IN THE COURT OF APPEAL **Appeal Ref: 2016/4216**
ON APPEAL FROM THE HIGH COURT
CHANCERY DIVISION
COMPANIES COURT
DAVID RICHARDS LJ
[2016] EWHC 2131 (Ch)

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) YORK GLOBAL FINANCE BDH LLC

Appellant

-and-

(1) ANTHONY 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))

(6) BURLINGTON LOAN MANAGEMENT LIMITED
(7) CVI GVF (LUX) MASTER SÀRL
(8) HUTCHINSON INVESTORS LLC
(9) WENTWORTH SONS SUB-DEBT SÀRL

Respondents

YORK'S APPELLANT'S SKELETON ARGUMENT ON THE ISSUE OF CURRENCY CONVERSION CLAIMS ARISING FROM SET-OFF (SUPPLEMENTAL ISSUE 2)

Introduction

1. By their application for directions dated 12 June 2014 (the "**Waterfall II Application**"), the Joint Administrators of Lehman Brothers International (Europe) sought directions from the Court as to the correct method of calculating interest ("**Statutory Interest**") under rule 2.88 of the Insolvency Rules 1986 (the "**Rules**") and various related matters.

2. By order of the Court, the Waterfall II Application was divided into three tranches. Tranches A and B were heard by David Richards J and were the subject of two judgments dated 31 July 2015. Tranche C was heard by Hildyard J and was the subject of a judgment dated 5 October 2016.

3. The judgment which is the subject of the present appeal was handed down on 24 August 2016 with the neutral citation [2016] EWHC 2131 (Ch) (the "**Judgment**"), and concerned further consequential issues arising out of the main Tranche A and B judgments of 31 July 2015.

4. The Appellant, York Global Finance BDH LLC ("**York**") appeals against the Judgment with the permission of the Judge. In particular, York appeals against paragraph 3 of the Judge's order dated 17 October 2016 (the "**Order**"). Paragraph 3 of the Order declared that:

> "A Currency Conversion Claim cannot arise from the discharge of a debt by way of set-off under Rule 2.85(3) of the Rules."

5. The Judge's conclusion on this point was based on the erroneous proposition that set-off in an administration is retrospective, and that, although it is only triggered some time after the commencement of the administration, it is deemed to have taken effect as at the commencement of the administration. This proposition is contrary to the clear wording of the Rules, was not supported by any other party in the Court below, and has since been positively disavowed in a Respondent's Notice filed by the Administrators, who seek to uphold the Judge's decision on entirely different grounds.

6. The Judge ought to have held that a currency conversion claim is capable of arising when a debt is discharged by way of set-off. In order to demonstrate the correctness of this position, it is convenient to consider:

    (1) the nature of currency conversion claims;

    (2) the operation of set-off;

    (3) the analysis when a foreign currency debt is discharged by way of set-off;

(4) the analysis when the debt owed *to* the company and the debt owed *by* the company are both denominated in foreign currencies;

(5) the analysis when the debt owed *to* the company and the debt owed *by* the company are both denominated in *the same* foreign currency; and

(6) the reasons the Judge below erred in not accepting this analysis.

(A) Currency Conversion Claims

7. In an administration, Rule 2.86(1) of the Rules provides that:

> "For the purpose of proving a debt incurred or payable in a currency other than sterling, the amount of the debt shall be converted into sterling at the official exchange rate prevailing on the date when the company entered administration …"

8. Any debts of the company which are denominated in a foreign currency are converted (for the purpose of proof) under the Rules into sterling at the rate prevailing at the commencement of the administration (the "**Date of Administration**"). Any dividend subsequently paid to the creditor is paid by reference to this sterling amount. There are similar provisions in the Rules applicable to liquidation (r.4.91) and bankruptcy (r.6.111).

9. However, even where creditors are paid 100p in the £, an adverse move in the exchange rate between the Date of Administration and payment of the dividend will result in the creditor receiving less than his full entitlement when converted into the foreign currency.

10. In its judgment in *Re Lehman Brothers (No.4)* [2016] Ch 50 (also known as *Waterfall I* – as it is the predecessor of the Waterfall II Application) the Court of Appeal held that a creditor in such a situation has a non-provable "**Currency Conversion Claim**" for the difference between the dividend he receives (converted into the foreign currency at the date of payment) and his original foreign-currency debt.

11. It will immediately be seen that, where the foreign currency debts are very large, and the delay between the Date of Administration and the date of payment is very long (both of which are true in the present case), Currency Conversion Claims can be very significant indeed.

