IN THE HIGH COURT OF JUSTICE **No. 7942 of 2008**

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

B E T W E E N

(1) ANTONY VICTOR LOMAS

(2) STEVEN ANTHONY PEARSON

(3) PAUL DAVID COPLEY

(4) RUSSELL DOWNS

(5) JULIAN GUY PARR

(THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION))

Applicants

- and -

(1) BURLINGTON LOAN MANAGEMENT LIMITED

(2) CVI GVF (LUX) MASTER S.A.R.L.

(3) HUTCHINSON INVESTORS, LLC

(4) WENTWORTH SONS SUB-DEBT S.A.R.L.

(5) YORK GLOBAL FINANCE BDH, LLC

(6) GOLDMAN SACHS INTERNATIONAL

Respondents

SUPPLEMENTAL ISSUE 1(a)
SENIOR CREDITOR GROUP'S SUBMISSIONS

A. INTRODUCTION

1. These written submissions are filed on behalf of Burlington Loan Management Limited, CVI GVF (Lux) Master S.a.r.l, and Hutchinson Investors, LLC (collectively, the "Senior Creditor Group").

2. Although the Senior Creditor Group has not been appointed as representatives of different classes of creditors, it is advancing arguments in effect on behalf of unsecured creditors to enable the Administrators to obtain directions and the Administrators are content to act on directions given by the court on this basis.

3. Supplemental Issue 1(a) asks:

> "*Whether, and in what circumstances, the words 'the rate applicable to the debt apart from the administration' in Rule 2.88(9) of the Rules 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 Administration."*

4. This issue is concerned with whether contractual interest rates, in particular the Default Rate accruing on close out sums arising under the 1992 and 2002 ISDA Master Agreements (the "**Master Agreements**")[1], are a "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9).

5. The Senior Creditor Group's position is that such contractual interest rates are a "*rate applicable to the debt apart from the administration"* within the meaning of Rule 2.88(9). This follows both from the terms of relevant provisions in the Master Agreements and the court's determination of Issues 6 – 8 in *Re Lehman Brothers International (Europe) (In administration)* [2015] EWHC 2269 (Ch) ("Waterfall IIA").

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1 The Senior Creditor Group has focussed in this Skeleton Argument on the ISDA Master Agreements, as they are most relevant master agreements in the LBIE administration. However, the same analysis applies to the French Master Agreements. The position in relation to the German Master Agreements is set out in the Senior Creditor Group's Skeleton Argument (GMA) filed in connection with Part C. These submissions do not address interest claims under other agreements (such as, for example, prime brokerage agreements) and are without prejudice to the Senior Creditor Group's rights to advance the arguments set out at paragraphs 21 to 33 of its Part A reply skeleton argument in these proceedings in respect of any agreements.

6. York's contention that, in light of the court's determination of Issue 4 in Waterfall IIA, contractual interest rates accruing on close out sums arising under the Master Agreements are not a "*rate applicable to the debt apart from the administration"* is misconceived. It is based on an incorrect understanding of the judgment of David Richards J in Waterfall IIA and on an incorrect understanding of the effect of that judgment on claims pursuant to the Master Agreements.

7. This Skeleton Argument proceeds on the basis that David Richards J's conclusions in relation to Issue 4 are correct. The SCG are, however, appealing that aspect of his decision, and nothing in this Skeleton Argument is intended to affect that appeal.

B. THE RELEVANT PROVISIONS OF THE MASTER AGREEMENTS

8. Supplemental Issue 1(a) arises in the context of both the 1992 and 2002 Master Agreements. While the provisions governing the determination of amounts due on early termination are different in the 1992 and 2002 Master Agreements, the provisions governing when such sums fall due and when the entitlement to receive interest on them arises, with which the court is no doubt familiar, are materially identical:

   (1) Under Section 6(a) of the Master Agreements, if an Event of Default with respect to a party (the "Defaulting Party") has occurred and is continuing, the other party (the "Non-defaulting Party") may (but is not required to) designate an "Early Termination Date" in respect of all outstanding transactions. Where "Automatic Early Termination" is specified in a Schedule, an Early Termination Date will occur immediately on the occurrence of certain specified Events of Default.

   (2) Events of Default are defined in Section 5 of the Master Agreements. They include "Bankruptcy Events" at Section 5(a)(vii), including where a party seeks or becomes subject to the appointment of an administrator.

