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

Respondents

WATERFALL II DIRECTIONS APPLICATION

SENIOR CREDITOR GROUP'S REPLY SKELETON ARGUMENT FOR TRIAL (PART A)

(1) INTRODUCTION

1. This Reply is limited to addressing two points arising in relation to Questions 6-8 in light of the submissions filed by the Administrators, and the Senior Creditor Group's prior indication that it would develop further certain submissions relating to the date from which contingent debts are to be treated as "*outstanding*" (see [303] of its skeleton argument).

2. The two points are:

   (1) The absence of a windfall for contingent creditors of LBIE if the Senior Creditor Group's primary approach is adopted; and

   (2) The Senior Creditor Group's alternative approach to the meaning of "*outstanding*" in the event that its primary case is rejected.

3. That the Senior Creditor Group does not reply in this skeleton to any other points made in the parties' skeleton arguments should not be taken as acceptance of those arguments. To the extent necessary such points will be dealt with during the course of oral submissions.

(2) ABSENCE OF A WINDFALL

4. The principal concern highlighted by the Administrators in their Position Paper (see [44.4]) was that, if their approach was not adopted, certain contingent creditors might otherwise receive a windfall. Evidence was submitted in the form of Lomas 11 at [2/5/12-15] in order to illustrate, from the Administrators' perspective, this perceived windfall.

5. No reference is made to that evidence in the Administrators' skeleton argument dealing with Questions 6-8, nor do the Administrators attempt to address the consequential issues highlighted in Zambelli 2 [2/6/1]. However, the suggestion that a windfall would arise nevertheless remains in respect of both contingent and future debts: see, for example, the Administrators' skeleton argument at [148(2)], [150(4)], and [151(3)-(5)].

6. That suggestion is wrong in principle, and has failed to engage with the arguments made by the Senior Creditor Group. In particular:

(1) The Administrators do not address fully the Senior Creditor Group's submission that, even post the contingency occurring, rule 2.81(1) requires the present value of the contingent claim to be estimated: [282]-[284]. Although they contend that contingent claims should be admitted at their full ascertained amount once the contingency has occurred without any discount for futurity, they do not seek to justify such an approach as a matter of principle. Nor do they address authorities which suggest that the approach at this stage involves putting a present value on debt as at the commencement date and is the same exercise as is carried out before the contingency vests but carried out with the benefit of hindsight (see, for example, *Hill v Bridges* (1881) 17 Ch D 342;*In re Law Car and General Insurance Company* [1913] 2 Ch 103 at 116 and 121): see the Administrators' skeleton argument at [148(1)]; Senior Creditor Group's skeleton argument at [286];

(2) The Administrators seek in their skeleton argument to rationalise the discounting of contingent claims before the contingency occurs for the purpose of valuation, and the payment of interest only from the date of the contingency occurring, on the basis that "*the making of such discount would not warrant the contingent creditor from receiving compensation from being kept out of his money (i.e. Statutory Interest) because the debt remains contingent and the creditors has not been kept out of its money. In fact, the contingency may never fall in*" [148(2)]. In so doing, the Administrators choose not to engage with the core of the Senior Creditor Group's argument i.e. [269]: that creditors would not be treated *pari passu* and creditors would not be compensated for delay in the manner intended by the legislature because:

(a) A contingent (or future) creditor would not receive the full value of his claim, as his proved debt would have been given a present value as at the date of administration, but dividends would only have been paid later;

(b) Nor would the creditor receive compensation on the present value of his claim for the delay in distributing that value, but would instead only receive compensation from some future date.

7. On the Administrators' approach, there is no compensation, or *pari passu* treatment, as regards the period between the date of administration and the date of payment of the dividend(s). This cannot be right: it is simply not possible to de-couple the valuation of the proved debt from the payment of dividends in respect of the proved debt, or the payment of interest on the proved debt valued as at the date of administration, as the Administrators seek to do at [146] onwards.

8. The Administrators' skeleton has also failed to address the concerns raised in Zambelli 2 regarding the issues that arise in this administration (by reference to prime brokerage agreements and the CRA) if contracts which are "*closed out*" are treated as carrying interest only from the date of the close out (as Question 7 suggests). The Senior Creditor Group indicated that it would develop its position further in this regard after exchange of skeleton arguments (see [303]), but has not been assisted by the Administrators' failure to engage in relation to these concerns.