12. It should be noted that although the creditor will have a Currency Conversion Claim (i.e. an unpaid debt claim) if the foreign currency appreciates against sterling, if the exchange rate moves in the opposite direction, the estate will <u>not</u> have have the equivalent of a Currency Conversion Claim against the creditor. As explained below, this is because any overpayment by the estate (in foreign currency, rather than sterling, terms) is simply an inevitable consequence of the need to apply a fixed exchange rate to achieve *pari passu* distribution up to the stage of payment of 100% dividends on admitted claims.

13. So, by way of example, suppose a creditor is owed $100. As at the Date of Administration, $100 is worth £75. Dividends amounting to 100p in the £ are subsequently paid, and the creditor therefore receives £75. However, suppose that by the time that dividend is paid, $100 is worth £70. The creditor has therefore received £5 more than he would have received had he been paid in dollars. In such a situation, the creditor receives a benefit: he is not required to repay the extra £5 he has received.

14. In his dissenting judgment in Waterfall I, Lewison LJ had thought that the existence of such a benefit was one reason why Currency Conversion Claims should not exist. However, the fact that the creditor receives a benefit in such a situation, which he is entitled to keep, was acknowledged by Briggs LJ in Waterfall I at [159]:

> "Lewison LJ's sixth reason [for rejecting the existence of Currency Conversion Claims] relates to a situation where sterling appreciates against the contractual currency, or where the creditor has debts owed in a basket of currencies. Taking those in turn, I accept that both competing constructions of the conversion rules give a non-contractual benefit to such a creditor, if he is paid in full, in sterling and with interest. But this is a necessary consequence of the pari passu scheme of distribution against provable claims, which generally entitles a creditor to keep what had been distributed by dividend, even if some other creditor's claim later turns out to have been undervalued…

15. Moore-Bick LJ was to like effect at [258]:

> "… As to [Lewison LJ's] sixth reason, I accept that if the foreign currency has depreciated against sterling the creditor is not expected to refund the balance and that as a consequence in such a case (no doubt relatively unusual) he will recover more than the true value of his debt. However, that is simply the result of the statutory procedure for ensuring a distribution among creditors pari passu, which requires their claims be valued in a common currency for the purposes of equitable distribution…"

16. Moreover, suppose that a creditor has two provable debts, one in USD and one in EUR, and that between the Date of Administration and the payment of the dividend, USD appreciates against the £, while EUR depreciates against the £. Suppose that as a result, the sterling dividend received by the creditor in respect of the USD debt is £10 less than his contractual entitlement in USD at the date of payment, but the dividend received in respect of the EUR debt is £10 more than the contractual entitlement.

17. In Waterfall I at [160], Briggs LJ acknowledged that the creditor would still have a £10 Currency Conversion Claim in respect of the USD debt, and would not be required to give credit for the £10 benefit he had received on the EUR debt:

> "As for multi-currency claims, the question whether the creditor must bring into account depreciation in one currency against appreciation in others is likely to turn on the contractual structure between the creditor and the company, and the rules as to insolvency set-off. If all the debts arise from a single contract there may be an express or implied requirement to account, but not otherwise. Subject to that, there is to my mind no real injustice in permitting a creditor to pursue to the full a particular contractual entitlement against a debtor, merely because he has been fully compensated (or more than fully compensated) in relation to some quite different contract…"

18. The existence of a Currency Conversion Claim therefore does not depend on a creditor actually having suffered a net economic loss as a result of currency conversion. If the mechanism for calculating Currency Conversion Claims produces a sum in favour of the creditor, it does not matter that he might not actually have suffered an overall economic loss after taking account of other benefits arising from the administration and the statutory scheme.

(B) Operation of set-off

Introduction

19. The effect of set-off in insolvency generally will be familiar. Suppose that a creditor owes the insolvent estate £100, and is also owed £100 by the estate. When set-off occurs, the two debts cancel each other out, and there is no net balance owing either way. When the estate is insolvent this operates to the creditor's advantage: without the doctrine of set-off, the creditor would be required to pay £100 to the estate, but would only receive so many p in the £ on his receivable from the estate.

