Feature

KEY POINTS

- Interest under the ISDA Master Agreement must be calculated based on the relevant payee's cost of borrowing, rather than any broader measure of its "cost of funding" (including equity funding).
- The relevant payee's certification of its "cost of funding" may only be challenged if it has been prepared irrationally or in bad faith, or contains a manifest numerical or mathematical error.
- In cases where the relevant payee is an assignee of ISDA claims from third parties, it is the original ISDA counterparty's cost of funding that matters.

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Interest under the ISDA Master Agreement: counting the cost

The latest judgment in the Lehman Brothers insolvency proceedings, *Lomas v Burlington Loan Management Ltd* [2016] EWHC 2417 (Ch); The Waterfall IIC Application, focuses on the interest provisions of the ISDA Master Agreement. Subject to appeal, Hildyard J has determined a number of important issues of potentially wide-ranging application.

THE ISSUES FOR THE COURT

The High Court has given judgment in the third and final stage of the Waterfall II Application, brought by the Joint Administrators of Lehman Brothers International (Europe) (LBIE) to determine a range of issues arising in the long-running LBIE insolvency. The Waterfall IIC trial concerned the interpretation of the interest provisions of the ISDA Master Agreement. These have never been considered in detail by any English or New York Court. The issue arose in the LBIE insolvency because a surplus of billions of pounds was available for payment of interest on claims, after payment of the principal amounts due to all creditors.

ISDA MASTER AGREEMENT

The ISDA Master Agreement is one of the most widely used standard form contracts in the world. Published by the International Swaps and Derivatives Association (ISDA), it governs "over-the-counter" derivatives worth trillions of dollars. The 2002 version of the ISDA Master Agreement is the most up to date version, though the 1992 version is also widely used. ISDA Master Agreements may be governed by either English law or New York law. There were no material differences between the 1992 and 2002 forms or between English law and New York law for the purposes of Waterfall IIC.

The ISDA Master Agreement (both 1992 and 2002 forms) provides for interest to be paid by the defaulting party at the "Default Rate". This is defined as follows:

> "'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."

The key issue in the Waterfall IIC application was the meaning of the words "the cost ... of funding". Some ISDA Master Agreement creditors of LBIE argued that this expression included *all* costs of funding, including equity funding. Other creditors, who stood to benefit from a lower interest being payable on ISDA claims, argued that this expression was limited to a cost of *borrowing*.

A very large sum turned on the correct interpretation of this short provision. In the LBIE insolvency alone, the Joint Administrators calculated that the opposing interpretations could produce a difference in the total interest payable of c.£5bn. The decision is also of significant interest to the wider market, since it will likely determine the correct meaning of the ISDA Master Agreement for all users of this pervasive standard form.

The court also considered the circumstances in which the non-defaulting party's certification of its "cost of funding" could be challenged, and how the interest provisions applied where the creditor was an assignee of a third party's ISDA claims.

THE MEANING OF "COST OF FUNDING"

The arguments on the meaning of "cost of funding" were complex. Hildyard J stated that they "caused [him] to waver considerably, especially on the most acute issue of whether the cost of funding language extends to equity funding".

However, he ultimately held that the expression "cost of funding" was limited to the payee's cost of borrowing, based on an actual or hypothetical transaction by which the relevant payee borrowed the relevant amount. "Cost" meant the price which the borrower was required to pay for the incremental amount of funding required. It would include the interest and fees payable to the lender, but not other fees payable to third parties (such as legal fees) or any opportunity costs or other detriment sustained due to raising the funding.

Hildyard J relied on a number of points in support of this conclusion, but the principal basis for his decision appears to have been that the "underlying objective" of the Default Rate definition was to determine an interest rate, and that "interest connotes borrowing". For the same reason, he held that the definition excluded forms of funding where the cost "is not properly described as interest".

The judge therefore adopted a narrow construction of the "cost of funding" language. Wider meanings of the phrase "cost of funding" were excluded, notwithstanding the judge's recognition that the word "cost" had a "broader meaning from a commercial perspective". These include general measures of a party's "cost of funding" such as a Weighted

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Average Cost of Capital. But the judge's approach also excludes types of equity funding which are based on discrete transactions, and where the cost could easily be expressed as an interest rate, such as preference shares carrying a cumulative fixed dividend.