9. The point remains that, rather than receiving a windfall, many creditors whose claims the Administrators appear to intend to treat as contingent would be in a materially worse position than creditors in economically similar or identical positions if the Administrators' approach is adopted, and therefore cannot sensibly be said to have received a windfall [2/6/4-5]. Such creditors may (a) have suffered a diminution in the value of their claims as a result of the delay in closing out the agreement and (b) have delayed because of the inability of the Administrators to confirm definitively whether their assets were held on trust, and a desire not to crystallise an unsecured claim by closing out their contracts .

10. Consider, by way of example, a close-out claim in relation to a prime brokerage agreement in circumstances where:

    (1) The creditor had held £10m of shares in its prime brokerage account with LBIE as at the date of administration;

    (2) A demand for return of the shares was made as at the date of administration;

    (3) LBIE had failed to comply with the demand (and was therefore in breach of the terms of the agreement, such that the creditor was entitled to claim damages as

from the date of breach) but the service of a close out notice was delayed whilst the creditor sought information from LBIE in order to ascertain if LBIE still held the shares on trust for it, or whether the shares had been rehypothecated such that the creditor would not have a potential proprietary claim to the shares. In that regard, as explained in Zambelli 2 [2/6/10], the Administrators were unable to inform creditors with assets such as shares in prime brokerage accounts whether their assets had been rehypothecated for many months following the date of administration, and creditors may have been unwilling to risk losing a proprietary claim by closing out their prime brokerage agreement before the Administrators confirmed definitively whether their shares had been rehypothecated.

11. It is very hard to see how such a creditor can be said to be benefitting from any form of windfall if interest is calculated as from the date of administration:

(1) The original damages claim for breach of the obligation to return the shares on demand existed as from the date of administration: it would not be regarded as contingent after the date of breach because it is ascertainable, notwithstanding that its quantification is dependent on assessment (see, by analogy, *In re Charge Card Services Ltd* [1987] Ch 150 at 178H). On any view, if a proof was submitted in respect of the damages claim, it would be "*outstanding*" as from that date, and the creditor is kept out of its money from that date.

(2) The close-out mechanism operates so as to quantify the loss and damage. The exercise being conducted is, in substance, essentially the same exercise as is done in respect of a damages claim, albeit it is conducted in accordance with a contractual provision by one party rather than by assessment by the Court.

12. However, because the claim that is eventually made in respect of the close-out amount is contingent (in the sense of being dependent on the close-out process occurring), the Administrators contend that interest is necessarily only payable as from the close-out process taking effect and that, if it were otherwise, the creditor would receive a windfall. This is said to be so, notwithstanding that:

(1) A non-contingent claim for damages existed (and was "*outstanding*") as of the date of administration;

(2) The delay in closing out the agreement may have been a direct consequence of LBIE's failure to provide information in a timely manner and thus as a result of further breaches by LBIE;

(3) LBIE has benefitted from the retention of the shares in the period since the date of administration; and

(4) There is no "*windfall*" for the creditor in any real commercial sense.

13. The effect of the Administrators' position is therefore that the date from which interest under rule 2.88 is payable is necessarily different (potentially dramatically), depending solely on whether the creditor relied on its common law right to damages or subsequently relied on the contractual close-out mechanism to value its claim. There is, however, no good reason why the outcome should be so different. The Administrators' approach elevates form over substance.

14. Furthermore, other creditors, who held assets such as stocks or shares under a prime broker arrangement, will have agreed to compromise claims in respect of those assets pursuant to the CRA. The consequences of entering into the CRA will be considered as part of Question 9. However, it is to be noted that a claim pursuant to the CRA arising in respect of rehypothecated securities (such as the shares in the example set out above) appears to be a claim that the Administrators intend to treat as a contingent claim (the contingency being the entering into of the CRA), and therefore as one which was not "*outstanding*" as at the date of administration, and as one in respect of which interest will not be payable from the date of administration. This is despite the fact that the relevant securities and certain other assets are valued by reference to the value of the assets as at the business day before the date of administration, which valuation ignores income payments such as dividend or coupon payments after that date.