20. Set-off does not create a new liability. Suppose that X owes Y £100 and Y owes X £75. When the two debts are set off, X will owe Y £25. But this £25 debt is not a new liability: it is simply the part of the pre-existing debt which has not yet been discharged. As Norris J said in *Re Kaupthing Singer & Friedlander Ltd* [2009] EWHC 2308 (in a part not affected by the subsequent appeal):

> "The balance is not a newly created liability, the novel product of a statutory process. It is the balance due under a contract, the remainder of which has been extinguished in the insolvency set-off. Indeed it is quite plain that 'the balance' continues to be subject to the terms of the contract under which it arises, for in the case of a contingent or prospective debt the rule goes on to say that such a balance 'shall be paid if and when that debt becomes due and payable' (i.e. under the contract, on the loan maturity date or earlier under any default provisions)."

21. There are some dicta which, when read out of context, appear to indicate the contrary. In particular, in *Stein* v *Blake* [1996] AC 243, the House of Lords was concerned with whether, following the operation of insolvency set-off, the trustee in bankruptcy could assign the entirety of a debt which had previously been owing to the bankrupt, or whether he was only able to assign the net balance. It was in this context that Lord Hoffmann posed the question: "*is the effect of section 323 of the Insolvency Act 1986 to extinguish the claims of A and B and to substitute a claim for the net balance owing after setting off the one against the other?*" a question which he answered in the affirmative.

22. However, *Stein* v *Blake* was put into context by the Court of Appeal in *In re Kaupthing Singer & Friedlander Ltd* [2011] BCC 555:

(1) The Court of Appeal in *Kaupthing* held that insolvency set-off only takes effect to the extent necessary to discharge the relevant liabilities. Thus it was held that discounting pursuant to rule 2.105 only took effect to the extent necessary for the purposes of set-off, and that any outstanding balance *due to the company* after the operation of set-off would not be so discounted: see [34].

(2) Similarly, the Court of Appeal approved the decision of the Judge at first instance that where insolvency set-off resulted in a balance owing to the company then that balance would continue to attract interest at the contractual rate: see [37].

(3) This was because, pursuant to the terms of rule 2.85(8), the original contractual liability owing to the company remained intact except to the extent discharged by the set-off. In this context, *Stein v Blake* was of no relevance as the question of the operation of insolvency set-off is a matter of statutory construction: see [36].

Discharge of a debt by way of set-off

23. It has long been acknowledged that when a debt (or part of it) is discharged by way of set-off, it is as if cash has actually changed hands. For example, in *Livingstone v Whiting* (1850) 15 Queen's Bench Reports 722; 117 ER 632, Lord Campbell CJ said:

> "If the parties met, and one of them actually paid the other in coin, and the other handed back the same identical coin in payment of the gross debt, both would be paid. When the parties agree to consider both debts discharged without actual payment it has the same effect, because in contemplation of law a pecuniary transaction is supposed to have taken place by which each debt was then paid."

24. Similarly, in *Re Harmony and Montague Tin and Copper Mining Co* [1873] LR 8 Ch App 407 (CA Ch) 414, Mellish LJ said:

> "[I]t is a general rule of law, that in every case where a transaction resolves itself into paying money by A to B, and then handing it back again by B to A, if the parties meet together and agree to set one demand against the other, they need not go through the form and ceremony of handing the money backwards and forwards."

25. In their submissions in the Court below, the Administrators sought to draw a distinction between discharge of a debt by payment of dividend and discharge by set-off. This distinction was not adopted by the Judge, and it is submitted that it was wrong. The Administrators' argument was as follows:

(1) The process of pari passu distribution (of which the payment of dividends is part) is "*non-substantive*" and leaves the underlying debts intact, such that when the process comes to an end, creditors are remitted to their contractual rights.

(2) Set-off, on the other hand, has substantive effect, and permanently alters the rights of the parties.

26. However, the quotations from the authorities which are said to support the view that payment of dividends is "*non-substantive*" while set-off is "*substantive*" have been taken out of context, and are dealing with different points.

27. *Wight* v *Eckhardt*, which the Administrators cite as authority for the proposition that the process of pari passu distribution is "*non-substantive*", concerned a creditor with a Bangladeshi-law governed debt. After the commencement of the liquidation, but before the payment of dividends, the debt was discharged by a Bangladeshi-law governed scheme. The Privy Council held that the company was no longer liable, and the liquidators could reject the creditor's proof. It was in this context that Lord Hoffmann said at [26]-[27]:

> "…It is first necessary to remember that a winding up order is not the equivalent of a judgment against the company which converts the creditor's claim into something juridically different, like a judgment debt…
>
> "The winding up leaves the debts of the creditors untouched. It only affects the way in which they can be enforced. When the order is made, ordinary proceedings against the company are stayed (although the stay can be enforced only against creditors subject to the personal jurisdiction of the court). The creditors are confined to a collective enforcement procedure that results in pari passu distribution of the company's assets. The winding up does not either create new substantive rights in the creditors or destroy the old ones. Their debts, if they are owing, remain debts throughout. They are discharged by the winding up only to the extent that they are paid out of dividends."