(3) Upon the occurrence of an Early Termination Date, all transactions entered into pursuant to the Master Agreement are terminated and no more payments or deliveries in respect of the Terminated Transactions are required to be made. In those circumstances the amount, if any, payable in respect of an Early Termination Date is calculated in accordance with Section 6(e) (Section 6(c)(ii)). Pursuant to Section 6(d)(i) the parties are required to make the calculations contemplated by Section 6(e) "*on or as soon as reasonably practicable following the occurrence of an Early Termination Date"*.

(4) The payment date for sums due on Early Termination is governed by Section 6(d)(ii). Where an Early Termination Date arises as a consequence of an Event of Default, section 6(d)(ii) provides that an amount calculated as being due in respect of any Early Termination Date under Section 6(e) "*will be payable on the date that notice of the amount payable is effective"*.

(5) The Master Agreements provides for interest to accrue on the early termination amount from the Early Termination Date:

(a) Section 6(d)(ii) of the 1992 Master Agreement provides that if an early termination amount is due in respect of an Early Termination Date, that amount "…*will be paid together with*…*interest thereon (before as well as after judgment) in the Termination Currency, from (and including) the relevant Early Termination Date to (but excluding) the date such amount is paid, at the Applicable Rate"*. Where the early termination amount is owed to the Non-defaulting Party, the Applicable Rate is the Termination Rate from the Early Termination Date to the date on which the early termination amount is payable (i.e. upon delivery of a calculation statement) and the Default Rate for the period thereafter.

(b) Section 6(d)(ii) of the 2002 Master Agreement provides that an amount due on early termination is payable "*together with any amount of interest payable pursuant to Section 9(h)(2)(ii)"*. Section 9(h)(2)(ii) provides that if an early termination amount is due in

respect of an Early Termination Date, that amount "*will…be paid together with interest thereon (before as well as after judgment) on that amount in the Termination Currency for the period from (and including) the Early Termination Date to (but excluding) the date the amount is paid, at the Applicable Close-out Rate"*. Where the early termination amount is owed to the Non-defaulting Party, the Applicable Close-out Rate is the Default Rate both for the period from the Early Termination Date to the date on which the early termination amount is payable (i.e. upon delivery of a calculation statement) and for the period thereafter.

9. Accordingly:

(1) Where Automatic Early Termination has been specified: (a) an Early Termination Date arises immediately upon the occurrence of the relevant Event of Default; (b) the early termination amount becomes immediately due; (c) interest immediately starts accruing on the early termination amount payable to the Non-defaulting Party at the Termination Rate (1992 Master Agreement) or the Default Rate (2002 Master Agreement); (d) the early termination amount becomes payable following delivery of a calculation statement under Section 6(d)(i); and (e) interest continues to accrue on the early termination amount at the Default Rate until payment.

(2) Where Automatic Early Termination has not been specified: (a) following an Event of Default, the occurrence of an Early Termination Date is contingent on the Non-defaulting Party designating an Early Termination Date under section 6(a); (b) upon designation of an Early Termination Date, the early termination amount becomes immediately due; (c) upon designation of an Early Termination Date, interest immediately starts accruing on an early termination amount payable to the Non-defaulting Party at the Termination Rate (1992 Master Agreement) or the Default Rate (2002 Master Agreement); (d) the early termination amount becomes payable following delivery of a calculation statement under Section 6(d)(i); and

(e) interest continues to accrue on the early termination amount at the Default Rate until payment.

C. THE "RATE APPLICABLE TO THE DEBT APART FROM THE ADMINISTRATION"

10. Where Automatic Early Termination has been specified in the Schedule to a Master Agreement, any early termination amount owed to the Non-defaulting Party is a future debt as at the date of administration (since it only becomes payable once a calculation statement has been provided: see Rule 2.89 of the Insolvency Rules 1986).

11. Where no Automatic Early Termination has been specified, any early termination amount owed to the Non-defaulting party is a contingent debt as at the date of administration (since it only becomes due if and when an Early Termination Date is specified and, thereafter, is only payable once a calculation statement has been provided).

12. In either case, the early termination amounts are provable in LBIE's administration and accrue interest from the date of LBIE's administration at the higher of the Judgments Act Rate and the Default Rate (being the rate applicable to such early termination amounts apart from the administration) [2].

Issues 6 - 8

13. Although York refers solely to Issue 4 (dealing with foreign judgments), issues relating to the right to interest in respect of future and contingent debts, including contractual debts, were in fact determined by David Richards J in the context of Issues 6 – 8 in the *Waterfall II A* Judgment.

14. By way of background:

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[2] Whether the debt is a future or contingent debt (see above), in order to submit a proof of debt in respect of an early termination amount, in practice a calculation statement will usually have been provided and (where necessary) an Early Termination Date will need to have been designated. In other words, by the time a proof of debt is submitted, the debt will be neither contingent nor future.

