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Lehman Brothers International (Europe) (In Administration) – Two Recent Judgments

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WATERFALL IIC JUDGMENT (ISDA MASTER AGREEMENT ISSUES)[1]

Last week, the High Court ruled on the meaning of "Default Rate" in the 1992 and 2002 ISDA Master Agreements (together, the "**ISDA Master Agreements**"). Whilst the decision addresses a multitude of issues, perhaps the most important take-away is the court's determination that the Default Rate is intended only to compensate a non-defaulting counterparty for the cost of raising funds by borrowing the unpaid amount and only for the period for which the amount was unpaid, and not to cover any other costs or losses that the counterparty may have suffered (as further explained below).

This issue is of significance to any party to the ISDA Master Agreements with a counter party that enters insolvency proceeding or otherwise defaults in paying the close-out sum on time. Surprisingly, given the size of the ISDA market, no decision had previously been made on this issue. The decision is one of a series of judgments in the Lehman Brothers International (Europe) (**LBIE**) administration.

The judgments arise out of the Joint Administrators applications for directions on a number of questions from the court as to the proper distribution of the approximately £7-8 billion surplus funds following payment of all provable claims in 2014 and after earlier determinations that, following payment of provable claims, surplus proceeds should be used sequentially to pay "statutory interest" (as provided under the Insolvency Rules (**IR**) under the Insolvency Act 1986 (UK)), then non-provable claims, then subordinated claims and finally shareholders. The parties to the cases included certain senior creditors of LBIE (the "**Senior Creditor Group**" or **SCG**) and subordinated creditors.[2]

Here are some of the more interesting points decided in the case.

Quantification of interest under the ISDA Master Agreements; meaning of "Default Rate"

Under the ISDA Master Agreements, interest due from LBIE as the defaulting party on close-out amounts is payable at the "Default Rate". Thus, since 2008, when LBIE entered administration, the question on creditors' minds has been the correct method of calculating this amount. In the context of LBIE's administration, the question is also relevant in the context of whether the calculation can exceed the "base rate" of interest as provided in the Judgments Act rate of interest (8% since the date of LBIE's administration) since interest on provable claims is payable under the IR [IR 2.88(9)] at the higher of the Judgments Act rate of interest or "*the rate applicable to the debt apart from the administration*". In the context of the ISDA Master Agreements, the "rate applicable to the debt apart from administration" is the "Default Rate" being "*a rate per annum equal to the cost*

[1] Lomas and others v Burlington Loan Management Ltd and others [2016] EWHC 2417 (Ch)] ("**Waterfall IIC**")

[2] MoFo represented one of the senior creditors.

(without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum". (The ISDA Master Agreements further provide that is to be calculated on a compounding basis). Given the size of the ISDA claims against LBIE, the question is significant in terms of the distribution of the surplus.

"*relevant payee"*

This phrase is relevant because (as can be seen from the definition of Default Rate), it is the "*relevant payee's*" rate that is in question. Claims against LBIE had an active secondary market and, depending on whose rate is being calculated, the Default Rate may differ significantly. Thus the Joint Administrators queried whether the "relevant payee" is LBIE's original counterparty to the ISDA Master Agreement or the subsequent holder of the claim. The court held that the proper construction was the original counterparty, notwithstanding that the ISDA Master Agreements permitted assignment of the close out amount.

"*cost … if it were to fund or of funding the relevant amount*"

The principal question regarding this phrase that the Joint Administrators asked for direction on was whether the phrase is referable to a "borrowing" by the relevant payee of the close-out amount or whether it can include other methods of funding which may be more expensive than borrowing (such as the cost of raising equity to fund the amount). The court held that it is confined to a borrowing of the relevant amount and that does not include any equity components.

In arriving at this construction, the judge focused on the fact that the Default Rate requires an interest rate calculation to be made. He seemed to conclude from this, that so too do the component parts (being the "cost to fund or of funding the relevant amount") of the Default Rate. Given this reasoning, the court determined that the phrase must have been contemplating borrowing rather than the cost of raising equity: "*Interest is payment by time for the use of money…. The obligation is in the nature of a debt established by the transaction under which the use of the money is provided. That obligation is plainly a cost, equal to the rate of interest charged… A share has very different characteristics*."