28. Lord Hoffmann was therefore clear that, although the commencement of the liquidation and the operation of the statutory machinery of pari passu distribution does not "*either create new substantive rights in the creditors or destroy the old ones*", the actual payment of dividends clearly does, since his Lordship says that the debts "*are discharged by the winding up … to the extent that they are paid out of dividends*".

29. Just as the payment of a dividend permanently discharges a creditor's debt to the extent of the dividend, so too does set-off permanently discharge a creditor's debt to the extent of the set-off. Both payment of the dividend and set-off have substantive, permanent effect on the underlying debt.

30. In the Court below, Wentworth made a similar submission to the Administrators, arguing that, whereas payment of a dividend discharges *pro tanto* the creditor's claim to the extent of the dividend received, set-off extinguishes the creditor's claim in its entirety and replaces it with a new claim for the net balance. This distinction is contrary to authority, in particular the passage from *Re Kaupthing* quoted at para.20 above, and was not adopted by the Judge below. Wentworth has not filed a Respondent's Notice indicating an intention to pursue this point on appeal.

Set-off in administration distinguished from set-off in bankruptcy/liquidation

31. Set-off takes place in both liquidation (r.4.90 of the Rules) and bankruptcy (Insolvency Act 1986 s.323) whenever there is a claim and a cross-claim between a person and the insolvent estate. It can also occur in an administration. However, there is an important difference in this respect between bankruptcy/liquidation and administration.

32. The whole purpose of the bankruptcy and liquidation processes is to provide an orderly process for creditors to prove their debts and be paid. It is known at the outset that this will take place, and set-off therefore takes place automatically at the commencement of the bankruptcy/liquidation, see for example *Stein v Blake* [1996] AC 243.

33. However, the first duty of an administrator is not to make distributions to creditors, but to rescue the company as a going concern unless it is not reasonably practicable to

do so or another objective would achieve a better result for the company's creditors (Insolvency Act 1986 Schedule B1 para.3). As Lewison LJ noted in *Waterfall I* at [88], it was only in 2003 that the Rules were amended to permit administrators to make distributions to creditors at all. Even where a company is placed in administration simply to provide a more orderly method of closing down its operations than placing it first into liquidation, it is often the case that the company will move from administration to liquidation in order to make distributions to creditors. Accordingly, it is often the case that administrations take place without any distributions being made to creditors.

34. It would obviously be impractical for insolvency set-off to apply in every administration, particularly in the ordinary case which is aimed at rescuing the business as a going concern. In such a case, the company will want (and public policy dictates that it should be able) to gather in debts owing to it without having to give credit for sums it owes the other way. Accordingly, set-off does not take place immediately upon the company entering administration.

35. Rather than being automatic (as in bankruptcy/liquidation), set-off in an administration operates as follows:

(1) The set-off machinery in r.2.85 of the Rules does not apply at all unless and until the administrators determine to convert the administration into a distributing administration by giving a notice of their intention to make distributions to creditors under r.2.95 of the Rules (see r.2.85(1)).

(2) If a notice is given under r.2.95 of a proposed distribution, rule 2.85(3) of the Rules then applies, which provides that:

> "An account shall be taken as at the date of the notice [under r.2.95] of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other."

(3) Although the account is taken as at the date of notice of proposed distribution, r.2.85(6), in conjunction with r.2.86, provides for the debts due to and from the company to be converted into sterling at the exchange rate prevailing on the Date of Administration.

(4) The operation of insolvency set-off uses all the same rules on quantification of debts as apply to the same debt if it were admitted for dividends (rather than discharged via set-off), with those same rules on quantification applied also to debts due to the debtor. This reflects the fact that set-off is part of the overall scheme to achieve *pari passu* distribution.

The Set-off Date and the Cut-off Date

36. It is convenient to describe the date on which set-off occurs as the "**Set-off Date**". As noted above, in a bankruptcy/liquidation, the Set-off Date is the date of the commencement of the bankruptcy/liquidation. In an administration, the Set-off Date is the date of the notice under r.2.95 of a proposed distribution.[1]

37. However, in both bankruptcy/liquidation and administration, not all claims and cross-claims existing at the Set-off Date are set-off against each other. Only debts arising out of obligations incurred before the date on which creditors had actual or deemed notice of pending insolvency proceedings (the "**Cut-off Date**") are taken into account. In the case of LBIE, this means that only debts incurred before the Date of Administration are taken into account.

