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The High Court hands down judgment in Part C of the Lehman "Waterfall II" application

Introduction

Mr Justice Hildyard ("**Hildyard J**") today handed down his judgment in respect of Part C of what has become known as the "Waterfall II Application".

The Waterfall II Application was made by the joint administrators of Lehman Brothers International (Europe) ("**LBIE**"), seeking directions in relation to a number of issues concerning the distribution of the surplus in LBIE's administration. The significance of these issues arises from the substantial surplus in the LBIE estate, which the joint administrators estimate to be in the region of £7 billion, after paying or providing for all the debts proved in the administration of LBIE.

Mr Justice David Richards handed down his judgment in respect of certain of the issues in the Application (grouped together in Parts A and B) on 31 July 2015. A copy of our note on these judgments can be found here. Hildyard J has since taken over as designated judge for LBIE matters following Richards J's move to the Court of Appeal.

Part C of the Application concerns the construction of standard form interest provisions contained in ISDA Master Agreements and certain other financial contracts entered into by LBIE prior to its administration. The relevance of these provisions stems from Rule 2.88 of the Insolvency Rules 1986 (the "**Rules**") which, in the form applicable to the administration of LBIE, provides that any surplus remaining after payment of the debts proved in the LBIE administration should be used to pay statutory interest in respect of the periods "*during which they* [the proved debts] *have been outstanding since the date of administration*". Such interest is payable at the higher of (a) the rate provided by section 17 of the Judgments Act 1838 (which has been 8% simple per annum throughout the period of the LBIE administration) (the "**Judgments Act Rate**"); and (b) the "*rate applicable to the debt apart from the administration*". In the case of debts existing under the ISDA Master Agreements, the "*rate applicable to the debt apart from the administration*" is determined by the interest provisions contained in those agreements. Any broad interpretation by the Court of such provisions may allow creditors to make claims for statutory interest at rates in excess of the Judgments Act Rate, thereby achieving a higher rate of return on those claims than would otherwise be so. Such claims could in turn affect how the surplus is

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distributed in light of the priority given to statutory interest claims, as determined by Richards J.

Interest accruing under the 1992 and 2002 ISDA Master Agreements is paid at the “Default Rate” which is defined as “*a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum*”. The Default Rate may apply both in circumstances where a party is late in paying a close-out amount due under an ISDA and also on any defaulted payments. The Court’s judgment in respect of the Part C issues is significant for wider market users of ISDA Master Agreements as it provides important guidance on the meaning of “cost of funding” as used in the Default Rate definition. Prior to this judgment, there was very little guidance on this point: it is not addressed in either the 1992 or 2002 ISDA Master Agreement User’s Guides or in any other English law or New York law court decisions.

Part C of the Application also considered creditors’ entitlements to seek interest on the close-out amount under the German Master Agreement (“**GMA**”) following their automatic termination by reason or in consequence of the LBIE administration.

The Part C judgment – the ISDA Master Agreement issues

The Court was asked to determine the following issues in respect of the ISDA Master Agreements:

Who is the relevant payee?

The Court was asked to determine whether the Default Rate should be calculated by reference to LBIE’s original contractual counterparty’s cost of funding or by reference to a third party to whom that original counterparty has transferred its rights under section 7 of the ISDA Master Agreement.

LBIE debt, including ISDA claims, has been heavily traded following LBIE’s entry into administration and this issue is therefore of significant importance from both financial and practical perspectives.

The parties agreed that for any period prior to assignment by LBIE’s original contractual counterparty, it is that party’s cost of funding which should be used for the purposes of calculating the Default Rate. However, the parties disagreed as to the identity of the “relevant payee” in the period after any such assignment. One respondent to the Application argued that it is always the original assignor (regardless of the number of assignments) and another contested that the “relevant payee” means the entity entitled to receive payment from time to time (i.e. the current assignee).

Hildyard J concluded that, for reasons based primarily on contractual interpretation and general principles of assignment, the "relevant payee" will always be LBIE's original contractual counterparty and the term does not extend to any third party to whom LBIE's counterparty has transferred its interest in any amount payable to it under section 6(e) of the ISDA Master Agreement.

What is "cost of funding"?

The Court was asked to decide the meaning of "cost of funding", with the main debate being whether it was limited to a creditor's cost of borrowing or whether it should be interpreted more broadly to include all types of funding, including equity funding.

This was arguably the most significant financial issue in Part C because of its potential impact on the amount of the surplus to be applied to statutory interest claims. On the one hand, a determination that "cost of funding" was limited to borrowing would make it less likely that interest in excess of the Judgments Act Rate would be certified by creditors, in turn reducing the amount of the surplus to be applied to claims for statutory interest. On the other hand, if parties are permitted to include all types of funding in their certifications, claims would be more likely to exceed the Judgments Act Rate and potentially significantly more of the surplus would be required to meet such claims.

