total losses and costs (or gain…) … in connection with" the Terminated Transactions and that the definition was non-exhaustive in its reference to loss of bargain, cost of funding etc. He also submitted that the intended width of the Loss definition was apparent from the ability to include the loss or cost incurred as a result of terminating or liquidating any hedge or related trading position, which he suggested would not be recoverable as damages at common law. Finally, Mr. Dicker pointed to the opening words of Section II.4.b of the ISDA Guide that the definition of Loss is a "general indemnification provision" which he said indicated an intention that the compensatory principle should be unlimited when embodied in the Loss definition.

212. It is clear from the authorities to which I have referred that the meaning of "Loss" in the 1992 ISDA Master Agreement is illuminated by principles of the common law, and I do not accept Mr. Dicker's submission that principles of remoteness should be excluded. As Asquith LJ explained in Victoria Laundry v Newman, the rules on remoteness form an important limit to the compensatory principle on the basis that unlimited liability would be too harsh, even in cases of advertent breaches of contract such as a failure to pay money when due. The circumstances in which contracts governed by the 1992 ISDA Master Agreement will terminate include situations that would not amount to advertent breaches of contract, and termination may take place automatically and without "fault" in any conventional sense. It makes no commercial sense to suppose that parties who chose to adopt a 1992 ISDA Master Agreement to be governed by and construed in accordance with English law should intend that a harsher rule should apply to identify the loss that should be compensated in such cases than would apply in conventional cases of breach of contract.

213. Put another way, I do not consider that any objective bystander interpreting the Loss definition in a contract to be governed by and construed in accordance with English law could reasonably think that by the simple reference to "total losses and costs (or gain…)", the Non-defaulting Party was being given an unrestricted indemnity for all loss *de facto* resulting from the termination of the transactions, in circumstances in which no such right has formed part of recoverable damages for breach of contract under English law for over a century and a half since Hadley v Baxendale was decided. If such a major departure from the common law had truly been intended by the drafters of the 1992 ISDA Master Agreement, I consider that it would have been spelled out more clearly in the Master Agreement and highlighted in the ISDA Guide.

214. For my part, I read the word "total" as part of an expression that connotes the sum of losses, costs and gains, and I believe that the reference in the ISDA Guide to the Loss definition being a "general indemnification" provision is broadly descriptive, rather than signifying an intention that it should confer rights to an unrestricted indemnity. I also do not think that the potential inclusion of the costs of terminating related hedges suggests that the parties intended a wider indemnification than would be the case at

common law. In many of the types of transaction that would be covered by the ISDA Master Agreement it would be within the reasonable contemplation of the parties that the counterparty would enter into hedging transactions so that if the main transaction was breached, the Non-defaulting Party would incur losses or costs in terminating the related hedges.

215. A similar approach can be seen in the decision of the Court of Appeal in the ANZ case. The US dollar/Rouble futures contracts in question were governed by the 1992 ISDA Master Agreement and had been terminated following the announcement of a Russian banking moratorium. The issue was whether, in calculating its gain (negative loss) on termination under the Loss clause, the Non-defaulting Party (SG) could take into account the losses which it claimed to have suffered under three back-to-back hedging contracts which it had entered into with a Russian Bank to cover its risk under the main contracts.

216. The Court of Appeal affirmed the decision of Aikens J that such losses could not be taken into account by SG. Aikens J had found, and the Court of Appeal agreed, that the losses claimed to have been suffered by SG under the hedges were not the sums that would have been determined to be due from SG to the Russian bank on termination of those hedges. The losses claimed were attributable to the fact that, because of the same Russian banking moratorium that had caused the termination of the main contract, the Russian bank could not pay any amounts due from it to SG on termination or liquidation of the hedges.

217. Mance LJ (with whom Kennedy LJ agreed) held, at paragraph [13],

> "13. The critical question is however for what purpose [the existence of a hedge] is foreseen and how it is provided for. This brings one back to the actual language of the Loss clause, and the scope of the words "as a result of" in the phrase "loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related position (or any gain resulting from any of them)". Here I find myself in full agreement with the judge that (a) it is readily understandable that the parties should agree to share loss or gain arising from the accelerated termination or liquidation or the need to take accelerated steps to obtain or re-establish a hedge, but that (b) it is inherently unlikely that a party in ANZ's position entering into a futures contract with SG would agree to share the risk of the simple collapse in value of a hedge arranged by its counterparty, SG."