38. There is good reason to impose a Cut-off Date. Suppose that a supplier owes his customer £100 in refunds, and he learns that his customer is about to enter bankruptcy/liquidation. If there was no separate Cut-off Date, the supplier might try to supply to the customer, on credit, further goods with a list price of £100, knowing that when insolvency set-off takes effect, his debt to the customer will be discharged. If the goods provided by the supplier only cost him £50 to produce, then the supplier will have 'purchased' the discharge of his £100 debt by supplying goods which only cost him £50. The customer's insolvent estate will have been deprived of a receivable worth £100, and will instead be left with goods which the officeholder may be unable to liquidate except at a heavy discount. Since the supplier in this example knowingly took the risk of extending credit to a company which could imminently be wound up, the law considers that it is inappropriate for the supplier to have the benefit of the set-

[1] For simplicity, this skeleton ignores the situation where an administration is preceded by liquidation, or liquidation is preceded by an administration.

off regime. Instead, he should pay the customer the £100 he owes, and should prove for the cost of the further goods supplied on credit.

39. To prevent this sort of manipulation of "*mutual dealings*", the law imposes a Cut-off Date which is prior to the Set-off Date.

(1) In bankruptcy, the Cut-off Date is the date on which the creditor had notice that proceedings on a bankruptcy application relating to the bankrupt were ongoing or that a bankruptcy petition relating to the bankrupt was pending: IA 1986 s.323(3).

(2) In liquidation, the Cut-off Date is the date on which the creditor had notice that a meeting of creditors had been summoned under s.98, or that a winding-up petition was pending: r.4.90(2).

(3) In administration, the Cut-off Date is the Date of Administration or the date the creditor had notice that an administration application was pending or the date any person had notice of intention to appoint an administrator: r.2.85(2).

Timing of set-off in administration

40. The wording of Rule 2.85(3), which states that the "*account shall be taken <u>as at the date of the [notice of proposed distribution]</u> ... and the sums due from one party shall be set off against the sums due from the other*" (emphasis added) indicates that set-off is not retrospective, but rather takes effect <u>as at</u> the date of the notice of proposed distribution i.e. the Set-off Date.

41. In the court below, David Richards LJ held that set-off in an administration *was* retrospective, and took effect from the Date of Administration. None of the parties below had suggested that this proposition (which is unsupported by authority and contrary to the plain wording of the Rules) was correct, and the Administrators have filed a Respondent's Notice indicating that they will not seek to uphold this part of the Judge's reasoning on appeal.

42. It is respectfully submitted that David Richards LJ was wrong on this point.

43. The only potential indicator in the Rules that the Judge was correct in this respect is that mentioned in para.45 of the Judgment: namely, that statutory interest (according to the Judge) runs only on the balance after set-off, whereas if set-off were not retrospective, one would expect interest to run on the entire (pre-set-off) debt until the date of the notice under r.2.95, after which interest would only run on the net balance.

44. Assuming for present purposes that the Judge was correct that statutory interest runs on the net balance after set-off[1], it does not follow from that assumption that the set-off itself takes effect at the Date of Administration. Rather:

(1) Set-off takes effect as at the date of the notice of the proposed distribution. However, it does so by reference to the claim and cross-claim as *quantified* at the Cut-off Date i.e. (in LBIE's case) the Date of Administration.

(2) The set-off which takes effect as at the date of the notice of distribution but between the claims quantified at the Date of Administration results in a net claim quantified as at the Date of Administration which is then admissible to proof.

(3) Statutory interest is payable on such proved debt from the Date of Administration, but this merely reflects the fact that the claim and cross-claim have been *quantified* as at the Date of Administration and thus that the resulting net balance has also been *quantified* as at that date.

(4) It therefore does not follow from the operation of the rules relating to statutory interest that set-off can only be said to take effect as at the Date of Administration. The rules relating to interest are consistent with set-off taking effect at the date of the notice but by reference to claims *quantified* at the Date of Administration.

45. Two further factors indicate strongly that set-off in administration takes effect only at the date of the notice of proposed distribution:

[1] This point was not in fact argued before the Judge and the interpretation of r.2.88(7) was not addressed.