A number of subsidiary questions followed and the answer to most of them can be found in the following principle explained by the judge that the ""*cost" is the price which the relevant payee paid, or would have to pay, to a counterparty to a transaction to borrow an equivalent sum, taking into account all relevant considerations. That leaves a broad margin, confined by certification, but which is tied to a borrowing transaction (actual or hypothetical) rather than the activities of the relevant payee as a whole*".

Thus, the Court confirmed that:

- The "cost of funding" should be assessed by reference to all of the relevant payee's unencumbered assets; not any narrower sub-set (such as its defaulted claim against LBIE),

- The "cost" will only be incurred where both the payment obligation and the amount of that obligation are compulsory and not discretionary, and

- A party's cost of funding need not necessarily be the lowest achievable rate but it must not exceed that which the payee knows is or could be available to it under the circumstances.

"as certified by it…"

The Default Rate provides that the "cost of funding" is to be certified by the non-defaulting party. The issue therefore is whether (and under what circumstances), its certification may be challenged.

In the end, the court's task on this particular question was made somewhat easier after the parties agreed that a certification is conclusive except in limited circumstances, including (a) where a certificate is made irrationally (i.e. where it is arbitrary, capricious, perverse or reflects a decision so unreasonable that no reasonable person exercising the relevant discretion could have reached it); and (b) where it is made otherwise than in good faith.

New York law ISDA Master Agreement

The Court held that the issues above would have been determined in the same way if New York law governed the ISDA Master Agreements.

German Master Agreement

The Joint Administrators also asked for direction on similar issues arising in relation to the German law master agreement (**GMA**); specifically, whether s.288(4) of the German Civil Code, which provides a claim for "further damage" for a default in payment, could be regarded as being a "*rate applicable to the debt apart from the administration*" for the purposes of IR2.88(9). The court rejected this and determined that a claim under s.288(4) was in the nature of a damages claim to be pleaded, proved and assessed by the court. Therefore the maximum interest rate capable of being claimed for loss under the GMA is the 8% Judgment Act rate.

A "supplemental issue" to *Waterfall IIA* also arose for consideration: i.e.

"*Whether, and in what circumstances, the words "the rate applicable to the debt apart from the administration" in rule 2.88(9) of the Insolvency Rules (1986) include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable due to action taken by the creditor after the Date of Administration*".

The court held that if a creditor's contractual rights in existence (whether actual or contingent) at the date of LBIE's administration include a right to a particular rate of interest (whether fixed, floating or formulaic) then when that right is exercised or vindicated, that is the rate applicable for the purposes of the rule. The court further held that this is the case whether or not the contractual right to a close-out sum and a particular rate of interest can be described as having "accrued" prior to or after the date of LBIE's administration. The court held that such a right conferred by contract, even if its exercise and quantification post-dates the date of LBIE's administration, is in existence at that date, whether as a contingent or future right.

The decision will be a relief to most counterparties to ISDA agreements where close-out occurred sometime after LBIE entered administration.

SUPPLEMENTAL ISSUES JUDGMENT[3]

The Supplemental Issues judgment handed down at the end of August 2016 concerned the proper calculation of interest payable on proved debts (statutory interest) and of interest payable on non-provable claims. The issues

[3] Lomas and others v Burlington Loan Management Ltd and others [2016] EWHC 2131 (Ch) ("**Supplemental Issues Judgment**")

arose out of matters decided in *Waterfall IIA* and *IIB*. Below we look at some of the issues decided in the judgment.

Interest on currency conversion claims relating to future/contingent debts (issue 1b)

This issue concerned whether interest on a contingent non-provable debt is payable if the contingency depends on the action of the non-defaulting party, and such action was only taken after the date of LBIE's administration. Thus, this question was similar to question 1a in that the question focuses on contingencies occurring after the date of LBIE's administration, but in respect of interest on non-provable debts.

In a decision that will be a relief to creditors that have a currency conversion claim (**CCC**)[4] and that closed out their agreement after the date of LBIE's administration, the court held that interest will be payable on such a claim provided such event or contingency actually occurred in accordance with the terms of the contract (whether or not it occurs by action of the creditor). The issue is particularly relevant in the case of claims under an ISDA Master Agreement, where service of a close-out notice may be required to give rise to an obligation to pay and close-out notices were often served after the Date of Administration.

