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UK Court of Appeal judgment in Lehman Waterfall I appeal

On 14 May 2015, the Court of Appeal (the “**Court**”) in London handed down judgment in the Lehman Brothers International (Europe) (in Administration) (“**LBIE**”) Waterfall I appeal. With the LBIE’s administrators having now paid unsecured creditors in full, the issues on appeal related to the distribution of LBIE’s considerable asset surplus (estimated to be approximately £7 billion).

1. Ranking of subordinated debt

Central to the Court’s considerations was the order of priority in respect of payments, in terms of the creditor waterfall (as established in the Insolvency Act 1986 (the “**Act**”) and *Re Nortel GmbH* [2013 UKSC 52], [2014] AC 209).

With LBIE’s unsecured creditors now repaid in full, the Court considered whether Lehman Brothers Holdings Intermediate 2 Limited (“**LBHI2**”), a significant subordinated creditor of LBIE, should rank before statutory interest and non-provable liabilities for payment. Aside from s. 74 question (discussed at paragraph 4 below), the Court held, based on the construction of the three relevant subordinated loan agreements between LBHI2 (as lender) and LBIE (as borrower), that repayment of the subordinated debt was contingent on, *inter alia*, (i) the repayment of statutory interest; and (ii) payment of any non-provable liabilities, including any Currency Conversion Claims (see below). As such, it follows that this debt would rank beneath (i) and (ii) in the waterfall.

The significance of this decision as a precedent is questionable, given the judicial reliance on the construction of the underlying documents. The subordinated loan agreements were in a form required by the FSA to qualify as Tier 3 regulatory capital, including that repayment of the subordinated debt was contingent on (i) and (ii) above. If an underlying subordinated loan agreement did not to contain these provisions, it is unclear where subordinated debt would rank in the waterfall and as such, for now, the ranking of subordinated debt appears a question of contractual construction.

2. Currency Conversion Claims

Much of LBIE’s debt was originally denominated in US Dollars (“**USD**”) and therefore USD (and other currency) creditors (together the “**Currency Creditors**”) converted their claims to Sterling when submitting their proofs of debt. However, as a result of subsequent currency fluctuations (namely the decline of the £ against the \$), this currency conversion caused Currency Creditors (notably USD creditors) to suffer FX losses of c. £1.3 billion. As such, in respect of the surplus, the Currency Creditors sought repayment of their currency losses as a non-provable liability. The Court upheld the High Court’s position, agreeing that Currency Creditors be paid their losses as a non-provable liability which, as at paragraph 1, will rank above the subordinated debt in the creditor waterfall.

Such losses are calculated as a sum equal to the difference between (i) the amount of the Currency Creditor’s contractual entitlement to payment in the contractual currency, and (ii) the amount received by it in respect of its proved debt against LBIE, converted into the

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contractual currency. Despite disagreement between the judges (Lewison LJ dissented) Moore-Bick and Briggs LJ held that the date of this conversion at point (ii) (above) should be at the date of payment, rather than at the date of submission of the proof of debt, with Briggs LJ arguing that the conversion made to facilitate the submission of the proof of debt should not “*operate as a substantive permanent alteration of the creditor’s contractual rights*” (para. 152).

3. Administration Statutory Interest

This issue centred on whether the right to statutory interest which has accrued during the administration of LBIE is payable, in a subsequent liquidation of LBIE, to creditors who proved in the initial administration. The Court overturned the judgment of the High Court, which had viewed an entitlement to statutory interest as pursuable in a liquidation as an independent non-provable claim. Instead, the Court viewed accrued rights to statutory liquidation as surviving the transition from administration to liquidation, and therefore payable to creditors who proved in the administration.

4. Section 74 Liability for LBIE shareholders as contributories

Pursuant to s. 74 of the Act 1986, LBIE’s shareholders (LBHI2 and Lehman Brothers Limited (“**LBL**”)), are liable to contribute to LBIE’s assets “*any amount sufficient for payment of its debts and liabilities*” (s. 74 (1) of the Act). Agreeing with the High Court, the Court held that “*debts and liabilities*” means “*all the liabilities of the company at all stages of the waterfall*” (para. 121), including statutory interest and non-provable debts. As such, the Court held that LBIE’s administrators are entitled to prove in the insolvencies of LBL and LBHI2 in respect of their liabilities under section 74, with the claim in LBHI2 unlimited, as LBHI2 is a company unlimited by shares meaning their liability to contribute was not limited to the value of the shares they held in LBIE.

Of more significance on the facts (given LBIE’s surplus and that LBHI2 is also in an insolvency process) the Court held that the contributory rule, which prevents a member from recovering anything in a liquidation until it has discharged its liability as contributory, should not be applied here, given distributions to unsecured creditors had been paid in full. The Court confirmed that it would be inequitable to prevent a member from proving in a distributing administration on the basis of a contingent future liability to a call.

Analysis

The Judgment is positive news for the senior creditor group holding senior unsecured debt, but damaging for holders of the subordinated debt facilities. The Court placed subordinated debtors beneath (i) the repayment of statutory interest; and (ii) payment of any non-provable liabilities, including any Currency Conversion Claims, in the waterfall. Given the figures in question (not least the £1.3 billion of non-provable claims for currency losses), the judgment could prove damaging for subordinated creditor recovery.

The case should be read in conjunction with the Waterfall II hearing (currently ongoing), which will determine, *inter alia*, the rate of the Statutory Interest payouts. Given the levels of debt in question and the time passed since the September 2008 administration, the application of

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statutory interest could serve to further damage subordinated creditor recovery. Cadwalader will provide an update on the Waterfall II judgment when it is available.