CADWALADER

Information piece regarding the judgments in the case known as *Waterfall IIC Application* handed down by Hildyard J (neutral citation [2016] EWHC 2417 (Ch) dated 5 October 2016) and judgment relating to HMRC in the same matter (neutral citation [2016] EWHC 2492 (Ch) dated 11 October 2016)

The judgment in the third tranche of issues - concerning the application of statutory interest pursuant to rule 2.88 of the Insolvency Rules 1986 on debts proved in the administration of Lehman Brothers International (Europe) ("**LBIE**") and forming part of what has become known as the "Waterfall II Application" - was handed down recently.

The Waterfall II Application concerns three main groups of issues:

(a) the entitlement of creditors to interest on their debts for periods after the commencement of the administration of LBIE;
(b) the construction and effect of various agreements made since the commencement of the administration between LBIE acting by the Administrators and very significant numbers of its creditors; and
(c) the construction and effect of pre-administration agreements in various standard forms containing (amongst other things) provisions entitling a counterparty of a defaulting party such as LBIE to interest on amounts payable under the relevant agreement(s).

The judgment noted here relates to the issues summarised under (c) above. The purpose of this note is to highlight some of the practical implications for LBIE creditors and generally, for participants in the debt trading market that acquire derivatives claims when determining the interest element of the close-out amount under a derivative contract, namely; (i) what may be included under "cost of funding" and how are those costs to be evidenced; and (ii) when a claim is on-sold, who is the relevant payee whose costs of funds are included in the calculations.

Cost of Funding

"Cost of funding" is a term used in the rate of interest determinations with respect to the close-out amounts due under the ISDA Master Agreement, but it is not term of art with a settled meaning.

Hildyard J found that:

- the cost of funding should be limited to the actual cost of borrowing by the original counterparty to the ISDA Master Agreement or the hypothetical cost of borrowing should the original counterparty have utilised borrowing to fund the sum of debt considered;
- the cost of funding language does not require the payee to be made whole, nor compensated for any opportunity cost;
- the cost of raising equity is not part of the cost of funding, rather, it is a consequential loss that may arise because of general business need or regulatory requirement.

Certification

The findings of Hildyard J were that:

- the cost to the relevant payee - if it were to fund or of funding the relevant amount - is to be certified by reference to the cost which the relevant payee is or would be required to pay in borrowing the relevant amount under a loan transaction, whether an actual cost, where the relevant payee does in fact enter into a loan, or a hypothetical cost, where it does not do so.
- "cost" means the price required to be paid in return for borrowing the funds over the period they are required. The reward for investment by way of a specified (but ultimately discretionary) share in profit is not a relevant "cost of funding": thus, equity funding is not within the cost of funding language.
- the rate must not exceed that which the borrower knows to be or which could be available to it in the circumstances pertaining to its business, having regard to the permitted object of the actual or hypothetical borrowing (to cover the relevant amount).
- a process of certification is to be accepted to preclude challenge otherwise than for the purpose of ensuring that the discretion contractually vested in the certifier is not abused by lack of good faith, or irrationality. Manifest error might not fall within the accepted exceptions to conclusiveness of irrationality and bad faith; but it should be limited to numerical or mathematical error.

Relevant Payee

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

Hildyard J based his reasoning on the need of protection of each party against unknown risks, in particular credit risks, through being forced to face, as counterparty, an unknown entity chosen solely by its original counterparty. I.e., if the rate of interest which a party has to pay upon its default depends upon the credit standing of potentially anyone to whom its counterparty transfers the right to payment (under Section 6(e) of the ISDA Master Agreement), then the defaulted party would be exposed to wholly unknown and unmanageable credit risks. The judge expressed this figuratively to say "the transferee is entitled to the tree planted by the transferor and such fruit as had grown and would grow on it when transferred, and not to fruit of a different variety or quantity which might have grown had the transferee planted the tree"

Takeaways

Assuming that the higher courts do not overturn parts of this judgment, buyers and sellers of derivatives claims would be well advised, when valuing the interest element of those claims:

- to keep good evidence of interest and costs determinations. As Hildyard J put it, the question a court would ask would be: “Let’s see what you say you did, or let’s see what you say you would have done, and let’s assess that.”
- The value of a traded claim should be reflective of the fact that subsequent buyers with higher costs of funding (compared to the original payer) will not be able to recover for interest at that higher rate.