218. Mance LJ was clearly not prepared to read the Loss definition as conferring an unrestricted indemnity upon the Non-defaulting Party. Whilst he did accept that losses caused to SG by termination of hedging contracts would be recoverable, his rationale for concluding that ANZ would be unlikely to have agreed to be liable for losses due to the inability of the Russian Bank to pay any sums due has echoes of Lord Hoffmann's approach to questions of remoteness in The Achilleas.

219. The same point, also echoing Lord Hoffmann's approach, is made in *Firth* at paragraph 11.150 when dealing with the question of whether, if a party enters into a completely

inappropriate hedge and suffers loss closing out the hedge which is much greater than would normally be the case, that increased loss can be taken into account in calculating the Loss for close-out purposes. *Firth* observes that the ANZ case,

> "…does show that the courts are prepared to take a restrictive approach to the interpretation of the Agreement where they do not believe the losses in question fairly represent the risk the parties thought they were accepting when the entered into the transactions. It is submitted, therefore, that the right to take into account any loss or cost incurred as a result of terminating or re-establishing "any hedge or related trading position" would only include transactions that were reasonably appropriate to hedge the exposure involved. The purpose of the party that entered into the hedging transaction would therefore not be conclusive."

220. Applying this approach to the instant case, the relevant question is whether it would have been within the contemplation of the parties that if the Transactions terminated due to the bankruptcy of LBHI, the Defendants would not only suffer the loss of the contractual obligations owed to them by LBF, but would also suffer greater loss by reason of being unable to recover their own Collateral from LBIE so as to be able to use it in obtaining replacement transactions.

221. The clearest evidence which I heard on this subject came from Mr. Losada, who, prior to working for Mediobanca, had worked for Lehman Brothers at the time that the arrangements over the Collateral were being put in place. Mr. Losada was asked in cross-examination whether he had thought that he was providing live quotations for replacement transactions to Mr. Kammerlander after 15 September 2008. His answer was that his quotes were live, because he thought that the Collateral was coming back to the Defendants. He said,

> "I had myself worked on the implementation of the security package at Lehman Brothers. I had spent huge amounts of time with LBIE and BNP, who was the sub-custodian of LBIE for the shares. We had segregated the shares on specific container accounts, labelled the accounts "Klaus Tschira", so we knew at Lehman, which was an edge which maybe other banks didn't know, we knew the shares are 100% segregated, they are coming.
>
> So our quotes were always live trading quotes, with the hope we have done such a good job when we were at Lehman, the shares are coming. It was a matter of time."

222. I returned to this with Mr. Losada at the end of his evidence. Mr. Losada explained that the 59 million SAP shares pledged as Collateral pursuant to the MCDs were not able to be rehypothecated or used by LBIE or LBF. He continued,

> "… 59 is a big number. They wanted to be able to vote the stock at the AGM and to be seen as the owners of the shares. So if

transfer title you lose and if you cross thresholds then you need to disclose, Mr. Tschira didn't like that. So we said, okay, we can do something different, which is to effectively not transfer title, you just -- we just hold your shares in custody and we segregate them, they are your shares.

Because the important point here is whilst the client was giving us over 2 billion euros worth of security, he was getting nothing in exchange other than a contract, let's meet in six years and we will settle then. So they were very concerned that these shares would somehow leave their estate.

The other thing is, as you can see, they were so concerned about that point that they even asked us, towards the back end of the structuring period, for an LBHI parent guarantee. We haven't discussed that, but this went to the top of the house. We don't typically give those guarantees on any single trade but they asked for that as a condition to trade in addition to the segregation. And we said, okay, and we gave them the LBHI guarantee as a kind of balancing act as versus them wiring over the 59 million shares.

….

MR JUSTICE SNOWDEN: Was there anything else you could have done to protect those shares against any sort of problems from the point of view of the KT clients?

A. Yes, there was another thing we could have done, which is not to custody the shares with Lehman. So the shares would have been custodied with maybe State Street or a third party provider and we would have the benefit of the pledge. But given the size of the transaction it was the strong preference of Lehman to have the shares in-house.

