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Briefing note

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Interest payable under the ISDA Master Agreement is a borrowing cost only

If a party fails to pay a sum due under the ISDA Master Agreement, it must pay interest on that sum. Interest is calculated by reference to the cost to the payee of funding the relevant amount. The English High Court has decided that the payee's cost of funding refers only to the interest that the payee would be required to pay if it borrowed the relevant amount. The payee's cost of equity cannot be included in the calculation.

Key issues

- Only borrowing costs are recoverable as interest under the ISDA Master Agreement
- The borrowing costs are those of the original party, not a transferee

In *Lomas v Burlington Loan Management Ltd* [2016] EWHC 2417 (Ch), Hildyard J commented, with considerable understatement, that it was "unusual" for a company in administration to pay all its debts, still more so for it to have a surplus. Yet in the eight years since it went into administration, Lehman's principal European arm, LBIE, has generated a surplus of £7 billion after paying its provable debts. A surplus, especially of this magnitude, inevitably arouses interest from competing creditors who might be entitled to share in the surplus.

One ground of competition has been the interest payable on debts owed by LBIE following close out of an ISDA Master Agreement. If there is a surplus in an insolvency, UK insolvency rules provide that a creditor is entitled to the higher of 8% simple interest and the rate that would have been payable apart from the administration, ie the contractual rate. The surplus available in LBIE's administration gives those with debts under an ISDA Master Agreement an incentive to explore whether the interest due under the Agreement exceeds the equivalent of 8% simple interest (or around 6% if compounded); and it gives creditors lower down the waterfall, such as subordinated creditors and shareholders, an incentive to ensure that the interest payable under the ISDA Master Agreement does not exceed 8% simple interest in order maximise the downward flow.

Loans or equity?

In *Lomas*, it was accepted that there was no material difference between the 1992 and 2002 ISDA Master Agreements. The 2002 Agreement provides for "interest" to be paid on a past-due Early Termination Amount at the "Default Rate" (section 9(h)(ii)(2)). The Default Rate means "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" (section 14).

The key question in *Lomas* was whether this cost of funding was a borrowing cost or whether it could also take into account the (higher) cost of raising equity. Following Lehman's collapse, many banks raised (indeed, were forced to raise) equity at a cost well in excess of the equivalent of 8% simple interest.

Hildyard J confessed to wavering on the point before reaching the "firm conclusion" that the interest

> "... 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... Reward for investment by way of a specified (but ultimately discretionary) share in profit is not a relevant "cost of funding": thus equity is not within the cost of funding language."

The judge's reasoning was lengthy, but boiled down to the propositions that the ISDA Master Agreement refers to interest, that interest is the price of borrowing money (which is fundamentally different from any costs associated with raising equity), and so the cost of funding must be the cost of borrowing the relevant amount.

The judge considered that the funding cost in question is the actual or hypothetical marginal cost of borrowing the Early Termination Amount, not the weighted average of the creditor's cost of borrowing. This can be determined by reference to payee's circumstances on a particular date or can take into account changing circumstances over time. Hindsight can even be used. However, any certification by the payee must be made in good faith and in a manner that is not irrational (in the sense that no reasonable party could have reached that conclusion).

Who is the relevant payee?

The ISDA Master Agreement allows a party to transfer an Early Termination Amount owed by a Defaulting Party (section 7(b) of the 2002 Agreement). Another question that arose in *Lomas* was whether the "relevant payee", whose cost of funding must be certified, is the original party to the Master Agreement only or whether it can include the transferee of the Early Termination Amount.

Hildyard J concluded that the "relevant payee" is the original party only. The ISDA Master Agreement

> "restricted the right to transfer to the amounts which had become payable and would become payable to the transferor as at the time immediately before the transfer, in each case measured according to the position of transferor."

A transferee is therefore entitled to the interest that the transferor could have claimed based on the transferor's cost of borrowing, not interest based on its own costs.

Conclusion

Lomas v Burlington Loan Management Ltd was referred to as Waterfall IIC since it is the third aspect of LBIE's administrators' second application to the court for directions as to how they should disburse LBIE's surplus. Waterfall I is on its way to the Supreme Court, and Waterfall IIA and IIB are on appeal to the Court of Appeal, and could follow Waterfall I to the end of the judicial road. The sums in dispute in Waterfall IIC are such that it too could be appealed. But even if not, it still requires LBIE's creditors to think carefully about what rate of interest they can certify. If a creditor's cost of funding plus 1% did not exceed the equivalent of 8% simple interest, then the rules provide for the creditor to receive 8%. But if the cost of funding plus 1% did or might have exceeded that amount, the creditor will need to pore carefully over Hildyard J's long judgment to see what it can claim and what it cannot.

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