The Court held that, in the context of any Default Rate certification, a party's "cost of funding" means its cost of borrowing the relevant amount under a loan transaction. It does not extend to costs associated with any wider types of funding such as equity funding. The Judge further noted that "cost" means the "*transactional cost, that is the price which is required to be paid in return for the funding for the period it is required*". He explained that such cost is effectively the rate of interest which was incurred or would have been incurred by the relevant payee for borrowing the close-out sum (or other defaulted payments) over the period during which it remained outstanding, at a daily compounding rate. The Judge made a number of further determinations as to the scope of the "cost of funding" language, including the following:

> the correct interpretation of the "cost of funding" language excludes other costs or expenses that cannot properly be described as interest, including, for example, any opportunity costs, third party fees associated with the funding transaction (other than fees payable to a lender which form part of the price of borrowing) or wider financial detriment arguably arising from the funding transaction;

> the relevant cost is the cost of the transaction (whether actual or hypothetical) to fund the relevant amount only, rather than any cost associated with funding the relevant payee's enterprise or other assets;

> in line with the nature of interest payments in loan transactions, a "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 to be or could be available to it in the circumstances.

How should any "cost of borrowing" be assessed?

Although the parties were in agreement that any "cost of funding" can include a creditor's borrowing cost, there remained disagreement as to the parameters of any such cost. The Court was asked to determine the sub-issues set out below:

Whether such borrowing could be assumed to have recourse to the relevant payee's unencumbered assets or only to the claim against LBIE:

The parties broadly agreed that borrowing should be assumed to have recourse to the relevant payee's unencumbered assets and not solely to its claim against LBIE although one party argued that exceptional circumstances may make it rational and in good faith to have recourse solely to the LBIE claim.

The Court confirmed that there is no basis for restricting the assets to which any borrowing should have recourse and that such borrowing should therefore be assumed to have recourse to the relevant payee's unencumbered assets.

Where borrowing is assumed to have recourse to unencumbered assets, should its cost reflect only the incremental cost of incurring additional debt against its existing asset base or should it include the weighted average cost of all of its borrowings:

It was agreed that a party's cost of borrowing should include the incremental cost of incurring the additional debt. One respondent further argued that such cost could be calculated by reference to its weighted average cost of borrowing where such a figure is rationally and in good faith determined to be a proxy for the incremental cost. The same respondent also contended that the cost can be calculated by reference to the relevant payee's weighted average cost of capital where it determines that it would have used a mixture of debt and equity to fund the relevant amount.

Hildyard J rejected this further argument, and in line with his determination as to the limited scope of the "cost of funding" language, determined that the cost should reflect only the incremental cost of incurring the additional debt against its existing asset base.

Whether the cost should include any impact on the entity's cost of equity which is attributable to such borrowing:

The respondents disagreed on this sub-issue. It was argued on one side that additional borrowing will increase the entity's leverage and therefore, any resultant impact on the entity's remaining borrowing and its cost of equity should be taken into account. In contrast, another respondent argued that only the cost of the replacement transaction itself can be taken into account.

Again, in line with his general approach, Hildyard J determined that a party's "cost" to be certified cannot include any impact on the relevant payee's overall cost of borrowing or any increase in the cost of its equity capital.

Whether the cost should be calculated on the basis of (i) overnight funding; (ii) term funding to match the duration of the claim to be funded; or (iii) funding for some other duration.

The respondents agreed that, depending on the circumstances, it may be rational and in good faith for the relevant payee to certify its cost of borrowing by reference to any of these funding durations.

The Judge agreed with this position notwithstanding his comment that, as a point of fact in the circumstances of the longevity of LBIE's administration, he considered it almost inconceivable that any relevant payee would claim that term borrowing was or would have been raised.

Should cost of funding be calculated by reference to a particular date or on a fluctuating basis?

The Judge agreed with the parties' common position that, in determining how it would have funded the claim (for example, the type and duration of borrowing it would have used), the relevant payee is not entitled to use hindsight. Such a determination, which under the ISDA Master Agreements' express terms, must be rational and in good faith, must be made in light only of the circumstances known to that party as at the time when the need to obtain funding arose, therefore ignoring subsequent events. For example, when determining how it would have funded the relevant amount, the relevant payee may not identify the highest rate of interest observed during the period for which the relevant amount remained outstanding and certify on the basis that it would have used short term funding up until that point and then switched to long term funding at that highest observed rate so as to maximise the value of its Default Rate certification.