MR JUSTICE SNOWDEN: But did you think that that caused any additional risk for the KT clients?

A. Not really because they were segregated. There would have been extra cost if they would have held the shares as custody elsewhere, so we didn't think there would be an issue.

MR JUSTICE SNOWDEN: So in the event of any problems at Lehmans, there would be no risk for KT in this arrangement?

A. No. In fact after the bankruptcy immediately it was like so, a few phone calls we get the shares, and then they realised.

MR JUSTICE SNOWDEN: So you couldn't foresee the problems that actually occurred?

A. Oh no, no. In fact, we were all shocked."

223. Although, for the reasons that I have explained, I do not accept Mr. Losada's evidence that he supplied "live" quotations to the Defendants, I entirely accept that no-one involved in the original Transactions foresaw or could reasonably have contemplated that the consequence of the bankruptcy of LBHI (and hence the automatic termination of the Transactions) would be that the Defendants would be unable to recover their Collateral from LBIE for a significant period. To the contrary, the parties took every possible step to ensure that the SAP shares held as Collateral would be segregated and clearly identified, and immune from any such risk.

224. If the matter is considered in the terms suggested in the ANZ case, or by Lord Hoffmann in The Achilleas, it is quite clear that LBF could not reasonably have been thought to be undertaking liability for the greater cost that the Defendants might have to incur if they were unable to retrieve their Collateral for use in replacement transactions because of a breakdown in the custody arrangements between them and LBIE.

225. Mr. Dicker also submitted that even if common law concepts of remoteness were applicable in determining Loss, the additional cost of replacement contracts due to the Defendants being unable to retrieve their Collateral from LBIE was not loss of a different type or kind to which the common law rules on remoteness would apply. He submitted that it was simply more extensive loss of the same type – the loss of bargain caused by the termination of the Transaction with LBF.

226. I do not agree. The additional amounts claimed by the Defendants have nothing to do with the termination of the Transactions with LBF as a result of the bankruptcy of LBHI. As Mr. Losada's valuation made clear, they represent his view of the increased credit risk of the Defendants for a notional replacement transaction in the absence of the Defendants being able to provide security. The Defendants are, in effect, seeking to charge LBF with the adverse financial consequences of their inability to retrieve the Collateral from LBIE. That is loss of a very different type to the loss of the payment obligations between the Defendants and LBF.

227. I also do not think that my conclusion is altered by analysing the case in terms of principles of mitigation of damages.

228. *Chitty on Contracts* (33rd ed.) describes mitigation at paragraph 26-087 in terms of three rules as follows,

> "First, the claimant cannot recover damages for any part of his loss consequent upon the defendant's breach of contract that the claimant could have avoided by taking reasonable steps. Secondly, if the claimant in fact avoids or mitigates his loss consequent upon the defendant's breach, he cannot recover for such avoided loss, even though the steps he took were more than could be reasonably required of him under the first rule. Thirdly, where the claimant incurs loss or expense in the course of taking reasonable steps to mitigate the loss resulting from the defendant's breach, the claimant may recover this further loss or expense from the defendant."

229. The basis for the Defendants' argument invoking the principles of mitigation appeared to relate to the first and third of these rules. Mr. Dicker referred me to the observation of Lord Sumption in Bunge, at paragraph [17],

> "Normally … the injured party will be required to mitigate his loss by going into the market for a substitute contract as soon as is reasonable after the original contract was terminated. Damages will then be assessed by reference to the price which he obtained. If he chooses not to do so, damages will generally be assessed by reference to the market price at the time when he should have done: Koch Marine Inc v d'Amica Societa di Navigazione (The Elena D'Amico) [1980] 1 Lloyd's 75, 87, 89. The result is that in practice where there is a renunciation and an available market, the relevant market price for the purposes of assessing damages will generally be determined not by the prima facie measure but by the principles of mitigation."

Mr. Dicker contended that the common law rules for the assessment of damages were therefore best seen as an aspect of the law of mitigation.

230. I do not, however consider that the Defendants' approach was a correct characterisation of the instant case. As I have found, when seeking to recover their Collateral from LBIE, the Defendants were not taking steps to mitigate their loss resulting from the termination of the Transactions. What they were attempting to do was to recover their own assets from their custodian.

