

Statutory interest: an unexpected problem

Restructuring Trends



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The global financial crisis signalled by the Lehman collapse highlighted a number of unprecedented regulatory, economic, legal and restructuring issues on a macro-level. As the Lehman European hub, LBIE* was the most complex part of the group and the unwinding of its balance sheet has given rise to a number of unprecedented challenges of its own: LBIE had around 6,000 clients across the globe, thousands of derivatives contracts, repos, stock loans, prime brokerage and equity trades and two Trust estates in addition to the general unsecured estate and multi-faceted relationships with other insolvent Lehman entities in different jurisdictions. A number of the most material issues have now been resolved and the upper end of the range of financial outcomes for the general estate suggests that creditors may have their claims repaid in full and with interest – an outcome that was unimaginable five years ago. However, as with many things relating to Lehman, working out the amount due to each creditor is not as easy as might be assumed.

“I will never forget deadline day for the first unsecured dividend in November 2012. The buzz on the floor was incredible - the culmination of four years' hard work. I was approving last-minute settlements until about midnight and when the phones finally stopped ringing it felt like a watershed moment.”

Paul Copley, PwC BRS
& joint administrator of LBIE

In the five years since the Lehman collapse, LBIE has realised almost £20bn of cash for the general estate, and made interim distributions of £5.9bn to unsecured creditors, representing 68.5p in the pound for admitted claims. The administrators now believe that there may eventually be a surplus of up to c£5bn in the general estate after settling all ordinary unsecured claims in full. It is extremely rare for unsecured creditors to recover 100% from a UK insolvency procedure, and even more exceptional given LBIE's scale and complexity. Consequently, a number of questions have arisen in considering how any surplus should be shared between relevant stakeholders.

The principal question arises from LBIE's pre-administration capital structure: LBIE was, unusually for a UK corporate, an unlimited company and its funding structure included £1.25bn of subordinated debt from its majority shareholder. Whilst it is clear that the claims of ordinary unsecured creditors rank ahead of this subordinated debt, it is not certain whether interest on unsecured claims should be paid in priority to shareholder claims and/or amounts due in respect of the subordinated debt.

To obtain clarity on this point, LBIE and its shareholders have made a joint application to the UK High Court covering a number of questions relating to respective rights of claims between LBIE, its unsecured creditors and its shareholders. The administrators' view is that interest on unsecured creditor claims is payable ahead of shareholder and subordinated debt claims and they anticipate that this will be confirmed by the court early in 2014, following the hearing due shortly.

The second question, which arguably has greater significance in value terms, is how interest claims should be calculated under the Insolvency Rules, particularly the interest rate to be applied and the date from which interest accrues. Given the amount of time it would likely take to resolve these details, through court directions or on a claim-by-claim basis, the administrators are developing a simplifying methodology to determine interest claims on an equitable basis for all LBIE's qualifying creditors.

Definitions:

* LBIE - Lehman Brothers International (Europe) - In Administration

**OTC - over-the-counter: a market in which securities, or other financial products, are traded by direct dealer-to-dealer communications.



The interest conundrum

In calculating the statutory interest rate, the administrators are faced with a number of challenges:

Rate:

- Simple interest at 8% p.a. accrues in accordance with the Insolvency Rules.
- If the underlying contract between the company in administration and a creditor specifies a rate higher than 8% p.a. should be used in the interest calculation, the Insolvency Rules allows this rate to be applied.
- For LBIE, this could affect claims arising from certain OTC** derivative agreements, principally ISDA master agreements under which the relevant rate is typically cited as the counter-party's cost of funds plus 1% per annum.

Date:

- Interest is due in respect of the periods during which the relevant claims were outstanding since the date of the appointment.
- It is unclear from what date a creditor's interest claim is to be calculated.
- Master agreements constituted the majority of LBIE's trading contracts. One interpretation of these contracts is that claims arising from them do not represent outstanding debts until at least the date of termination under the close-out netting provisions.
- This could mean that interest accrues from the termination date not the date of administration; in certain cases this could significantly reduce the period for which interest is due.

Other factors to consider:

- The set-off of amounts receivable and payable under different master agreements, often with different termination dates, to derive a single net claim against LBIE for each counterparty.
- Claim transfers to third parties, particularly where the original holder may no longer exist – there is an active secondary market in LBIE claims.
- The date, or dates, that a counterparty's cost of funds should be fixed for the purpose of determining the interest rate applicable to an ISDA claim.

Finding the solution - keeping it simple

The administrators are aware that LBIE claims are currently trading at amounts in excess of 130p in the pound on the secondary market, with a third distribution due before the end of 2013. Faced with these challenges, they have started to develop an interest resolution mechanism that will enable both LBIE and its creditors to circumvent many of the uncertainties associated with calculation on a statutory or contractual basis.

The primary objective of this approach is to facilitate an accelerated payment of interest on unsecured claims, assuming that the outcome of this month's UK High Court

application hearing enables this. It is possible that the chosen mechanism will be implemented by a Company Voluntary Arrangement or a Scheme of Arrangement.

Alternatively, a consensual solution may be possible, albeit a very high acceptance hurdle-rate is likely to be required in order that a manageable reserve can be made for non-consenting creditors under such an approach. LBIE expects to announce further details regarding the resolution mechanism during the first half of 2014.

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