(1) In both bankruptcy and liquidation, the Set-off Date comes after the Cut-off Date. It has never been suggested that, merely because the debts are quantified for the purpose of set-off as at the Cut-off Date, set-off in bankruptcy and liquidation is retrospective and takes effect from the Cut-off Date. It clearly takes effect from the Set-off Date. Similarly, the mere fact that proved debts are quantified as at the Date of Administration for the purpose of set-off in administration is not a reason to believe that set-off is retrospective. Proved debts that are admitted for dividends are also quantified as at the Date of Administration but it could not be suggested that this means that such debts are in fact discharged on the Date of Administration. In both cases, valuation as at the Date of Administration is a necessary feature of *pari passu* treatment of debts and has nothing to do with the actual date on which those debts are discharged.

(2) If set-off were retrospective, and was effective from some date prior to the Set-off Date, serious difficulties would arise where contractual (i.e. non-insolvency) set-off took place in the interim period between the Date of Administration and the date of notice of proposed distribution. Suppose that a creditor's contract with the company gives the parties a contractual right of set-off. The creditor is owed £100 by the company in administration, only half of which was incurred prior to the Cut-off Date. The company is owed £90 by the creditor, all of which was incurred prior to the Cut-off Date.

i. If the creditor invoked his contractual set-off right in the interim period between the Date of Administration and the date of notice of proposed distribution (and there is nothing in the Rules to prevent this), the company would be left owing a net balance of £10.

ii. If the creditor did not invoke contractual set-off, and waited for the administrator to give notice of proposed distribution, the £50 debt incurred by the company after the Cut-off Date would be ignored. Accordingly, the outcome would be that the £50 incurred before the Cut-off Date would be set off against the £90 owed by the creditor, so that the creditor would be left owing £40, and would have to prove for

the £50 debt incurred after the Cut-off Date (perhaps receiving a dividend of only a fraction of that amount).

iii. However, if (as the Judge below held) insolvency set-off in administration is retrospective, an obvious problem arises where the creditor invokes his contractual set-off rights, and the administrator subsequently gives notice of a proposed distribution. Insolvency set-off would (according to the Judge) be deemed to have taken place before the contractual set-off. The contractual set-off would presumably have to be unwound (even though it might have taken place some time ago, and the parties might have changed their position in reliance on it having been effective) so that insolvency set-off could take effect. This cannot be what the draftsman of the Rules intended, and is yet another reason why, contrary to the finding of the Judge, set-off in administration is not retrospective.

(C) Analysis when a foreign currency debt is discharged by set-off

46. Once the nature of Currency Conversion Claims, and of set-off, are properly understood, it can be seen that a Currency Conversion Claim can arise when a debt is discharged by way of set-off.

47. It is convenient first to recall a straightforward example where there are no cross-claims and a creditor's claim is discharged entirely by payment of cash, before considering a very similar example, where the debt is discharged by way of set-off.

48. Suppose a creditor (A) is owed \$100. As at the Date of Administration, \$100 is worth £75. Dividends amounting to 100p in the £ are subsequently paid, and A therefore receives £75. However, suppose that by the time that dividend is paid, \$100 is worth £80. £75 is no longer sufficient to discharge the \$100 which A is owed. A will have a Currency Conversion Claim for £5. This is (below the level of the Supreme Court) uncontroversial.

49. Suppose now that the same company also owes a different creditor (B) \$100, but that B owed the company £75 at the Date of Administration. As at the Date of

Administration, these amounts are equivalent, but the exchange rate later moves so that by the time the administrator gives notice of proposed distribution under r.2.95 of the Rules, $100 is worth £80. Set-off takes effect as at the date of the notice of proposed distribution. As explained at paras 23-24 above, it is as if the company had paid B £75 in cash on this date. But of course, at the date the set-off takes place, B's claim against the company is no longer worth £75, it is worth £80.

50. Just as A has not received his full contractual entitlement (because he has been paid £75, when his full contractual entitlement is to $100, or £80 at the date of payment), B has not received his full contractual entitlement either. B has, like A, been 'paid' only £75: £5 less than his contractual entitlement.

51. Both A and B therefore have a Currency Conversion Claim for £5.

(D) Analysis where the debt owed to the company and the debt owed by the company are both denominated in different foreign currencies

52. To develop the examples above, suppose that the same company also owes a different creditor (C) $100, and that C owes the company €100 at the Date of Administration. At the Date of Administration, both of these debts are worth £75. However, by the time the Administrator gives notice under r.2.95, $100 is worth £80, but €100 is worth £70.