231. At most it might be said that, assuming that the Defendants were actually intending to enter into replacement transactions (which I have found was not the case), they were seeking to recover their own assets so as to be able to minimise the cost of such replacement transactions by pledging them as security. But that type of situation is usually seen as a question of whether a claimant can recover greater than normal costs of mitigation caused by its own impecuniosity. So, for example, in *Chitty* at paragraph 26-091, after making the point that the approach set out in tort cases such as Lagden v O'Connor [2004] 1 AC 1067 is not applicable in contract cases where the rule in Hadley v Baxendale applies, the commentary continues,

> "But even in contract the claimant's impecuniosity might be relevant if it prevented him from choosing a cheaper form of mitigation. The rules on mitigation and those on remoteness are entwined in some cases, where what was "within reasonable contemplation" and what was "reasonable" mitigation are treated as inter-changeable concepts. In the Monarch SS case [1949] AC 196, Lord Wright said (with reference to the decision of the House of Lords in Muhammad Issa el Sheikh Ahmad v Ali [1947] AC 427 that:
>
>> "… damages consequent on impecuniosity were held not too remote because … the loss was such as might reasonably be expected to be in the contemplation of the parties as likely to flow from breach of the obligation undertaken."

> This means that the claimant's impecuniosity will be relevant in contract if it falls within the defendant's reasonable contemplation (as at the time of contracting) as not unlikely to affect the claimant's ability to mitigate after a breach of the particular undertaking, viz that the claimant would be likely to incur greater than usual expense (or higher than normal interest charges) in a reasonable attempt to mitigate."

232. This shows that the principles of mitigation are not to be divorced from the principles of remoteness. A claimant who seeks to mitigate his loss cannot recover increased costs of doing so, caused by his impecuniosity, unless that impecuniosity would have been within the defendant's reasonable contemplation as not unlikely to result from the breach of contract.

233. Applying this approach, and for the same reasons as I have explained, I do not consider that it was in the reasonable contemplation of the parties (as at the time of entering into the Transactions) that the Defendants would be likely to incur greater than usual expense in seeking to mitigate following termination of the Transactions.

234. I therefore conclude that the inclusion in the Loss Calculation of the extra amount attributable to the inability of the Defendants to provide collateral for the replacement transactions was therefore not in accordance with the Loss definition, properly construed.

235. I consider that this conclusion is consistent with the decisions in a number of the cases to which Briggs J referred in Anthracite to the effect that a terminated transaction must be "valued clean" for the purposes of determining loss of bargain under the ISDA Master Agreement. In Anthracite, Briggs J sought to explain the "value clean" principle as follows,

> "This means that the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion, and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world."

Although doubts have been expressed in some commentaries as to whether that dictum overstates the "value clean" principle, it was approved by the Court of Appeal in Lomas, at paragraph [131].

236. The operation of the "value clean" principle can be illustrated by the decision of the Court of Appeal in the ANZ case. After giving its decision on the appeal in the manner that I have described above, the Court of Appeal then went on to consider a new argument that SG sought to raise for the first time on appeal, namely that the terminated futures contract should be valued "dirty" – i.e. taking into account the potential diminution in value of the contract on the basis that if it had continued, SG would have determined that a "trade event" had occurred so as to limit its payment obligations under the contract.

237. Mance LJ first considered the position that would have applied if the Market Quotation basis of calculation had been adopted and stated, at paragraph [24],

> "24. If the Market Quotation basis of calculation had been adopted between ANZ and SG, it is clear that it would have been necessary to assume the satisfaction of all conditions precedent both in respect of any amounts unpaid on early settlement and in respect of any future payments on settlement. The task of the Reference Market Makers would not have been to put themselves in the shoes of either of the actual parties under the actual transaction, but to assess the consideration required to enter into a replacement transaction to preserve the economic equivalent of any payment provided by such transaction on a hypothetical basis. One hypothesis is that no Early Termination Event has occurred or been effectively designated, another that "each other applicable condition precedent specified in this Agreement" has been and will be satisfied."