(1) Rule 2.88(7) requires any surplus remaining after payment of debts proved to be "*applied in paying interest on those debts in respect of the periods during which they have been outstanding since the relevant date*".

(2) The rate of interest payable under Rule 2.88(7) is whichever is the greater of the rate specified in section 17 of the Judgments Act 1838 (the "Judgments Act Rate") and "*the rate applicable to the debt apart from the administration"* (Rule 2.88(9)).

(3) Issues 7 – 8 were concerned with whether in relation to contingent and future debts, interest under Rule 2.88(7) and (9) at the Judgments Act Rate is calculated from the date of administration or the date that the contingent debt ceased to be subject to a contingency or the future debt became payable.

(4) Issue 6 was concerned with whether in relation to contingent and future debts, the "*rate applicable to the debt apart from the administration"* is calculated from the commencement of administration or from the date that the contingent debt ceased to be subject to a contingency or the future debt became payable.

15. David Richards J held that "*in the case of both future and contingent debts, interest is payable under rule 2.88(7) from the date that the company entered into administration, not from the date (if any) on which any such debt fell due for payment in accordance with its terms. The parties are agreed that it follows that the comparison under Issue 6 is between judgment rate and the rate applicable apart from the administration, in each case from the date of administration"* (at [225]).

16. The reasoning which led to this conclusion can be summarised as follows:

(1) The purpose of Rule 2.88(7) is to compensate creditors for the delay in the payment of their proved debts (as ascertained or estimated in accordance with the legislation) since the commencement of the administration, and not for the delay in the payment of their underlying claims: Waterfall IIA at [207], [212].

(2) Proved debts are ascertained as at the date of administration so as to ensure the *pari passu* distribution of the debtor's assets. In the case of future and contingent debts, this requires a present value to be put on such debts:

(a) Debts which are not payable at the date of administration (i.e. future debts) are admitted to proof in full (Rule 2.89) and, if they have not fallen due for payment before the date a dividend is declared, are discounted back to the date of administration for the purposes of such dividend (Rule 2.105): Waterfall IIA [197].

(b) Where a debt does not bear a certain value, by reason of it being subject to a contingency or for any other reason, the value the debt as at the Date of Administration is estimated for the purposes of proof (Rule 2.81). Such an estimate may include an element of present-value discounting in order to approximate the value, as at the Date of Administration, of a contingent debt which can only fall due for payment in the future[3]: Waterfall IIA [198]

(3) For the purposes of entitlement to interest under Rule 2.88(7), all proved debts (as ascertained or estimated in accordance with the legislation) are "*outstanding*" from the date of administration. Interest is therefore paid on all proved debts at the greater of the Judgment Act Rate and the "*rate applicable to the debt apart from the administration*" from the date of administration, irrespective of whether such debts were future or contingent as at that date: Waterfall IIA at [225]; Rule 13.12(3).

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3 By contrast, David Richards J held that it is not necessary to discount a contingent debt which becomes an actual liability before the payment of a dividend: *Waterfall II* [216].

(4) In the case of future and contingent debts, the "*rate applicable to the debt apart from the administration"* is the rate which applies to such debts when they become due and payable: Waterfall IIA at [225]. This is justified in light of the nature and effect of the rules governing the estimation of contingent debts and the payment of dividends on future debts.

17. The Default Rate applicable to any early termination amount owed to a Non-defaulting Party is "*the rate applicable to the debt apart from the administration"*, since:

(1) The creditor had an existing contractual right to payment of interest at the Default Rate at the time when the administration commenced. This right to interest was an existing right, forming part of the rights and obligations of the parties under their contract, applicable in respect of any future or contingent debt as from the point at which the debt became due.

(2) The "*rate applicable to the debt apart from the administration"* is, in the case of future and contingent debts, the rate which applies to such debts when they become due and payable. This necessarily follows from the determination of Issues 6-8 in Waterfall IIA.

Issue 4

York's submissions are based not on Issues 6 – 8, but on Issue 4. That issue was, however, not concerned with future or contingent contractual rights to interest, but with rights to Judgment Act interest in respect of a hypothetical judgment which the creditor had not obtained by the date of the administration and may never have obtained:

(3) The question considered in the context of Issue 4 was whether the "*rate applicable to the debt apart from the administration"* in Rule 2.88(9) includes (particularly with reference to foreign judgments) a "*judgment rate on a judgment obtained after the commencement of the administration or the judgment rate which would apply to a debt if the creditor had obtained judgment for it but did not in fact do so"* (see *Waterfall IIA* ibid [243(iv)] [173]).