This interpretation produces a number of difficulties, which were raised in argument before the judge and which are likely to be raised again on appeal. In particular:

- The judge's premise, ie that the "Default Rate" definition is focussed on determining an interest rate, is arguably flawed. The ISDA Master Agreement does not require certification of an interest rate, but rather a "cost ... of funding", which is then expressed as a "rate per annum". The judge's approach therefore conflates the requirement to certify a cost of funding that can be used to *produce* an interest rate with a requirement to *certify* an interest rate. He therefore adopted an excessively narrow interpretation of the broad words "cost ... of funding".
- The judge's interpretation may be commercially unrealistic. Commercial parties raise funding by a number of methods, using both debt and equity funding. They also use hybrid instruments incorporating elements of both debt and equity. The judge's interpretation assumes that parties will respond to an ISDA default by raising borrowing, but this does not reflect the way that commercial parties actually fund themselves. The judge's approach may also lead to arbitrary results, where forms of funding with commercially equivalent results (such as preference shares and convertible bonds) would fall to be treated very differently. It may also produce commercially nonsensical outcomes, whereby "debt" components of hybrid instruments may be certified but "equity" components may not be.
- The judge's approach may be particularly unrealistic for financial institutions and other regulated entities, which are required to maintain a particular level of equity capital, such that they would not (at least in some circumstances) respond to a default by raising further borrowing.

It remains to be seen whether these (and other) arguments have more traction in the Court of Appeal. It may well be that a broader interpretation of "cost of funding" ultimately prevails.

CERTIFICATION: GOOD FAITH AND RATIONALITY

The judge also considered the margin of discretion afforded to the non-defaulting party in certifying their "cost ... of funding". On this issue he adopted an interpretation of the ISDA Master Agreement that was more generous to the certifying party.

It was common ground that any certification had to be prepared in "good faith" and "rationally", applying the well-known limits on the exercise of contractual discretion set out in *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] Bus. L.R. 1304. A certification that fell outside the judge's interpretation of the definition of Default Rate could also be challenged.

However, it was argued that it should also be possible to challenge a certification on the basis that it contained an "error" (or possibly a "manifest error"). The judge rejected this further limitation. He held that a general right of challenge for errors would be "inimical to the special emphasis understandably placed on certainty in the architecture of the ISDA Master Agreements". Similarly, to permit a challenge for manifest error would be to "refashion" the terms of the ISDA Master Agreement rather than to interpret them.

Accordingly, while the judge held that it was possible to challenge a certification where it contained a "manifest *numerical or mathematical* error", or was otherwise "abused or polluted by lack of good faith, or rationality", no broader challenge would be permitted.

It follows that it should be very difficult for a defaulting party to challenge a certification of "cost of funding" put forward by a non-defaulting party, absent exceptional circumstances.

THE COST OF FUNDING OF ASSIGNED CLAIMS

The judge also considered how the cost of funding language applied to ISDA claims that had been assigned from third parties: was it the assignee's cost of funding that had to be certified, or that of the original counterparty to the ISDA Master Agreement? Many (if not most) LBIE ISDA claims have been traded following LBIE's insolvency, so this question had significant practical implications.

Hildyard J held that it was the original counterparty's cost of funding that mattered. He considered that this followed from the language of the ISDA Master Agreement, which generally used the expression "relevant payee" to mean the original counterparty to the ISDA Master Agreement, as well as the general principle of assignment whereby an assignee cannot usually recover more than the assignor.

This result is attractive from the defaulting party's perspective, since it leaves it exposed only to the cost of funding of its original counterparty. It is not exposed to the unknown (and unknowable) costs of funding of any future assignee. However, it presents practical difficulties for a party acquiring ISDA claims on the secondary market, since the ultimate transferee may have to track down and certify the cost of funding of the original holders of each of its claims.

CONCLUSIONS

The decision in *Waterfall IIC* represents a mixed result for parties seeking payment of interest under an ISDA Master Agreement. The decision on the meaning of "cost of funding" may be excessively narrow, while the decision on how the interest provisions apply to assigned claims raises practical difficulties. Both points may yet be subject to appeal. However, the judge's interpretation of the certification requirements will make it difficult for defaulting parties to challenge a certification of a cost of funding, offering a measure of certainty to non-defaulting parties. ■

Further Reading:

- White water rafting down the Lehman waterfall [2014] 6 JIFBL 357.
- The ISDA Master Agreement and CSA: close-out weaknesses exposed in the banking crisis and suggestions for change [2009] 1 JIBFL 16.
- LexisNexis Loan Ranger blog: ISDA time limits – on defaults.