238. Mance LJ then continued, at paragraphs [29]-[30],

> "29. … Bearing in mind the intention of the Loss and Market Quotation clauses to arrive at broadly the same results, the calculation of loss, or loss of bargain, must proceed on the same basis, that is valuing the transaction according to the nominal value of the payments which would have been required under it, assuming satisfaction of all conditions precedent.
>
> 30. I would therefore have held that ANZ's loss and SG's gain on early termination of the ANZ-SG transactions fell to be valued "clean". That is without reference to the possibility that, had no early termination date been determined by SG, SG might still … have determined on settlement that a Trade Event existed, and so have restricted SG's obligation to pay to one of the four specified methods…."

239. Although I doubt that either Briggs J in Anthracite, or the Court of Appeal in ANZ, had in mind the type of situation that arose in the instant case, it is nevertheless the case that the provision by the Defendants of the Collateral pursuant to the MCD was, according to the Confirmations, a condition precedent to the Variable Forward Sales. Hence, if applying Briggs J's statement of the "value clean" principle, the assumption should be made that the condition as regards the provision of the Collateral would continue to be satisfied, whatever the possibility of that occurring in the real world. This suggests that any quotations or valuations for replacement transactions should have been on a collateralised basis.

Rationality

240. In addition to the points made above concerning the meaning of Loss, LBF contended that there were features of the Defendants' approach to the determination of Loss that were irrational.

241. The first point was that, as Lord Sumption indicated in Bunge, the technique of using a notional replacement contract to measure a party's loss of bargain at common law requires the replacement to be on the same terms as the terminated contract. That is

because if there is any difference in the assumed terms, the cost of the replacement transaction may not be a reliable guide to the value of what has been lost.

242. The decision in Enasarco shows that the Non-defaulting Party may have some latitude in this respect, and that some differences in the actual or assumed terms of the replacement contract may not be sufficiently material to invalidate the determination of Loss. In Enasarco, the transaction for which live quotations were obtained (and which was actually entered into) was not on identical terms to the terminated transaction: it had the same strike price but a different maturity date and provisions as to premium. David Richards J dismissed arguments that these terms were so different from the terminated transaction that it was not a comparable replacement transaction: see [2015] EWHC 1307 (Ch) at [129]-[136]. In particular, he accepted that the difference in maturity date "did not have a significant impact on the price, and hence on the calculation of Loss … and indeed may have caused the price to be lower."

243. In contrast, in the instant case, the requirement to provide the Collateral was a condition of the Variable Forward Sales which had a very substantial effect upon the assumption of risk and pricing of the Transactions. Valuing replacement contracts on the assumption that they were uncollateralised would obviously, and did, produce a substantially different result from doing so on a collateralised basis. That meant that the uncollateralised replacement contract which formed the basis for the Loss Calculation was not a reliable guide to the value of what had been lost. In my judgment, to use that basis of calculation of Loss was not a rational approach for the Defendants to take.

244. Secondly, I consider that the authorities all affirm that the technique of using quotations or valuations of the cost of a replacement contract to measure loss depends upon the replacement being one that claimant could enter into in an available market - albeit that, as Lord Toulson explained in Bunge, whether or not the claimant actually does so is at its option. If the claimant decides to use the technique of determining loss of bargain by reference to the value of a replacement contract, I do not see how, logically, a conclusion by the claimant that it cannot enter into a replacement transaction on the same terms as the one that has been lost, should entitle it to value its loss of bargain by reference to another, different, contract that it also cannot enter into.

245. In that regard, I have found that there was no realistic prospect of the Defendants entering into replacement transactions for the terminated Transactions on an uncollateralised basis (whether at 16 October 2008 or otherwise). I therefore do not see how a valuation of such contracts could rationally be used as a method of determining the Defendants' Loss.

246. I therefore conclude, for these two reasons, that it was in any event not rational for the Defendants to determine their loss of bargain by reference to the cost of uncollateralised replacement transactions. The terminated transactions should have been valued on the basis of collateralised replacement transactions.

A valid determination of the Defendants' Loss

247. Having determined that the Defendants' Loss Calculation was not in accordance with the Master Agreements and not binding upon LBF, I must therefore decide what would have happened if a reasonable person in the position of the Defendants had correctly

performed their task of determining Loss under the Master Agreements: see e.g. Socimer at paragraph [65] and Oppenheim at paragraph [35].