The court rejected an argument that interest on a CCC will only be payable where the contingency or event occurs without the intervention of the creditor (in particular rejecting an argument that a creditor "cannot improve its position" after the Date of Administration by taking some steps in an effort to gain a right to the payment of interest that was not payable on the Date of Administration).

Contractual interest on a provable debt starting to run after the date of LBIE's administration: timing of calculation of "rate applicable to the debt apart from the Administration"

This issue arises in the context of IR2.88(9) which, as noted above, provides that the rate of interest payable under IR2.88 is whichever is the greater of the Judgments Act rate and the "rate applicable to the debt apart from the administration". The court had previously decided that the comparison required by Rule 2.88(9) was between the total amount of interest that would be payable under the rules based on each method of calculation (rather than only on the numerical rates themselves). The court had also previously held that interest under the rules was payable in respect of future and contingent debts from the Date of Administration, rather than from the date they became payable under the contract. The question therefore needing to be answered was whether, the "rate applicable" starts to run from the date of LBIE's administration or the later date on which the interest starts to run in accordance with the contract. If it is the latter, then only the Judgments Act rate at 8% (and not a potentially higher contractual rate) could accrue for the period from LBIE's administration until the date on which interest started to run under the contract.

In holding that it was the latter, the court reasoned that, if no interest is contractually payable on a contingent debt until the contingency occurs, then interest at the contractual rate for any earlier period simply cannot be regarded as interest at "*the rate applicable apart from the administration*". During that period, there was no interest payable on the debt apart from the administration. The judge, however, noted that this decision does not leave the

[4] A CCC arises in circumstances where a creditor of LBIE was party to a contract in a currency other than Sterling. English insolvency law requires that creditors wishing to prove their claims convert them into Sterling on the date of LBIE's administration and thus, if Sterling depreciates between the date of administration and the date on which the creditor is actually paid its provable claim, the creditor will suffer a loss in the amount it has contracted to receive. The English court has held that such a loss can be claimed in the administration as a non-provable claim.

creditor uncompensated for that period because it will be entitled to interest at the Judgments Act rate prevailing on the date of LBIE's administration. The purpose of providing the alternative interest at the "rate applicable apart from the administration" is to ensure that the creditor receives what it would have received if there had been no administration, if that would be more than interest at the Judgments Act rate. This was not designed to enable the creditor to do better than it would have done if there had not been an administration.

The court further held that, under Rule 2.88(9), when determining the greater of the rate specified in section 17 of the Judgments Act 1838 and the rate applicable to the debt apart from the administration, the periods before and after the date on which contractual interest starts to run should be taken together, not separately.

Whether, and if so to what extent, a non-provable claim to interest on a CCC should be reduced by interest received by the creditor pursuant to Rule 2.88 on its proved debt

The background to this issue is the decision in *Waterfall IIA* that, if under the contract with LBIE the creditor was entitled to interest on its foreign currency contract, then the creditor was also entitled to include such interest as part of its non-provable claim. The subordinated creditors argued that such claim for interest should be reduced by statutory interest received by the creditor on its proved debt, if and to the extent that the total interest, both statutory on the proved debt and contractual on the non-provable claim, exceeds the contractual interest that the creditor would have been entitled to receive on its total foreign currency debt. The argument posited that, although the CCC is regarded as a distinct claim to the creditor's proved claim, there is in fact only one debt owed to the creditor and, therefore, any interest for the period after LBIE's administration, whether statutory or contractual, is payable in respect of the same debt. Since statutory interest and contractual interest are payable in respect of the same debt and for the same period, it would be unjust if the creditor were to receive more interest than it would have been entitled to receive under its contract.

But the court disagreed and ruled in favour of the SCG that a non-provable claim to interest on a CCC is not to be reduced by interest paid to the creditor under the Rules. In arriving at this decision, the court reasoned that interest under the IR is payable on proved debts only. The proved debt is the Sterling sum only (not the CCC). Interest on the CCC is payable outside the statutory scheme. Therefore, the creditor is entitled to the full amount of contractual interest on that part of the debt.

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