15. If such claims are not treated as being "*outstanding*" from the date of administration (as Lomas 11 suggests), no compensation will be received in respect of those claims for the

period between the date of administration and the date of entering into the CRA, notwithstanding that (as explained in Zambelli 2 [2/6/14-15]):

(1) LBIE may have benefitted from income or value appreciation in respect of the relevant assets during that period; and

(2) The CRA would have required the creditor to pay LBIE interest from the date of administration had the CRA valuation mechanism produced a sum due to LBIE from the creditor (as opposed to a creditor claim).

16. That would be a commercially bizarre result, which serves to illustrate the difficulties in adopting an approach other than that advocated by the Senior Creditor Group.

(3) THE ADMINISTRATORS' REVISED CASE

17. The Administrators' skeleton argument indicates a change in stance regarding the meaning of the word "*outstanding*" for the purpose of Questions 6-8.

18. The position adopted by the Administrators in their position paper in respect of Questions 7 and 8[1] was (and Wentworth's position in its skeleton argument is) that a debt must be an "*actual debt*" before it can be treated as "*outstanding*" for the purpose of rule 2.88, and therefore that (for the purpose of Question 7) a debt which is subject to any contingency as at the date of the administration cannot be "*outstanding*" for the purposes of rule 2.88(7) unless and until it has "*ceased to be a contingent debt*", and therefore has become "*due and payable*" by the company (Administrators' Position Paper at [44.1] and [44.3]; Wentworth's skeleton argument at [147]).

19. The position now adopted by the Administrators appears to have changed:

(1) Question 6: in the Question 6 scenario, the start date for the calculation of interest applicable to the debt apart from the administration is said to be "*the date on which the creditor would have first become entitled to such interest apart from the*

[1] No positive position was taken in respect of Question 6: see [51] of the Administrators' Position Paper.

administration" [137]. The answer to that question is fact-specific. It said by the Administrators that it will usually, but not invariably, be the due date ([138]);

(2) Questions 7 and 8:

(a) Where Statutory Interest is payable at the rate applicable to the debt apart from the administration, it is said that the debt will be treated as "*outstanding*" as from the date on which interest would have been payable apart from the administration (i.e. not necessarily the date that it would have fallen due): [142(1)];

(b) Where Statutory Interest is payable at the Judgments Act rate, it is said that the debt will be treated as "*outstanding*" from the date on which the creditor could first have commenced proceedings against the debtor, which is the date on which it ceased to be contingent or ceased to be a future debt: [142(2)].

20. The Senior Creditor Group's primary position is that this revised argument is wrong as a matter of interpretation of the Rules and the operation of the statutory scheme for the same reasons that were given by the Senior Creditor Group in its skeleton argument in respect of the Administrators' original argument. To the extent necessary, the revised argument will be further addressed in oral submissions (see also [26] and [27] below).

(4) THE MEANING OF "OUTSTANDING": THE ALTERNATIVE APPROACH

21. If, however, the Senior Creditor Group's primary argument is incorrect, the Senior Creditor Group contends by way of alternative (and by way of answer to Wentworth and the Administrators' arguments, both as originally and now pursued) that whether a liability should be regarded as "*outstanding*" as at the date of the administration or some later date, and whether interest should therefore be treated as running on the claim from that date or a later date, is a fact specific issue. In particular, not all contingent claims will be capable of being treated as outstanding from the same date.

22. In this regard, the Rules and statutory scheme require that the debt is "*outstanding*" within the meaning of rule 2.88. Paraphrasing "*outstanding*" to mean "*an actual debt*" which has

become "*due and payable*" is incorrect, and apt to confuse. It is also inconsistent with the reference in rule 2.88(7) to debts i.e. proved debts, the concept of which includes all "*debts and liabilities*" within rule 13.12 and therefore "*any debt or liability to which the company may become subject after that date by reason of any obligation incurred before that date*".

23. Each case will turn on its own facts. For example, in respect of contingent liabilities, the date from which whether a debt is to be regarded as "*outstanding*" may depend on the terms of the agreement in issue, the facts and circumstances giving rise to the claim, the nature of the contingency, and the date from which, as a matter of substance, the liability ought to be regarded as "*outstanding*".

24. Liabilities may be classified as "*contingent*" for a number of reasons. For example, a liability may be contingent because its quantification depends on uncertain future events (e.g. *In re Daintry* [1900] 1 Q.B. 546), or it may be contingent because the liability itself is conditional upon an uncertain future event (e.g. *Lee & Chapman's Case* (1885) 30 Ch D 216).

