Nos.7942 and 7495 of 2008 and No.429 of 2009

IN THE HIGH COURT OF JUSTICE

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)

IN THE MATTER OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)

IN THE MATTER OF LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

BETWEEN

(1) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)
(2) THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS LIMITED (IN ADMINISTRATION)
(3) THE JOINT ADMINISTRATORS OF LB HOLDINGS INTERMEDIATE 2 LIMITED (IN ADMINISTRATION)

Applicants

and

(1) LEHMAN BROTHERS HOLDINGS, INC (a company incorporated in the State of Delaware, USA)
(2) LYDIAN OVERSEAS PARTNERS MASTER FUND LIMITED

Respondents

SUPPLEMENTAL SUBMISSIONS

ON BEHALF OF THE JOINT ADMINISTRATORS OF LBHI2

THE SUB-DEBT

1. LBHI2 gratefully adopts the further submissions made on this issue by LBHI.

2. In its Written Opening Submissions, LBIE seeks to rely on the general principle from Re Maxwell (No. 2) that contractual subordination is effective in a formal insolvency without there needing to be, for example, a trust deed (see [24] of the Written Opening Submissions). That proposition is not controversial, so far as it goes, but it does not assist LBIE when they seek to say at [40] of their Written Opening Submissions that the contractual subordination provision in the Sub-Debt Agreements "*varies the effect of IR 2.88(7)*".

3. Further, LBIE cites (at p. 14, footnote 15) Re British & Commonwealth Holdings plc (No.3) [1992] 1 WLR 672, [1992] BCC 58 for the proposition that, *"There is nothing inherently surprising in a creditor (particularly one which is also a member of the company) lending on a subordinated basis or subordinating its debt behind statutory interest"*. While not disagreeing with the first part of that proposition, LBHI2 does dispute the second part of that statement. Neither LBIE nor Lydian has identified authority for the contention that it is possible contractually to subordinate debt to statutory interest. LBHI2's position is that it is not possible for a creditor to do this, given the point made in Written Opening Submissions that the payment of statutory interest is simply, on the face of the insolvency legislation, a direction to the office-holder as to how to apply a surplus in his hands, and not a "liability" of the company; and see also LBHI's Written Opening Submissions at [107]. Nor have LBIE or Lydian identified authority or set out analysis to justify the contention that any such subordination would be consistent with business common sense or unsurprising. The obiter passage from Vinelott J's decision in Re British & Commonwealth Holdings[1] relied on by LBIE (which concerned the true construction of a clause in a particular trust deed in the context of a scheme of arrangement) does not provide a sound basis for LBIE/Lydian's contention.

[1] This was a directions application by administrators who proposed a scheme of arrangement under sec. 425 of the Companies Act 1985 to enable them to make an interim distribution of the proceeds of assets realised in the administration. The debts owed to the holders of convertible subordinated unsecured loan stock ("CULS") issued by the company were, by virtue of the terms of issue contained in a trust deed, subordinated to the claims of all other creditors in the event of a winding up. The administrators sought directions as to whether they could exclude the subordinated creditors from the scheme, and the trustee representing them from voting at the meeting to approve the scheme.

LBIE'S/LYDIAN'S FORMULATION OF THE CONTRIBUTORY RULE

4. LBHI2's submission is that the formulation of the Contributory Rule advanced by LBIE and Lydian is too broad.

5. In particular, LBIE and Lydian stretch the Contributory Rule too far in extending it from a rule forbidding set-off of a contributory's debt against its liability to pay a call made by a company's liquidator to a rule prohibiting a contributory from receiving any dividends in respect of debts owed to it (other than as a shareholder) unless and until it is no longer under a potential liability to pay a call (even where the company is not in liquidation and no calls have been made). For the reasons set out in LBHI2's opening submissions, that extension of the Contributory Rule is unjustified and unfair.

6. Further, the extended rule for which LBIE and Lydian contend has, as is clear from the opening submissions filed by those parties, no basis in authority. The relevant paragraphs of LBIE's opening submissions [156]-[162] contain only the assertion that the rule is as LBIE and Lydian contend, with no authority for the proposition and no argument which (on analysis) supports its existence. In particular:-

   (a) [156] contains no authority beyond a quotation from Lord Walker's speech in Kaupthing (No.2), which is taken out of context and which does not bear the weight of the reliance put on it. In stating that members *"must stand in the queue behind [the company's] creditors"*, Lord Walker was referring back to the point which he identified as arising from the cases on contributories, as set out at [52] of Kaupthing (No. 2). He was not purporting to describe or establish any broader principle.