53. It is important to note that under r.2.85(6), for the purpose of set-off, the €100 owed to the company is converted to sterling at the exchange rate prevailing on the Date of Administration. It is not permissible to take account of the subsequent revision of the rate. This may operate harshly against the creditor, since in sterling terms, he now owes the company less than he did previously and is forced to use a debt worth £80 to discharge a liability worth £70. It is, however, a consequence of the machinery set out in the Rules that is designed to achieve *pari passu* treatment of debts by reference to fixed sterling values.

54. Accordingly, when set-off takes effect, it is as if the creditor has paid the company (and has received from the company in return) £75. He therefore has a Currency

Conversion Claim for only £5 (not £10, which would be the case if the €100 had been converted as at the date of the notice under r.2.95).

55. This reasoning can be taken a step further. Suppose that in the example above, C is owed $100 and owes the company €100 at the Date of Administration, and that these debts are both worth £75. However, this time, suppose that the $ and € exchange rate both move the same way, such that by the time the Administrator gives notice under r.2.95, $100 is worth £80, and €100 is also worth £80.

56. When set-off takes effect, the €100 owed to the company is converted into sterling at the exchange rate prevailing on the Date of Administration. It is therefore as if C has paid the company £75, and the company has paid him £75 in return. However, by this stage, the debt owed by the company to C is worth £80. C has therefore received £5 less than his contractual entitlement, and has a Currency Conversion Claim for this amount. The company has also received only £75 in discharge of a euro debt then worth £80. However, that apparent shortfall in payment to the estate is not recoverable as it arises as an inevitable - and permanent - consequence of the scheme for *pari passu* distribution in the context of a distributing administration (in exactly the same way as an overpayment, in foreign currency terms, on admitted debts as explained in para 12 above). In contrast, the effect on creditors of using fixed exchange rates has only such limited effect as is necessary to achieve *pari passu* distribution on payment (by dividend or set-off) of up to 100% of the sterling value of such claims.

57. It might be objected that C has not, in this example, actually suffered any net economic loss and so should not have a Currency Conversion Claim at all. What he has lost on his $ debt, he has made up on the cost to him in sterling terms of the discharge of the € debt he owes the other way. However, as Briggs LJ noted in Waterfall I, (see paras 16-18 above), the question whether a creditor must bring such a benefit into account will simply turn on the contractual agreement between the creditor and the company.

(E) Analysis where the debt owed to the company and the debt owed by the company are both denominated in the same foreign currency

58. Suppose now that the same company also owes a different creditor (D) $100, and that D owes the company $100 at the Date of Administration. At the Date of Administration, both of these debts are worth £75. However, by the time the Administrator gives notice under r.2.95, $100 is worth £80.

59. The Rules require the $100 which is owed to the company to be converted to sterling as at the Date of Administration. Accordingly, the sterling value of this debt is fixed at £75. When set-off takes place, it is as if the creditor has paid the company £75 in cash, and has simultaneously received £75 cash in return. And, for the purpose of proof, the debt owed to D is also valued as at the Date of Administration at £75, with the consequence that D no longer has a provable debt.

60. However, when it comes to the stage of calculating D's Currency Conversion Claim, it is necessary to calculate the difference between the $ debt owed to D, and the £ amount actually received by D. The £ amount 'received' by D is £75. The $ debt owed to D, however, converted into sterling at the date of 'payment', is £80. D therefore has a Currency Conversion Claim for the difference: £5. As noted above in the context of different currency claims, D has also discharged the $100 liability to the estate for £75, even though that liability is then worth £80. For the reasons explained above, the company has no right to recover that £5 difference.

61. This resulting £5 Currency Conversion Claim for D initially seems counterintuitive. It may sound surprising that a Currency Conversion Claim can arise in circumstances where the creditor has not ultimately suffered any net economic loss as a result of currency conversion. However, it is in practice no different to the example given in para.56 above. If C (in that example) has a Currency Conversion Claim where the two debts are denominated in different currencies, but have both appreciated against sterling to the same extent, there is no reason in principle why a Currency Conversion Claim should not arise where (i) the two debts are denominated in the same currency and (ii) the comparison is between a loss on a claim and an economic benefit on a liability that has been discharged, where that economic benefit is not a debt due to the debtor for which there is any legal basis for the creditor to give credit . Once again, as

Briggs LJ noted in Waterfall I, there is no injustice in principle in a creditor receiving a benefit in these circumstances (see paras 16-18 above). It is simply a consequence of the way in which the contractual arrangements between the parties and the Rules operate.

