

EUROPEAN RESTRUCTURING WATCH ALERT

LANDMARK LEHMAN SUBORDINATED DEBT RULING

JULY 2020

By Adam B. Plainer,
Mark Lawford,
Lindsay Merritt,
Rosalind Meehan and
Maeve Brady

The High Court in London gave judgment on Friday, 3 July 2020 on the relative ranking of over \$10 billion of subordinated liabilities in the administrations of two entities in the Lehman Brothers group.

The judgment covers a series of important issues for restructurings and insolvencies, including: the provability and relative ranking of regulatory subordinated debts, the effect of partial guarantee payments on the provable values of creditors' claims, the discounting of future claims, the provability of future interest, the construction of settlement agreement releases, and rectification of amendments where their impact on ranking was "simply not considered".

Background

Lehman Brothers Holdings PLC (in administration) ("**PLC**") and LB Holdings Intermediate 2 Limited (in administration) ("**LBHI2**") each issued regulatory subordinated debt under FSA standard form loan agreements, being the "**PLC Sub-Debt**" and the "**LBHI2 Sub-Debt**" respectively. Following a series of post-administration transfers, the PLC Sub-Debt is now held by Lehman Brothers Holdings Inc. ("**LBHI**"), the ultimate parent company of the global Lehman Brothers group. The LBHI2 Sub-Debt is held by PLC.

PLC and LBHI2 each also issued regulatory subordinated notes. In the case of PLC, the notes (the "**PLC Sub-Notes**") were issued to certain limited partnerships, which in turn issued preferred securities known as ECAPS. In the case of LBHI2, the notes (the "**LBHI2 Sub-Notes**") are held by an affiliate of LBHI ("**SLP3**").

The administrators of PLC and LBHI2 asked the court to determine how the subordinated claims in each estate rank against each other. The administrators of PLC also asked the court to determine whether the PLC Sub-Debt had been released pursuant to a New York law settlement agreement dated 24 October 2011 (the "**Settlement Agreement**"), as well as how the PLC Sub-Debt and PLC Sub-Notes should be valued for the purposes of distributions.

LBHI/SLP3 argued that the PLC Sub-Debt and PLC Sub-Notes rank *pari passu*, that the PLC Sub-Debt was not released by the Settlement Agreement, or partially discharged by guarantee payments and that the PLC Sub-Notes ought to be discounted in accordance with the Insolvency Rules.

LBHI/SLP3 also argued that the LBHI2 Sub-Debt and LBHI2 Sub-Notes rank *pari passu* both before and after certain amendments made to the LBHI2 Sub-Notes in 2008, and that if the amendments to the LBHI2 Sub-Notes had the effect of altering the ranking they should be rectified to reflect the common intention of the parties.

Conclusions

The Judge's conclusions were as follows:

1. The PLC Sub-Debt and the PLC Sub-Notes rank *pari passu*.
2. The PLC Sub-Debt was not released pursuant to the release clause in the Settlement Agreement.
3. The PLC Sub-Debt was not partially discharged by payments made to the original creditor by LBHI under a guarantee.
4. The PLC Sub-Notes should be discounted for futurity under the Insolvency Rules to approximately 27% of their face value. This is because subordinated debts are provable debts, the PLC Sub-Notes are future debts, and there is no basis on which the holder of the PLC Sub-Notes can prove for interest that accrues after the administration date.
5. Certain subordinated guarantees given by PLC rank behind the PLC Sub-Debt and the PLC Sub-Notes, as agreed by the parties.
6. When issued, the LBHI2 Sub-Notes ranked senior to the LBHI2 Sub-Debt. Following the amendments in 2008, the LBHI2 Sub-Notes now rank junior to the LBHI2 Sub-Debt. The amendments to the LBHI2 Sub-Notes do not fall to be rectified.

Further detail on the Judge's findings is set out below.

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The Judge's general observations on subordination

A creditor can subordinate its claim using contingent debt subordination and/or simple contractual subordination. The Judge commented that for a simple contractual subordination clause to be effective it "*must render the creditors unable to prove at least until the obligations prior to that debt have been satisfied in full*".

A creditor can subordinate itself not only within a category of obligation but also between categories of obligation. However, a creditor probably cannot subordinate itself below shareholders. Shareholders come last by the very nature of their legal position and form an altogether different class of obligation to that of creditors.

A creditor can only subordinate itself to others and cannot unilaterally promote itself above other creditors.

The PLC Sub-Debts and the PLC Sub-Notes rank *pari passu*

The Judge held that on a literal construction of the agreements, the PLC Sub-Debts and the PLC Sub-Notes are each 'Senior Liabilities' for the purpose of the other instrument, creating an endless loop or impasse, with the result that neither can be paid until the other is paid in full.