248. That exercise involves a consideration of the evidence as to the valuations which were actually obtained by the Defendants on a collateralised basis shortly after the Early Termination Date, together with the expert evidence.

249. There were two relevant sets of valuations for collateralised replacement transactions obtained by the Defendants from Mediobanca in the Information Memorandum of 22 September 2008 and from Goldman Sachs in the emails dated 19 and 23 September 2008. In each case the valuations were by reference to the opening of the markets on 15 September 2008 and in each case resulted in an amount payable by the Defendants to their putative counterparties, being €28.22 million (Mediobanca) and €17.46 million (Goldman Sachs). The two valuations were averaged by the Defendants to produce a "without prejudice and informal" claim of €22.84 million against LBF on 25 September 2008.

250. These valuations were obtained on a collateralised basis shortly after, and by reference to, the Early Termination Date. If such valuations had been used as the basis for a determination of Loss, it would have been irrelevant whether or not the Defendants actually intended to enter into collateralised replacement transactions or not. Moreover, at this very early stage in events, although Mr. Losada was plainly eager to assist the Defendants, I do not consider that there is any evidence to support a conclusion that he was doing anything other than providing the Defendants with a genuine assessment of the value of the terminated Transactions. In that regard it is also notable that Goldman Sachs – whom it is not suggested were in any way seeking to curry favour with the Defendants or provide unduly favourable valuations – provided a valuation that was not dissimilar to Mediobanca's.

251. The expert evidence from Mr. Downey and Dr. Gandhi also agreed that the general approach and many of the parameters used by Mediobanca in its valuations and as set out in its Information Memorandum were reasonable. They both agreed, for example, that at least as at 15 September 2008 the discount of 7% which Mediobanca had applied to the price of SAP shares on account of the effect on the share price of the placing of a "delta hedge" by the counterparty to a replacement transaction (i.e. shorting SAP shares to hedge its position) was reasonable. And although Mr. Downey had expressed doubts in his reports, it also became common ground between the parties that the Defendants were entitled to receive a "rebate" from LBF under the VFP if the price of the SAP shares fell below the "down and in" barriers triggering LBF's right to exercise the put option. That rebate was to be calculated by multiplying the number of shares covered by the Variable Forward Purchases by the difference between the put strike price and the barrier in those transactions.

252. There remained, however, some points of disagreement. These included, in particular, the question of whether the valuation should have been performed by reference to the closing price of SAP shares on 15 September 2008 rather than the opening price on that date (Mediobanca and Goldman Sachs both adopting the latter approach): and secondly whether Mediobanca was correct to price a replacement transaction on the basis that the likely cost to it of borrowing SAP shares to create the delta hedge would be 65bps, rather than the 45bps which LBF had agreed to bear in the original Transactions.

253. The experts provided a variety of calculations for comparison to those of Mediobanca and Goldman Sachs. The results illustrated how sensitive the Loss Calculation would have been to the assumed inputs. By way of illustration, if a borrow cost to the counterparty of 45bps was used rather than 65bps, and if the SAP share price had been determined at the close of the market on 15 September 2008 rather than at the opening, the experts calculated that the Defendants would have been paid a total of €41.56 million (Mr. Downey) or €67.92 million (Dr. Gandhi) by a counterparty to enter into collateralised replacement transactions. That would have resulted in a significant payment being required to be made by the Defendants to LBF on close-out, rather than the other way around.

254. Mr. Downey's evidence demonstrated that the factor having by far the greatest effect on the various valuations was the question of whether the valuation should have been performed by reference to the price of the SAP shares at the opening or the closing of the market on 15 September 2008. The difference in borrow cost had far less effect.

Opening or closing SAP prices

255. Neither Mr. Kammerlander nor Mr. Losada were pressed upon why the Mediobanca valuation had been by reference to the opening rather than the closing of business on 15 September 2008. What is, of course, readily apparent, is that the opening price on 15 September 2008 was closer in time to the Early Termination Event on that day. Mr. Downey accepted in cross-examination that it would be appropriate to use the opening price as the starting point for a replacement transaction "if you think you can execute at that time".