   (b) [158] simply asserts in different words the extended rule for which LBIE contends, and no authority is identified which supports that assertion.

   (c) [159] identifies what is said to be a *"general principle"* that *"(i) where an estate is being administered by the Court, a party cannot take anything out of the fund until he has made good what he owes to the fund; and (ii) it is immaterial that*

what he owes to the fund is not ascertained". There cannot be a general principle to the effect stated in (i) in relation to the administration of the assets of an insolvent company, because otherwise insolvency set-off would always be ousted by this "general principle" (whereas it is not – it is mandatory and self-executing, as set out in LBHI2's Written Opening Submissions at [68] ff.) wherever there were creditors between whom and the company there were mutual credits and debits, so this assertion does not take the argument advanced by LBIE further. As to the principle asserted at (ii), the authority relied on (Re Rhodesia Goldfields) concerned a claim against a director for misfeasance (a different situation to a call on a contributory), in which the Court was concerned not to permit the director to be paid out of the company's insolvency, only to be found later to be required to pay money to it as a result of his wrongdoing and then for the company to be unable to recover it from him. Thus, LBHI2 submits, this authority also does not advance LBIE's argument.

(d) [160] does not explain why the pari passu principle would be subverted if, in a distributive administration, Members were entitled to prove for debts owed to them other than as Members, and receive dividends as all other creditors are doing in this administration. It is in fact LBIE's approach to the Contributory Rule which is in conflict with the pari passu rule, not the position advanced by LBHI2 and LBL.

(e) [161] again falls back simply on assertion that the Contributory Rule *"is not limited to circumstances in which a call has already been made"*, with no authority given for that proposition.

(f) The point made in [162] is not strong. A denial that the Potential Liability as Contributory is provable in administration is entirely consistent with and explicable against the background of a distributive administration embarked upon by administrators who must have been entirely aware that, under the terms of the insolvency legislation, a call could not be made on contributories other than in liquidation. Further, LBHI2's fallback alternative analysis, that the Potential Liability as Contributory should be dealt with in the same way as any other

provable debt, including by way of set-off, recognises (and is, LBHI2 submits, more consistent with) the fact that LBIE's contingent claim under section 74 will be provable in the Members' distributive administrations/liquidations than the position proposed by LBIE and Lydian, ie simply excluding LBHI2 and LBL from LBIE's distributive administration.

7. The assertion made by Lydian (at [40] of its Written Opening Submissions) that, *"If the court's conclusion in this case is that the creditors of LBIE will take priority over the claims of members only in the event that LBIE is in, or will subsequently go into, liquidation, there could be no realistic doubt as to whether LBIE would go into liquidation, such that there would be no reason to discount the value of the contingent claim against members"* (emphasis added) is contrary to the evidence (in particular, the evidence of LBIE's liquidators that, *"... depending upon the outcome of certain issues in the Joint Application, it may, at some stage, be in the interests of LBIE's creditors for LBIE to enter into liquidation"* (Downs 4, [64]-[65] [3/6/21], emphasis added).

8. The assertion also fails adequately to reflect the duty of the administrators of LBIE in considering (a) whether to move from administration into liquidation, and then, if in liquidation, in considering (b) whether to make a call on contributories, to make a decision in the interests of LBIE's creditors in the light of the then current financial position of LBIE and the likely impact of taking those steps. It will not necessarily be the case that the right decision would be for LBIE to go into liquidation (and LBIE's administrators have, of course, previously decided on a distributive administration rather than liquidation, a decision which was clearly taken against a background, including advice as to the ability of a liquidator, but not an administrator, to make calls).

LBHI2'S POTENTIAL LIABILITY AS CONTRIBUTORY

9. As set out in its position paper at (7) and (8) [2/2/6], LBHI2's primary position is that:-

(a) LBIE's administrators cannot use LBHI2's Potential Liability as Contributory either by way of set-off to reduce LBHI2's proof in the administration or in application of the Equitable Rule to prevent payment to LBHI2 from the administration; and

(b) LBIE is not entitled to prove in the administration or any subsequent liquidation of LBHI2 in respect of LBHI2's Potential Liability as Contributory[2] because that Potential Liability is not a provable debt.