In such circumstances, the Judge concluded that the contractual subordination provisions are ineffective as between each other, and the instruments rank *pari passu* by default as a matter of law.

The PLC Sub-Debt was not released pursuant to the Settlement Agreement

It was argued that the mutual releases between PLC and LBHI (among others) in the Settlement Agreement extended to claims acquired by LBHI after the Effective Date of the Settlement Agreement, including the PLC Sub-Debt.

Having heard expert evidence on New York law, the Judge, finding that the words of the Settlement Agreement were clear and

unambiguous, concluded that:

- a) none of the terms in the definition of "*Causes of Action*" address the transfer of a claim after the Effective Date;
- b) notwithstanding the generality of the release, there needed to be some legal relation between PLC and LBHI capable of being released as at the Effective Date. A relationship that arises altogether after the Effective Date (via a claim transfer) cannot sensibly be the subject of a release, discharge or acquittal; and
- c) this interpretation of the release is consistent with certain other provisions in the Settlement Agreement, including: (i) a warranty that each party owned all claims that it was releasing; and (ii) a restriction on the transfer of claims, which could have provided for a release of after-acquired property, but did not.

The PLC Sub-Debt has not been discharged in part by payments made to the original creditor by LBHI under a guarantee

Where a primary debtor is insolvent, a creditor is entitled to prove for the full amount of the debt notwithstanding part payment by the guarantor. As such, the original creditor's claim was not reduced by the guarantee payments.

As a matter of law there is no reason why an assignee, such as LBHI, should have less right to prove than the assignor.

The PLC Sub-Notes should be discounted for futurity in accordance with Insolvency Rule 14.44

Rejecting the argument that subordinated debts are non-provable, the Judge concluded that there is no need for a debt subordinated by way of simple contractual subordination or contingent debt subordination to lose its status as a provable debt and become a non-provable obligation. The effect of simple contractual subordination is to prevent the lodging of a proof until all prior obligations have been satisfied.

The PLC Sub-Notes were carefully drafted

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documents and it was not conceivable that the effect of the Insolvency Rules on discounting could have been overlooked. As such there can be no implication of an acceleration clause and the PLC Sub-Notes should be discounted as provable future debts.

The Judge also held that there was no basis to circumvent the statutory provision that no interest is provable with respect to the period after the administration date.

Amendments made to the LBHI2 Sub-Notes altered their ranking against the LBHI2 Sub-Debts from senior to junior and did not fall to be rectified on the grounds of common mistake

The Judge concluded as matter of construction that under the original terms of the LBHI2 Sub-Notes, the LBHI2 Sub-Notes ranked senior to the LBHI2 Sub-Debts.

However, under their amended terms, the Judge held that the degree of subordination of the LBHI2 Sub-Notes was altered. The Judge considered that the amended LBHI2 Sub-Notes subordinate themselves by reference to preference shares and therefore express themselves to rank junior to all other debt, including subordinated debt, but are senior to all shares and other creditors whose claims are subordinated by reference to the rights of shareholders. He considered that the LBHI2 Sub-Debts do not subordinate themselves by

reference to the rights of shareholders, so they rank in priority to the amended LBHI2 Sub-Notes.

The Judge concluded that there was no evidence that either LBHI2, as issuer, or SLP3, as Noteholder, considered the relative ranking of the LBHI2 Sub-Notes and the LBHI2 Sub-Debts at the point of subscription or at the time of the amendments. There was no evidence of any intention of how the LBHI2 Sub-Notes and the LBHI2 Sub-Debts would rank as against each other: it appeared to be a matter that was simply not considered at all. There was therefore no basis for rectification.

Weil acted for LBHI and SLP3, led by London Restructuring partner Mark Lawford, assisted by counsel Lindsay Merritt, associates Rosalind Meehan and Maeve Brady, and (then) trainee associates Jessica Carty, Eilish Cassidy and Milosz Palej. Restructuring partner Garrett Fail and associate Jason Hufendick advised as to matters of New York law. LBHI and SLP3 were represented in Court by Mark Phillips QC, William Willson and Edoardo Lupi of South Square.

Weil has represented LBHI and certain of its affiliates since its historic bankruptcy filing in September 2008. As part of the ongoing representation, we continue to field a multi-disciplinary team, led in London by Adam Plainer.

If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any of the authors listed below.

Adam B. Plainer	View Bio	adam.plainer@weil.com	+44 20 7903 1030
Mark Lawford	View Bio	mark.lawford@weil.com	+44 20 7903 1050
Lindsay Merritt	View Bio	lindsay.merritt@weil.com	+44 20 7903 1417
Rosalind Meehan	View Bio	rosalind.meehan@weil.com	+44 20 7903 1146
Maeve Brady	View Bio	maeve.brady@weil.com	+44 20 7903 1243

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