256. I also note that although Mr. Gupta of LBF used the "market assumptions" as at the close on 12 September 2008 as the basis for his "first cut" valuation of the positions in LBF's books on 26 September 2008, this was stated to be because of the problems experienced with Lehman's books and records on Monday 15 September 2008. It is, moreover, clear from his internal email dated 25 September 2008 that Mr. Gupta understood that the Defendants were using valuations by reference to the opening on Monday 15 September 2008. Although there was a significant "valuation gap" between the parties, there is no evidence that anyone at LBF voiced any specific objection to the Defendants' use of valuations based upon the opening prices on 15 September 2008.

257. However, Mr. Downey's evidence was that valuing derivatives by reference to the closing prices is conventional in the market, in part because relevant data (e.g. implied volatilities) is not available as at the opening of the markets and that a consistent approach should be used throughout a valuation. Mr. Downey was also of the opinion that the pricing of a replacement transaction would assume that the counterparty would set its delta hedge by way of a block transaction rather than by a "dribble out" over a period of weeks. His evidence was that such block transactions are almost always executed after the market has closed because of the need to minimise an adverse effect upon the market and are based upon a discount to the closing price. Accordingly, he suggested in his report that it would be inconsistent to value a derivative using the opening price and a block trade discount.

258. Dr. Gandhi was of a different opinion. He accepted that block trades are normally executed after the close of the market, that data as to some parameters are not available other than at the market close, and that valuations for accounting purposes are generally

provided using the market close. However, he expressed the view that if a client wished to have a quotation or an indicative valuation for a proposed trade, a bank would normally provide that intra-day using parameters that it could obtain from a variety of sources. By inference, Dr. Gandhi did not consider that the Mediobanca or Goldman Sachs valuations using the opening price of SAP shares were inappropriate or unreasonable if it were otherwise correct to value replacement transactions on 15 September 2008.

259. In the Joint Report of the Experts, Mr. Downey expressed the opinion that use of the closing price on 15 September 2008 was "most appropriate" for the reasons which he had given, and the Joint Report continued,

> "[Mr. Downey] confirms that in practice banks may use opening or intraday prices to produce live valuations [sic] for client, but in the case of calculating Loss, the most certain and consistent data point is the closing price."

260. Cross-examination did not result in either expert moving materially from their respective positions.

Borrow costs

261. As to the borrow cost, under the terms of the original Transactions, LBF had the right to pass any borrow cost in excess of 45bps and up to 150 bps on to the Defendants by activating a so-called "Increased Borrow Cost" mechanism. In his evidence, Mr. Losada accepted that the use by Mediobanca of a borrow cost of 65 bps rather than 45bps was not a precise replication of the terminated Transactions, but he explained that this was what the Mediobanca trading team who were looking at the issue had told him to quote for a replacement transaction. It is unclear what borrow cost Goldman Sachs used in its valuation: its valuation emails simply state that the valuations were based upon the information in the KT Data Sheet. That document did not, however, contain details of the Increased Borrow Cost mechanism to pass any costs above 45 bps to the Defendants.

262. Mr. Downey was of the opinion that an appropriate borrow cost for a large transaction in a liquid stock such as SAP would have been 45 bps. He indicated that given that the borrow cost was supposed to be the average over the lifetime of the transactions, it would not have been foreseen in September 2008 that the borrow cost would have been consistently any higher than this over the lifetime of the transactions. His opinion was, therefore, that the higher borrow cost of 65 bps could not be justified. In cross-examination, he accepted, however, that a bank might seek to increase the borrow cost to obtain a higher profit on a given transaction.

263. Dr. Gandhi's evidence was that given the rise in credit spreads at the time of the Lehman collapse it was not obvious in 2008 that borrow costs would not remain consistently high, and that 65 bps was a reasonable figure for Mediobanca to have used. He also considered that it was reasonable for the Defendants to have used such a valuation based upon such a figure if it was what was available at the time. Dr. Gandhi accepted, however, that a bank might have been willing to accept less money for a transaction on the terms of the original Transactions under which the borrow costs over 45bps could have been passed on to the Defendants.