LBHI2 gratefully adopts the submissions on these issues set out in LBHI's Written Opening Submissions at [14] to [23] and LBL's Written Opening Submissions at [72] to [73].

10. LBHI2's case on set-off is set out at [68]-[72] of its Written Opening Submissions, assuming (contrary to its primary case) that LBHI2's Potential Liability as Contributory is a claim provable by LBIE in LBHI2's administration (as well as a "sum regarded as due" from LBHI2 to LBIE for the purpose of IR2.85(3)).

THE APPLICATION OF THE EQUITABLE RULE[3]

11. LBHI2 gratefully adopts the submissions made by LBL at [65] to [67] of its Written Opening Submissions as to the way in which the Equitable Rule should be applied if it is to be applied (ie if LBIE goes into liquidation and its liquidator makes a call on LBHI2).

12. Further support for such an approach being the correct way of applying the Equitable Rule is provided by Lightman and Moss, The Law of Administrators and Receivers of Companies, 5th Edn at [22-017]: *"Where the contributor's share is a pro rata*

[2] It also set out at (8) of its position paper its alternative position: "If that is not right, and LBIE is entitled to prove, LBHI2 is entitled to set off both the LBHI2 Non-Subordinated Debt and the LBHI2 Sub-Debt against the Potential Liability as Contributory to reduce the amount of the provable claim."

[3] LBHI2 stated at [67] of its Written Opening Submissions that it would respond in these Supplemental Written Submissions or orally to any case made by another party as to how the Equitable Rule should be applied in this case.

participation in the fund, the contributor's share is generally calculated by ascertaining what it would have been if the contributor had paid its contribution to the fund and then deducting its contribution from that notional share." Such a notional 'netting-off' approach is plainly appropriate if the Equitable Rule falls to be applied.

POSITION AS BETWEEN LBL AND LBHI2 FOR CALLS MADE BY LBIE

13. LBL suggest that LBIE's liquidators (if appointed) should only be entitled to make a call on LBL to a very limited extent, given LBL's shareholding of one ordinary share. That, as pointed out in LBIE's Written Opening Submissions at [75], is to misunderstand the nature of the call liability of members. Members are each liable for the whole of the relevant call liability.

14. None of the examples given in the footnotes on p. 72 of LBL's Written Opening Submissions is relevant to call liability under s. 74 of the Act. The point is that the contributories are liable for all sums that are properly claimable by the Court/liquidator under s. 150 of the Act. The statements in commentary and authorities on which LBL rely do not demonstrate that there is any way in which LBIE's liquidators would be restricted in making calls on all contributories. The authorities to which LBL refer in [144] of their Written Opening Submissions deal instead with the distribution of a surplus after payment of all debts and expenses, where the surplus was insufficiently large to pay back to members all the paid-up capital and the losses that arose out of that matter were to be borne rateably by the shareholders.

15. LBL's approach towards the Members' Potential Liability as Contributories also appears to contravene the rule against double proof. The rule against double proof is the principle that an insolvent estate should not pay two dividends in respect of the same debt: Kaupthing No. 2 at [10]-[11] citing In re Oriental Commercial Bank (1871) LR 7 Ch App 99 at 103-104. The primary purpose of the rule is the protection of other creditors of the insolvent estate against unfair treatment in circumstances where there are multiple creditors in respect of the same debt. The effect of the rule is

that, so long as Creditor 1 has not been paid in full, then Creditor 2 may not compete with Creditor 1 either directly by proving against the insolvent estate for an indemnity, or indirectly by setting off his right to an indemnity against any separate debt owed by Creditor 2 to the insolvent estate: Kaupthing No. 2 at [12]. In this case, therefore, if LBIE is able to prove in LBHI2's insolvency for LBHI2's Potential Liability as Contributory, then LBL is not entitled to compete (with LBIE) by proving for the alleged indemnity or contribution against LBHI2 in LBHI2's insolvency or by seeking to set off the alleged indemnity or contribution against LBHI2's claim in LBL's insolvency.

4 November 2013

ANTHONY TRACE QC
LOUISE HUTTON
ROSANNA FOSKETT

Maitland Chambers
Lincoln's Inn
Tel: 020 7406 1200
Email: atrace@maitlandchambers.com; lhutton@maitlandchambers.com;
rfoskett@maitlandchambers.com