62. As all three members of the Court in Waterfall I noted, the insolvency process inevitably produces winners and losers (see [100] per Lewison LJ, [165] per Briggs LJ and [259] per Moore-Bick LJ). A uniform and consistent application of the rules will result in some creditors doing better than they might do absent the insolvency process (for example, those creditors with non-interest-bearing debts, who become entitled to statutory interest at 8%), just as it will result in some creditors doing worse.

63. Just as the Court of Appeal held, in Waterfall I, that a creditor who has suffered no net loss as a result of currency conversion will nonetheless still have a Currency Conversion Claim if he is owed a debt denominated in a currency which has appreciated between the Date of Administration and the payment of dividends, so too will a foreign currency creditor who has suffered no net loss as a result of set-off nonetheless have a Currency Conversion Claim, if the currency in which his debt was denominated appreciated against sterling after the Date of Administration.

(F) Error in the Judgment below

64. It appears that the learned Judge (who determined this point entirely on the basis of written submissions, and did not have the benefit of oral argument) did not fully understand York's submissions (see for example para.47 of the Judgment).

65. David Richards LJ's error flows from his conclusion that, in an administration, set-off is deemed to have taken place as at the Date of Administration (see Judgment paras 42-45). As noted above, this proposition:

    (1) was not advanced by any of the parties in the Court below, and has been disavowed by the Administrators in their Respondent's Notice;

    (2) is unsupported by authority; and

(3) is contrary to the plain wording of the Rule 2.85(3), which states that the "*account shall be taken as at the date of the [notice of proposed distribution] … and the sums due from one party shall be set off against the sums due from the other*" indicates that set-off is *not* retrospective, but rather takes effect as at the date of the notice of proposed distribution.

66. As the Judge noted at para.42, if set-off does take effect as at the date of the notice of proposed distribution (as York contends) then:

> "there would be something to be said for equating discharge by set-off with the payment of a dividend. It might be said that the creditor was receiving satisfaction in a devalued currency and therefore not receiving its full contractual entitlement."

67. As the Judge further acknowledged in para.46 of the Judgment, if set-off were not retrospective, but was instead deemed to take effect at the account date, "*it might produce an unfair result*" if a Currency Conversion Claim was not to result from the operation of set-off. The learned Judge was of course correct: for the reasons explained in this skeleton argument, to give a Currency Conversion Claim to creditors whose foreign currency debts are discharged by payment in cash, but not to creditors in an otherwise identical position whose debts are discharged by set-off, would be unfair.

68. Although not dealing with the submissions of the Administrators and Wentworth in any detail, David Richards LJ did say at paras 46-47 that "*the effect of* Stein *v* Blake *provides a ground for rejecting York's submissions*", subject to the qualification that "*it might produce an unfair result*" if set-off was not retrospective. This is a reference to the argument, based on *Stein* v *Blake*, that insolvency set-off has "*substantive effect*", and can therefore be distinguished from the non-substantive effect of discharge of debts by payment of dividends. However, as explained at paras 26-30 above, this distinction is unsound: both discharge by set-off and discharge by payment of dividends have the same, substantive effect in sterling terms (but that tells you nothing about the effect of such sterling discharge on the non-sterling claims of the creditor)..

69. Finally, the Judge dealt with York's submission that a Currency Conversion Claim can arise when two claims denominated in the same currency are set off against each

other very briefly indeed at para.47, describing it as "*surprising*" and admitting that he did not understand it. As noted above, the Judge's "*instinctive reaction*" that the argument was wrong is understandable: in such a situation, the creditor has not actually suffered a net loss after taking account of some (but not all) other post-administration benefits obtained in the administration. However, as also explained at paras 16-18 above, the existence of a Currency Conversion Claim does not actually depend on the creditor having suffered a net loss. Once this is understood, it can easily be seen how the machinery for calculating Currency Conversion Claims will result in a Currency Conversion Claim arising in these circumstances.

<u>Conclusion</u>

70. The Court of Appeal is therefore invited to allow York's appeal, and to declare that a Currency Conversion Claim can arise in favour of a creditor from the discharge of a debt by way of set-off under Rule 2.85(3) of the Rules, and that the quantum of such a Currency Conversion Claim is the difference between:

(1) the debt owed by the creditor to the company, converted into sterling (if necessary) at the Date of Administration; and

(2) that portion of the debt owed by the company to the creditor which is discharged as a result of set-off, converted into sterling at the date of the notice under r.2.95.

Tom Smith QC
Robert Amey

South Square
Gray's Inn
London
WC1R 5HP

31 January 2017