(4) In other words, in Issue 4 the court was being asked to consider whether the "*rate applicable to the debt apart from the administration"* could be determined not only by reference to a creditor's existing contractual or other rights to interest (or other compensation for delayed payment) as at the commencement of the administration, but also by reference to any rights which the creditor could have acquired, or did in fact, acquire pursuant to a judgment obtained *after* the date of administration.

(5) It was in this context (and not in the context of contractual or other rights to interest with an existing legal foundation) that David Richards J held that "*The words "the rate applicable to the debt apart from the administration" cannot be read as including a hypothetical rate which would be applicable to a debt if the creditor took certain steps*" but that "*the rate applicable to the debt apart from the administration is to be determined by reference to the rights of the creditor as at the commencement of the administration*": Waterfall IIA ibid at [177] and [181]. York's submissions take these words out of context, and wrongly seek to apply them to all and any rights to interest, including rights to interest under an existing contract.

(6) The distinction drawn by David Richards J in the context of Issue 4 is between rights to interest, or other compensation for delayed payment, which have an existing legal foundation as at the date of administration on the one hand (pursuant to, for example, a contract, or a statute that provides for interest on the debt proved) and rights to interest, or other compensation for delayed payment, which have no existing legal foundation as at the date of administration on the other (pursuant to a hypothetical judgment).

(7) A right to interest payable on a foreign judgment obtained only after the administration would not, on the Judge's analysis, constitute an existing right in the required sense at the date of administration. In contrast, a pre-existing contractual right to be paid Default Rate on the early termination amount does constitute an existing right at the date of administration. This is the case irrespective of whether: (i) the debt to which the Default Rate will apply is a future or contingent debt; or (ii) the Default Rate has yet to be assessed or quantified as at the date of administration. No steps need to be taken to establish that right, as opposed to assessing or quantifying the applicable rate.

D YORK'S POSITION

18. York contends the decision of David Richards J in relation to Issue 4 means that contractual interest rates, in particular the Default Rate, accruing on early termination amounts arising under the Master Agreements and under the FBF Master Agreement are not "*rates applicable to the debt apart from the administration*". York's position is wrong.

19. Standing back, there can be little doubt that, if consideration is given to the position of a creditor with a claim under the Master Agreements, the rate in fact applicable to any claim for an early termination amount is, apart from the administration, the Default Rate. The SCG's analysis of the Waterfall IIA judgment, and interpretation of Rule 2.88(9), as set out above, leads to the unsurprising conclusion that the Default Rate is the correct comparator for the purpose of Rule 2.88(9) when assessing the rate that would have been applicable apart from the administration. York's analysis does not, and leads to the conclusion that a creditor is deprived of any right to interest payable at the Default Rate (if higher than the 8% Judgments Act rate) notwithstanding the self-evident purpose of Rule 2.88(9). York, however, provides no argument as to why its interpretation of Rule 2.88 and Issue 4 of the Waterfall IIA judgment makes sense or would otherwise be likely to reflect the intention of the statutory draftsman.

20. York's submissions, if correct, would appear to be applicable not merely to rights to interest at the Default Rate under the Master Agreements, but to all and any contractual rights to interest that were contingent at the date of administration, at least where the contingency involved a step being taken; see York's Skeleton at [15] ("*the reference to 'rights' … was to present and accrued rights of the creditor to receive interest and not to merely contingent rights to interest*") and [31].

21. Insofar as the particular arguments raised by York are understood by the SCG, they appear to be based on an incorrect understanding of the judgment of David Richards J in *Waterfall IIA* and an incorrect understanding of the process of proving a debt in respect of a claim under the Master Agreements.

22. As regards York's characterisation of the decision of David Richards J, York submits that, in deciding that the rate applicable to the debt apart from the administration is to be determined "*by reference to the rights of the creditor as at the commencement of the administration"* (*Waterfall II* at [181]), the Judge was referring to "*present* ***and accrued*** *rights of the creditor to receive interest on the relevant debt"* (York's Submissions at [15], emphasis added). In this regard is said that since entitlement to interest on the early termination amount "*is dependent upon an effective notice of the amount payable being given"*, it is contingent at the time of the commencement of the administration "*and cannot be said to be rate* [sic] *applicable to the debt at that time"* (York's Submissions at [31]). As set out above, these submissions proceed on an incorrect basis for two main reasons:

    (1) York's submission ignores the specific context in which Issue 4 was determined (as set out above). Set in that context, it is plain that the distinction drawn by David Richards J in the context of Issue 4 was not between any present and "*accrued"* rights on the one hand and present and contingent rights on the other, but between rights which have an existing legal foundation as at the date of administration on the one hand (e.g. pursuant to an existing contract) and rights which have no existing legal foundation as at the date of administration on the other (e.g. pursuant to a hypothetical judgment).