On the remaining contentious point on this issue, the Judge rejected the argument favoured by one party that the relevant payee must certify its cost of funding by reference to the date on which it seeks payment of such interest only, using hindsight to calculate the cost by reference to relevant market conditions over the period between then and the termination date.

The Judge considered such an approach to be too prescriptive and instead determined that a relevant payee's cost of funding could be calculated either by reference to a particular date or on a fluctuating basis, taking into account relevant market conditions and any other relevant facts or circumstances known to the relevant payee from time to time. Any such certification must be rational and in good faith.

In what circumstances, if any, can a certification be challenged?

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.

In light of various arguments raised by the parties, the Judge further determined that a certification may also be challenged (a) on the ground of manifest numerical or mathematical error; and (b) where the certified cost does not fall within the scope of the expression "*cost … if it were to fund or of funding the relevant amount*", as construed by the Court.

Are any of the above issues answered differently if the ISDA Master Agreement is governed by New York law rather than English law?

The parties all submitted that each of the issues considered by the Court in respect of the ISDA Master Agreements should be answered in the same way under both English and New York law. The Court confirmed this position in its judgment, having considered the respondents' written expert evidence on contractual interpretation under New York law.

Other agreed issues

The Court was originally asked to consider a number of issues which were subsequently agreed between the parties before trial. The parties agreed the following positions, all of which were supported by the Court:

> should the Defaulting Party seek to challenge a certification on any of the bases set out above, it will bear the burden of proving, on the balance of probabilities, that the relevant payee's certification has not met the relevant requirements;

> anyone expressly or impliedly authorised by the relevant payee can certify on its behalf and that the existence of such authorisation is a question of fact to be determined on a case by case basis. In circumstances where the relevant payee is incapable of certification, the court will determine what decision it would have made;

> a party's right under section 7(b) of the 1992 ISDA Master Agreement to transfer any amount payable to it from a Defaulting Party without its written consent includes any amount payable to it under section 6(e); and

> the nature of a counterparty does not impact the answers to the cost of funding issues considered in the Waterfall II Application.

The Part C Judgment - the German Master Agreement issues

Can GMA creditors rely on provisions of the German Civil Code to claim further damages for the delayed payment of a close-out sum?

Unlike the 1992 and 2002 ISDA Master Agreements, the GMA does not provide for the payment of interest on the close-out sum after termination. Instead, one of the parties to the Application contended that GMA creditors could, pursuant to certain provisions of the German Civil Code (the “**BGB**”), claim “*further damages*” for delayed payment of the close-out amount and that such “*further damages*” constitute “*a rate applicable to the debt apart from the administration*” for the purpose of Rule 2.88(9).

The Court concluded that a creditor cannot rely on the interest and further damages provisions under the BGB to make a claim against LBIE for interest in respect of the delayed payment of the close-out amount. It further concluded that even if such a claim did arise, it would not constitute a “*rate applicable to the debt apart from the administration*” for the purpose of Rule 2.88(9) as any such right cannot be equated to a right existing as at the date of administration.

If such a claim exists, how is the relevant rate to be determined?

This issue does not in fact arise on the basis of the Judge’s conclusion that no such claim for further damages exists. For completeness, however, Hildyard J concluded that if a claim for further damages can be included as part of the “*rate applicable to the debt apart from the administration*” for the purposes of Rule 2.88(9), it is only the claim of the assignor, and not that of the assignee, that can fall within the scope of Rule 2.88(9).

Supplemental Issue 1A

Hildyard J was also asked to determine a further issue arising in part out of Richard J’s judgment on an Issue in Part A of the Application. Hildyard J held that the words “*the rate applicable to the debt apart from the administration*” in Rule 2.88(9) 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 the commencement of LBIE’s administration. The fact that steps under a contract were taken after the commencement of the administration does not mean the contractual rate cannot be claimed under Rule 2.88(9).

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Conclusion

The issues considered in Part C of the Waterfall application were complex and required the parties to analyse and consider principles of insolvency law alongside those of contractual construction and the provisions of the specific master agreements in question. The judgment of Hildyard J will have a significant impact on creditor recoveries from the LBIE estate and as a result of the intense analysis conducted in preparation for the Part C hearing and the guidance received from the Court, a number of uncertain issues have now been resolved. Moreover, guidance on the correct interpretation of the Default Rate will be of significant interest to all users of swaps. This case has confirmed the principle that the Default Rate under an ISDA Master Agreement is not supposed to give a party scope to claim for all the losses which a failure to pay on time might cause, but only to compensate that party at the rate it would have cost it to borrow the outstanding amount for the period of non-payment, with an uplift of 1%. That rate will be the rate of the original counterparty owed the close-out amount, and not any subsequent assignee(s).

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