25. Depending on the terms of the agreement and the nature of the contingency in question, there may be cases in which certain aspects of a contingent liability which render its quantum uncertain, or which are pre-requisites to its procedural enforcement, do not need to be fulfilled in order for the liability to be regarded as "*outstanding*" for the purpose of rule 2.88.

26. That a debt need not be "*due*" in order to be outstanding for the purpose of rule 2.88(7) is now accepted by the Administrators, at least in respect of debts attracting Statutory Interest at the rate applicable to the debt apart from the administration. In respect of those debts, the Administrators argue that the date from which they are outstanding is "*fact specific*" [138] and that "*the terms governing the payment of interest on the debt apart from the administration must be considered in order to ascertain the correct answer*" [142(1)].

27. However, their approach is too limited. The date from which the claim is to be treated as outstanding cannot turn simply on the "*terms governing the payment of interest on the debt apart from the administration*". Such an approach focuses on the period during which the interest obligation in respect of a proved debt has been or could be treated as outstanding, rather than the period during which the debt has been outstanding.

28. Once LBIE made it clear that it would not perform its obligations generally in respect of the prime brokerage agreement (such that there was an anticipatory repudiatory breach of the agreement), there is no good reason not to treat the claims arising as a consequence of that breach as "*outstanding*" from such a date. As Zambelli 2 explains at [2/6/12], from its entry into administration, LBIE was unable to fulfil its contractual obligations, and made public statements to this effect.

29. Consider, for example, a claim in respect of £100 in a current account in respect of which no demand for payment has been made. Prior to entering administration, LBIE is not technically liable to repay the creditor unless and until a demand is made: *Joachimson Swiss Bank Corp* [1921] 3 KB 110 at 127; *Paget's Law of Banking (14th Edition)* at [5.5]. The account would technically only become "*due and payable*" (without demand) once LBIE in its insolvency proceedings had conducted itself in manner that brought the relationship of banker/customer to an end: see, by analogy, *Russian Commercial and Industrial Bank* [1955] 1 Ch 148 at 157 and *Hodson v Tea Co* (1880) 14 Ch D 859. But it should be regarded as "*outstanding*" as at the date of administration for the purpose of rule 2.88.

30. The logic of this position suggests that the same answer should be arrived at in respect of a prime brokerage account holding stocks or shares, even if there is subsequently a contractual close-out.

31. The Administrators' approach may (in the absence of discounting of contingent claims for futurity) be correct, and make sense, in scenarios where the debtor had an obligation to make a payment at a specific future date subject to a contingency (for example, under a derivatives contract such as an interest rate swap). The debtor could never have been liable to make any payment at an earlier date, and the only issue was whether, as a result of the contingency, it would become liable to pay it on the future date at all. In such a scenario, the Administrators' concern regarding the creditor obtaining a "*windfall*" may have force, and, if so, can be avoided by treating the liability as "*outstanding*" only from the point at which the contingency occurs.

32. But, as set out above, not every contingent claim, or every claim that the Administrators appear to regard as contingent, can be regarded in this way or will be such as to give rise to a risk of windfall. In this regard, the Senior Creditor Group does not accept that the date at which a contract was "*closed out*" after LBIE entered administration equates to the

earliest date at which any contingent debt can be regarded as having become "*outstanding*" for the purpose of rule 2.88 or that the debt cannot be regarded as having been "*outstanding*" prior to that date.

33. A creditor, faced with a breach of the terms of its prime brokerage agreement who was entitled to close out at any date on or after the date of administration, will not receive a windfall if it receives interest from the date of administration merely because, for various reasons, it delayed serving a close out notice. If shares are held in an account on behalf of a client by LBIE, the liability arising from the obligation to return the shares should be capable of being regarded as "*outstanding*" for the purpose of rule 2.88 prior to the service of the close-out notice. The creditor may have a claim which, for the purpose of rule 2.88, was "*outstanding*" as at the date of administration, alternatively at the date of breach of contract by LBIE, even if technically the close-out amount in respect of which it eventually proved had not also crystallised or become due as at that date.

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SENIOR CREDITOR GROUP'S SKELETON ARGUMENT FOR TRIAL (PART A)

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