(2) York's submission also ignores the broader context in which Issue 4 was determined. In relation to Issues 6 – 8 it was agreed between the parties[4] (and held by the Court) that interest runs on contingent debts from the date of administration at the rate applicable to the debt apart from the administration even if the interest entitlement is subject to the same contingency as the debt: see *Waterfall IIA* ibid. at [225]. Pending any appeal of Issues 6 – 8, it is not open to York to argue that a contractual rate of interest is not a "*rate applicable to the debt apart from the administration"* merely because it arises in respect of a contingent debt[5].

23. Insofar as far as the Senior Creditor Group can understand York's discussion of the relevant provisions of the Master Agreements in the context of proof, the suggestion appears to be that, where an Event of Default has occurred under the Master Agreement but the transactions remain open at the date of the administration (i.e. where there is no Automatic Early Termination), any proof of debt submitted by the Non-defaulting Party is necessarily a proof in respect of "*contingent rights to payment and delivery under the open transaction together with any Unpaid Amounts / Amounts Due (if any)"* and can never be a proof in respect of the early termination amount (York's Submissions at [29] and [30]). As a consequence, it is said that "*any interest rate applicable to the…Termination Amount is not in any case a rate applicable to the debt apart from the administration for the purposes of Rule 2.88(9). To conclude otherwise is to confuse the debts which are this subject of the proof with the subsequent Termination Amount / Settlement Amount which is a different debt"* (York's Submissions at [30]).

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4 See, for example, [128] of York's Skeleton argument for Part A: "*there is no logical or principled basis for calculating the relevant amount of interest pursuant to the rate applicable to the debt apart from the administration for the purposes of rule 2.88(9) as accruing from some other date* [than the date of administration]" and [129]: "*if York is wrong on Issue 6 (and interest runs from the later of the date on which the debt became due and the date of administration)…"*

5 It is worth noting that, despite the ISDA Issues having been present in the Administrators' Application from the start, no party sought to suggest that there was an issue as to whether interest at the Default Rate was incapable of being a "*rate applicable to the debt apart from the administration*", until York suggested this following the judgment on Waterfall IIA.

24. This is misconceived and contrary to the orthodox approach in relation to proving future and contingent debts:

(1) Where no Automatic Early Termination has been specified, the Non-defaulting Party has two relevant contractual rights as at the date of administration: it has a right to keep the transactions entered into under the Master Agreement open; alternatively it has a right to terminate the transactions by designating an Early Termination Date in accordance with Section 6(a).

(2) Where the Non-defaulting Party elects to designate an Early Termination Date, it has no right to further payments or deliveries under transactions entered into pursuant to the Master Agreement, and its right is to receive the early termination amount calculated in accordance with Section 6(e): Section 6(c)(ii).

(3) An early termination amount owed to the Non-defaulting Party is a contingent debt as at the date of administration and is provable as such. To this end, Mr Justice Briggs held in *Anthracite Rated Investments (Jersey) v Lehman Brothers Finance* [2011] 2 Lloyd's Rep 538 at [122] that *"[T]he provisions of Section 6(e) of the Master Agreements … gave the issuers distinct contractual rights to contingent early close-out payments from LBF"*.

(4) It is a question of fact whether or not a proof submitted by such a Non-defaulting Party relates to its rights in respect of the early termination amount owed under Section 6(e) or its rights to payment / delivery under open transactions together with any Unpaid Amounts (albeit one that should be readily determinable by reference to whether or not an Early Termination Notice has been given).

(5) Where a proof is submitted in respect of the contingent early termination amount, the effect of the judgment in Waterfall IIA is that the rate applicable to the debt apart from the administration is the Default Rate, for the reasons given above.

E. CONCLUSION

25. For the reasons set out above, Supplemental Issue 1(a) should be answered on the basis that the words "*the rate applicable to the debt apart from the administration"* in Rule 2.88(9) of the Rule, 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.

26. York is incorrect to contend that the effect of David Richards J's judgment in respect of Issue 4 prevents the Default Rate under an ISDA Master Agreement from being the "*the rate applicable to the debt apart from the administration"* merely because such rate did not start running until after the Date of Administration.

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14 December 2015

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No.7942 of 2008

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WATERFALL II DIRECTIONS APPLICATION

SENIOR CREDITOR GROUP'S SKELETON ARGUMENT:

Supplemental Issue 1(a)

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