Analysis

264. The question that I have to address is what Loss determination would have been arrived at by the Defendants, acting reasonably and in good faith, in accordance with the view I have taken as to the proper interpretation of the Loss definition As I have indicated, I consider that such determination should have been based upon quotations or valuations for collateralised replacement transactions as of a date as soon as reasonably practicable after the Early Termination Date. In my judgment, the Mediobanca and Goldman Sachs valuations both fulfilled those requirements.

265. On the evidence, the use of the opening prices as opposed to the closing prices for SAP shares on 15 September 2008 can be justified as being closest in time to the Early Termination Date, and the objection from Mr. Downey to the use of opening prices was ultimately couched in terms of what might be the "most certain and consistent data point", rather than being an objection in absolute terms. It also does not appear that anyone at Mediobanca, Goldman Sachs or LBF considered it inappropriate for the trades to be valued using opening prices.

266. As such, the use of opening prices, rather than closing prices, seems to me not to reflect any fundamental error in the valuations obtained from Mediobanca and Goldman Sachs, but to be a difference in methodology. For the reasons that I have explained above, I believe that I should accept that such an approach would be within the scope of the discretion given to a determining party, as discussed in the authorities such as Intel.

267. So far as the borrow costs are concerned, it would appear that Mediobanca used a borrow cost of 65bps that did not precisely reflect the terms of the terminated Transactions in the sense that it did not reflect the ability of LBF to put Increased Borrow Costs on to the Defendants. It is unclear what borrow cost Goldman Sachs used.

268. Even if the operation of the Increased Borrow Costs mechanism for dealing with borrow costs over 45 bps might mean that the valuation for a replacement transaction would be lower, such additional costs placed upon the determining party might arguably be capable of inclusion as part of that party's "total loss *and costs*" under the Loss definition. But in any event, applying the approach of David Richards J in Enasarco, it would seem that there can be some variations between the terms of the replacement transactions and the terminated transactions without the Loss determination being invalidated, provided that such differences would not have had a significant impact on the price.

269. Applying this approach, given what I was told about the possible alternative approaches to the prediction of future borrow costs, and the relatively small difference that this element might make to the overall valuation, I am not persuaded that there was any, or any significant, error in the approach of either Mediobanca or Goldman Sachs in this regard. I would therefore not be inclined to disregard either valuation on this basis.

Could the Defendants favour their own interests?

270. As I have indicated above, there was a dispute between the parties as to whether, as a matter of law, the Non-defaulting Party could, under the Loss definition, have regard

to its own interests in making a determination of Loss based upon a number of alternative valuations.

271. Put shortly, Mr. Dicker suggested that the judgment of Rix LJ in Socimer was authority for the proposition that in exercising a discretion the Non-defaulting Party could do precisely that. If correct, that would mean that the Defendants would have been entitled to make a determination on the basis of the Mediobanca valuation on the basis that it would have resulted in a larger payment to it by LBF than the valuation by Goldman Sachs. On the other hand, Mr. Wolfson contended that the decision of the Privy Council in Lion Nathan was authority for the proposition that when a contract required a profit forecast to be made "in good faith", the forecaster was required to make a "bona fide estimate without regard to whether it would have produced a higher or lower figure".

272. On the facts of the instant case I do not think that I need to resolve this question, because it seems clear to me that if the Defendants had made their Loss determination on the basis of the valuations from Mediobanca and Goldman Sachs, they could properly have adopted the same course that Mr. Kammerlander in fact did in the "without prejudice" informal calculation which he presented to LBF on 25 September 2008 – i.e. he split (averaged) the difference.

273. Accordingly, I conclude that if the Defendants had determined their Loss in accordance with the true meaning of the Master Agreements, they would have arrived at an aggregate figure of €22.84 million before taking into account the Independent Amount.

Conclusion

274. In conclusion, I find that the Defendants' Loss Calculation was not in accordance with the close-out provisions of the 1992 ISDA Master Agreement as incorporated into the Transactions, and that it was not binding upon LBF. I also find that if the Defendants had determined their Loss in accordance with the contracts, they would have arrived at an aggregate figure of €22.84 million, before taking account of the Independent Amount, leading to a net figure of minus €77.16 million.

275. I shall hear submissions as to consequential matters and an order to reflect the terms of this judgment on a date to be fixed. I should also express my thanks to all counsel and solicitors for the high quality of their written and oral submissions, together with my sincere apologies for the delay in production of this judgment.